

# Silent Partnership in Japan and Germany

*Martin Arnold*

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## I. HISTORICAL BACKGROUND AND IMPORTANCE OF SILENT PARTNERSHIP IN MODERN JAPANESE BUSINESS

The concept of Japanese silent partnership (*tokumei kumiai*) dates back to the Italian trading business in the 10<sup>th</sup> century<sup>1</sup> and was first provided for in the 1890 draft of the Japanese Commercial Code (*Shôhō* <sup>2</sup>). In modern Japanese business, silent partnerships still play an important role as an investment tool due to the versatility of the arrangement and various tax benefits. These benefits have also attracted the attention of foreign investors, especially in the leveraged lease market. As a result of the increasing use of silent partnership arrangements, the Japanese national tax administration (NTA) have recently focused their attention on arrangements where favourable tax treaties have been used by foreign investors to minimize or indeed totally avoid Japanese taxation.<sup>3</sup> Nonetheless, silent partnership arrangements remain an important alternative in the financing of businesses.

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1 Concept of “commendator” and “tractator”.

2 Law No. 48/1899, as amended by Law No. 79/2001. First draft by the German *Rösler* in the year 1890.

3 See *Yomiuri Shinbun* February 10, 2001.

## II. COMMERCIAL CODE REGULATIONS

### 1. Japan

Under the provisions of the Japanese Commercial Code,<sup>4</sup> a *tokumei kumiai* agreement may be formed between a silent partner (*tokumei kumiai-in*) and a proprietor (*eigyôsha*). It should be carefully noted that the Japanese silent partnership is different from the *nin'i kumi-ai* (partnership) under the Japanese Civil Code (*Minpô*),<sup>5</sup> and it may be said that the status of the silent partner resembles the position of a limited partner in a limited partnership (*gôshi kaisha*)<sup>6</sup> under Japanese law.

Under the silent partnership agreement, the silent partner contributes cash or other assets to the business of the proprietor. The amounts contributed become the property of the proprietor and are not jointly held by the parties.<sup>7</sup> The silent partner is generally not liable for third-party claims made on the proprietor.<sup>8</sup> Under a silent partnership agreement, the silent partner is entitled to share in the profits arising from the business. Profits are determined by comparing the assets of the silent partnership at the beginning of each business year with the assets of the silent partnership at the end of each business year. Insofar as the silent partner's contribution is diminished by losses, the silent partner is not entitled to request a profit distribution, unless such diminution is made up – for example – by additional contributions.<sup>9</sup> Though not stipulated by law, the parties ordinarily make provisions for the sharing of losses. Insofar as the sharing in losses is not specifically excluded in the agreement, the silent partner is deemed to share in losses in proportion to asset contribution.

A silent partnership agreement typically contains provisions regarding the dissolution of the partnership. However, if the term and termination of the partnership are not provided for in the agreement, or if the agreement contains a provision that the partnership shall continue until the death of one party, any party may terminate the agreement by way of notice at least six months prior to the end of the business year.<sup>10</sup> The agreement may be terminated at any time with due cause.<sup>11</sup> If the business purpose of the silent partnership has been achieved or becomes impossible to achieve, the silent partnership may be deemed terminated.<sup>12</sup> Furthermore, the silent partnership agreement is terminated if either party becomes bankrupt. Upon termination of the silent partnership,

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4 Cf. Artt. 535 *et seq.* *Shôhô*.

5 Cf. Artt. 667 *et seq.* *Minpô*; Law No. 89/1896 and No. 9/1898, as amended by Law No. 41/2001.

6 Cf. Artt. 146. *et seq.* *Shôhô*.

7 Cf. Art. 536 para. 1 *Shôhô*.

8 Cf. Art. 536 para. 2 *Shôhô*.

9 Cf. Art. 538 *Shôhô*.

10 Cf. Art. 539 para. 1 *Shôhô*.

11 Cf. Art. 539 para. 2 *Shôhô*.

12 Cf. Art. 540 *Shôhô*.

the proprietor is obliged to repay the assets contributed plus undistributed profits less losses incurred.<sup>13</sup>

Finally, the Commercial Code provisions related to Japanese limited partnership (*gōshi kaisha*) are applicable to silent partnerships by analogy.<sup>14</sup> For example, the silent partner may, with the court's approval, investigate the situation of the business.<sup>15</sup>

## 2. Germany

In contrast to Japanese law, two forms of silent partnership exist under German law:

- (1) typical silent partnerships (§ 230 *et seq.* German Commercial Code (HGB));
- (2) atypical silent partnerships.

Both forms differ basically regarding rights, obligations, and tax treatment<sup>16</sup> of the silent partners.

### a) *The Typical Silent Partnership*

The typical silent partnership (*stille Gesellschaft*) is a partnership in which one partner participates in a commercial enterprise run by another by making an asset contribution to the owner of the business. Such contribution becomes the property of the owner of the business.<sup>17</sup> In this respect, the typical silent partnership is similar under German and Japanese law. In contrast to the Japanese concept of silent partnership, a silent partner in a typical German silent partnership may contribute services to the silent partnership. With respect to third parties, the business owner is the sole owner of the commercial enterprise and carries on business in his own name.

