2009 Japanese Tax Reform Measures to Promote Private Equity Investment

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I. INTRODUCTION

During the past several years, Japan has been attempting to encourage individuals and corporations (both Japanese and foreign) to invest in Japanese companies through private investment partnerships. The intention of the Japanese government has been to encourage private equity as an additional source of funding for both start-up enterprises as well as distressed companies, as these types of entities have often found it difficult to access the more conventional bank financing or public securities markets.

For foreign investors, one of the problems has been the potential tax risks from investing into Japan through partnerships, due to the lack of clear and comprehensive tax rules, particularly pertaining to foreign investors. Consequently, for example, in 2008, Japan adopted an independent agent exception, under which foreign investors can avoid a local tax nexus (that is, a permanent establishment or "PE") notwithstanding activities conducted on their behalf in Japan by an independent, on-shore fund manager under certain conditions.

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The most recent round of changes again is directed squarely at foreign investors in certain collective investment vehicles. In early 2008, the Ministry of Economy, Trade and Industry ("METI") created a study group to investigate the historically low level of foreign direct investment ("FDI") through investment funds and to provide recommendations for increasing such FDI. Based on these efforts, METI proposed two measures which were designed to encourage foreign investment by reducing the potential Japanese tax burden on foreigners investing in private equity funds.

Specifically, the first provides an exemption from PE treatment for foreign limited partners in certain kinds of Japanese limited partnerships (or "similar" foreign partnerships). The second provides an exception for such partners from the partnership attribution that otherwise would combine their individual partnership interests with those of the other partners to determine whether the partner is subject to Japanese tax on capital gains from the sale of shares of a Japanese company due to holding a "substantial participation" (25% or more) in the company. The proposals, embodied in statutory amendments and related cabinet orders, were successfully incorporated into the 2009 tax reform, which was passed by the House of Representatives of the Diet on February 27, 2009, and became effective beginning April 1, 2009 (the Tax Reform Act ("2009 TRA")).[1]

Nevertheless, a close examination of the new rules and subsequent guidance issued by the Japanese tax authorities has revealed a number of limitations and potential pitfalls, which may severely curtail the ability of foreign investors to utilize these incentives. While certain issues can be resolved through careful planning, others likely will require further dialogue with the pertinent Japanese authorities to amend and/or clarify the rules and interpretations thereof.

II. PE EXEMPTION FOR LIMITED PARTNERS

1. *Background*

Since the establishment of the first venture capital partnerships in Japan in the mid-1980s, a recurring tax issue for foreign investors has been whether a foreign partner investing in such a partnership would be considered to have a PE in Japan merely due to such investment, thereby becoming subject to ordinary Japanese individual income tax or corporation tax applicable to residents in regard to profits earned through such partnerships. The earliest such partnerships were simple Japanese partnerships (*nin'i kumiai*) under the Civil Code[2] that were called "investment business partnerships" (*tôshi jigyô kumiai*). At that time, the tax issue was whether such partnerships were engaged in business activities (*jigyô*) or were merely engaged in investing activities. If the "executive partner" (the partner charged with operating the partnership activities, in the

1 *Shotoku-zei-hô tô no ichibu o kaisei suru hôritsu*, Law No. 13/2009.
2 *Minpô*, Law No. 89/1896 and No. 9/1898.

same manner as a general partner) was engaged in business activities, a PE would arise. However, if the executive partner was simply identifying and investing in shares but not, for example, regularly buying and selling shares, providing consulting services for a fee, or performing other recurring activities, it was questionable whether it should be considered to be engaged in a business activity, as opposed to a mere investment activity.

Nevertheless, over the years the activities of executive partners became broader, encompassing more active involvement in managing or advising invested companies, as well as providing different types of financing (such as loans) requiring more oversight. This resulted in an increased risk of PE treatment. Because the ultimate determination of whether the executive partner was engaged in a business would be made only after the fact during a tax audit, this risk was viewed as excessively high by most foreign investors. Consequently, various alternative offshore investment structures were created to reduce this risk for foreign investors by avoiding direct investments as partners in Japanese investment partnerships.

