

Financial Services Tax News

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PwC Japan Tax Newsletter

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Release of Guideline for applying PE determination and 25/5 Rule for foreign investment in certain partnerships

As reported in our Newsletter in April 2009, the 2009 Tax Reform introduced provisions that provide a safe harbor rule to allow foreign investors to invest in certain partnerships without creating a permanent establishment ("PE"), and liberalized the application of the so-called "25/5 Rule" for certain transactions.

While it was determined in the 2009 Tax Reform that a foreign partner in certain partnership must not be involved in the management or operation of the partnership to apply the above new rule, the Ministry of Economy, Trade and Industry ("METI") published guidelines ("Guideline") in July 2009 on its website to clarify what kind of activity is deemed to be involved in the management or operation of the partnership. The Guideline issued by METI was reviewed by the National Tax Agency.

This Newsletter provides a summary of the above Guideline.

Background summary of PE determination and 25/5 Rule introduced in 2009 Tax Reform

The 2009 Tax Reform introduced a relieving provision that a foreign individual or corporate partner (“Foreign Partner”) may invest in a Japanese investment business limited partnership (*toushi jigyou yugen sekinin kumiai*, or “IBLP”) or other foreign partnership fund similar to an IBLP (“Foreign Limited Partnership”) without creating a direct PE in Japan on account of such investment provided certain requirements are met. These conditions are:

- (A) The Foreign Partner has limited liability with respect to the IBLP or Foreign Limited Partnership;
- (B) The Foreign Partner is not involved in the management or operation of the IBLP or Foreign Limited Partnership;
- (C) The Foreign Partner’s investment ratio in the IBLP or Foreign Limited Partnership is less than 25%;
- (D) The Foreign Partner is not specially related to the general partner of the IBLP or Foreign Limited Partnership; and
- (E) The Foreign Partner does not otherwise have a PE in Japan.

The 2009 Tax Reform also introduced a provision that the application of 25/5 rule, where gains realized by a foreign partner from the sale of shares in a Japanese corporation are subject to tax if the foreign partner (together with specially related persons) sells 5% or more of the shares in such corporation during a fiscal year and such foreign investor (together with specially related persons) owned or has owned 25% or more of the shares in such company at any time during a specified lookback period, is tested not at the partnership level but at the Foreign Partner level, provided that a Foreign Partner in an IBLP or a Foreign Limited Partnership meets conditions (A) to (E) above or a Foreign Partner in a Foreign Limited Partnership having no PE in Japan meets conditions (A), (B) and certain other conditions.

A Cabinet Order stipulated that the management or operation of the IBLP or Foreign Limited Partnership in condition (B) includes decision of the management or operation, approval or consent of the management or operation (including approval or consent of its decision) and other activities similar to approval or consent (collectively, “Management or Operation for Tax Purposes”).

Summary of the Guideline

The Guideline published in July 2009 classifies activities by a Foreign Partner who has limited liability (“LP”) with respect to an IBLP or a Foreign Limited Partnership into three categories as described below, and provides further details on what kind of activities by an LP is treated as Management or Operation for Tax Purposes.

- (1) LP’s act which is irrelevant to management or operation

Exercise of LP’s fundamental rights as a partner, supervision of management or operation or exercise of LP’s own economic rights is not treated as Management or Operation for Tax Purposes.

- (2) LP’s act which is not management or operation itself but is relevant to management or operation

- Approval or consent on the management or operation (including its decision) and other similar activities (“Approval”) to the General Partner (“GP”) in the IBLP or Foreign Limited Partnership in advance in order to implement a specific investment project, where such implementation is within the GP’s authority, is treated as Management or Operation for Tax Purposes.
- Approval to the GP in order to implement a specific investment project, where it is necessary for the GP to obtain the Approval prior to implementation (e.g., where an investment guideline determines that it is necessary for GP to obtain certain LPs’ approval to invest more than certain amount), is treated as Management or Operation for Tax Purposes.
- Approval for GP to carry out a transaction (except such transactions that are outside the scope of the business of the IBLP or Foreign Limited Partnership) which could cause a conflict of interest between GP and LP, where it is necessary for the GP to obtain the LP’s approval, is treated as Management or Operation for Tax Purposes. However, having the GP explain or report in advance regarding a

transaction which could cause a conflict of interest or making advice or objection (except where the advice or objection is substantial) regarding the transaction is not treated as Management or Operation for Tax Purposes.

- Approval of changes in the scope of the authority of the GP, such as the ceiling on the investment amount or the scope of assets to be invested in, is not treated as Management or Operation for Tax Purposes. However, where the approval is substantially regarded as the Approval of management or operation of a specific investment project, such Approval is treated as Management or Operation for Tax Purposes.
- Advice to GP in connection with a specific investment project is not treated as Management or Operation for Tax Purposes unless such advice binds the GP's management or operation. However, where the advice substantially binds the GP's management or operation, such advice is treated as Management or Operation for Tax Purposes.

(3) LP's act which is management or operation itself

Management or operation itself, such as a negotiation with a company to be invested in, an investment decision, or a sale of an investment, is treated as Management or Operation for Tax Purposes.

Where the IBLP or Foreign Limited Partnership has an advisory board which is set up to advise the GP on management or operation of partnership businesses, the advice made by the advisory board is not treated as Management or Operation for Tax Purposes for each LP on the advisory board, except where the advice is deemed as Management or Operation for Tax Purposes.

Accordingly, in order to ensure that the LP's activities are not treated as Management or Operation for Tax Purposes, the role and the activities of the LPs in an IBLP or Foreign Limited Partnership seeking to take advantage of the exemptions introduced by the 2009 Tax Reform should carefully be examined and considered.

For more detailed information, please do not hesitate to contact your financial tax services representative or any of the following members:

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