The silent partner(s) (*stille(r) Gesellschafter*) and the proprietor (*Inhaber des Handelsgeschäfts*) typically conclude a silent partnership agreement, which is (with some exceptions) not subject to notarization.<sup>18</sup>

Under the basic concept of the German typical silent partnership, the silent partner has no voting rights and no rights to participate in day-to-day business decisions. However, the typical silent partner has limited rights of inspection, including the right to demand a copy of the annual financial statements and a right to examine the accuracy of books and records.<sup>19</sup> The silent partner ordinarily participates in profits and losses of

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13 Cf. Art. 541 *Shōhō*.

14 Art. 542 *Shōhō*.

15 Cf. Art. 542 *Shōhō*, Art. 153 para. 2 *Shōhō*.

16 For the tax treatment of the silent partnership in Germany, see below IV.

17 Cf. § 230 HGB.

18 In case the silent partner contributes real property, notarization is required (German Civil Code (*Bürgerliches Gesetzbuch*, BGB) § 311 b).

19 Cf. § 233 HGB.

the business. Whereas a participation in losses may be excluded contractually, a participation in profits may not be excluded in a typical silent partnership agreement.<sup>20</sup> The right of profit participation may be set flexibly in the silent partnership agreement. For example, the silent partner may receive profit-related interest on his contribution at varying rates.

Loss participation of the silent partner is limited to the amount of the paid-in or outstanding contribution, whichever is greater. Subsequent losses do not give rise to any obligation to repay earlier profit received.<sup>21</sup> However, to the extent the silent partner's contribution is reduced by a loss, the annual profit shall be used to cover such loss.

Similar to Japanese agreements, German silent partnership agreements generally contain provisions for the termination of the agreement and determination of settlement payments.

In contrast to the atypical German silent partnership (see below b), the silent partner is merely entitled to claim repayment of the balance of his contribution in the event of the dissolution of the silent partnership. Thus, the typical German silent partner does not participate in any increase in hidden reserves – a concept which is in line with the Japanese provisions on silent partnership. In contrast to Japanese law, German law provides for rescission of bankruptcy by a bankruptcy trustee.<sup>22</sup>

#### *b) The Atypical Silent Partnership*

Under an atypical silent partnership agreement, the silent partner contributes assets into the business, assumes business risk, and is given participation rights which equal those of a limited partner in a German limited partnership (*Kommanditgesellschaft*). An atypical silent partner participates not only in profits and losses of the business, but also in hidden reserves and goodwill of the silent partnership. Atypical silent partnership agreements are a flexible form of participation, and the contracting partners have considerable flexibility in setting terms and conditions.<sup>23</sup> Atypical silent partnerships are thus an effective alternative investment tool in the financing of business in Germany.

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20 Cf. § 231 para. 2 HGB.

21 Cf. § 232 para. 2 HGB.

22 Cf. § 136 para. 1 German Insolvency Code (InsO); formerly § 237 HGB.

23 For more details on German atypical silent partnerships, see: ZACHARIAS / HEBIG / RINNEWITZ in: *Die atypische stille Gesellschaft* (2000); or PAULICH / BLAUROCK in: *Handbuch der stillen Gesellschaft* (1998).

### III. TAXATION ISSUES OF THE SILENT PARTNERSHIP IN JAPAN

#### 1. *Taxation at the Level of the Proprietor*

The silent partnership itself is not subject to taxation.<sup>24</sup> However, profits and losses arising from the silent partnership are taxable at the level of the proprietor and the silent partner. All income received by the business conducted by the proprietor is included in the gross income of the proprietor for Japanese corporation income tax purposes. Distributions of profits to the silent partner are treated as deductible expenses of the proprietor in the year of payment.<sup>25</sup>

#### 2. *Taxation at the Level of the Silent Partner*

Under Japanese income tax law, a distinction is made between silent partnership arrangements with ten or more silent partners and those with less than ten silent partners. This distinction was valid until March 31, 2002. Profit distributions in a silent partnership arrangement with ten or more Japanese resident silent partners are subject to 20% Japanese withholding tax. If the silent partner is a Japanese corporation, the amount withheld is creditable against annual corporation income tax. If the non-resident silent partner does not have a permanent establishment in Japan, the 20% withholding tax is final.<sup>26</sup>

In contrast, up to March 31, 2002, profit distributions in a silent partnership arrangement with less than ten silent partners were not subject to Japanese withholding tax.<sup>27</sup> In such a case, the regular Japanese corporation income tax rules applied, *i.e.*, national (corporation) income tax and local tax. The aforementioned favourable tax treatment offered tax-planning opportunities for foreign investors. For example, under the Double Tax Convention between Japan and the Netherlands, profits distributed to a silent partner resident in the Netherlands without a taxable presence in Japan are taxable in the Netherlands only. From April 1, 2002 onwards, profit distributions in a partnership arrangement with less than ten silent partners are subject to withholding tax if the silent partner is a non-Japanese resident.

