



# Financial Services Tax News

Financial Services Tax Group

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## Japan 2005 Tax Reforms

The Japanese 2005 Tax Reforms were approved by the Diet on March 31, 2005. On the same date, the Cabinet and the Ministry of Finance issued amendments to the Enforcement Orders and Enforcement Rules of the relevant tax laws to effect the new reforms. The pertinent issues relating to the taxation of *kumiai*'s or partnerships for the financial services industry are summarized as follows.

The tax reform makes it easier to tax investment funds that own 25% or more of a Japanese corporation and investors in real estate holding corporations. The new law also imposes withholding tax on fund distributions in certain circumstances and limits the deduction of passive losses.

### 1. Taxation of capital gains on transfer of shares in a Japanese corporation

When a non-resident individual or a foreign corporation without a permanent establishment ("PE") invests in shares of Japanese corporations through (a) *nin-i kumiai* established under the Japanese Civil Code ("NK"); (b) investment limited partnerships established under the Limited Partnership Act for Investment ("Japanese LP"); (c) limited liability partnerships established under the Limited Liability Partnerships Act ("Japanese LLP"); or (d) similar vehicles established in foreign countries (collectively referred to as "Vehicle"), taxation on capital gains may be imposed on the sale of such shares if the following conditions are met:

- (i) The non-resident investor (and special related persons and Vehicles in which the investor holds an interest), owns or has owned at any time during the fiscal year of sale (or calendar year in case of individual investor) and the prior two years, 25% or more of the shares in the Japanese corporation; and

- (ii) The non-resident investor (and special related persons and Vehicles in which the investor holds an interest), sells 5% or more of the shares in the Japanese corporation in the fiscal year of sale (calendar years for individual investors).

If a non-resident individual or a foreign corporation owns shares in a Japanese corporation through a Vehicle, the above conditions (i) and (ii) are calculated at the Vehicle level, not by the number of shares corresponding to each investor's (beneficial or legal) interest in the Vehicle, as was previously the case.

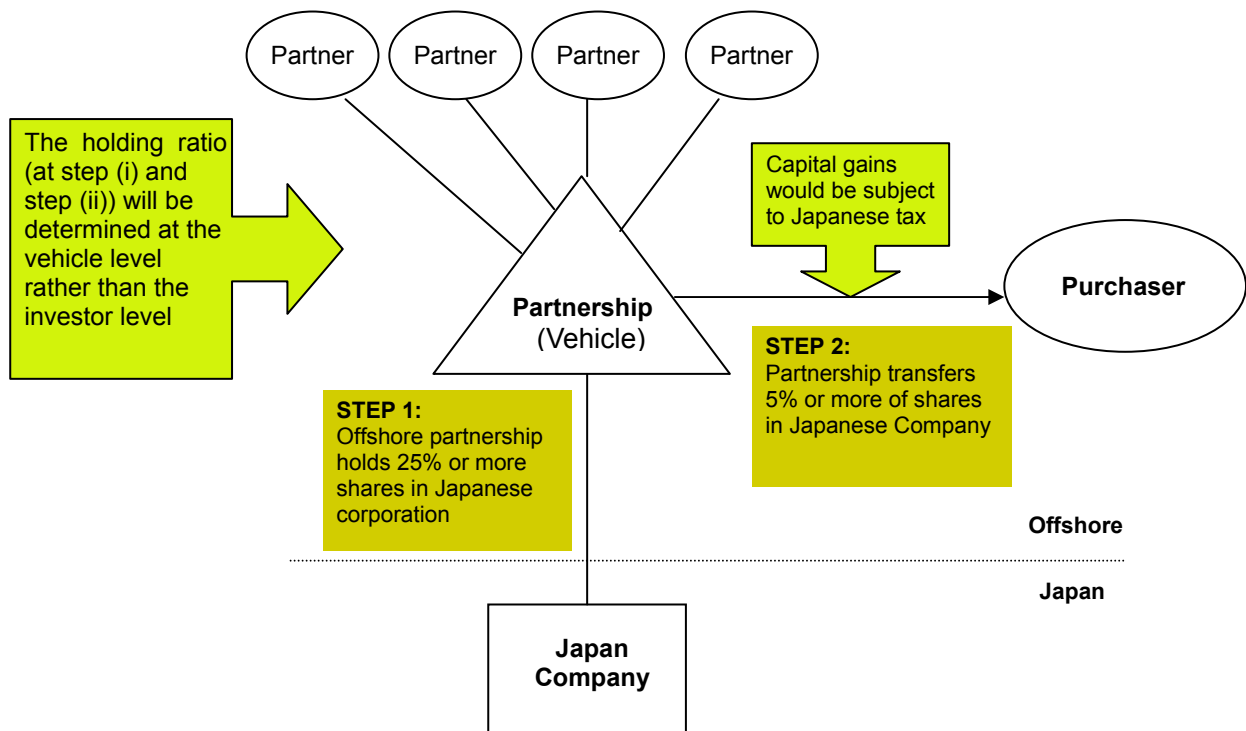
The new legislation also applies to Vehicles investing in other Vehicles.

