# PRACTITIONERS' CORNER

## Foreign Entity Classification in Japan

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The Japanese Supreme Court classified a Delaware limited partnership as a corporation for Japanese tax purposes. The case is important because it is the first time the Court addressed how a foreign entity should be classified under Japanese tax law. This article explains the case and discusses relevant issues including how the new decision could affect the Japanese tax status of other types of foreign entities.

On July 17 the Second Petty Bench of the Japanese Supreme Court held that a limited partnership (LP) under Delaware state law is regarded as a corporation for Japanese tax purposes (heisei 25 (gyou-hi) No. 166). There are pending cases regarding this issue on which high courts[1] were unable to reach consensus. The Supreme Court showed its position on the issue in response to an appeal against one of those high courts' decisions. The case is important because it is the first time the Court addressed how a foreign entity should be classified under Japanese tax law, which may apply to other foreign entities. In particular, if Japanese tax law treats a foreign entity differently from the tax treatment under the home jurisdiction or any other relevant country, it will bring up a ''hybrid entity'' (treated as transparent for tax purposes in one country and as nontransparent in another country[2]) issue that may produce unintended tax consequences favorable or unfavorable to taxpayers. The Supreme Court decision gives general guidance on how to deal with such a foreign entity issue under Japanese tax law.

### Facts of the Case

Simplified facts of the case[3] are as follows: The plaintiffs are individual investors resident in Japan, who contributed funds to the project of leasing real properties in the United States through an LP formed under the Delaware Revised Uniform Limited Partnership Act (or Chapter 17, Limited Partnerships, Title 6 of the Delaware Code). They took a position that the Delaware LP is a passthrough entity for purposes of Japanese tax so that they as limited partners are entitled to any loss arising from the project; they claimed offset of the loss against their other income on their

[1]While the Osaka High Court on April 25, 2013 (heisei 23 (gyou-ko) No. 19), and the Tokyo High Court on March 13, 2013 (heisei 23 (gyou-ko) No. 302), held that an LP under Delaware state law is regarded as a corporation for Japanese tax purposes, the Nagoya High Court on January 24, 2013 (heisei 24 (gyou-ko) No. 8, No. 37), reached the opposite conclusion.

(Footnote continued in next column.)

[2]OECD, ''Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues'' (Mar. 2012).

[3]Notwithstanding certain trust arrangements involved in the project, the plaintiffs were treated as if they had made a direct investment in the project for Japanese tax purposes.



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Japanese tax returns and requests for correction.[4] However, the director of the local tax office denied the offset and issued assessment notices or notices of refusal of requests for correction against them, arguing that the Delaware LP should be regarded as a corporation under Japanese tax law and that any profit earned or loss incurred through the project should be attributed to the Delaware LP, not its partners. The plaintiffs brought a lawsuit against the Japanese government in an attempt to revoke the assessment notices issued by the tax office director.

In the United States, an LP is authorized by the state of its formation to conduct business and investment by two or more members, of which at least one partner (a general partner) assumes unlimited liability against obligations of the partnership and at least one partner (a limited partner) assumes only limited liability to the extent of his or her contribution amount and has only a limited right to take actions binding on the partnership. For U.S. federal tax purposes, an LP may elect to be taxed as either a partnership or a corporation under Treas. reg. section 301.7701-3.

## Nagoya High Court Decision

The original court (Nagoya High Court) considered the attribution of profits and losses under the act in judging whether a foreign entity is treated as a corporation for Japanese tax purposes. In other words, according to the Nagoya High Court, a foreign entity is a corporation for Japanese tax purposes if it is regarded in substance as an entity to which any profit or loss deriving therefrom should be attributed (that is, an entity on which profit or loss is not directly attributed to its members) (the profit/loss test).[5] It should be noted that the attribution of profits and losses is determined solely according to the foreign governing law (that is, the act in the present case), and has nothing to do with U.S. tax treatment of the entity. In concluding that the Delaware LP is not a corporation for Japanese tax purposes, the Nagoya High Court held that, while it acknowledged that the claims and liabilities of the Delaware LP are regarded separately from its members, the profits and losses of the Delaware LP are attributable to its members. The Nagoya High Court relied on statutory provisions of the act and noted, among others, that (i) the profits and losses of an LP are to be allocated among the partners in the manner provided in the partnership agreement (and each partner is ensured the principle of freedom of contract and the enforceability of a partnership agreement under the act); and (ii) each partner is granted a share in the profits and losses of an LP.

