# Japan: Recent Supreme Court decision impacts individuals who hold partnership investments

*August 28, 2015*

## In brief

On July 17, 2015, the Japan Supreme Court overturned a lower court (Nagoya High Court) decision and determined that Delaware Limited Partnerships (Delaware LPs) should be considered foreign corporations under Japanese tax law and thereby denied losses taken by individual taxpayers who invested in Delaware LPs with US real estate. The decision on how to classify Delaware LPs had been awaited with great interest by the Japanese tax community since decisions issued by the Tokyo, Nagoya, and Osaka lower courts were divided on this question and a number of Japanese taxpayers have investments in Delaware LPs.

After the 2005 Tax Reforms which disallowed the utilization of partnership losses against other income by individual taxpayers, some may consider the decision not to allow real estate losses via Delaware LPs of limited consequence. However, for individuals filing tax returns in Japan, the decision is relevant with respect to:

- reporting income (as compared to losses) from investments in Delaware LPs previously reported on a pass-through basis
- characterizing investments in a partnership or limited partnership under a different jurisdiction, thereby impacting whether gains or losses may be claimed. Note that the decision only provides basic parameters and therefore, each investment must be analysed on a case-by-case basis.

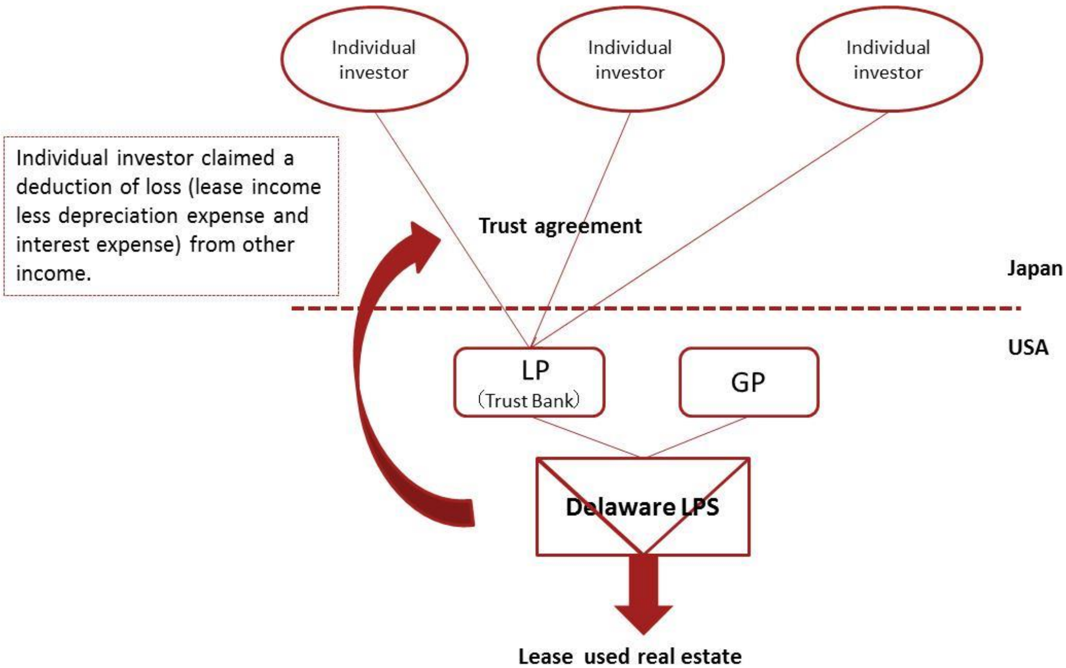
## In detail

### Background of the case

Individual taxpayers in Japan invested in US real estate via Delaware LPs. Tax losses from the Delaware LP interests created mainly through depreciation and loan interest expense was taken on the taxpayers' 2001, 2002, and 2003 individual tax returns as well as a downward assessment request for the 2004 tax year. These tax losses were disallowed by the Japanese tax authorities who asserted that such losses should not be treated as a rental loss and tax assessments were issued.

The taxpayers disputed the assessments and filed a petition with the Nagoya Tax Tribunal, which in turn rejected the taxpayers' petition on the basis that the income from the investments should not be treated as pass-through income from real estate. Rather, the Tribunal ruled, the income should be treated as other distributions and thus reported and characterized as miscellaneous income. The taxpayers disagreed with the

Tribunal's decision and brought the case to the Nagoya District Court. After being heard in the Nagoya District and High Courts, the case was ultimately heard by the Supreme Court.