There are cases where a return of capital or other transactions by the Japanese corporation may be deemed to be a sale of shares by the non-resident investors and may be subject to the above taxation.

If the transfer of shares by the non-resident individual or the foreign corporation without a PE meets conditions (i) and (ii) above, the investors will be required to file a Japanese tax return. Individual investors will be subject to tax on their capital gains at the rate of 15% and foreign corporations without a PE will be subject to tax at the rate of 30%.

If the investors in the Vehicle (provided the Vehicle is "pass through" for Japanese tax purposes) are resident in a country that has a double tax treaty ("treaty") with Japan, and that treaty exempts from Japanese taxation capital gains from the sale of shares, the treaty may protect investors in the vehicle.

**Diagram1**

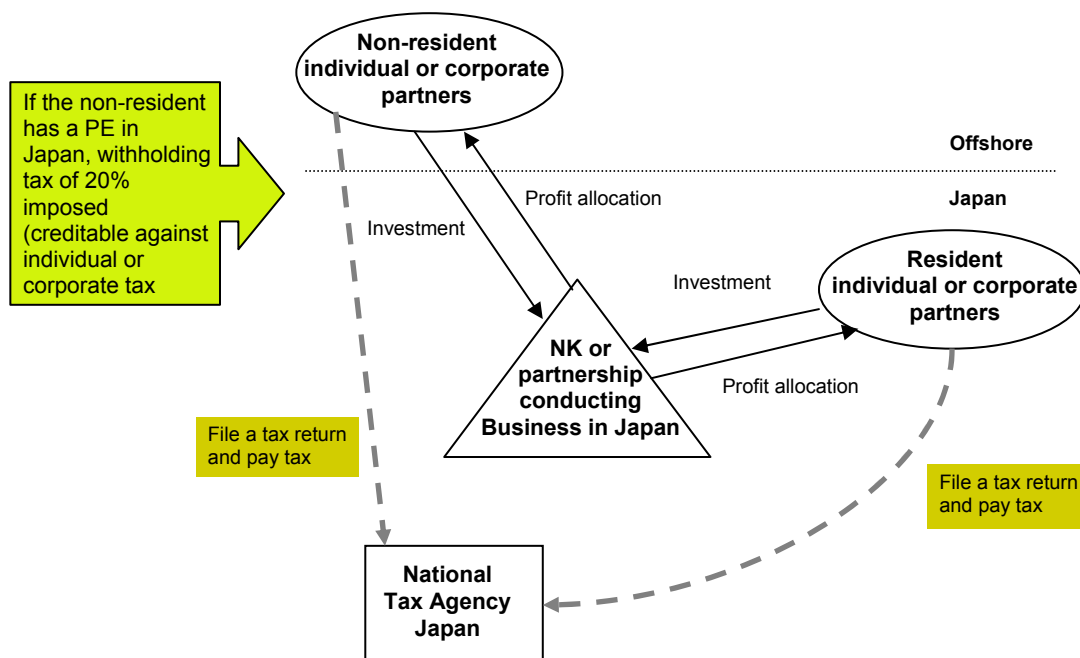


## 2. Withholding tax of 20% on distributions from partnerships conducting business in Japan

When a non-resident individual or corporate investor invests in a Vehicle and receives profit distributions, the distribution is subject to 20% withholding tax if the Vehicle is deemed to create a PE for the non-resident by carrying on business in Japan on their behalf. The withholding tax is creditable against the individual or corporate tax liabilities when the investors file their Japanese tax returns.

The distributions will not be subject to withholding tax if the non-resident individual or corporate investor does not have a PE in Japan. The withholding tax obligation will basically be a joint liability of the partners of the Vehicle.

Diagram 2



## 3. Utilization of kumiai losses

- (i) Individual partners of an NK or similar vehicle with rental income from real estate

If an individual partner of an (i) NK (including similar vehicles established in foreign countries); (ii) Japanese LP (including similar vehicles established in foreign countries); or (iii) a vehicle similar to a Japanese LLP established in foreign countries (collectively referred to as “NK Vehicle”), incurs losses from “rental real property activities”, such losses are to be disregarded for Japanese tax purposes for the individual partners. Rental real property activities include rental income from real estate and the leasing of ships and aircrafts.

