Taxation of Partnerships in Japan

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This is the first in a series of articles on the taxation of partnerships. The articles are based on papers presented at the international colloquium on the subject sponsored by Deakin University School of Law.

Contents

I. INTRODUCTION

At the 1995 Congress of the International Fiscal Association, the National Reporter for Japan stated that "[t]here are almost no laws, rulings or authoritative statements on most of the issues concerning [the] taxation of partnerships".[1] Unfortunately, this statement remains true today.

The simple reason why the tax rules on partnerships are relatively undeveloped in Japan is that partnerships are not used very much.[2] Most businesses in Japan take the form of a corporation[3] or sole proprietorship. Corporations are by far the preferred form of business organization for both tax and non-tax reasons.[4] As long as the corporate tax rules are sufficient, no partnership tax rules are necessary.

This seemingly straightforward answer, however, does not fully capture the development of the Japanese tax rules regarding partnerships. In fact, as early as the 1950s, a special type of partnership arrangement emerged as a notorious device for attracting money from the public. The Ministry of Finance was active in sponsoring legislative responses in terms of both financial regulation and income taxation. Given that a partnership arrangement was in fact used, corresponding tax rules could have been developed in theory. In reality, however, the government acted to discourage, rather than to foster, partnership structures.

A more plausible hypothesis is that Japan avoided the emergence of partnership tax issues by keeping the tax consequences unpredictable. There are only six circulars that cover the vast area of partnership taxation in Japan. Inevitably, it is almost impossible to find the predictable tax outcome if a person wants to form a partnership to conduct business. As a result, only a handful of tax-conscious experts enter into a partnership agreement (and do so carefully) to benefit from the pass-through treatment. According to this hypothesis, the undeveloped tax rules are not merely the outcome of the unpopularity of partnerships, but are its cause.

Part II of this article describes the relatively minor status of partnerships in Japan, and Part III considers the conspicuous use of the partnership structure in the early 1950s. In Part IV, the author contends that the undeveloped tax rules are more likely the cause, rather than the result, of the infrequent use of partnerships in Japan. Finally, Part V evaluates the policy behind the current rules and makes a modest prediction.

1. Otsuka, Ichiro, National Reporter for Japan on Subject I: International income tax problems of partnerships, *Cahiers de droit fiscal international*, Vol. LXXXa (1995), at 317, 332.
2. The term "partnership" in this article is used in a general sense encompassing a variety of legal forms, following the terminology in Easson, Alexander and Victor Thuronyi, "Fiscal Transparency", in Thuronyi, Victor (ed.), *Tax Law Design and Drafting* (Washington, D.C.: International Monetary Fund, 1998), Vol. 2 at 929.
3. In 1998, there were 2,508,852 corporations in Japan. Most of them took the form of a joint stock company (42.9%) or limited company (54.4%). See http://www.nta.go.jp/taxstat/stati/h10/zeimu01/03.htm (visited on 9 February 2000). According to Kuboi, Takashi and Yoichi Asakawa, "Partnering in Japan: Form of Entry and Recent Tax Issues", 13 *Tax Notes International* (1996), at 445, 448, almost all business ventures in Japan are conducted by joint stock companies and limited companies.
4. There are essentially three tax advantages of choosing a corporate form in Japan. (1) Rate differential. Historically, the top individual marginal rate tended to be much higher than the corporate tax rate. In 1999, there was a seven point difference between the top individual rate (37%) and the corporate tax rate (30%) at the national level. There was, however, almost no difference if the national and local taxes were combined. The rate structures will remain the same for fiscal year 2000. (2) Deferral. As in many other jurisdictions, retained earnings of a corporation are not taxable in the hands of shareholders. Taxation is deferred at the shareholder level until the profits are distributed. Combined with the rate differential, this assures tax savings. (3) Income splitting. Salaries paid to family employees are deductible expenses at the corporate level. By splitting the corporate income as salaries to different family members, it is possible to take advantage of lower brackets. In addition, each employee can benefit from a relatively large standard deduction for employment income.

The non-tax reasons for incorporation include limited liability, familiarity and reputation.