## Supreme Court Decision

The Supreme Court reversed the original court's decision with the following reasoning: Any profit or loss of a foreign entity is treated as that of the entity for Japanese tax purposes where the entity has corporate characteristics under Japanese tax law, while it is treated as that of the members where the entity does not have corporate characteristics under Japanese tax law, unless "special circumstances" dictate otherwise. The Court noted that Japanese tax law defines the scope of a foreign corporation by an analogy to a domestic corporation. Accordingly, the Court concluded that the Delaware LP is treated as a corporation if it shares similar characteristics with Japanese corporations.

In Japan, the most essential characteristic of a corporation is that rights and obligations are attributable to the entity itself. The Supreme Court explained that the treatment of a foreign entity under Japanese tax law should be based on the following considerations:

- whether there is no doubt that the concerned foreign entity is granted by the governing foreign law a legal status corresponding to a Japanese corporation, taking into account the language of the relevant provisions and the legal structure of the governing foreign law (the first-step test); and
- (if the result of the first-step test is not clear without any doubt) whether the concerned foreign entity is regarded as an entity to which rights and obligations are attributable (the second-step test).

Specifically, the second-step test is an analysis of whether the governing foreign law allows the concerned foreign entity to become a party to its legal actions and attributes the legal effect of the actions to the concerned foreign entity. The analysis should be based on the content or purpose of the relevant provisions in the governing foreign law.

Relying on the two-step approach, the Supreme Court examined whether the Delaware LP is regarded as a corporation for Japanese tax purposes. In applying

[4]The 2005 tax reform restricts the use of losses incurred from real estate investments through a general partnership established under the Japanese Civil Code (nini-kumiai) or any other similar domestic or foreign entity or arrangement for the purpose of calculating taxable income of individual passive investors. The present case occurred prior to the enforcement of the above loss restriction rule. After the introduction of the rule, even if a Delaware LP were regarded as a passthrough entity for Japanese tax purposes, the plaintiffs would not have been entitled to any loss arising from the project for the purpose of calculating their taxable income.

[5]More precisely, the Nagoya High Court took into account two factors: (i) whether the governing law can be interpreted as granting a corporate status to a foreign entity, in light of the content of the relevant governing law; and (ii) whether a foreign entity is regarded in substance as an entity to which any profit or loss deriving therefrom should be attributable, with more emphasis on the latter. In other words, the court acknowledged that the governing law may not necessarily be clear with respect to the issue of (i) above and held that it would be necessary to go through the profit/loss test set forth in (ii) above regardless of whether the governing law is considered as granting a corporate status; a foreign entity would not be considered as a corporation for Japanese tax purposes unless it satisfied the profit/loss test.



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the first-step test, the Court noted that section 17-201(b) of the act provides that an LP formed under the act shall be a ''separate legal entity,'' although it held that the provision is not clear enough to conclude that the act grants the Delaware LP a legal status corresponding to a Japanese corporation. Regarding the second-step test, the Court found that section 17-106(a) allows an LP to carry on any lawful business, purpose, or activity, whether or not for seeking profit, with certain exceptions and that section 17-106(b) provides that an LP shall possess and may exercise all the powers and privileges granted by the act or by any other law or by its partnership agreement, together with any powers incidental thereto. Taking into account these provisions, the Court interpreted the act as granting an LP a right or power to take a legal action under its name and attributing the legal effect of the action to the LP itself. The Court added that that interpretation is in line with the provision stating that a partner has no interest in specific LP property (section 17-701 of the act) and that the Delaware LP's partnership agreement did not contain any article inconsistent with the statutory provisions.