Whether or not the Japanese tax authorities will challenge silent partnership arrangements that are considered abusive and consider the foreign silent partner, regardless of its jurisdiction, as having a permanent establishment in Japan is unclear. However, according to media reports and Japanese tax professionals, the Japanese tax authorities are increasingly focusing their attention on silent partnership arrangements.

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24 Cf. Japanese Basic Corporation Tax Circular 1-1-1 (*Hôjinzei kihon tsûtatsu* 1-1-1).

25 Cf. Japanese Basic Corporation Tax Circular 14-1-3, Japanese Basic Income Tax Circular 36-37 (*Shotokuzei kihon tsûtatsu* 36-37).

26 Cf. Japanese Corporation Tax Act Art. 138 (*Hôjin zeihô* 138 (11); Law No. 34/1965, as amended by Law No. 101/2001), Japanese Income Tax Act Art. 161 (12) (*Shotoku zeihô*, Law No. 33/1965; as amended by Law No. 101/2001).

27 Cf. Japanese Income Tax Act Art. 161 (1) and Japanese Corporation Tax Act Art. 138 (1).

#### IV. TAXATION ISSUES OF THE SILENT PARTNERSHIP IN GERMANY

##### 1. *The Typical Silent Partnership*

###### a) *Taxation at the Level of the Silent Partner*

Profits derived from the silent partnership are treated as income from capital investments at the level of the silent partner.<sup>28</sup> Where the contractual agreement provides that the silent partner does not have to bear losses, any loss of capital contribution due to bankruptcy of the business, dissolution of the silent partnership, or sale of a typical participation, cannot be utilised for income tax purposes. However, if the contractual agreement requires the silent partner to bear losses, any loss is deductible as capital investment income-related expense. Further, any loss due to bankruptcy of the business that participated is also deductible as capital investment income-related expense. Regardless of loss participation, the silent partner may deduct any expenses related to his participation in the silent partnership – for example, cost incurred for consulting, etc.

According to a decision by the German Federal Tax Court, capital gains resulting from the sale of the typical participation to third parties are basically not taxable under German law, provided that the silent partnership is held by the individual as private property and not as business property. Capital losses resulting from the sale of a typical participation to third parties have no tax effect. Losses of the contribution due to bankruptcy or liquidation of the business are borne by the silent partner and have no tax effect.<sup>29</sup>

###### b) *Taxation at the Level of the Proprietor*

At the level of proprietor, profit distributions to silent partner(s) are deductible expenses for corporation income tax purposes. Further, the proprietor is obliged to withhold tax at a rate of 25% on any profit distribution to the silent partner.<sup>30</sup> Tax withheld is creditable against personal income tax. Although profit distributions are deductible expenses for corporation income tax purposes, profits attributable to the silent partner are added to the trade income of the proprietor for trade tax purposes, provided that the silent partnership contribution is privately held.<sup>31</sup>

##### 2. *The Atypical Silent Partnership*

Profits or losses arising from the atypical silent partnership as well as capital gains from the sale of the atypical partnership are treated as business income at the level of the

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28 Cf. Art. 20 para. 1 (4) German Income Tax Act (*Einkommensteuergesetz*, EStG).

29 Munich Lower Tax Court, Decision Nov. 5, 1980 (EFG 1981, 341, 342).

30 Cf. §§ 43 para. 1 (3), 43 a para. 1 (2) EStG.

31 Cf. § 8 (3) German Trade Tax Act (*Gewerbsteuergesetz*).

atypical silent partner and taxed accordingly.<sup>32</sup> Losses arising from the atypical silent partnership (i) may not be used to offset profits from other business income or other income and (ii) may not be carried forward, insofar as the losses exceed the capital account of the silent partner in the business.<sup>33</sup> Profits distributed to the atypical silent partner are generally not subject to withholding tax.

## V. SUMMARY

Whereas the silent partnership in both forms is a flexible investment tool and widely accepted in German business practice, the future of the Japanese silent partnership from the tax perspective of foreign investors is presently unclear. Investment vehicles such as “Special Purpose Companies” (*tokutei mokuteki kaisha*) may become an alternative for the structuring of investments.

## ZUSAMMENFASSUNG

*Der Beitrag gibt zunächst einen knappen Überblick über die rechtliche Regelung der stillen Gesellschaft im japanischen und deutschen Handelsrecht und beleuchtet sodann ausführlich die für die Praxis wichtige steuerrechtliche Behandlung dieser Rechtsfragen in beiden Ländern. Der Verfasser weist darauf hin, dass die Besteuerung der stillen Gesellschaft in Japan aus dem Blickwinkel eines ausländischen Investors einige ungeklärte Fragen aufwerfe, was es nahe lege, andere rechtliche Vehikel zur Strukturierung eines Investments in Japan mit in die Überlegungen einzubeziehen.*

*(die Red.)*

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32 Cf. § 15 EStG.

33 Cf. § 15 a para. 5 (1) EStG.