***Main issue in the case: How to characterize the Delaware LP***

In the cases concerned, the disputes related to the deductibility of tax losses stemming from real estate investments within Delaware LPs against other income. In the Opinions, there were three main issues considered:

1. whether Delaware LPs have characteristics typical to corporate entities under Japanese tax law
2. whether Delaware LPs have characteristics typical to associations without legal personality under Japanese tax law but which under the tax law should be considered taxable entities
3. whether income generated by the real estate business within the LPs could be treated as real estate income for individual tax purposes.

The primary issue that was ultimately dispositive by the Supreme Court was the first point. If yes, individual investors could not claim the losses on their individual income tax returns.

The criteria provided by the various Courts regarding whether or not a Delaware LP should be considered a corporation for the Japanese tax purposes are summarized below:

| | Tokyo | Nagoya | Osaka |
|---|---|---|---|
| **District Court Decisions** | **July 19, 2011 – taxpayer won**<br><br>In order to determine if an entity is to be considered a corporation under Japanese tax law, the foreign country's laws should be used as the basis for the determination.<br><br>Based on foreign country rules, is the entity granted the status of a legal | **Dec 14, 2011 – taxpayer won**<br><br>In order to determine if an entity is to be considered a corporation under Japanese tax law, the foreign country's laws should be used as the basis for the determination.<br><br>Based on foreign country rules, is the entity granted the status of a legal | **Dec 17, 2010 – taxpayer lost**<br><br>In order to determine whether a foreign entity is corporate in nature from a Japan tax perspective, the abilities and attributes must be examined from a substantive perspective. |

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| | person (statutory legal status test) and is the purpose of the entity to determine the attribution of profit or loss from the business to its owners (entity purpose test) | person (statutory legal status test) and is the purpose of the entity to determine the attribution of profit or loss from the business to its owners (entity purpose test) | Specifically, the following three elements should be used to evaluate the entity:<br><br>(1) Are the entity's assets separate from its members、<br>(2) Can the entity enter into contracts in its own name with its own rights and responsibilities<br>(3) Does the entity has the ability to litigate |
| **High Court Decisions** | **March 13, 2013 – taxpayer lost**<br><br>In order to determine if a foreign entity is to be considered as a corporation for tax purposes, how the entity is established, organized, and managed under the foreign jurisdiction's laws should be examined, not just if the entity is a corporation under the foreign laws.<br><br>Who has rights to the business entity's profit and loss (the entity itself or its owners) is irrelevant. | **Jan 24, 2013 – taxpayer won**<br><br>In order to determine if an entity is to be considered a corporation under Japanese tax law, the foreign country's laws should be used as the basis for the determination.<br><br>Based on foreign country rules, is the entity granted the status of a legal person (statutory legal status test) and is the purpose of the entity to determine the attribution of profit or loss from the business to its owners (entity purpose test) | **April 25, 2013 – taxpayer lost**<br><br>In the High Court's ruling, the Osaka District Court's Items (1) and (3) above were determined not to be determinant enough to be factors that the LP was corporate in nature.<br><br>Rather, in order to determine if an entity established under a foreign jurisdiction's rules can be considered as a corporation for tax purposes, how the entity is established, organized, and managed under the foreign jurisdiction's laws should be examined, not just if the entity is a corporation under the foreign laws. |
| **Supreme Court Decision** | **Appeal Rejected** | **July 17, 2015 – taxpayer lost**<br><br>Is the entity established legally and would the entity under foreign laws be considered to have a similar corporate standing under Japan laws.<br><br>If there is no clear conclusion from the first test, whether or not the entity has its own established rights and obligations under the governing law should be examined.<br><br>The Court ruled that a LP has its own rights and obligations under the law and thus should be treated as a corporation for Japanese tax purposes. | **Appeal Rejected** |

***The Supreme Court's analysis***

*Comparison to the lower courts*

In considering whether Delaware LPs have corporate characteristics, the lower courts （Tokyo and Nagoya District Courts, Nagoya High Court） ruled in favor of the taxpayers and generally approved the following two criteria as appropriate in evaluating the Delaware LPs corporate characteristics:

- whether the entity is granted the status of a legal person under the applicable law (statutory legal status test)
- whether the purpose of the entity is to attribute profit or loss from a business (entity purpose test).