Based on the above reasoning, the Supreme Court concluded that the Delaware LP is an entity to which rights and obligations are attributable and thus is treated as a corporation for Japanese tax purposes. As there are no special circumstances as described above, any loss incurred by the Delaware LP is attributed to the partnership, not its partners, according to the Court.[6]

## Comments

### Treaty Versus Domestic Law

Some tax treaties provide specific rules for the treatment of income derived through fiscally transparent entities. Article 4(6) of the Japan-U.S. tax treaty is one such example, as it defers to the jurisdiction of the person claiming the benefits of the treaty as a resident in determining whether an entity through which an item of income arises should be treated as transparent. Thus, when a U.S. resident makes an inbound investment into Japan through an entity, U.S. tax law governs the treatment of the entity for purposes of determining availability of the tax treaty benefits to the U.S. investor. However, Japanese domestic tax law controls the issue of transparency of an entity in an outbound investment by a Japanese resident, and the tax treaty may not govern the issue. Any treatment under the tax treaty (or the U.S. domestic law) may not affect Japanese taxation of its resident partners on their share of income of an entity established under the laws of the United States or a third country. Thus, in the present case, whether the Delaware LP is treated as a fiscally transparent entity for Japanese tax purposes is determined solely from the viewpoint of Japanese domestic tax law.

### Supreme Court's Two-Step Approach

The Supreme Court's two-step approach is new and has some noteworthy features.

The first-step test looks to whether it is clear without any doubt that the legal status granted to the foreign entity is analogous to a Japanese corporation. The Court did not specifically clarify what ''it is clear without any doubt'' means. However, in concluding that the Delaware LP does not satisfy the first-step test, the Court reasoned that the act lacks the term ''a body corporate'' that is used for a corporation under Delaware's General Corporation Law. In line with that reasoning, we may infer that the first-step test would be met only when an entity is described as a body corporate or something equivalent under the relevant governing foreign law.

Next, the second-step test looks to attribution of rights and obligations, instead of focusing on attribution of profits and losses as the original court did. It is not arguable in the present case that the Delaware LP holds or incurs rights or obligations separately from its partners. The Japanese government had argued (as defendant/appellant) that the attribution of rights and obligations should be sufficient to conclude that the Delaware LP corresponds to a corporation under Japanese tax law.[7] The Nagoya High Court did not agree with the Japanese government, stating that the attribution of rights or obligations to an entity is a result of being granted a corporate status and, thus, it is not an appropriate test for determining a corporate status. The

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[6]Even though a foreign entity may not be regarded as a corporation for Japanese tax purposes, it may nevertheless be treated as an ''unincorporated association'' under Japanese tax law so that the passthrough treatment is still denied. While the Supreme Court did not make any decision in this regard, the original court (Nagoya High Court) held that a foreign entity is regarded as an unincorporated association for Japanese tax purposes if (i) it has developed a scheme as an association, (ii) its decision is made by majority vote, (iii) the entity survives a change in its members, and (iv) major items of an association (such as a way to represent the entity, operation of general meetings, and asset management) have been determined by the scheme. The Nagoya High Court concluded that the Delaware LP lacks an internal scheme for decision-making by its members and thus it is not treated as an unincorporated association, in view of the fact that limited partners are not entitled to participate in major decisions of a partnership.

[7]Specifically, the Japanese government argued that the following three factors should be considered in determining whether a foreign entity is treated as a corporation for Japanese tax purposes:

- whether it holds its own property separately from the members' personal items;
- whether it may become an independent holder of rights and obligations (for example, an ability to make a contract under its name and to acquire rights and incur obligations under its name); and
- whether it may become a litigation party concerning its rights and obligations under its name.



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court also added that the Japanese government's criteria cannot explain how Japanese tax law distinguishes a domestic corporation from a passthrough entity in Japan, such as a general partnership established under the Japanese Civil Code (nini-kumiai), without considering to whom profits or losses are attributable. However, it appears that the Supreme Court took the opposite approach in that it held that, unless ''special circumstances'' dictate otherwise, attribution of profits or losses should follow the issue of whether the concerned entity is granted a corporate status and did not use the profit/loss test as an independent threshold. Instead, the Court focused on what would be the most important characteristics for substantiating qualifications as a corporation and concluded that attribution of rights or obligations is regarded as such.

We are not sure what the Supreme Court tried to rule out by mentioning ''special circumstances,'' although it may be intended to address some exceptional situations in which legal form does not follow economic reality (such as a trust or a nominee arrangement).

