

Financial Services Tax News

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Proposed 2009 Japanese Tax Reforms – Changes to investment into certain partnerships and the 25/5 Rule

Today, the Liberal Democratic Party released its proposed 2009 Tax Reform package (“2009 Tax Reform Proposal”). Following the release of this proposal, it is anticipated that the Ministry of Finance will further summarize the proposal for the Cabinet’s approval, with such summary subsequently being modified into draft legislation for the Diet’s approval to amend existing Japanese tax laws.

As one part of the 2009 Tax Reform Proposal, certain amendments have been proposed that may significantly affect taxation of foreign private equity and other investment funds investing in Japan. These reforms in general follow similar reform efforts proposed by the Financial Service Agency and the Ministry of Economy, Trade and Industry as a joint effort to bring Japan’s taxation of foreign investment into domestic venture companies in line with international standards, revitalize domestic industries, and facilitate further foreign direct investment in Japan to stimulate the economy.

This Newsletter provides an initial summary of these proposed changes. It should be noted that the proposal is not law and may change upon further review and discussion.

Further details on the 2009 Tax Reform Package, including proposed changes to the taxation of financial and corporate securities, international taxation and taxation in relation to real estate will be provided next week in a separate Newsletter.

(1) Taxation in relation to foreign investment in certain Japanese partnerships (Determination of Direct PE)

Under existing Japanese tax rules, foreign investors investing in Japanese investment business limited partnerships (*toushi jigyou yugen sekinin kumiai*, or “IBLP”) may have a risk of a permanent establishment in Japan. Under the proposed changes, a foreign individual or corporate partner (“Foreign Partner”) may invest in IBLPs without risk of a direct permanent establishment (“PE”) in Japan on account of such investment provided certain requirements are met. These conditions include:

- (A) The Foreign Partner has limited liability with respect to the IBLP;
- (B) The Foreign Partner is not involved in the management or operation of the IBLP;
- (C) The Foreign Partner’s investment ratio in the IBLP is less than 25%;
- (D) The Foreign Partner is not specially related to the general partner of the IBLP; and
- (E) The Foreign Partner does not otherwise have a permanent establishment in Japan.

The above proposal will apply to determinations on or after April 1, 2009 in connection with whether a Foreign Partner will have a Direct PE in Japan in relation to an investment in such IBLP.

(2) Application of the 25/5 Rule to certain foreign partners

Under existing rules, gain from the sale of shares of a Japanese corporation is subject to tax, even where the Foreign Partner does not have a PE in Japan, 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) owns or has owned 25% or more of the shares in such company for a specified holding period. (“25/5 Rule”).

The 2009 Tax Reform Proposal liberalizes the 25/5 Rule for certain transactions where the sale is by a IBLP or other foreign partnership fund similar to an IBLP, assuming certain criteria is met. This reform proposes to cover 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.

If a transaction is a covered transaction, the 25% ownership threshold may be tested at the Foreign Partner level where the following conditions are met:

- (1) The Foreign Partner meets the criteria provided in (1) above; or
- (2) The Foreign Partner is in a partnership similar to an IBLP where (A) the Foreign Partner does not have a PE in Japan; (B) the Foreign Partner is a limited partner in the partnership; (C) the Foreign Partner does not own 25% or more of the shares of the corporation sold; and (D) the Foreign Partner is not involved in the management or operation of the partnership.

The above amendment is proposed to apply to the sale of shares on or after April 1, 2009.

It should be noted that the 2009 Tax Reform Proposal is silent with regard to the interplay of the above proposal and the existing rules on taxation of real estate holding companies.

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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