



Financial Services Tax News

Financial Services Tax Group

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**PricewaterhouseCoopers
(Zeirishi-Hojin ChuoAoyama)
Financial Services**

**Kasumigaseki Bldg., 15F
2-5 Kasumigaseki 3-chome
Chiyoda-ku, Tokyo 100-6015
Telephone: 81-3-5251-2400
<http://www.pwc.com/jp/tax>**

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Japan's 2005 Proposed Tax Reforms

On January 17, the Cabinet approved the 2005 proposed tax reforms. Recent newspaper articles on these reforms and their effect on offshore investors, have sent alarm bells ringing throughout the financial services industry. This newsletter hopes to clarify some of the details of the proposed reforms and their application to this industry.

The interpretive regulations of these proposed changes have not yet been released, thus the specifics of the legislation and the application to offshore investors will have to be determined more precisely on its release.

Included in this issue are the following proposed changes which may be of particular importance to the financial services industry:

1. **Taxation of capital gains on disposal of shares in a Japanese company**
2. **Withholding tax of 20% for partnerships conducting business in Japan**
3. **Utilisation of partnership losses**
4. **Capital gains from disposal of certain real estate interests.**

1. Taxation of capital gains on disposal of shares in a Japanese company

Japan's domestic law currently provides that non-residents without a permanent establishment in Japan are not subject to capital gains tax for the sale of shares in Japanese companies, unless:

A non-resident (and special related persons, as defined) sell 5% or more of the shares in a Japanese company;
and

The non-resident (and special related persons), owns or has owned at any time during the fiscal year of sale and the prior two years, 25% or more of the shares in such company.

The proposed tax reforms seek to expand this exception. Where an offshore investor owns shares through a partnership, or similar vehicle, the shareholding test is determined at the investor level, not at the vehicle level. Under the proposed changes, where the investment in Japanese shares is made through a Japanese nin-i kumiai ("NK"), or any domestic or foreign vehicle similar to an NK, the definition of the term "special related persons" shall include all of the partners or members in the NK or similar vehicle. Thus, under the proposed changes, the shareholding test will be determined at the vehicle level rather than at the investor level.

PwC Comment

The impact of this reform for offshore investors is that if the partnership or similar vehicle purchases 25% or more of the shares in a Japanese corporation, each nonresident investor in the Fund is deemed to have owned, for the purposes of this rule, 25% or more of the shares. Accordingly, the investor may be subject to tax on the sale of those shares even if they do not have a permanent establishment in Japan. Currently, the tax rates for nonresident corporate investors without a permanent establishment is 30% and for individuals is the normal progressive marginal rates.

2. Withholding tax of 20% for partnerships conducting business in Japan

Under current law, a profit distribution from an NK or similar vehicle to a nonresident partner is not subject to withholding tax. Rather, a nonresident partner that has taxable Japan source income is required to file a Japanese tax return to report the income received.

Pursuant to the proposed changes, when nonresident individual or corporate partners in NK or similar vehicles receive an allocation of profit derived from business conducted in Japan, the allocation is subject to 20% withholding tax.

The withholding tax would be imposed on the earlier of (i) the profit distribution; or (ii) the date two months after the last day of the calculation period.

PwC Comment

This proposed legislation applies only to NK's or similar vehicles "carrying out a business in Japan." Although this term has not yet been defined, the term is likely to mean that the NK or similar vehicle has a fixed place of business in Japan or an agent in Japan that gives rise to a permanent establishment. This is supported by comments from Ministry of Finance officials who have said this is not a new tax but a means of collecting tax from those that should have been filing a tax return but have failed to do so. It is currently unclear who will have the withholding tax obligation and how it is expected to be enforced.

3. Utilisation of partnership losses

Under this proposed reform, certain individual and corporate investors in a NK or similar domestic or foreign vehicle, may be prevented from utilizing losses from the partnership against their other

Japanese income. This proposed reform applies to:

Individual partners of NK or similar vehicle with rental real property activity

For individual partners of a NK or any domestic or foreign vehicle similar to an NK, where losses were incurred from “rental real property activity”, such losses are to be disregarded for Japanese tax purposes for the individual partners. Rental real property activity includes not only rental business from real property but also leasing ships and aircraft.