## Freedom of Contract

Japanese tax law is supposed to respect freedom of contract, which is applicable to the act. Thus, the parties may consider entering into a partnership agreement in such a way that their partnership does not satisfy the tests adopted by the Supreme Court. In this regard, the first step is clearly a matter of interpretation of statutory provisions, and thus, it is irrelevant what the partnership agreement actually provides. However, while the second-step test is also supposed to be based on statutory provisions in the governing foreign law, the Court referred to the actual partnership agreement in applying the second-step test. Therefore, it is possible that the Court considered the provisions of the partnership agreement in the analysis of the second-step test, and it appears uncertain what would happen if a partnership agreement has special provisions that deem rights or obligations are attributable to the partners despite the act.

## Treatment of Other Foreign Entities

*Limited Liability Company*

How would a limited liability company under foreign law be treated under the Supreme Court's new approach? The Tokyo High Court issued a decision (heisei 19 (gyou-ko) No. 212)[8] on October 10, 2007, classifying an LLC formed under New York state law as a corporation for Japanese tax purposes. Under the New York Limited Liability Company Law, an LLC is defined as an ''unincorporated organization'' (section 102(m)) but is formed and remains as a ''separate legal entity'' (section 203(d)). For U.S. federal tax purposes, an LLC is an eligible entity, which may elect to be taxed as either a partnership or a corporation under Treas. reg. section 301.7701-3.

The Tokyo High Court held that the New York LLC law grants an LLC extensive powers such as those to sue or be sued in any action or proceeding in its name (section 202(a)); to acquire, own, or use real or personal property (section 202(b)); to dispose of all or part of its property or assets (section 202(c)) and to make various contracts (section 202(e)). It also held that the operating agreement was consistent with the above statutory provisions. The New York LLC law also stated that a member of an LLC has no interest in specific property of the LLC (section 601). In view of the above, the Court concluded that the New York LLC in question was granted a legal status independent from its members and actually acts as such, and therefore was regarded as a corporation for Japanese tax purposes.

We believe that the Supreme Court's two-step approach would not alter such treatment of a New York LLC. As long as a New York LLC is defined as an ''unincorporated organization'' under the state law, it would not be ''clear without any doubt'' that its legal status corresponds to a Japanese corporation. Accordingly, the first-step test would not be satisfied. However, in view of the extensive powers granted to a New York LLC and the denial of the members' interest in specific property of the entity as described above, it would be regarded as an entity to which rights and obligations are attributable as stated in the second-step test. Thus, it would be most likely that a New York LLC is still treated as a corporation for Japanese tax purposes even under the Court's two-step approach.

*Bermuda LP*

On February 5, 2014, the Tokyo High Court held that an exempted limited partnership formed under the Limited Partnership Act 1883 and the Exempted Partnership Act 1992 in Bermuda is not classified as a corporation (heisei 24 (gyou-ko) No. 345). The court's decision is similar to the original decision of the Nagoya High Court as described above in that, while the Japanese government (as defendant/appellant) focused on attribution of rights or obligations, the Tokyo court put more emphasis on where profits or losses are attributed and concluded that the Bermuda exempted limited partnership in the case was not treated as a corporation for Japanese tax purposes. The Tokyo court also noted that, unlike an LP formed under Delaware state law, a partnership is not treated as a ''separate legal entity'' under the relevant laws in Bermuda. The court explained that a Bermuda partnership is not supposed to be a party to contracts or lawsuits separately from its partners and therefore would not be regarded as a corporation for Japanese tax purposes even under the criteria of the Japanese government relying on attribution of rights or obligations.

While the Japanese government moved to appeal the Tokyo court's decision concerning the Bermuda LP,

[8]This case became final without further being appealed to the Supreme Court.



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the Supreme Court did not grant the appeal and the high court decision became final. While the Supreme Court did not make any substantive decision as to the Japanese tax treatment of the Bermuda LP, it appears that it sustains the original court's conclusion (that is, the Bermuda LP is treated as a passthrough entity for Japanese tax purposes).

We also believe that the Court's two-step approach would reach the same conclusion because, as Tokyo court stated, the Bermuda LP has no right or power to take legal action under its name and thus the legal effect of such action would not be attributable to the Bermuda LP itself.