In 1998, however, METI sponsored an entirely new law designed to introduce a "limited liability partnership" investment vehicle in Japan. As noted above, the previous venture capital funds had been simple Civil Code partnerships, which are a simple form of general partnership with no limited liability for investors. The Act Concerning Investment Business Limited Liability Partnership Agreements (the "LPS Act")[3] created an entirely new partnership, the "investment business limited liability partnership" (*tôshi jigyô yûgen sekinin kumiai*) ("Investment LPS"). An Investment LPS can have more than one general partner ("GP"); this partner(s) has the sole responsibility for managing the operations of the Investment LPS.[4] The Investment LPS initially was subject to onerous restrictions in regard to both its investors and its permissible investments and, as a result, was not popular with the investing community. Subsequent amendments in 2004 substantially reduced the restrictions on the investors and broadened the scope of permissible investments.

Notwithstanding the 2004 amendments, the PE issue has continued to exist for foreign limited partners in an Investment LPS. Indeed, an Investment LPS was permitted to engage not only in investing in stock, but also providing loans, as well as rendering management advice or technical guidance to entities in which it invested, and its activities were routinely described as an "investment business." Consequently, the PE risk was substantial, if not certain in most cases.

However, under the METI proposal, a foreign limited partner, which is a non-resident individual or a foreign corporation, and which has concluded an "investment partnership agreement" (an "FLP"), will not be deemed to have a PE in Japan ("PE Exemption"), notwithstanding that it otherwise is considered to have a PE in Japan con-

3 *Tôshi jigyô yûgen sekinin kumiai ni kansuru hôritsu*, Law No. 90/1998, as amended by Law No. 109/2006.

4 Art. 7 LPS Act.

cerning its business activities conducted pursuant to the investment partnership agreement; provided, however, that certain requirements are satisfied and certain procedures are followed.[5] For this purpose, an "investment partnership agreement" is limited to either: (a) an Investment LPS agreement; or (b) a foreign partnership agreement which is "similar" to an Investment LPS agreement as prescribed under the LPS Act.[6]

2. *Requirements for PE Exemption*

To qualify for the PE Exemption, all of the following must be satisfied:

a) *Passive Role*

FLP does not in fact engage, directly or by attribution through another partnership, in the performance of the business carried on pursuant to the Investment LPS agreement at any time from the date the FLP concludes the Investment LPS agreement (basically, from the time the FLP became a partner in the Investment LPS);

b) *Less Than 25% Interest*

FLP owns, directly or by attribution through a "specified relationship," an interest of less than 25% in the assets of the Investment LPS at any time from the date the FLP concludes the Investment LPS agreement (basically, from the time the FLP became a partner in the Investment LPS);

c) *No Relationship to GP*

FLP does not have a "specified relationship" with any GP of the Investment LPS at any time from the date the FLP concludes the Investment LPS agreement (basically, from the time the FLP became a partner in the Investment LPS);

d) *No Other PE*

FLP does not otherwise already have an existing PE in Japan during the period that the PE Exemption is claimed;[7] and

e) *Reporting Requirements*

Certain reporting requirements are met.[8]

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5 Arts. 41-21(1), 67-16(1) Special Taxation Measures Law (*Sozei tokubetsu sochi-hô*), Law No. 26/1957, as amended by Law No. 63/2009 ("STML").

6 Art. 41-21(2), no. 6 STML.

7 Even if the FLP previously had a PE(s) in Japan, the requirement is satisfied; provided that such other PE(s) are terminated prior to the period for which the PE Exemption is claimed. Art. 26-30(14), (15) Cabinet Order issued with respect to the STML (*Sozei tokubetsu sochi-hô sekô-rei*) No. 43/1957, as amended by Cabinet Order No. 166/2009 ("CO-STML").

8 Arts. 41-21(1), Art. 67-16(1) STML,

3. *Period During Which Requirements Must Be Satisfied*

With respect to (1), (2), and (3) above, it is important to note that an FLP, which at some time in the past (even if for only a brief period) did not meet these requirements during the period the FLP was a partner in the Investment LPS, will not generally be able to satisfy these requirements. Thus, such an FLP, having once failed to meet any of requirements (1), (2), or (3), will never be able to qualify for the PE Exemption with respect to the FLP's interest in the Investment LPS.

For example, this requirement would adversely affect FLPs of partnership if the FLP was previously the GP, related to the GP, played any active role in the partnership's business, or held a 25% or more interest in the partnership. Based on a technical reading of the statute, it appears that the FLP must have met the requirements since becoming a partner, even if the Investment LPS did not previously own any Japanese assets or conduct any activities in Japan.

