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Recent Tax Reporting Involving Kumiai Taxation

The Tokyo District Court has ruled in favor of the taxpayer in a case regarding the reclassification of income distributed in accordance with a Tokumei Kumiai (TK) agreement (a silent partnership established under the Japanese Commercial Code) entered into with its Japanese affiliate.

Dutch company vs. Tokyo Regional Tax Bureau

On September 30, 2005, the Tokyo District Court (“TDC”) reversed a judgment of the Tokyo District Tribunal (“TDT”) on June 30, 2003, invalidating the assessment of tax issued by the Tokyo Regional Tax Bureau (“TRTB”) to the taxpayer, a Dutch company. According to some sources, the TRTB brought this case to the upper court.

Facts

The plaintiff, was assigned its interest in the Tokumei Kumiai (“TK”) agreement (the “Agreement”) with its Japanese affiliate (the “Operator”) by the plaintiff’s Dutch parent. Under the Agreement, the plaintiff received annual profit distributions from the TK of approximately JPY 1 billion, equivalent to 90% of the income derived from business activities conducted by the Operator in Japan under the Agreement. The plaintiff’s position was that income distributed to it was dealt with by Article 23 of the income tax convention between Japan and the Netherlands (the “Tax Treaty”), the so-called “other income” article, and was therefore exempt from Japanese taxation. The TRTB held that the income distributed to the plaintiff was not earned through the TK arrangement but rather, was business income¹ earned through a joint business (partnership) with the Operator and assessed tax and penalties to the plaintiff on this basis. The plaintiff filed an objection with the administrative agency requesting annulment of the action concerned.

¹ Pursuant to Article 5 of the Tax Treaty, business income is subject to the Japanese taxation if a Dutch resident has a permanent establishment (the “PE”) in Japan and the income is attributable to the PE.

Judgment by the TDT

In its judgment issued on June 30, 2003, the TDR rejected the claim by the plaintiff, holding that (1) from a legal perspective, the Agreement should be classified as a Nin-i Kumiai (partnership under the Japanese Civil Code) agreement rather than a TK agreement², (2) since the Nin-i Kumiai (“NK”) is considered a joint business partnership between the plaintiff and its Japanese Affiliate, the office of the latter that is co-owned by the plaintiff and its Japanese Affiliate constitutes a PE of the plaintiff in Japan, and (3) accordingly, income distributed by the Japanese Affiliate pursuant to the Agreement should be deemed as business income of the plaintiff and subject to taxation in Japan.

Judgment by the TDC

On September 30, 2005, the TDC reversed the Judgment of the TDT and invalidated the assessment of the TRTB. The relevant issue was whether the Agreement should be classified as either a TK agreement or a NK argument from a legal perspective. The court concluded that the Agreement should be considered a TK agreement from a legal perspective by taking into consideration the contents of the Agreement and the intention of the parties (the Japanese Affiliate, the plaintiff and its Dutch parent) who entered into the Agreement.

The court also held that the tax authorities are not empowered to reclassify a TK agreement into another form of agreement or invalidate the TK agreement (even if the agreement was concluded with the purpose to reduce the tax liabilities of the parties concerned) unless the tax code prescribes provisions to allow the tax authorities to do so. As far as it is a true intention of the parties to enter into a TK agreement, and in the absence of a statutory basis to invalidate or reclassify the agreement which is legally existing between the parties, the tax authorities are unable to assess tax by disregarding the legal form solely because the tax saving is among the elements for the taxpayers to enter into the arrangement.

² Three reasons were provided as a basis for reclassifying the Agreement as a NK agreement:

- i. The TK investor (the plaintiff) and the TK Operator are group companies.
- ii. The TK investor and the Operator have similar commercial names. For a third party conducting transactions with the Operator, this would give an impression that the TK investor is also engaged in the TK business, which is inconsistent with a TK arrangement under which the TK investor remains anonymous.
- iii. Pursuant to the Agreement, the Operator was required to separately record the profit and loss of the TK Business from its non-TK business. In the present case, the Operator commingled the profit and loss of the TK business with that of its non-TK business.

The Nagoya High Court upheld for the tax payers in the “air craft leasing” case, and the tax authorities decided to annulled the assessment

On October 27, 2005, the Nagoya High Court (“NHC”) rejected an appeal by the Tax Authorities (the Nagoya Regional Tax Bureau (“NRTB”)) against a decision given by the Nagoya District Court (“NDC”) on October 28, 2004. In that decision, the NDC held that investment losses distributed pursuant to a NK agreement should be deductible from other categories of income in the individual taxpayers’ income tax returns and disallowed the assessments issued by the NRTB. The NRTB has decided not to pursue any further appeal with the Supreme Court and based on newspaper reports, the National Tax Administrative Agency³ (the “NTA”) has decided to annul the tax assessments issued to the taxpayers and refund the tax and penalties collected (estimated to be around 5 billion yen).

Facts

The individual investors formed a NK which purchased an aircraft with non-recourse financing and leased the aircraft to a foreign airline. Under Japanese tax law, each NK member recognizes its allocable share of the income or loss of the NK business and reports its allocable share in its income tax return. For Japanese income tax purposes, income/loss from aircraft leasing is classified as real estate income which can be offset against other income. For the 1999 fiscal year, the individual investors deducted losses from the NK business against other income. (It should be noted that following amendments made in the 2005 tax reform, such losses are now disregarded for individual investors in a NK for the 2005 and subsequent fiscal years.) The NRTB disallowed the deductions on the basis that the NK agreement (the “Agreement”) should be reclassified as a “profit distribution agreement” from a legal perspective, taking into account the contents of the Agreement and the intention of the investors. Accordingly, the distributed losses to the investors should be classified as miscellaneous losses which cannot be offset against other income for individual income tax purposes.

Judgment by NDC

In its judgment issued on October 28, 2004, the NDC concluded that the Agreement should be considered a valid NK agreement from a legal perspective by taking into consideration the contents of the Agreement and the intention of the individuals who entered into the Agreement and therefore, the assessments of tax were not legal.

³ The NRTB is one of the regional bureaus of the NTA

The NDC also held that (1) taxpayers have a choice of a legal form to achieve certain economic benefits, (2) however, the validity of the legal form elected may be arguable from the view point of tax avoidance if the legal form is rarely adopted or the use of the legal form is not reasonable, and (3) the Tax Authorities are only empowered to invalidate the legal form of an agreement if a statutory basis exists in the tax code. With respect to the validity of the legal form, the NDC held that the Tax Authorities are not empowered to deem the intention of taxpayers differently from the legal form which was actually selected in the transaction solely because tax liabilities are reduced by the selected legal form compared to that resulting from other legal forms.

Judgment by NHC

With regard to the judgment by the NDC, the Tax Authorities argued that the substance over form approach should be applied in determining the appropriate tax treatment of the arrangement. The NHC rejected this argument and held that a tax assessment based solely on the taxpayer's tax motivations in the transaction, and therefore, disregarding the legal form, is illegal.

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