II. PARTNERSHIPS UNDER JAPANESE LAW

A. NK and TK structures

Several legal structures are treated as flow-through entities under the Japanese income tax rules (see IV.A.).[5] Among them, two structures share the common characteristics of a partnership. The first is "*Ninn'i Kumiai*" or NK which, under the Japanese Civil Code, is a contractual arrangement and which is not a taxable legal entity. The Civil Code (Art. 668) defines "NK" as a contractual agreement among two or more parties in which the parties make contributions to the NK and by which a common undertaking is carried on. The word "*Ninn'i Kumiai*" means voluntary association. The name derives from the fact that an NK can be formed without any special law or registration. Because an NK does not require registration, it is not possible to know the exact number of NK arrangements in Japan. NK structures are found, for example, among attorneys at law, tax attorneys and medical doctors, who wish to operate a joint office but are prohibited from incorporating by the regulatory framework.

The second is "*Tokumei Kumiai*" or TK which, under the Commercial Code, lacks the feature of co-ownership and which is also not a taxable entity. The Commercial Code (Art. 535) defines TK as a contractual arrangement in which one or more investors contribute money or other assets to an operator who is to engage in business with a view to sharing the profits with the investors. "*Tokumei*" literally means anonymous. The investors remain anonymous and have no right or power to manage the business. Only the operator actively conducts the business. A TK contract is an offspring of *stille Gesellschaft* (silent partnership) in the German Commercial Code and *société en participation* (joint venture formed under the Civil Code) in the French Commercial Code. These continental constructions were adopted by the Japanese Commercial Code of 1899. A TK does not require any registration for its establishment. As a result, no statistics on TK arrangements are available.

B. Structures similar to a corporate taxpayer

Other arrangements share certain characteristics of a partnership, but are taxable entities subject to the corporate income tax. Accordingly, such arrangements are not flow-through entities under the income tax rules.

The unlimited partnership company, *Gomei Kaisha*, is a corporation organized under the Commercial Code (Art. 62). A *Gomei Kaisha* has a corporate personality and is a taxpayer under the Japanese Corporation Tax Law. A *Gomei Kaisha* is functionally similar to an unlimited partnership which, in an Anglo-American context (unlike in Japan) is generally not a corporate taxpayer. In some civil law jurisdictions, the equivalent structure is not a corporate taxpayer, for example, the *société en nom collectif* (general partnership) in France and the *offene Handelsgesellschaft* (general commercial partnership) in Germany.

The limited partnership company, *Goshi Kaisha* (Art. 146 of the Commercial Code) is also a corporate taxpayer under the Japanese Corporation Tax Law. Members of a *Goshi Kaisha* can have either unlimited or limited liability. A *Goshi Kaisha* is the functional equivalent of a limited partnership, i.e. *Kommanditgesellschaft* in Germany or *société en commandite* in France. The Japanese Corporation Tax Law categorically refuses to grant fiscal transparency, which is available for similar structures in many other jurisdictions.

The two structures are seldom used in practice. In 1997, there were only 6,300 *Gomei Kaisha* (0.3% of the total number of corporations) and 29,656 *Goshi Kaisha* (1.2%) in Japan. These structures are not considered further in this article since they are corporate taxpayers rather than fiscally transparent entities.

C. Minor status of partnership arrangements

The rest of this article focuses on the NK and TK structures because they are treated as flow-through entities under the Japanese income tax. As mentioned earlier, the Japanese business community tends not to use flow-through entities, such as NK, TK and trusts.[6] For example, Kuboi and Asakawa speculated that "[p]ublicly traded companies generally prefer not to use pass-through entities, perhaps because of the difference in tax cultures, the dissimilarities between book and tax accounting, and because financial performance is usually judged on a single-company basis, not on a consolidated basis".[7] This statement is based on their experience as practitioners and should have some merit.

There are, however, problems with the reasons given by Kuboi and Asakawa as to why pass-through entities are unpopular in Japan. "Tax culture" is a magic word, which explains everything – or almost nothing. Differences between book and tax accounting are sometimes detrimental to companies but, at other times, are beneficial. Likewise, financial performance may be judged no less harshly under transparent structures because both good and bad performance becomes conspicuous to outsiders. Moreover, Japanese accounting standards were recently modified to better reflect the consolidated results of corporate groups. If Kuboi's and Asakawa's reasons are insufficient, what explains the unpopularity of the NK and TK in Japan?