4. *Engaging in the Investment LPS Business*

The cabinet order provides that any of the following activities constitute the performance of the business carried on pursuant to the Investment LPS agreement ("Engaged in the Investment LPS Business"):

(1) Carrying out the business of the Investment LPS;
(2) Making decisions with respect to carrying out such business;
(3) Providing approval or consent with regard to such decisions; or
(4) Activities similar to the above.[9]

In addition, the cabinet order provides that, if an FLP is a partner in another partnership which itself conducts any of the above activities, then the FLP itself is deemed to conduct such activities.[10]

5. *Specified Relationship*

The cabinet order provides that, in determining whether an FLP owns less than 25% of the assets of the Investment LPS formed under an Investment LPS agreement, the interests in the Investment LPS assets of the following persons with a "Specified Relationship" to the FLP are attributed to the FLP:

a) *Related Individual*

A relative within six degrees of relationship (three degrees by marriage), a common law spouse, an employee of an individual FLP, other individuals economically supported by the FLP, a relative (within six degrees of relationship (three degrees by marriage)) of

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9 Art. 26-30(1) CO-STML.
10 Art. 26-30(2) CO-STML.

any of the foregoing individuals who live together with any such foregoing individual; or with respect to a corporate FLP, any director and any of the foregoing with respect to such director (for example, relatives of the director) ("Related Individual").[11]

b) Controlled Company

Any company in which the FLP and any Related Individuals hold, directly or indirectly, more than 50% of the total amount of shares or voting rights; or comprise more than 50% of the shareholders/members of such company ("Controlled Company").[12]

c) Other Partnership(s)

Any partnership, other than the Investment LPS, in which the FLP is a partner ("Other Partnership"). Any Investment LPS interests of other partners in the Other Partnership, which are not held through the Other Partnership, are not counted for this attribution purpose.[13]

The interest in the "assets" of the Investment LPS is determined based on the higher of the total interest in the Investment LPS assets, or total of the profit allocation ratios, of the FLP and other partners with whom the FLP has a Specified Relationship.[14]

In addition, the cabinet order provides that an FLP has a "specified relationship" with the GP if the GP is either a Related Individual or Controlled Company.[15]

In the context of tiered partnership structures, such as fund-of-funds investing in an Investment LPS, qualifying for the PE Exemption may be difficult because, under these attribution rules, an FLP is deemed to own all the shares of any Other Partnership in which the FLP is a partner. The Ministry of Finance Commentary specifically provides that an upper-tier partnership is treated as an Other Partnership.[16] For example, if a fund-of-funds invests in an Investment LPS, each investor in the upper tier foreign fund-of-funds will be deemed to own all of the fund's interest in the Investment LPS. If the fund owns a 25% or more interest in the Investment LPS, then each fund investor would fail the less than 25% ownership in the Investment LPS assets requirement. Because of this treatment of upper-tier partnerships as an Other Partnership, a tiered fund structure will not qualify for the PE Exemption unless the upper-tier fund owns, directly or through attribution, not more than a 25% interest in the Investment LPS (assuming all other requirements are satisfied).

11 Art. 26-30(6) no. 1 CO-STML.
12 Art. 26-30(6) nos. 2 and 3, (7), (8) CO-STML.
13 Art. 26-30(5) no. 3 CO-STML.
14 Art. 26-30(4) CO-STML.
15 Art. 26-30(6), (9) CO-STML.
16 Ministry of Finance (ed.), Complete Explanation of the 2009 TRA (*Kaisei zeihô no subete*), August 1, 2009 *www.http://www.mof.go.jp/jouhou/syuzei/kaisetsu21/index.html*.

In addition, foreign investors in foreign funds structured as limited liability companies (or other entities) ("LLCs"), rather than as limited partnerships, will have difficulty qualifying for the PE Exemption if they have a 25% interest in the Investment LPS. For Japanese tax purposes, an LLC (or other corporate entity) is generally treated as a corporation (*hôjin*), a separate taxable entity, rather than as a tax-transparent (pass-through) entity, such as a partnership (*kumiai*). Based on this treatment, the individual LLC fund-of-funds investors would not be treated as the investors in the Investment LPS; rather the LLC fund itself would be treated as the investor in the Investment LPS. Thus, if an LLC fund holds a 50% interest in an Investment LPS, then the LLC fund would not meet the less than 25% ownership in Investment LPS assets requirement. Thus, the LLC fund's investors would not generally be able to obtain the benefits (through the LLC fund) of the PE Exemption.