This restriction will not apply to certain individual partners who actively participate in all the decision making and all the negotiations of the NK vehicle.

(ii) Corporate partners of an NK, tokumei kumiai or similar vehicles

If a corporate partner of an NK Vehicle or a *tokumei kumiai* and other similar *tokumei kumiai* vehicles established in Japan and foreign countries (“TK”) incurs losses from its investment in the NK Vehicle or TK, the portion of the losses exceeding the equity interest of the corporate partner will not be deductible if the NK Vehicle or TK’s liability is substantially limited to the value of the assets of the NK Vehicle or TK. However, these non-deductible losses may be netted against income from the NK Vehicle or TK’s business in subsequent years provided a schedule of the calculation is attached to the corporate tax return.

Similarly, if it is clear that the business of the NK vehicle or TK will not be in a loss position due to the existence of certain agreements in connection with the liability of the NK vehicle or TK, such as a profit guarantee contract or other similar arrangements, the corporate partner cannot deduct any of the attributable losses of the NK vehicle or TK.

This reform will not apply to certain corporate partners who actively participate in the decision making of the NK Vehicle or TK or who conduct business of the same kind as the business of the NK Vehicle as their main business.

For Japanese LLPs, there are also restrictions on the utilization of losses for individual and corporate partners, however these rules differ slightly.

#### **4. Capital gains from the disposal of certain real estate interests**

Capital gains derived by non-resident individuals or foreign corporations from the transfer of shares in a corporation and the transfer of beneficiary interests in a specified trust that predominantly hold real estate in Japan are subject to Japanese taxation if non-resident investor (and special related persons and Vehicles in which the investor holds an interest), owned more than 5% of the shares in a public corporation/beneficiary interests in a specified trust that holds real estate (2% if the corporation / specified trust is not listed) at the prior fiscal year-end (for an individual investor, December 31 of the prior year) in which the shares/beneficial interests are transferred.