III. THE TK SAGA

A. Black financial market

A look into history gives a clue.[8] In June 1950, war broke out in the Korean Peninsula. The war stimulated the Japanese economy for a short time. Established financial

5. See e.g. Hanna, Christopher, "Initial Thoughts on Classifying the Major Japanese Business Entities under the Check-the-Box Regulations", 51 *Southern Methodist Univ. Law Review* (1997), at 75, 86.
6. Trusts are treated as pass-through entities. The income of a trust is taxable directly either to a beneficiary or to the grantor (Art. 13(1) of the Income Tax Law). Due to legal barriers, business trusts are not used in Japan.
7. Kuboi and Asakawa, *supra* note 3, at 448.
8. Sugawara, Kikushi, "Hozen Keizaikai Jiken", 900 *Jurist* 86 (1988).

institutions borrowed money from households at low interest rates and lent it to large corporate groups. Ordinary persons wished to have higher interest rates, while small enterprises were not able to borrow money from the established financial institutions. Supply and demand created a black market for the unregulated loan industry. During the 1950s, kerb-side financial businesses became fashionable.

The war ended three years later, after which came the depression. To counter inflation, the Japanese government squeezed money in mid-1953. As a result, in October 1953, many of the unregulated finance businesses went bankrupt. One bankruptcy case involved *Hozen Keizai Kai,*[9] which had 150,000 investors and had collected 4.5 million yen. There were 300 similar structures all over Japan. Some even estimated that ordinary investors contributed nearly 100 billion yen to similar unregulated structures.

Hozen Keizai Kai asserted that it had collected money from investors under a TK contract. When a TK contract terminates, the operator is required to pay back the investors the amounts they contributed. If the business suffers a loss, the operator is obliged to pay back only the remaining amount. On the other hand, the investors claimed that the contract was in fact a loan so that they were entitled to receive the full amount of their initial contribution.

The dispute became a big social issue, and a solution was discussed in the Finance Committee of the Diet. In 1954, a new law was introduced to prohibit unregulated bodies from collecting deposits from the public.

At the same time, legislative responses were made on the tax front. Numerous investors had participated in the TK structure of finance. In order to facilitate tax enforcement, the government introduced a withholding mechanism in 1953 regarding distributions of profit made by the operator to the investors.[10] Under the new mechanism, the operator of a TK structure must withhold tax at 20% from the distributed profit if paid to more than ten investors.[11]

From the late 1950s to the early 1960s, there were a number of court cases on the application of this withholding rule.[12] In one case, the Supreme Court found that the contract at issue was not a TK within the meaning of the tax statute and held that the operator was not required to withhold tax.[13] This decision is one of the most famous in the history of Japanese tax law because it made clear that the interpretation of tax statutes should follow the commercial law concepts.

B. Overview of the TK tax cases

As mentioned earlier, the TK structure was used openly in the early 1950s. Already at that time, however, the TK was regarded as an obscure structure created for the purpose of avoiding financial regulation in the dark. It is noteworthy that the TK arrangement was treated as fiscally transparent throughout this period, without any specific statutory provisions that gave certainty regarding its tax treatment.

In the late 1950s, the Japanese economy commenced a period of spectacular economic growth. Only a few cases involving TK arrangements were reported after the late 1960s. Three examples are considered here.

Business organizations at coal mines.[14] At Ube City in Yamaguchi Prefecture, some local citizens developed a special type of business organization that closely resembled a TK contract. For tax purposes, an issue arose regarding the proper attribution of income from the coal mine operation. This issue became moot after the 1957 amendment of the Corporate Tax Law. Since 1957, the Ube- style joint venture has been classified as an “association without legal personality” whose income is subject to corporate income tax.

Real estate investment.[15] A real estate company solicited contributions from investors and bought plots of land. The company sold the plots for use either for rental offices or parking lots. Of the profits arising from the business, 75% was distributed to the investors. The issue was how much of the profits were subject to the separate flat tax on capital gains from the alienation of land (Art. 63 of the Special Tax Measures Law). The company claimed that the structure was an NK contract and that only 25% of the profit was subject to the separate flat tax at the company level. The district director contended that the arrangement in question was a TK contract, that the land belonged to the company because the company was the operator under the TK contract, that all the capital gains were attributable to the company, and that 100% of the profit was subject to the separate flat tax. The company lost the case. The court decision was incorporated into the circular (Special Tax Measures Law Circular 62-3(6)-1 and -2 and 63-3(6)-1 and -2).