Moreover, even if the investors are residents of a country with a tax treaty with Japan, and the treaty contains a look-through rule for tax transparent entities, it is unlikely for the fund's investors to be treated as the FLP in the Investment LPS under the look-through rule. This is because treatment under a tax treaty is generally not used for purposes of interpreting provisions of domestic tax law. Thus, even if an investor holds a less than 25% ownership in the LLC fund, the less than 25% ownership in the Investment LPS assets requirement would not be satisfied because the less than 25% ownership requirement would be applied at the LLC fund level (no pass-through treatment – the FLP of the Investment LPS is the LLC, rather than the LLC investor).

6. Reporting Requirements

To obtain the PE Exemption, an FLP must apply by filing certain forms through the GP of the Investment LPS; these forms include information which demonstrates that the FLP satisfies all the requirements for the PE Exemption.[17]

The law also requires that an FLP report all Japanese source income which would be included in the computation of the taxable income of a Japanese tax resident, but which income is not so treated (as taxable income) because of the PE Exemption.[18] This may require additional disclosure that investors would be hesitant to provide. It is not clear from the statute or cabinet order whether the FLPs must also report all other Japanese source income, whether or not related to the Investment LPS. If the PE Exemption did not apply, and thus the FLP is treated as having a PE in Japan, then any other Japanese source income (whether or not related to the Investment LPS) would be subject to tax as the income of a Japanese tax resident under Japanese domestic tax law. However, if the PE Exemption applies, then such other Japanese source income would not generally be subject to tax as the income of a Japanese tax resident. Thus, read literally, it appears

17 Art. 41-21(3) STML.
18 Art. 19-12(1) Cabinet Order No. 15/1957, as amended by Cabinet Order No. 47/2009.

that the statute would require that an FLP report all other Japanese source income because such income would not be subject to tax as the income of a Japanese tax resident.

III. INVESTMENT LPS AND "SIMILAR" FOREIGN INVESTMENT LPS

It is important to note that the PE Exemption applies only to Investment LPS agreements or "similar" foreign partnership agreements.[19] Consequently, a thorough understanding of the Investment LPS under the LPS Act is useful, as well as how "similar" a foreign investment LPS must be to qualify for the PE Exemption.

1. Limitations on the Activities of an Investment LPS

Significantly, the LPS Act limits the activities of an Investment LPS to the following:

a) Investment Assets

Acquisition and holding of:

- Stocks, stock warrants, other equity interests, bonds, and other securities issued by Japanese corporations (*kabushiki kaisha*) and certain other corporate entities;
- Equity interests in limited liability companies (*gôdô kaisha*);
- Certain cash receivables of (issued by), or owned by, a Japanese entity or individual;
- New loans to a Japanese entity or individual;
- Equity investment through a silent partnership (*tokumei kumiai*) contract (TK Investment) in which a Japanese entity or individual acts as the operator (*eigyô-sha*);
- Beneficial interests in a trust in which a Japanese entity or person serves as the trustee; and
- Industrial (intellectual) property rights or copyrights (including granting a license to use the rights relating thereto) owned by a Japanese entity or individual.[20]

b) Management Consulting Services

Provision of management-related advice and technical guidance to a Japanese entity or individual in relation to which the Investment LPS owns any of the Investment Assets listed above.[21]

c) Investment in an Investment LPS, Etc.

Investment in an Investment LPS, a Japanese partnership (*kumiai*) the purpose of which is to pursue an investment business, or similar organizations located in a foreign country.[22]

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19 Art. 41-21(2) No. 6 STML.
20 Art. 3(1) Nos. 1 – 7 LPS Act.
21 Art. 3(1) No. 8 LPS Act.

d) Ancillary Business Activities

The cabinet order prescribes the following additional business activities:

