

Japan – Tax transparency of a foreign entity in Japan

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Although recent tax reforms in Japan have promoted foreign investment, one significant issue for foreign investors remains unsolved: whether a foreign investment vehicle is treated as a transparent entity (or pass-through entity) under Japanese tax laws. Japanese tax statutes do not have any clear rule or guideline for such transparency issue, and therefore, Japanese courts are struggling with this issue through individual cases, but they have not established universal criteria.



Recent trend of tax reforms in Japan

Recent Japanese tax reforms were intended to promote foreign investment in Japan by reducing permanent establishment (PE) taxation risk. With respect to the risk of agent permanent establishments (agent PEs), the independent agent exemption was introduced by tax reforms in 2008. Under this rule, independent agents are excluded from the scope of agent PEs. In addition, tax reforms in 2009 reduced the risk that a foreign member of a partnership is deemed to have a PE when a general partner of the partnership has an office for the partnership in Japan. After such reforms, a foreign member of limited partnerships who meets certain requirements will be deemed not to have a PE in Japan.

Overview of Japanese tax statute with respect to entity classification

Despite these improvements, one significant issue for foreign investors, who make an investment in Japan through a foreign investment vehicle, remains unsolved: whether a foreign investment vehicle is treated as a transparent entity under Japanese tax laws.

Under the Corporation Tax Act of Japan, if an entity is a 'corporation' (*hojin*), such entity will not be treated as a transparent entity for Japanese tax purposes, and therefore, the income earned through the entity will be treated as the income of the entity itself. A 'corporation' is subcategorised into 'domestic corporation' (*naikoku hojin*), which is a corporation maintaining its head office or main office within Japan, and a 'foreign corporation' (*gaikoku hojin*), which would include any corporation other than a domestic corporation.

In addition, as the Corporation Tax Act deems a 'non-judicial organisation, etc.' (*jinkaku no nai shadan tou*) to be a 'corporation' for Japanese tax purposes, if an entity, which is not a 'corporation', meets the requirements of a 'non-judicial organisation, etc.', such entity is also not transparent. A 'non-judicial

organisation, etc.' is not defined in any Japanese statute, but a Supreme Court decision of October 15, 1964 described it as an entity meeting the following criteria: it is organised as an association; it makes decisions by way of majority vote; it exists regardless of a change in its members; and rules have been established regarding its representatives, the operation of its meetings and the management of its property and other major matters.

On the other hand, if an entity does not meet requirements of a 'corporation' or a 'non-judicial organisation, etc.', such entity will be regarded as a transparent entity, and therefore, the income attained through the entity will be treated as the income of the members of that entity. A typical example of such entity is a Japanese partnership (*nin'i kumiai*), which is an entity organised under the Civil Law of Japan.

Thus, with regard to a foreign entity, if it is neither a 'corporation' (i.e. a 'foreign corporation') nor a 'non-judicial organisation, etc.', it will be treated as a transparent entity for Japanese tax purposes. But the problem is that there are no statutory criteria to determine whether a foreign entity is a 'corporation'. As for an entity organised under Japanese law, it is easy to determine whether it is a 'corporation' or not by confirming the relevant domestic statute: if it grants the entity a juridical personality, it is regarded as a 'corporation' (a 'domestic corporation'). As for a foreign entity, however, the Corporate Tax Act merely defines a 'foreign corporation' as 'a corporation other than a domestic corporation'. In addition, the Japanese tax statute does not provide any universal rule or guideline with respect to the classification of a foreign entity as a 'corporation'.

Cases regarding the tax treatment of a foreign entity

The National Tax Agency (*Kokuzeicho*), the official tax collecting administrative agency in Japan, and Japanese courts have been faced with individual cases in which

such classification was the main point of issue. The disputed entities in these cases were, primarily, (i) a limited liability company organised in New York ('New York LLC'), (ii) an exempted limited partnership organised in the Cayman Islands ('Cayman Islands ELPS'), and (iii) a limited partnership organised in Delaware ('Delaware LPS'). In each case, the complainant, a taxpayer seeking pass-through tax benefits, argued that the contested entity was neither a 'corporation' nor a 'non-judicial organisation, etc.', thus, income derived through the entity should be treated as the taxpayer's income, and the defendant, the Japanese government, insisted that the contested entity was not transparent under Japanese tax laws.

New York LLC

The issue as to whether a foreign entity should be regarded as a transparent entity was first addressed in a case regarding a New York LLC. On February 26, 2001, the National Tax Tribunal (*Kokuzei Fufuku Shinpansho*), the administrative tribunal organisation under the jurisdiction of the National Tax Agency, decided that the contested New York LLC was not a partnership but a 'corporation', even if the taxpayer had chosen transparent treatment under the Check-the-Box regulation in the US. Following that decision, the National Tax Agency announced in June 2001 that a limited liability company established in a state of the US would, in principle, regardless of the taxpayer's choice under the Check-the-Box regulation, be treated as a 'corporation' because it has the following factors:

- (a) it is established for the purpose of performing commercial transactions, thus it can be a commercial company;
- (b) when it is established, its trade name and other features are registered officially;
- (c) it is treated as a legal entity in that it may sue and be sued in its own name; and
- (d) the Uniform Limited Liability Company Act of the US provides that a limited liability company is a legal entity distinct from its members and that a limited liability company has the same powers as an individual to do all things necessary or convenient to carry on its business or affairs.