Aircraft leasing. A TK arrangement was used so that the investors could benefit from the accelerated depreciation for aircraft. In a recent case on the timing of loss deductions, the National Tax Tribunal held that the loss was attributable to the investor at the end of the operator’s business year.[16]

9. “*Hozen Keizai Kai*” means “money preservation association”. Instead of preserving money, the business went bankrupt.
10. Art. 42(3) of the Income Tax Law in effect in 1953. The same rule is in Arts. 210 and 211 of the current Income Tax Law.
11. Arts. 327 and 288 of the Income Tax Law Enforcement Order.
12. Decisions of the Tokyo District Court of 3 July 1958, Gyosei Jiken Saiban Reishu (GJSR), Vol. 9, No. 7 at 1340, of 11 September 1958, GJSR, Vol. 9, No. 9 at 1899, and of 17 July 1959, GJSR, Vol. 10, No. 6 at 1110; decisions of the Tokyo High Court of 12 September 1959, GJSR, Vol. 10, No. 12 at 2353, of 31 January 1961, GJSR, Vol. 12, No. 1 at 99, and of 12 July 1961, Shomu Geppo, Vol. 7, No. 9 at 1868; decisions of the Supreme Court of 27 October 1961, Minshu, Vol. 15, No. 8 at 2357, and of 2 October 1962, Shomu Geppo, Vol. 8, No. 11 at 1682; and decision of the Tokyo District Court of 10 October 1963, GJSR, Vol. 14, No. 10 at 1740.
13. Decision of the Supreme Court of 27 October 1961, Minshu, Vol. 15, No. 9 at 2357, 2360.
14. Decision of the Yamaguchi District Court of 26 June 1971, Shomu Geppo, Vol. 17, No. 10 at 1671.
15. Decision of the Nagoya District Court of 25 March 1985, Zeimu Sosho Shiryo (ZSS), No. 144, at 741; decision of the Nagoya High Court of 16 July 1986, ZSS, No. 153 at 119; decision of the Supreme Court of 13 October 1988, ZSS, No. 166 at 131; and decision of the Nagoya District Court of 18 May 1990, Shomu Geppo, Vol. 37, No. 1 at 160. A similar issue was discussed in the decision of the Osaka District Court of 19 December 1990, ZSS, No. 181 at 970.
16. Decision of the National Tax Tribunal of 16 September 1992, Saiketsu Jireishu, No. 44 at 217.

C. TK as a suspicious phenomenon

TK arrangements have often been used in a tax savings context. Practitioners even published a reference book containing a model TK contract for leveraged leasing.[17]

The TK arrangement is also mentioned as one of the available forms of investment vehicle under the Commodity Fund Law, the Specified Loans Law, and the Specified Real Estate Joint Business Law. Investors, however, generally prefer to establish a limited partnership in the Cayman Islands. The TK structure under the Japanese Commercial Code never became a popular vehicle even when supported by the above laws. (The situation was the same for the NK structure.)

Thus, generally speaking, the TK structure has been considered suspicious in Japan, especially after the incident in the early 1950s when the government learned how flexibly the structure could be used for a variety of purposes. The tax policy toward the TK arrangement could thus be characterized as cold neglect with suspicion.

IV. UNPREDICTABLE TAX OUTCOME

A. Lack of specific rules

As stated at the outset, there are almost no tax laws or regulations regarding NK and TK arrangements in Japan.[18] The rare exception is the withholding mechanism introduced in 1953 for TK structures. There is no provision clarifying how the income of an NK flows through to its partners or how the income of a TK passes through to its investors. There are also no rules in the statute about the cost base of the partnership property or of the partnership interest.

Lacking specific rules, parties to NK and TK arrangements are subject to tax under the general provisions of the Income Tax Law (Art. 36 (gross income) and Art. 37 (necessary expenses)) and the Corporate Tax Law (Art. 22 (corporate income)). The National Tax Administration issued a set of circulars to apply these general provisions. Both NK and TK arrangements are in principle treated as an aggregate of partners and of investors. A pure aggregate approach, however, has not been adopted, as explained below.

The circular sets out the following rules for NK structures. The profits and losses of an NK are to be calculated at the NK level. Such profits and losses are included in the income of the partners on the last day of the NK's accounting period.[19] The income of the partners of the NK is to be calculated according to one of the following three methods:[20]

(1) the net result method, under which a partner of the NK reports his share of the NK's net income or net losses;
(2) the partial flow-through method, under which a partner reports only his proportionate share of NK revenues and expenses and does not record in his books a share of the other separate NK accounts; or
(3) the flow-through method, under which a partner records in his books his share of each separate account entered on the NK's financial statements, including revenues, expenses, assets, liabilities and reserve accounts.

Taxpayers may elect one of the three methods. The flow-through method regards the NK as an aggregate of partners, who can take advantage of exemptions, tax credits, reserves and accelerated depreciation as if the NK's business were conducted directly by the partners. On the other hand, the net result method regards the NK more as an entity in that the type of the income is determined at the NK level rather than at the partner level.