- Acquisition and holding of certain promissory notes issued or owned by a Japanese entity or individual, as well as negotiable certificates of deposit; and
- Purchase, sale, exchange or lease, or brokering or mediation of real estate or movable property which secures promissory notes or cash receivables acquired by the Investment LPS with respect to the above.[23]

e) Foreign Securities

Acquisition and holding of stock, stock warrants, other equity interests, bonds, and other securities issued by foreign corporations; provided that such investment does not hinder the above business and such foreign holdings are limited to 50% of the total capital contribution of the partners.[24]

f) Investment of Surplus Cash

Surplus cash may be invested in deposit accounts; postal savings; Japanese government or municipal bonds; or bonds issued or guaranteed by: (i) a foreign or local government, (ii) an international institution, (iii) a foreign government-affiliated institution (that is, an institution in which the main equity investor is a foreign local government in which the head or principle office of the institution in located), (iv) a corporation in which a local government is the main equity investor, or (v) a foreign bank or other financial institution.[25]

It is important to note that the Investment LPS is not generally permitted to hold certain assets, such as direct ownership in real property and common units in a special purpose company (*tokutei mokuteki kaisha*) which is used for the liquidation of distressed real estate or other business assets under the Asset Liquidation Law.[26] However, certain interests in real property are permitted, such as direct ownership of real property (and neighboring property) secured by promissory notes or cash receivables acquired by the Investment LPS as noted above and beneficial interests in trusts holding real property.[27]

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22 Art. 3(1) no. 9 LPS Act.

23 Art. 3(1) no. 10 LPS Act; Art. 2 Cabinet Order issued with respect to the LPS Act (*Sozei tokubetsu sochi-hô sekô-rei*) No. 235/1998, as amended ("CO-LPS Act").

24 Art. 3(1) no. 11 LPS Act.

25 Art. 3(1) no. 12 LPS Act; Art. 4 CO-LPS Act.

26 *Shisan ryûdô-ka ni kansuru hôritsu*, Law No. 105/1998.

27 Art. 3 LPS Act; Art. 2(3) CO-LPS .

2. *Limitation on Interests in an Investment LPS*

Under the LPS Act, each partner of an Investment LPS must own at least one unit of investment. The cash value of one unit of investment must be uniform.[28] A partner's investment may be made only in the form of cash or other assets.[29] Thus, a partner is generally not permitted to make an investment in the form of services (unlike the case with general partnerships (*nin'i kumiai*), for example).

3. *Similar Foreign Investment LPS*

Neither the statute nor the cabinet order specifies the circumstances under which a foreign investment partnership agreement will be considered to be "similar" to an Investment LPS agreement ("Similar Foreign LPS Agreement"). It is unclear whether a foreign vehicle, the activities of which are not limited to those enumerated in *Limitations on Activities of Investment LPS* above, will qualify. In addition, it is unclear whether the vehicle must be in the form of a limited partnership (with at least one partner having unlimited liability and one partner having limited liability), have uniform cash value of its partnership interests, require only contributions of cash or other assets for partnership interests (that is, no partnership interests in exchange for services), etc.

The restriction on partnership interests received for services rendered raises a question regarding whether a typical investment fund partnership agreement containing a carried interest for the GP (fund manager) would be treated as "similar" to an Investment LPS agreement. From a technical standpoint, the concept of "carried interest" does not exist in Japan; rather, the economic objectives of a "carried interest" have customarily been met through the use of so-called "success fees" (*seikô hôshû*) payable to certain partners as compensation for services rendered. It is unclear whether the economic substance of a "success fee" and "carried interest" would be considered sufficiently "similar."

IV. EXCEPTION FROM PARTNERSHIP ATTRIBUTION RULE

Except with respect to certain holdings in a Japanese real property holding company, Japan does not generally impose tax on capital gains from the sale or other disposition of shares of a Japanese company by a non-resident individual or foreign corporation, unless: (a) the foreign shareholder owns directly or through attribution 25% or more of the outstanding shares of the Japanese company at any time during the three-year period ending in the year of the sale or other disposition; and (b) that foreign shareholder disposes of 5% or more of such shares, taking into account any shares disposed of by

28 Art. 6(3) LPS Act.
29 Art. 6(2) LPS Act.

related parties, in the same tax year.[30] This is referred to as the "25/5 Rule," which is a kind of substantial participation rule. Consequently, as long as the foreign investor owns less than 25%, then any gains from the disposition of such shares would avoid taxation in Japan.

In determining whether either the 25% ownership or 5% disposition of outstanding shares threshold is met, a rule was adopted in 2005 which attributes all shares held by the partnership to the foreign partner ("Partnership Attribution Rule").[31] This significantly increased the potential for foreign partners to be subject to Japanese tax, especially in the private equity context, where such funds often take substantial or majority ownership stakes in the companies in which they invest.

