

Japan Tax Update

Monthly tax update



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Included in this issue are the following tax case analyses:

Income classification for investment income earned through a US limited partnership (Tokyo Regional Tax Tribunal decision issued on February 2, 2006) –

On February 2, 2006, the Tokyo Regional Tax Tribunal ("TRTT") handed down a decision regarding the classification of investment income earned by an individual through a US limited partnership (the "LPS 1"). It was held that the income does not fall within the category of real estate income or dividend income, and should instead be miscellaneous income. The plaintiff had filed the income tax returns as real estate income, however, the tax officer made an assessment on the grounds that the income should be treated as dividend income. As a result of the tribunal's decision, the assessment made by the tax officer was amended (i.e. the amount of the assessment and penalty was reduced). It is not known if this case has been taken to court. According to the new legislation under the 2005 tax reform, real estate income is not deemed to arise if an individual invests through a partnership (including a foreign limited partnership ("LPS")). However, this treatment does not apply to the above case (i.e. the rule is only applicable to income filed on or after January 1, 2006).

Facts

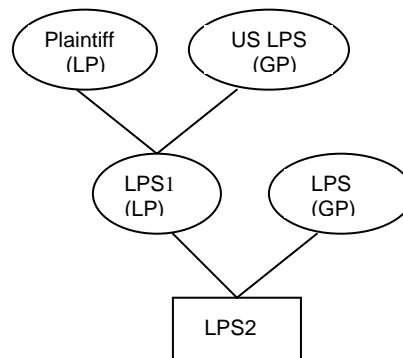
In 1996, the plaintiff (the "Plaintiff"), a Japanese individual, entered into a partnership agreement with a US LPS to form LPS 1, where the Plaintiff is a limited partner and the US LPS is a general partner. In 1996, LPS 1 and a real estate managing company entered into a partnership agreement to form another LPS ("LPS 2") which owns leased property (the real estate) in the USA. LPS1 acquired 99% of the beneficial interest in LPS 2 as a limited partner. The real estate managing company acquired 1% of the beneficial interest in LPS 2 and carried out the property management activities of LPS 2 as a general partner.

In the individual tax returns filed by the Plaintiff for the years from 1999 to 2001, the Plaintiff reported the allocated income earned through LPS 1 as real estate income, claiming a deduction of the depreciation expense of the leased property owned by LPS 2.

The tax officer disallowed the deduction claimed by the Plaintiff arguing that the income earned through LPS 1 should be treated as dividend income and accordingly made an assessment on March 7, 2003. The Plaintiff filed an objection with the administrative agency requesting that the assessment be annulled.

Judgment by the TRTT

In the fact findings, the tax officer argued that (1) the LPS organized under US law is a foreign corporation from a Japanese tax law perspective, (2) the real estate is not owned by the Plaintiff but by LPS 2, and (3) as a result, the income earned by the Plaintiff through LPS 1 should be treated as dividend income from the investment in LPS 1.



In its judgment issued on February 2, 2006, the TRTT amended the assessment made by the tax officer. However, it rejected the claim by the Plaintiff that the income is real estate income, and concluded that the income of the Plaintiff should be treated as miscellaneous income.

(1) Dividend income

The TRTT acknowledged that the LPS has some elements of a corporate entity (e.g. the LPS is able to be a contracting partner in transactions), however, the allocable income of each partner in LPS 1 (i.e. the Plaintiff and the US LPS) is not identical to dividends distributed by a corporation. In the partnership agreement of LPS 1, it was agreed how the income earned by LPS 1 should be allocated between the partners, and based on this provision, the TRTT found that each partner's income was an allocation of income rather than a distribution from LPS 1 and therefore should not be characterized as dividend income.

(2) Real estate income or business income

The Plaintiff argued that the LPS formed under US law is equivalent to the Japanese Kumiai, and real estate leasing income earned and associated expense incurred by LPS 2 should be attributable to the partners of LPS 1. The tax officer found that the real estate is owned by LPS 2, which is a separate entity from LPS 1, and thus the income earned by the Plaintiff through LPS 1 should be dividend income from LPS 1, and not from real estate leasing that is carried out by LPS 2. The Plaintiff counter-argued that even if the income does not qualify as real estate income, it should be treated as business income due to the fact that the Plaintiff was engaged in the continuing activities of LPS 2 and was remunerated accordingly.

The TRTT rejected the argument by the Plaintiff concluding that the income would not be treated as real estate income or business income, but would be treated as miscellaneous income. From the interpretation of Article 26 of the Individual Income Tax Law, the TRTT argued that the income would qualify as real estate income to the extent that the individual leases the real estate. However, the Plaintiff was not found to have leased the real estate in this case due to the facts below;

- 1) The leasing business of the real estate was entrusted to the general partner of LPS 2
- 2) The Plaintiff was not granted any right to be involved in the management of the leasing business and was not liable to indemnify third parties of the leasing business
- 3) The Plaintiff was guaranteed to receive the income as agreed in the LPS 1 agreement regardless of the earnings or loss of LPS 2

Further, the Plaintiff's investment in LPS 1 was not found to be business income, which should have characteristics of "continuity" and "repeated".

Since the income earned by the Plaintiff does not fall under the category of interest income, dividend income, real estate income or business income, it will be treated as miscellaneous income for the purposes of Article 35 of the Income Tax Law.

It is reported that a similar judgment was issued on August 14, 2006 by the TRTT, though details of the ruling have not yet been disclosed.

You have a vision. PricewaterhouseCoopers helps bring that vision to reality. We hope you enjoy the current issue of Japan Tax Update and appreciate your comments or ideas for what you'd like to see covered in future issues.

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