With regard to TK structures, the circular gives the following guidelines.[21] When an operator distributes profits to investors in a TK arrangement, the distribution is deductible as a necessary expense at the operator level and is taxable at the investor level. The type of income is determined according to the nature of the operation. For example, if the operator derives business income, the distribution is classified as business income at the investor level.[22]

B. Unsettled issues

These general guidelines unfortunately raise more questions than they answer. Many issues are either unresolved or have no clear answer. Some of the major issues concerning the tax treatment of NK structures are discussed below.

1. Creation of an NK

Regarding the definition of an NK for tax purposes, the circular picks up on the definition in the Civil Code (see II.A.). No registration is required for its formation. Whether a particular contract fits in the definition of NK requires a consideration of all the facts on a case-by-case basis.

As to when an NK is created, the NK exists for tax purposes from the time the agreement was reached, whether orally or otherwise. A deed is not necessary for the NK contract to be valid.

Regarding the tax treatment of assets other than cash contributed to an NK, non-recognition provision does not exist. The default rule in the Civil Code (Art. 668) is that the property of an NK is owned jointly by its members. Therefore, when a partner contributes his property to an NK, the contribution is likely to be characterized as a

17. Sakura Sogo Office (ed.), *Tokumei Kumiai No Horitsu Kaikei Zeimu To Hyoka* (1997), at 65.
18. Otsuka, *supra* note 1, at 317.
19. Income Tax Basic Circular 36.37-19 for the individual members of an NK, and Corporate Tax Basic Circular 14-1-1 for the corporate members of an NK.
20. Income Tax Law Basic Circular 36.37-20 for individual members. Corporate Tax Basic Circular 14-1-2 for corporate members. For further details, see Hanna, *supra* note 5, at 83, and Kuboi and Asakawa, *supra* note 3, at 446.
21. Income Tax Basic Circular 36.37-21 for individual operators and individual investors. For corporate operators and corporate investors, there is a timing rule in Corporate Tax Basic Circular 14-1-3.
22. There is an exception to this income classification rule. By contractual agreement, an investor may be guaranteed to receive a fixed amount of distribution from the operator, even when there are no net profits from the operation. In such a case, the distribution is taxed as interest on a loan at the investor level. Income Tax Basic Circular 36.37-21, second sentence.

transfer of part of his property to the other partners. Whether the unrealized gains (or losses) in the property should be taxable to that extent to the contributing partner is an unresolved issue.

As to the cost base of an asset acquired by an NK, there are no provisions regarding the cost base of a partner's interest in the NK or the NK's cost base in the property.[23] Presumably, no distinction between the two is envisaged. Under the default rule in the Civil Code, each partner is an owner of a fraction of all the assets of the NK.

2. Operation of an NK

As to when an NK's income is taxable at the partner level, the circular states that a partner in an NK arrangement must report his income at the end of the NK's accounting period. The circular further provides that, if an NK does not calculate its profit more than once during a calendar year, the district director will compute the profit.[24] This treatment is designed to avoid tax deferral. It is not certain, however, how to compute the NK's profit when the account is not closed or is missing.

The Japanese tax rule generally tends to take an aggregate approach to taxing an NK's income. The NK itself is not required to submit an information return or to withhold income tax when it makes a distribution. Some features of the entity theory creep in, however, when the net result method is elected. Under this method, the NK calculates its own net profits and losses, and the type of the income derived is determined at the NK level.

Whether the income retains its character when it flows through to the partners depends on the method elected by the taxpayer. Under the flow-through method, each item of income or deduction is treated as if it had been received or incurred directly by the partner.[25] Under the net result method, taxable income is determined at the NK level, with the net amount being allocated among the partners as a single category of income according to the activity of the NK itself.[26]

As to whether it is possible to allocate a special item to a certain partner in the NK arrangement, Japanese tax law does not have any provision on the effect of special allocations. The circular simply states that income should be calculated according to the "profit and loss split ratio" under each contract.[27] No further rules are made public. It is not certain if the tax authorities would accept a contractual term that, for example, allocates dividend income to the corporate partners that can benefit from a participation exemption and capital gains to the partners who have capital losses to offset.