*Cayman LP*

In another tax case involving a foreign LP, Japanese individuals invested in foreign vessels in a ''fund of funds'' manner, meaning that those individuals acquired the membership of certain general partnerships established under the Japanese Civil Code (nini-kumiai) (Japan NKs), which were the limited partners of an exempted limited partnership formed under the Partnership Law (revised as of 1995) and the Exempted Partnership Law (revised as of 1997) in the Cayman Islands. The Cayman LP leased the vessels under bareboat charter agreements and allocated lease fees received to the members of the Japan NKs in proportion to their respective shares. While those individuals claimed offset of depreciation expenses derived from the leasing business against their other income on their Japanese tax returns, the directors of the relevant tax offices denied the offset, challenging the validity of the Japan NKs.

Although it was not directly at issue whether the Cayman LP should be treated as a corporation or a passthrough entity for Japanese tax purposes, the Nagoya High Court held on March 8, 2007, that a Cayman partnership is not granted a corporate status but rather a contractual relationship among its members in view of the relevant provisions of the Cayman Partnership Law (heisei 18 (gyou-ko) No. 1).[9] The Nagoya court also upheld the legality of the Japan NKs and gave a decision in favor of the taxpayers.

The Supreme Court did not grant an appeal in the case, and the high court decision became final. Although the Court did not make any substantive decision as to the Japanese tax treatment of the Cayman LP, we believe that the two-step approach adopted by the Court would result in the same conclusion. That is because the Cayman LP is viewed as a contractual relationship among its members and thus neither the first- nor second-step test would be satisfied.

## Unresolved Issues

While the Supreme Court judgment regarding the Delaware LP ended discrepancies regarding high court decisions, treating a Delaware LP as a corporation for Japanese tax purposes leaves some derivative issues unresolved.

For instance, the judgment might cast doubt on the availability of a foreign tax credit[10] for U.S. income tax paid by Japanese limited partners, either Japanese corporations or individual residents. This is because:

- the Supreme Court did not clarify who is liable for the U.S. income tax (that is, the Delaware LP or its limited partners) for foreign tax credit purposes; and
- even though it is the limited partner who bore the U.S. income tax, the limited partner might be treated as not having any foreign-source income because an item of income earned by the Delaware LP is attributable to the entity, not its partners, for Japanese tax purposes.

In addition, the applicability of the Japanese anti-tax-haven rules (counterparts to the rules imposing current taxation of controlled foreign corporation income on U.S. shareholders) should also be reconsidered. These rules will be triggered if the effective tax rate applicable to a foreign corporation is below 20 percent in the local jurisdiction. In the present case, as the Delaware LP elected to be taxed as a partnership for U.S. federal tax purposes, there is no taxation at the entity level, and thus, the effective tax rate applicable to the Delaware LP might be treated as zero, which might invoke the Japanese anti-tax-haven rules depending on the circumstances.

Furthermore, once the Japanese anti-tax-haven rules apply, a Japanese individual who is a partner of the Delaware LP and currently taxed by the United States on his share of income of the Delaware LP may not claim a foreign tax credit for such U.S. income tax imposed on the share of income, as there is no double international taxation at the entity level. However, if the partner is a Japanese corporation, a foreign tax credit is available for the corresponding U.S. income tax (like section 902 of the Internal Revenue Code (the deemed-paid credit)) in the context of the anti-tax-haven rules to eliminate double international taxation of earnings at the entity level. ◆

[9]This case occurred prior to the enforcement of the loss restriction rule introduced by the 2005 tax reform; *see supra* note 4.

[10]Japan adopted a foreign tax credit system under which foreign taxes directly levied on a Japanese corporation or a Japanese individual resident may be credited against Japanese corporation or personal income tax, respectively. The purpose of the foreign tax credit is to eliminate or mitigate international double taxation. The available foreign tax credit is subject to an overall limitation, calculated by the following formula: (A) x (B)/(C), where:

(A) = amount of Japanese corporation or personal income tax liability in the taxable year concerned;

(B) = amount of taxable foreign-source income in the taxable year; and

(C) = total amount of taxable worldwide income in the taxable year.

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