However, under the second of METI's proposals, the cabinet order creates an exception from the Partnership Attribution Rule, subject to certain requirements and limitations, for FLPs in an Investment LPS or "similar" foreign Investment LPS, which would generally result in the FLP being deemed to own shares in the Japanese company equal only to the FLP's interest in the Investment LPS or "similar" foreign Investment LPS ("Partnership Attribution Exception").[32] That is, the FLP is not deemed to own all the shares held by the Investment LPS or similar foreign Investment LPS. The Partnership Attribution Exception is subject to the following additional requirements and limitations:

a) Minimum Period as an FLP

The FLP must have been an FLP of the Investment LPS (or similar foreign Investment LPS) for the lesser of: (i) the period starting from the second fiscal year prior to the year in which the disposition occurs until the end of the year in which the disposition occurs; or (ii) the period in which the FLP was an FLP of the Investment LPS prior to the disposition until the end of the year in which the disposition occurs;[33]

b) Not Engaged in the Investment LPS Business

The FLP, directly or by attribution, must not have been engaged in the Investment LPS business for the lesser of: (i) the period starting from the second fiscal year prior to the year in which the disposition occurs, until the end of the year in which the disposition occurs; or (ii) the period in which the FLP was an FLP of the Investment LPS prior to the disposition until the end of the year in which the disposition occurs;[34]

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30 Art. 291(1), (6), (7) Cabinet Order issued with respect to the Income Tax Law (*Shotoku-zei-hô sekô-rei*), No. 96/1995, as amended by Cabinet Order No. 104/2009 ("CO-Inc"); Art. 187(1), (6), (7) Cabinet Order issued with respect to the Corporation Tax Law (*Hôjin-zei-hô sekô-rei*), No. 97/1995, as amended by Cabinet Order No. 166/2009 ("CO-Corp").

31 Art. 291(4), (5); CO-Corp, Art. 187(4), (5) CO-Inc.

32 Arts. 26-31(1), 39-33-2(1) CO-STML.

33 Arts. 26-31(1) No. 1, 39-33-2(1) no. 1 CO-STML.

34 Arts. 26-31(1) no. 2, 39-33-2(1) no. 2 CO-STML.

c) FLP Owns Less Than a 25% Interest in the Japanese Company Shares Being Sold by the Investment LPS

With respect to the shares of a Japanese company held by an Investment LPS and which are sold or otherwise disposed of, the FLP cannot have owned, directly or by attribution through a Specified Relationship, 25% or more of the shares of such company at any time during the three-year period ending in the year of the sale or other disposition[35] (in determining the FLP's share ownership by attribution through a Specified Relationship, shares held by the Investment LPS, which are allocable to the other partners of the Investment LPS, are not attributed to the FLP[36]);

d) Holding Period for Shares Disposed Of

The Japanese company shares disposed of must have been held by the Investment LPS for at least one year;[37] and

e) Certain Distressed Financial Institutions

The shares disposed of cannot include shares of a "distressed financial institution" (a "special crisis management bank" (*Tokubetsu kiki kanri ginkô*) as defined in the Deposit Insurance Law[38]).[39]

Alternatively, if the partnership meets all the requirements for PE Exemption (as discussed above) then requirements (1) and (2) above do not have to be satisfied.[40]

It is important to note that the Partnership Attribution Rule itself was not repealed and, as a result, except with respect to partners of an Investment LPS or "similar" foreign Investment LPS which meet the requirements above, it continues to apply to attribute ownership from any other partners for purposes of computing the 25% ownership and 5% disposition of outstanding shares thresholds under the 25/5 Rule.

35 Arts. 26-31(1) no. 3, 39-33-2(1) no. 3 CO-STML.

36 That is, the FLP is attributed ownership of the shares held by the Investment LPS only to the extent of the FLP's allocable share of the Investment LPS assets.

37 Art. 26-31(2) no. 1, 39-33-2(2) CO-STML.

38 *Yokin hoken-hô*, Law No. 34/1971.