After the announcement, the Saitama District Court also held on May 16, 2007, that a contested New York LLC was not a partnership but a 'corporation' regardless of the taxpayer's choice under the Check-the-Box regulation. The court opined that whether an organisation or foundation which is established pursuant to and in accordance with foreign laws is treated as a 'corporation' will be, in principle, determined by the content of the laws and the substance of the entity. The court declared that an association with juridical personality under common law had four characteristics:

- (a) it may sue and be sued in its name;
- (b) it may own and dispose of assets in its own name;
- (c) it has the ability to execute agreements in its own name; and
- (d) it uses a corporate seal.

The court decided that the contested New York LLC had the factors of (a) through (c) and that the deficit of the factor of (d) did not mean that it was not a 'corporation'. Additionally, the court pointed to Article 203(d) of New York Limited Liability Company Law, which provides that "a limited liability company formed under this chapter shall be a separate legal entity", and Article 601 of the law, which provides that "a member has no interest in specific property of the limited liability company." From a comprehensive standpoint, the court decided that the contested New York LLC was an association with a juridical personality under New York law; accordingly, it was a 'corporation'. Such judgment was upheld by the Tokyo High Court, which was the final decision by the courts.

Cayman Islands ELPS

On March 8, 2007, the Nagoya High Court held that a contested Cayman Islands ELPS did not have a juridical personality for Japanese tax purposes and was instead a contractual relationship between the members. The reasoning was that since Article 3 of the Partnership Law ("the relation which subsists between the persons carrying on a business in common with a view to profit") was applicable to the disputed exempted limited partnership, the exempted limited partnership could be treated as a partnership for Japanese tax purposes. The final appeal to this decision was rejected by the Supreme Court on March 27, 2008 and this decision has become the final judgment by the courts. Following this court decision, the Gifu District Court reached the same conclusion in a separate case on January 24, 2008.

Delaware LPS

There have been three cases so far covering the issue whether a Delaware LPS is a 'corporation'. Interestingly, although the facts regarding contested Delaware LPSs in these cases were substantially same (in fact, they were established under the identical tax structuring for the purpose of being used by Japanese individual residents as investment vehicles for real estate located in the US), the conclusions of the courts were different. In the first case, the court determined that the contested Delaware LPS was a 'corporation', but in the other cases, they determined that the disputed Delaware LPSs should not be treated as 'corporations'.

The former decision was held by the Osaka District Court on December 17, 2010. The court acknowledged the defendant's claim that whether a foreign entity was a 'corporation' should be

determined by three factors: (a) whether it may own property distinct from its members' property; to be more precise, whether the members do not have any interest in the entity's property and whether it may register its own name as an owner of the entity's property; (b) whether it has the ability to execute agreements and other juristic acts in its own name and to acquire rights or incur obligations in its own name; and (c) whether it may sue and be sued in its own name. The court determined that a 'corporation' should meet all the requirements. Based on these criteria, the court ruled that the disputed Delaware LPS should be treated as a 'corporation'.

On the contrary, the latter cases, a judgment by the Tokyo District Court on July 19, 2011 and by the Nagoya District Court on December 14, 2011, adopted a different standpoint. Those courts found that the factors considered by the Osaka District Court could not explain why a Japanese partnership (*nin'i kumiai*), which they decided has these factors, is undoubtedly treated as a transparent entity. Instead, they presented two alternative factors:

- (a) a 'foreign corporation' should be, in principle, an entity which is granted juridical personality pursuant to and in accordance with relevant foreign laws; and
- (b) a 'foreign corporation' is an entity to which profit and loss derived through the entity should be directly attributed. If such profit and loss are instead attributed directly to its equity holders instead of the entity, the entity is not regarded as a 'corporation'. Whether such profit and loss is attributed to the entity or its equity holders is determined on the basis of how the foreign laws set out its establishment, organisation, operation, and governance.

The courts emphasised the second factor and opined that an entity should be treated as a 'corporation' only when the second factor is satisfied.

In the latter cases, it was argued that the contested Delaware LPS should be treated as a 'corporation' because of Article 201(b) of the Delaware Revised Uniform Limited Partnership Act, which provides that "a limited partnership formed under this chapter shall be a separate legal entity", but the court denied the defendant's argument on the grounds that 'separate legal entity' did not have the same meaning of corporation under Japanese civil laws. Furthermore, the courts stated that, because a Delaware LPS is intended to let profit and loss derived through it be attributed to its partners, the contested Delaware LPSs were not 'corporations'.

The courts also denied the argument that the contested Delaware LPSs were not transparent because they were 'non-judicial organisation, etc.' Thus,

they finally determined that the disputed Delaware LPSs were transparent entities.

All of the Delaware LPS cases referred to above seem to have been appealed and to be pending before different High Courts now.

Foresight with this problem

As described above, the Japanese courts have not yet established universal criteria to determine transparency of a foreign entity. As the Tokyo District Court and the Nagoya District Court described in the Delaware LPS cases, it is not easy to determine whether foreign entities should be categorised as 'corporations' from a substantive perspective by looking at: how the entities' property is treated under the governing laws, whether they may sue or be sued, etc. For example, with a Japanese partnership (*nin'i kumiai*), which is regarded as a typical transparent entity in Japan, even though its property (partnership property) is jointly owned by all partners, it is somewhat misleading to say that it does not own partnership property distinct from its partners because no partner has the right to dispose of his/her interest with respect to the partnership property. In addition, a Japanese partnership may sue or be sued under the Code of Civil Procedure of Japan.

On the other hand, the criterion focusing on the attribution of profit and loss, which was emphasised in the Tokyo District Court and the Nagoya District Court decisions, is not a very clear standard and could yield different results in different courts even with cases that have relatively similar facts. The criteria that are focused on by the High Courts and possibly the Supreme Court in the Delaware LPS cases will likely have a major impact on tax structuring. However, it is clear that this is an issue that would be better addressed by a revision of the Corporate Tax Act setting out a definitive rule or guideline.

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