This will not apply to individual partners who actively partake in the decision making of the partnership and in its operations.

Corporate partners of an NK or similar domestic vehicle such as a tokumei kumiai, or foreign vehicle, without substantial risk

- (a) If the NK or similar vehicle’s liability is substantially limited to the value of the NK or similar vehicle’s assets, the corporate partner’s share of the losses of the NK or similar vehicle which exceeds the equity contributed by that corporate partner, are not deductible by the corporate partner.
- (b) If it is clear that the NK or similar vehicle’s business will not be in a loss position due to the existence of a profit guarantee contract or other similar arrangement that guarantees the income of the NK or similar vehicles business, the corporate partner cannot deduct any of the NK or similar vehicle losses attributable to the corporate partner.

This will not apply to corporate partners who actively partake in the decision making of the partnership and in its operations.

PwC Comment

For individual partners, this proposal is aimed to prevent individuals from utilizing partnership tax losses against other categories of personal income, and will be determined on a case by case basis. It derives from recent cases where it was held that the losses could not be used to offset other categories of income if they were not involved in the activities of the partnership. The same rationale applies to the corporate partners although the determination is not by the kind of income derived by the partnership but rather by the risk adopted by the corporate partner.

4. Capital gains from disposal of certain real estate interests

It has been proposed that capital gains derived by nonresidents from investments in certain companies and trusts that predominantly own real estate may be subject to Japanese taxation, regardless of the shareholding ratio. Capital gains earned from the following would be subject to the proposed changes:

- Shares in a company where 50% or more of the company’s total assets consist of real estate in Japan; or
- Beneficiary rights in a specified trust where 50% or more of the total deposited assets consist of real estate in Japan.

PwC Comment

This proposed change will affect Funds that invest in companies and trusts that predominantly own

Japanese real estate. However if the Fund itself or the investors in the Fund (provided the Fund is pass through) and are resident of a country that has a tax treaty with Japan, provided that tax treaty provides capital gains tax protection on the sale of shares in Japanese companies, this change should not have an impact.

Effective date of 2005 Proposed Reforms

If passed, the effective date of the above proposed changes is expected to be as follows:

Proposed Changes	Effective Date
1. Taxation of capital gains on disposal of shares in a Japanese company	Years beginning January 1, 2006 for nonresident individuals and for fiscal periods beginning on and after April 1, 2005 for non-resident corporations.
2. Withholding tax of 20% for partnerships conducting business in Japan	Calculation periods beginning on or after April 1, 2005.
3. Utilisation of partnership losses	For individual partners, applies from 2006 for national income tax purposes and from 2007 for inhabitants tax purposes. For corporate partners, applies to partnership contracts entered into on or after April 1, 2005.
4. Capital gains from disposal of certain real estate interests.	For non-resident individuals from 2006 and for nonresident corporations, from fiscal years beginning on or after April 1, 2005.

For further information, please contact:

Partner	Sachihiko Fujimoto	81-3-5251-2423	sachihiko.fujimoto@jp.pwc.com
	Katsuyo Oishi	81-3-5251-2565	katsuyo.oishi@jp.pwc.com
	Yuka Matsuda	81-3-5251-2556	yuka.matsuda@jp.pwc.com
	Tetsuo Iimura	81-3-5251-2834	tetsuo.iimura@jp.pwc.com
	Akemi Kitou	81-3-5251-2461	akemi.kitou@jp.pwc.com
	Raymond Kahn	81-3-5251-2909	raymond.a.kahn@jp.pwc.com
Director	Stuart Porter	81-3-5251-2944	stuart.porter@jp.pwc.com
Senior Manager	Hiroshi Takagi	81-3-5251-2788	hiroshi.takagi@jp.pwc.com
Manager	Kimihito Takano	81-3-5251-2698	kimihito.takano@jp.pwc.com
	Hiroko Suzuki	81-3-5251-2156	hiroko.suzuki@jp.pwc.com
	Shunji Suzuki	81-3-5251-2483	shunji.suzuki@jp.pwc.com
	Kenji Nakamura	81-3-5251-2589	kenji.nakamura@jp.pwc.com
	Yoko Kawasaki	81-3-5251-2450	yoko.kawasaki@jp.pwc.com
	Keiko Arai	81-3-5251-2771	keiko.arai@jp.pwc.com