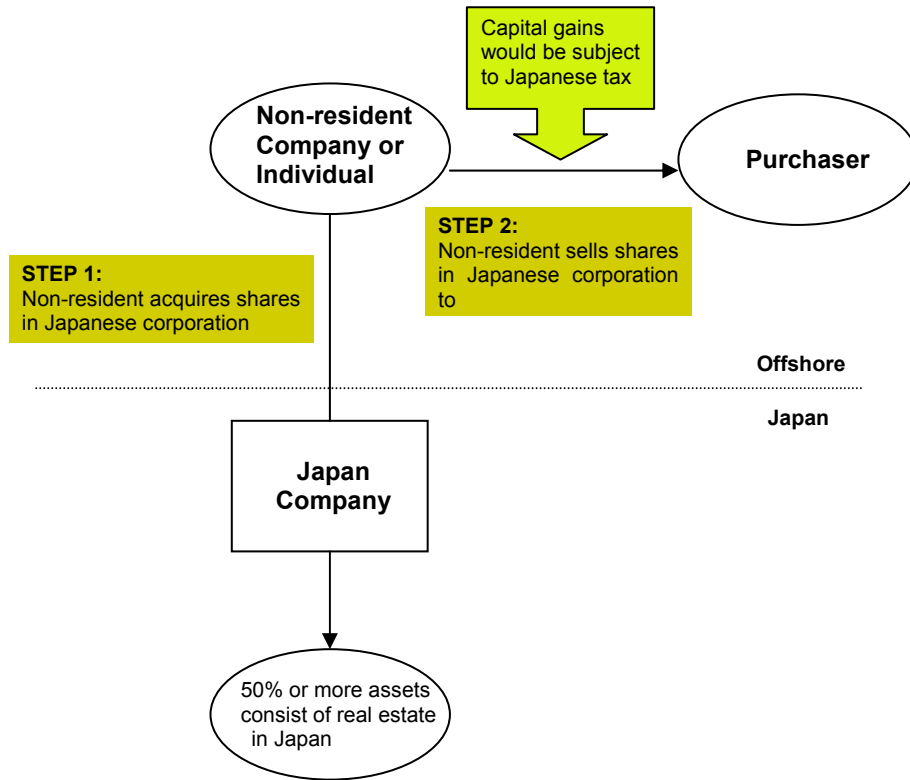
A corporation or a specified trust will be treated as holding real estate if 50% or more of the assets of the corporation or the specified trust consist of real estate in Japan, such as land and buildings and shares in other corporations or specified trusts that hold real estate. In order to determine whether or not 50% or more of the total assets consist of real estate, the fair market value of the real estate is used.

If a non-resident individual or a foreign corporation owns shares in the corporation or the specified trust through a Vehicle, the above holding ratio is calculated by the number of shares held by the Vehicle, not by the number of shares corresponding to each investor’s interest in the Vehicle (as in Diagram 1 above).

If the non-resident individual or foreign corporation without a PE meets the requirements above, the individual investor will be subject to tax at the rate of 15% and the foreign corporation will be subject to corporation tax at the rate of 30%.

If the investors in the Vehicle (provided the Vehicle is “pass through” for Japanese tax purposes) are resident in a country that has a double tax treaty (“treaty”) with Japan, and that treaty exempts from Japanese taxation capital gains from the sale of shares or beneficial interests in specified trusts, the treaty may protect investors in the vehicle.

Diagram 3



## 5. Effective dates

The above changes apply from the following dates.

Changes	Effective Date
1. Taxation of capital gains on transfer of shares in a Japanese corporation	Years beginning January 1, 2006 for non-resident individuals and for fiscal periods beginning on and after April 1, 2005 for non-resident corporations
2. Withholding tax of 20% for Vehicles conducting business in Japan	Calculation periods beginning on or after April 1, 2005.
3. Utilization of kumiai losses	For individual partners, applies from 2006 for national income tax purposes. For corporate partners, applies to kumiai contracts entered into or inherited on or after April 1, 2005. (April 1, 2007 if the rental income of aircrafts used for air transportation services.)
4. Capital gains from transfer of certain interests holding Japanese real estate	For non-resident individuals from 2006 and for non-resident corporations, from fiscal years beginning on or after April 1, 2005.

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