39 Arts. 26-31(2) no. 2, 39-33-2(2) CO-STML.

40 Arts. 26-31(1), 39-33-2(1) CO-STML.

V. Combined Impact of PE Exemption and Partnership Attribution Exception

The combined effect of the PE Exemption and the Partnership Attribution Exception will potentially be to enable foreign investors in certain private equity and other investment funds to avoid or significantly reduce Japanese tax on their allocable share of certain income and capital gains from the disposition of the fund's Japanese investments. This is because: (i) under the PE Exemption, each FLP would not be deemed to have a PE in Japan, even though the fund itself, through the GP, would be considered as conducting business activities in Japan; and (ii) under the Partnership Attribution Exception, the likelihood that each FLP would be able to avoid being subject to the 25/5 Rule (and thus, be exempt from Japanese tax on capital gains on dispositions of shares) would be increased because all shares held by the Investment LPS (or similar foreign Investment LPS) would not be attributed to the FLP in determining the 25% ownership and 5% disposal of outstanding shares thresholds.

Generally, a non-resident, individual investor in Japanese equities or non-performing loans ("NPLs") having a Japanese PE is subject to the Japanese income tax applicable to Japanese tax residents. Thus, dividends are taxed at up to 50%, the highest marginal rate (10% for listed shares until December 31, 2011),[41] capital gains from the sale or disposition of such equity investments is taxed at 20% (10% for listed shares sold through a Japanese registered securities broker until December 31, 2011)[42] and up to 50% in the case of NPLs,[43] and collection gain from NPLs is taxed at up to 50%.[44] In the case of a foreign corporate fund investor, dividends are taxed at up to 21%, the highest marginal rate after taking into account a 50% dividends received deduction (0% if the investor owns 25% or more of the shares),[45] capital gains from the sale or disposition of such equity investments or NPLs, and collection gain from NPLs is taxed at up to 42%.[46]

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41 Art. 32(1) Tax Reform Act (*Shotoku-zei-hô tô no ichibu o kaisei suru hôritsu*), Law No. 23/2008 ("2008 TRA").

42 Art. 43(2) 2008 TRA.

43 Art. 89 Income Tax Law (*Shotoku-zei-hô*), Law No. 33/1965, as amended by Law No. 13/2009 ("ITL").

44 *Id.*

45 Arts. 21, 23 Corporation Tax Law (*Hôjin-zei-hô*) , Law No. 34/1965, as amended by Law No. 13/2009 ("CTL").

46 Art. 21 CTL.

However, by avoiding a PE, these rates may be substantially lower in the following cases:

a) Dividends

If an investor is not deemed to have a PE in Japan, then the individual or corporate investor is subject only to a 20% withholding tax on dividends (reduced to 7% for listed shares until December 31, 2011);[47]

b) Capital Gains

If the investor is not deemed to have a PE in Japan, then on a sale of shares, the investor is generally subject to a tax of 15% and 30% for individuals and corporations, respectively, if the 25/5 Rule does not apply.[48] However, there is no capital gains tax on dispositions of NPLs;

c) Collection Gain from NPLs

If the investor is not deemed to have a PE in Japan, then the investor is generally subject to a tax of up to 40% and 30% for individuals and corporations, respectively;[49] or

d) Preferential Treaty Treatment

Under an applicable tax treaty between Japan and the investor's resident jurisdiction, the determination as to what activities constitute a PE are determined under the treaty, and the Japanese tax on dividends, capital gains, and collection gain may be further reduced. However, the newer Japanese treaties (which generally contain a limitation on benefits provision) often require that each fund investor file (and regularly update) a form to apply for treaty benefits.[50] Thus, as a practical matter, many funds and investors elect not to claim applicable treaty benefits.

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47 Art. 33(2) 2008 TRA.

48 Art. 164(1) no. 4 ITL; Art. 141(1) no. 4 CTL.

49 Art. 165 ITL; Art. 143 CTL.

50 Art. 3 Cabinet Order on Special Treatment under the ITL, CTL, and Local Tax Law Under Tax Treaties (*Sozei jôyaku no jisshi ni tomonau shotoku-zei-hô, hôjin-zei-hô, oyobi chihô-zei-hô no tokurei tô ni kansuru hôritsu no sekô ni kansuru shôrei*) No. 1/1969, as amended by Cabinet Order No. 4/2009.

The following table summarizes the taxation (using the highest marginal rates) of foreign fund investors investing in Japanese equities.

