



# Financial Services Tax News

Financial Services Tax Group

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## IRS Rules Special YK are Eligible Entities for U.S. Check-the-box Purposes

On December 19, 2005, in response to a request from a business coalition led by Raymond Kahn and Marc Lim of PricewaterhouseCoopers Tokyo and Alan Fischl from the PricewaterhouseCoopers' National Tax Service in Washington DC, the U.S. Internal Revenue Service ruled that *Yugen Kaisha* that become *Tokurei Yugen Kaisha* under the new corporate governance statutes likely to be effective from May 2006 will remain eligible entities for U.S. check-the-box purposes.

On July 26, 2005, the Japanese Diet promulgated a new set of corporate governance statutes to streamline the multiple corporate statutes in existence and establish a more flexible corporate and administrative governance structure: the Corporation Law and accompanying Coordination Law ("New Laws").

The New Laws repeal the *Yugen Kaisha* ("YK") corporate form, with YKs in existence at the time the New Laws become effective being converted into a type of *Kabushiki Kaisha* ("KK") called a *Tokurei Yugen Kaisha* ("Special YK").

Because Special YKs are a type of KK under the New Laws and KK are considered *per se* corporations ineligible to check the box and achieve flow-through tax treatment for US tax purposes, there was significant concern absent Internal Revenue Service guidance whether a YK's change in legal status to Special YK invalidated existing check-the-box elections made by these entities as well as destroyed their eligibility to check the box in the future.

Failure by the Internal Revenue Service to address this situation could have resulted in the automatic incorporation for US tax purposes of all Special YK, which could have triggered a significant tax cost to many US taxpayers operating in Japan.

After receiving a number of letters from the business community and meeting with a business coalition led by PricewaterhouseCoopers to discuss the coalition's position, the New Laws and their impact to US taxpayers in Japan, the IRS published Revenue Ruling 2006-3, which states that a YK that becomes a Special YK will continue to remain an eligible entity for U.S. tax purposes and the check-the-box rules. Links to Revenue Ruling 2006-3 can be found below.

**Text of Revenue Ruling 2006-3**

(Please see the attachment for "Revenue Ruling 2006-3")

**Link to Treasury Website:**

<http://www.treas.gov/press/releases/js3053.htm>

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Part 301

Section 7701 Definitions

26 CFR 301.7701-2: Business entities; definitions

Rev. Rul. 2006-3

ISSUE

Will a Japanese Yugen Kaisha business entity ("YK") that becomes a Japanese Tokurei Yugen Kaisha business entity ("TYK") pursuant to the Kaisha Ho, Law No. 86 of 2005 (Company Law) and the Seibi Ho, Law No. 87 of 2005 (the Law Concerning the Coordination, Etc., of Associated Laws in Connection with the Enforcement of the Companies Law) (Coordination Law), as promulgated on July 26, 2005, remain an eligible entity for purposes of § 301.7701-1 through 3 of the Procedure and Administration Regulations?

FACTS

On July 26, 2005, the Japanese Diet reorganized Japanese corporate law through the promulgation of the Company Law and the Coordination Law, which were passed on June 29, 2005. Pursuant to the Coordination Law, the YK will be abolished as a Japanese corporate entity. All YKs in existence as of the effective date of the

Coordination Law will continue as TYKs, a special type of Kabushiki Kaisha business entity ("KK") under the Company Law. The effective date of these laws will be determined by a Cabinet enforcement order; however, the provisions will be effective no later than January 26, 2007. After the effective date of the new laws, no new YKs or TYKs may be formed.

#### LAW AND ANALYSIS

Section 301.7701-2(a) defines the term "business entity" as any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded. However, § 301.7701-2(b)(8) provides that certain foreign business entities are always classified as corporations for federal tax purposes (per se corporations). Under § 301.7701-2(b)(8), a KK is a per se corporation. Further, a YK is an eligible entity, for which an entity classification election can be made under § 301.7701-3.

Based on the Company Law and Coordination Law promulgated on July 26, 2005, TYKs are not per se corporations described in § 301.7701-2(b)(8) and will be classified in the same manner as YKs were prior to the effective date of the new Japanese corporate law. Therefore, a YK that becomes a TYK will remain an eligible entity for purposes of § 301.7701-1 through 3.

**HOLDING**

A Japanese YK that becomes a Japanese TYK, pursuant to the Company Law and the Coordination Law, as promulgated on July 26, 2005, will remain an eligible entity for purposes of § 301.7701-1 through 3.

**DRAFTING INFORMATION**

The principal author of this revenue ruling is Ronald M. Gootzeit of the Office of Associate Chief Counsel (International). For further information regarding this revenue ruling, contact Ronald M. Gootzeit on (202) 622-3860 (not a toll-free call).