

# Japan Tax Update

Monthly tax update



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Included in this issue are the following articles:

1. **Japan-US Social Security Agreement**
2. **Japan-U.K Treaty**
3. **The Japanese LLP Act Enacted**

## 1. Japan-US Social Security Agreement

On February 19, 2004, the Japanese and U.S. legislatures signed the Agreement between the United States of America and Japan on Social Security ("Agreement"). The Japanese and U.S. legislatures exchanged Official Notes on July 27, 2005 such that the Agreement will enter into force on October 1, 2005.

The Agreement has two primary objectives. First, it provides for the elimination of double social security taxation. Second, the Agreement allows for the combination of work coverage periods under both the Japanese and U.S. systems in determining the eligibility for pension and other benefits (i.e. totalized benefits). The periods of coverage to obtain benefits are 40 quarters for the U.S. and 25 years for Japan.

For example, if an employee participated in the Japanese system for 20 years, he/she would not be eligible to receive Japanese social insurance benefits since the Japanese social insurance system requires 25 years participation. However, if the employee also participated in the U.S. social security system for 7 years, he/she would be permitted to receive benefits under both the Japanese and U.S. systems.

In addition, the Agreement provides that where an employee who is covered by the social security laws of his/her home country and is normally employed in the home country by an employer that has a place of business in the home country is sent by the home country employer to work in the host country, and the assignment is not expected to exceed five years, the employee will be exempted from enrolling in the host country's social insurance system.

If the employee expects to stay in the host country for more than five years, the employee can apply for a further extension of the exemption.

Similar provisions apply to self-employed persons.

## **2. Japan-U.K Treaty**

The Japanese and United Kingdom governments have reached an agreement in principle on the text of a new income tax treaty to replace their existing bilateral treaty. The two governments are now moving forward to finalize the treaty for signature.

The proposed new treaty is a complete modernization of the existing treaty, which is over 30 years old. The new agreement reflects a desire to promote investment between the two countries. Most significantly, the proposed treaty provides for substantial reductions in the withholding taxes imposed on cross-border dividends, interest, and royalties, including the complete elimination of source-country withholding taxes on royalties and certain interest and intercompany dividend payments. The new agreement also incorporates modern rules to ensure that the benefits of the treaty are enjoyed as intended by the businesses and residents of the two countries and to prevent improper exploitation of the treaty, and to ensure taxation of investment income earned in Japan via tokumei kumiai (TK) structures. Similar provisions were incorporated in the new Japan-US income tax treaty.

## **3. The Japanese LLP Act Enacted**

On July 29, 2005 the Ministerial Ordinance of the Limited Liability Partnership (“LLP”) Act was promulgated and enacted with the LLP Act on August 1, 2005. At present, it is uncertain whether the Japanese Limited Liability Corporation (“LLC”), called “Godo Kaisha”, which will be organized under the new corporation law will be treated as a pass through entity under the Japanese tax law. Under these circumstances, the LLP will be the sole entity which ensures the limited liability of all its partners and pass through taxation.

The LLP is a special form of partnership prescribed in the Japanese Civil Code (Nin-i Kumiai), and therefore has basically the same characteristics of the Civil Code Partnership. Major differences include (1) each LLP partner’s liability to a third party in relation to the operation of the LLP (except for tort or gross negligence) is limited to its capital contribution to the LLP, whereas the liability of the Civil Code partner is unlimited, (2) each LLP partner is required to be involved in the operation of the LLP business whereas there is no such requirement for a Civil Code partner, and (3) the LLP is subject to commercial registration and is required to prepare financial statements. These specific features of the LLP are provided so that the LLP is able to carry out its business smoothly similar to a corporation.

Certain aspects of the tax treatment of the LLP were provided in the 2005 tax reform bill. The new rules include the limitation of losses incurred from the LLP to the contributed amount and withholding taxation on profit distributions to non-resident partners of the LLP. At present, tax rules for a Civil Code partnership are not clearly defined as historically, it has not been commonly used as a joint venture vehicle in Japan.

One unclear area relates to the making of a contribution in kind by partners. Under the Japanese Civil Code, the assets of the partnership are considered to be owned jointly by all partners. Accordingly, when a partner transfers assets to the partnership, it is considered to have partially disposed those assets to other partners and subject to capital gains taxation. Although the corporate tax law allows a corporate investor to make a tax free contribution in kind to another corporation under certain conditions, a tax free contribution cannot be

made to a partnership. This may deter investors from using the LLP as a joint venture vehicle. It is expected that the tax treatment of contributions in kind to a corporation and to a LLP will be harmonised in the near future.

You have a vision. PricewaterhouseCoopers helps bring that vision to reality. We hope you enjoy the current issue of Japan Tax Update and appreciate your comments or ideas for what you'd like to see covered in future issues.

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