The Supreme Court, however, concluded that Delaware LPs should be analysed for Japan tax purposes without considering the entity purpose test and that only the attributes of the entity itself should be considered. More specifically, the Court concluded that the statutory legal status test should be based upon whether the entity itself is recognized to have legal rights and obligations (a substantive legal status test) under the provisions, legislative purpose, or context of the governing law.

In the rulings against the taxpayers, the Tokyo and Osaka High Courts found that a Delaware LP:

- should be a corporation by referring to the Delaware State Law concerning limited partnerships (§17-201(b)) which inferred that LPs established by Delaware law become a 'separate legal entity', and
- exists independently from its members and that the LP itself has legal rights and obligations by referring to §17-106(b), §17-701 and other provisions of the same law.

The Supreme Court's decision differed from the Tokyo and Osaka High Courts in concluding that under Delaware law §17-201(b), it was not clear that a Delaware LP should be considered to have been granted the status of legal person. However, the Court did find by examining the provisions of Delaware state law and its intent that Delaware LPs had separate legal rights and obligations and thus concluded that they should be treated as foreign corporations under Japanese tax law.

### *Criteria to analyse a Delaware LP*

Generally, the Supreme Court took the following approach in analyzing a Delaware LP for Japanese tax purposes:

- *A foreign corporation should be defined as a taxpayer*

  Under Japanese tax law, a foreign corporation is included in the definition of a 'taxpayer' in the same way as domestic corporations and unincorporated associations. As a result, if a foreign entity is determined to be an entity equivalent to a Japanese corporation which should have separate tax responsibilities from the foreign entity's constituent members, it should be treated as a foreign corporation.

- *Certain basic criteria should be used to determine if an entity is a foreign corporation*:
  - An entity should be examined under that foreign country's laws and regulations or operation thereof to establish whether or not it would receive the status of a 'legal person' (equivalent to a corporation) under Japanese laws. If this cannot be determined, then
  - The nature of the entity should be determined based on whether or not it has legal rights and obligations under the foreign country's relevant laws and regulations by examining the legislative purpose or context of the governing law.

- *Application of the above criteria to Delaware LPs*

  With respect to (i), the Supreme Court could not conclude definitively that a Delaware Limited Partnership should be considered having the status of a legal person. With regards to (ii), however, the Court concluded that Delaware LPs have certain legal rights and obligations by referring to §17-106(b), §17-701 and other provisions of the same law.

### ***Comparison with the decision to treat limited liability companies as corporate entities***

Separate from the Supreme Court case, the National Tax Agency (NTA) has published guidance as to their position as to the tax treatment of US limited liability companies (LLCs). This guidance is outlined in the NTA's website. The NTA's view is that for the reasons listed below (which are based on Japanese civil law), a US LLC should be considered a foreign corporation.

The reasons specified by the NTA for treating US LLCs as foreign corporations:

1. Under each separate US state laws, the purpose of setting up an LLC is to carry out business, and it is recognized as a trading company under US state law
2. An LLC is registered in its own name
3. An LLC is its own legal entity in becoming a party to litigation
4. An LLC is a separate legal entity from its members as established under the Unified LLC Act, and it holds the same rights for carrying out a business as individuals.

The Supreme Court Decision on Delaware LPs did not clearly provide such criteria for determining the LP as a foreign corporation, but it only indicated a basic approach for consideration.

## *The takeaway*

### ***Practical implications of the decision***

### *Investments in Delaware LPs*

The Supreme Court's decision as to whether real estate losses taken through Delaware LPs should be allowed is largely irrelevant for individual taxpayers following the enactment of a 2005 Tax Reform provision which disallowed losses to offset against other income by individual taxpayers (the government evidently considered such investments as tax evasion schemes). As such, from a direct impact perspective, the recent Supreme Court case relates only to the reporting of real estate losses from Delaware LPs before the 2005 Tax Reform.

However, the Court ruling will affect individual taxpayers who are currently reporting income from Delaware LPs on a pass-through basis in Japan. It will be necessary to review the tax treatment of income generated by these entities.

*Income and losses from other types of partnerships*

Other types of partnerships or limited partnerships established under different jurisdictions will have to be considered on a case-by-case basis taking into account both the basic approaches as outlined by the Supreme Court. This analysis must occur as a first step to determine what income and losses can be claimed on individual income tax returns.

## Let's talk

For a deeper discussion of how this issue might affect your business, please contact your regular Global Mobility Services engagement team or one of the following professionals from PwC Japan:

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