INVESTOR:	HAS A PE	DOES NOT HAVE A PE
– ***INDIVIDUAL***		
Dividends	50% (10% for listed shares)	20% (7% for listed shares) *
Capital Gain – Shares	20% (10% for listed shares sold through a Japanese securities broker)	15% (0%, if <25% of shares held, or <5% of shares sold during the tax year) *
Capital Gain – NPLs	50%	0%
NPL Collection Gain	50%	40%*
– ***CORPORATION***		
Dividends	21% (0% , if ≥25% of shares held) *	20% (7% for listed shares) *
Capital Gain – Shares	42%	30% (0%, if <25% of shares held, or <5% of shares sold during the tax year) *
Capital Gain – NPLs	42%	0%
NPL Collection Gain	42% *	30% *

* *Under an applicable income tax treaty, the determination as to what activities constitute a PE are generally specified and limited, and the Japanese tax on dividends and capital gains may be reduced.*

Based on the above, Japanese taxation of foreign private equity fund investors can be significantly minimized if the investor is not deemed to have a PE and, in the case of capital gains on the disposition of shares in a Japanese company, by increasing the chances of avoiding tax under the 25/5 Rule.

ZUSAMMENFASSUNG

In den vergangenen Jahren wurde in Japan der Versuch unternommen, Investitionen in japanische Unternehmen für private und institutionelle Anleger aus dem In- und Ausland attraktiver zu gestalten, indem eine neue Gesellschaftsform, die „investment business limited liability partnership“ *(*tôshi jigyô yûgen sekinin kumiai, *im Folgenden “*Investment LPS*”) eingeführt wurde. Mit Wirkung vom 1. April 2009 hat die Regierung nunmehr neue Maßnahmen erlassen, mit denen ausländische Beteiligungen an* Investment LPS *durch Senkung der potentiellen japanischen Steuerbelastung gefördert werden sollen. Zum einen werden ausländische beschränkt haftende Gesellschafter einer* Investment LPS *oder ausländischer Äquivalente von der Behandlung als Betriebsstätte ausgenommen. Zum anderen muss sich ein ausländischer Gesellschafter einer* Investment LPS *bei der Frage, ob er der japanischen Steuer auf Veräußerungsgewinne aus Anteilsverkäufen unterworfen ist, nicht die Anteile der anderen Gesellschafter der* Investment LPS *am fraglichen Unternehmen zurechnen lassen. Grundsätzlich entsteht die vorgenannte Steuerpflicht, wenn ein Anteilseigner eine „wesentliche Beteiligung“ (mindestens 25%) an einem japanischen Unternehmen hält und 5% der Anteile an diesem Unternehmen veräußert (sog. „25/5-Regel“).*

Die beiden Maßnahmen ermöglichen es ausländischen Investoren unter Umständen, eine Steuerbelastung in Hinsicht auf Einkünfte und Gewinne, die der Fonds durch Veräußerungen von Investments in Japan erzielt, ganz zu verhindern oder erheblich zu mindern. Die Ausnahme von der Behandlung als Betriebsstätte führt dazu, dass bei ausländischen beschränkt haftenden Gesellschaftern einer Investment LPS *aus steuerlicher Sicht keine Betriebsstätte in Japan angenommen wird. Dies gilt selbst dann, wenn die* Investment LPS *selbst durch ihren unbeschränkt haftenden Gesellschafter in Japan Geschäfte tätigt. Durch die Ausnahme von der Anteilszurechnung ist es wahrscheinlicher, dass ein ausländischer beschränkt haftender Gesellschafter nicht unter die 25/5-Regel fällt und damit auch nicht der japanischen Besteuerung von Veräußerungsgewinnen aus Anteilsverkäufen unterfällt. Denn die von der* Investment LPS *oder der entsprechenden ausländischen Gesellschaft gehaltenen Anteile werden nicht dem ausländischen Gesellschafter zugerechnet und bleiben daher bei der Berechnung des Schwellenwertes gemäß der 25/5-Regel unberücksichtigt.*

Allerdings hat eine genaue Untersuchung der neuen Regeln und eines durch die japanischen Steuerbehörden im Anschluss veröffentlichten Leitfadens ergeben, dass die Möglichkeit für ausländische Investoren, die steuerlichen Anreize zu nutzen, aufgrund einiger Begrenzungen und potentieller Fallstricke stark eingeschränkt ist.

(dt. Über. durch die Red.)