There are differing views on what happens if the interest of the partners in the underlying assets differs from the allocation under the NK contract. For instance, A and B each contribute 100,000 in an NK arrangement to start a joint venture. Under the NK contract, the "profit and loss split ratio" is 1:4. The joint business produces a profit of 500 for the year 2000, of which 100 is distributed to A and 400 to B. The general rule inferred from the circular is that A should report 100 as his income and that B should report 400. It is not certain, however, if and when a tax officer would accept their tax return. Some commentators state that, if such a return is to be sustained, the taxpayer (A) should show "reasonable cause" in agreeing to the 1:4 split ratio, instead of 1:1.[28] In a similar vein, others maintain that the taxpayer must prove a "substantial economic effect" in order to claim that the 1:4 ratio is valid.[29] Others take the position that, if the taxpayers fail to show such reasonable cause, the consequence is a deemed gift.[30] According to this position, if the court finds the appropriate split ratio to be 1:1, A's income is adjusted upward to 250 (from 100), and B's income is adjusted downward to 250 (from 400). In addition, B is deemed to have received 150 as a gift from A, which triggers gift tax consequence to B as a donee under the Inheritance Tax Law.

It is possible for an NK to pay a salary to its partners different from the distribution of profits under the NK contract. If a partner receives a salary from the NK, the salary payment is deductible in computing net profits at the NK level. As a matter of factual determination, however, a salary payment is often indistinguishable from a distribution of profits when the partner contributes services instead of cash or property (Art. 667(2) of the Civil Code) or when the partner is appointed a manager of the joint business (Art. 670 of the Civil Code).

A partner may do business with an NK of which he is a partner. Under the Civil Code, a partner can enter into transactions with the NK. When a partner rents property to the NK, for example, he is making a contract with all the partners in the NK arrangement.[31] A difficult issue arises regarding the part of the contract under which he enters into with himself. Again, there are no rules on how to treat the portion of the rent that the partner pays to himself.

3. Dissolution of an NK

As to when an NK contract ends, the NK is dissolved when (a) the NK's business succeeds or fails (Art. 682 of the Civil Code), (b) a member requests dissolution due to

23. In the context of the United States, the former corresponds to the outside basis (US Internal Revenue Code, Sec. 722), and the latter to the inside basis (US Internal Revenue Code, Sec. 723).

24. Income Tax Basic Circular 36.37-19 and Corporate Tax Basic Circular 14-1-1.

25. This treatment corresponds to the "pure aggregate approach" in Easson and Thuronyi, *supra* note 2, at 940. For different forms of tax transparency, see Le Gall, Jean-Pierre, General Reporter on Subject I: International income tax problems of partnerships, *Cahiers de droit fiscal international*, Vol. LXXXa (1995), at 655, 662.

26. In other words, a "pure entity approach" is taken, according to the terminology in Easson and Thuronyi, *supra* note 2, at 940.

27. Under the Civil Code, the parties to an NK contract are free to agree on the "profits and loss split ratio". When the parties do not stipulate how to split the profits and losses, the court presumes that they should be distributed based on the amount contributed by each party (Art. 674(1)). When the sharing ratio is agreed upon with regard to profits only, the same sharing ratio is to be used with regard to losses (Art. 674(2)). Conversely, when the split ratio is agreed upon with regard to losses only, the same ratio should be applied to profits (Art. 674(2)).

28. Uematsu, Morio, "Koza Shotoku Zeiho No Shomondai No. 18", *Zeikei Tsushin*, Vol. 43 (1988), No. 3 at 58, 60.

29. Hirano, Yoshiaki, "Venture Capital To Shisan Shokenka No Tameno Zeimu Kaikei", *Zeikei Tsushin*, Vol. 54 (1999), No. 1 at 50.

30. Tohru Suda, *Beikoku No Partnership* (1994), at 237.

31. As a result of the transaction, the partners become joint tenants of the rented property. This treatment reflects the approach that regards an NK arrangement as an aggregate of partners, not an independent entity.

an "unavoidable reason", e.g. a serious disagreement among the members (Art. 683 of the Civil Code), or (c) all the members agree to dissolve the NK. Financial accounts will be cleared either by all the members or by an appointed liquidator (Art. 685 of the Civil Code). From a tax perspective, there is no specific rule on the termination of an NK.[32]

Regarding the relationship between a departing partner and the remaining partners, the departing partner is entitled to a payback of his interest in the NK based on the situation of the NK's property at the time of departure (Art. 681(1) of the Civil Code). It is possible to pay cash for such an interest, even if the departing partner had initially contributed services or property to the NK rather than cash (Art. 681(2) of the Civil Code). For example, if an NK operates a farming business that has large expenditures in the first half of the year, with all the income coming in the second half of the year, and if partner A departs half way through the year, it is not certain whether A gets all the deductions and the remaining partners get all the income. It is possible to postpone a calculation of an item that is still not closed at the time of departure (Art. 681(3) of the Civil Code). If all the partners agree to defer the calculation until the end of the year, the departing partner and the remaining partners will be even. In this case, the remaining partners do not receive all the income for their own tax purposes. In other cases, there is no indication as to how the income and expenses should be apportioned among the partners.

