

Financial Services Tax News

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2009 Japanese Tax Reforms approved – Changes to the application of the 25/5 Rule and PE determinations for foreign investment into certain partnerships

On March 27, 2009, the 2009 Tax Reform Proposal was approved by the Diet (“2009 Tax Law”). The 2009 Tax Law includes certain amendments that may significantly affect the taxation of foreign private equity and other investment funds investing in Japan. The new law applies to transactions which take place on or after April 1, 2009 (“2009 Tax Law”). On March 31, 2009, Cabinet Orders and Enforcement Orders were published, which provide greater detail on the practical application of these rules.

As expected, the 2009 Tax Law introduced provisions that liberalize the application of the 25/5 Rule (as defined below) for certain transactions, and provides a safe harbor rule to allow foreign investors to directly invest in certain Japanese domestic partnerships without creating a permanent establishment (“PE”).

This Newsletter provides a summary of the above changes and highlights certain aspects in respect of the practical application of these rules that remain subject to further confirmation.

Application of the 25/5 Rule to certain foreign partners

Under Japanese tax law, gains realised by a foreign partner 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") 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 of such corporation during a fiscal year and such foreign partner (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 ("25/5 Rule"). The 2009 Tax Law does not liberalize the taxation of transactions involving the transfer of shares in a real estate holding company.

Under rules introduced as part of the 2005 tax reforms, the interests of foreign partners in a limited partnership were aggregated under the concept of "specially related persons" for purposes of testing the 25/5 Rule. However, the 2009 Tax Law effectively "rolls back" the changes implemented in 2005 by testing the application of the 25/5 Rule at the foreign partner level for transactions where (1) a 1-year holding period criteria is met; and (2) the transaction does not involve a shareholding in certain distressed financial institutions ("Covered Transaction").

For a Covered Transaction involving an IBLP, the foreign partner must:

- A. Have limited liability with respect to the IBLP;
- B. Not be involved in the management or operation of the IBLP;
- C. Together with specially related partners, have an investment ratio in the IBLP that is less than 25%;
- D. Not be specially related to the general partner of the IBLP; and
- E. Not otherwise have a PE in Japan.

For a Covered Transaction involving a Foreign Limited Partnership, the foreign partner must:

- A. Have limited liability with respect to the Foreign Limited Partnership;
- B. Not be involved in the management or operation of the Foreign Limited Partnership.
- C. Not own, together with specially related shareholders, 25% or more of the shares of the corporation sold at any time during a specified lookback period; and
- D. Not otherwise have a PE in Japan.

To claim benefits under this new rule, however, the Cabinet Orders and Enforcement Orders require the foreign partner file certain documentation. The scope of information required by the Cabinet Orders and Enforcement Orders may make it practically difficult, in some circumstances, for certain foreign partners to claim the exemption.

Foreign investment in certain Japanese partnerships (PE determination)

Under previous rules, foreign partners investing in an IBLP had a risk of a PE in Japan arising from the joint operation of the partnership business. Under 2009 Tax Law, a foreign partner may invest in an IBLP without risk of a PE in Japan on account of such investment provided certain requirements are met. These requirements are similar to those for foreign partners in an IBLP as outlined above.

Similar to the 25/5 Rule exemption, certain documentation requirements were included in the Cabinet Orders and Enforcement Orders, including the requirement for the foreign partner to provide a residency certificate with the filing. As noted above these documentation requirements may make it practically difficult, in some circumstances, for certain foreign partners to claim the exemption.

We understand that further discussions between the Ministry of Finance, the Ministry of Economy, Trade and Industry and the Japanese tax authorities are likely to occur in relation to the application of these rules, with further details expected to be released later this year.

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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