With respect to the treatment of payments to retiring partners,[33] as explained in IV.B.1., Japanese law does not distinguish between the cost base of a partner's interest in the NK (outside basis) and the NK's cost base in the property (inside basis). This complicates the tax treatment of retiring partners. It is not clear if, or under what conditions, a retiring partner is treated as transferring his interest in the NK to other partners, thus becoming eligible for capital gains treatment.

4. Anti-avoidance provisions

Japanese law has no anti-avoidance provisions specifically targeting the NK structure.[34] For example, there are no anti-avoidance provisions dealing with NK income that is allocated to inactive partners (e.g. spouses or children). A predominant understanding among Japanese tax lawyers is that, without specific anti-avoidance provisions, a tax officer may not disregard the effect of a private transaction.[35] The particularity of NK taxation, however, is that almost everything is left to interpretation. A tax officer might therefore be tempted to deny a particular allocation by a liberal interpretation of a general provision. In the author's view, such an attempt may have a good chance of success in court.

5. International aspects

Regarding the international aspects, issues abound.[36] For instance, one issue is whether income that is subject to Japanese withholding tax if paid directly retains that character if paid to non-resident partners. All that can be inferred from the circular is that the withholding requirement remains under the flow-through method. It is not clear whether a taxpayer can avoid the withholding tax by electing the net result method of pass-through treatment.

Another issue is when a foreign partner is regarded as having a permanent establishment in Japan.[37] A foreign partner in an NK arrangement is deemed to have a domestic permanent establishment when the NK is considered to own a domestic permanent establishment. If the NK generates only passive income, its foreign partner is taxable as if he receives the passive income directly. In this case, the income is likely to be subject to withholding tax at the domestic (non-treaty) rate, unless an applicable treaty provides otherwise.

6. Summary

As shown above, it is often not certain how an NK structure is taxed under Japanese law. The lack of clear answers to concrete questions stems from the fact that, although an aggregate approach is generally adopted, its consequences have never been thought out in a systematic manner. The simplicity of written rules invites insurmountable transactional complexity.[38] Likewise, many issues remain unresolved regarding the taxation of TK structures. In short, the tax rules are fairly unpredictable for both NK and TK arrangements.

C. Call for legislative reform

This article is undoubtedly not the first to point out the lack of specific rules for the taxation of NKs and TKs. Many Japanese scholars have been aware of this unsatisfactory situation. Below are some examples highlighting their concern.

Prof. Usui states that the provisions of the Income Tax Law regarding NK structure are unsatisfactory.[39] He proposes that legislation be enacted that would impose a reporting requirement on the NK itself and govern the fis-

32. The accounting period of an NK is closed at the time the financial accounts are cleared. For example, in May 2000, the partners agree to dissolve their NK arrangement as of the end of the previous fiscal year. In May 2000, the NK assets are still in the process of being sold or distributed. The financial accounts are closed on the last day of June 2000. In this case, it is likely that, for tax purposes, the NK terminates on the last day of June 2000, not on the last day of December 1999. There is, however, no precedent on this issue.
33. If an NK arrangement is totally dissolved, the residual assets are distributed back to each partner according to his contribution (Art. 688(2) of the Civil Code). The partners, however, are free to enter into a contractual agreement to modify the manner of the final distribution. Therefore, under a particular contract, it may happen that, out of the residual assets of 500, partner A receives 100 and partner B receives 400, although the initial contribution of each was 200. It is again an open question whether and when, in this case, a tax officer deems a gift from A to B.
34. If a family corporation becomes a partner in an NK arrangement, the anti-avoidance provision against family corporations may be applied (Art. 157 of the Income Tax Law and Art. 132 of the Corporation Tax Law).
35. See Kaneko, Hiroshi, *Sozeiho* (7th ed., 1999), at 121-122.
36. See Le Gall, *supra* note 25, at 665.
37. See Otsuka, *supra* note 1, at 323.
38. The experience of Japan seems to support the proposition in Easson and Thuronyi, *supra* note 2, at 948 that "[d]espite the statutory simplicity, the practical difficulties preclude the adoption of the pure aggregate approach as a general rule in developing and transition countries".
39. Usui, Mitsuaki, "Kyodo Jigyo To Shotokuzei No Kazei", *Zeiri*, Vol. 25 (1982), No. 6, at 9, 15.

cal year of an NK; he also proposes that there be a rule to coordinate with the blue return system of individual members.

Mr Uematsu, a former high-profile official at the Ministry of Finance, criticizes the ambiguity of the three methods set out in the circular.[40] He proposes to introduce a provision requiring NKs to submit an information return to the tax authorities. Another proposal is to oblige NKs to notify each member of the computation items as a condition for flowing through such items to each member.

Prof. Hirano agrees that neither the Corporation Tax Law nor the Income Tax Law has specific rules for NK structures.[41] He makes a wide range of recommendations based on his comparative study on partnership taxation in the United States.[42]

Prof. Takahashi also refers to the US rules. From a comparative perspective, he clarifies the lack of necessary rules in Japan regarding the following specific areas: the cost base of a member's interest in the NK,[43] the contribution to the NK of an asset with a built-in gain or loss,[44] the transfer of a member's interest in the NK,[45] and special allocation among members of an NK.[46]

Prof. Sato's opinion is that the Japanese legislature must take measures against income splitting through the NK structure[47] and introduce an entity approach by clear provisions.[48]

D. Legislative impasse

Despite these warnings, the Japanese legislature has taken no action in the partnership field. One possible reason for this is that tax policy makers have deliberately neglected this area. According to this hypothesis, the Ministry of Finance does not wish to foster the development of NK and TK arrangements because they are too difficult to handle. In addition, the National Tax Administration is concerned that tax enforcement could become very costly if NK and TK structures become popular forms of doing business. A reasonable policy maker would choose a strategy that keeps the tax rules as open and unpredictable as possible. In the author's view, this is one reason why there are only six circulars on the taxation of NKs and TKs in Japan.

The established business community dislikes unpredictable rules. Only risk takers try to structure their tax savings device through the partnership structure. The name TK connotes tax avoidance. The NK arrangement is also used in leveraged leasing. In a recent case, the court ruled that the corporate member of an NK could not use accelerated depreciation for foreign film.[49]

Legislative inaction has side effects. Established businesses move out of the NK and TK market. Innocent citizens who operate a joint business potentially face an unexpected tax adjustment since their arrangement might accidentally fit into the NK or TK patterns, which do not require formal registration.

Seen in this light, the undeveloped tax rules are not merely the outcome of the unpopularity of partnerships, but are also its cause.

V. EVALUATION AND PREDICTION

Assuming that this explanation makes sense, the question is whether the policy makers' strategy is a clever one. In the author's view, this is not the correct way to confront the tax issues arising from TK and NK structures. Ambiguity in tax effects should not be used as a tool to police the selection of business forms. Flow-through entities could become friendlier toward mainstream business communities in Japan. Aggressive tax avoidance can be prevented only by well-targeted legislative provisions, not by a lack of specific rules.

It appears that the present impasse will continue for the time being. In 1998, the Ministry of Trade and Industry introduced a law establishing limited partnerships in order to stimulated small venture businesses. Under this law, for the first time in Japan, a party to an NK contract is able to have limited liability.[50] The accompanying tax issues, however, were again dealt with in a short circular issued by the National Tax Administration, and many issues were left unresolved. More academic input into the legislative process seems necessary.[51]

40. Uematsu, *supra* note 28, at 58.
41. Hirano, Yoshiaki, *Partnership No Homu To Zeimu* (1994), at 236.
42. Hirano, *supra* note 29.
43. Takahashi, Yusuke, "Partnership Mochibun No Kijun Kakaku Ni Tsuite", *Zeihogaku*, No. 534 (1995), at 1.
44. Takahashi, Yusuke, "Partnership Ni Taisuru Shusshi To Built-in Gain/Loss No Haifu Ni Tsuite", *Zeihogaku*, No. 537 (1997), at 17.
45. Takahashi, Yusuke, "Partnership Mochibun No Johto Ni Tsuite", *Zeihogaku*, No. 540 (1998), at 35.
46. Takahashi, Yusuke, "Kyodo Jigyo Kara Shozuru Shotoku No Kazei Ni Kansuru Ichi Kohsatsu", *Hogaku Ronso* (1997-1998), Vol. 141, No. 6 at 25 and Vol. 143, No. 4 at 26.
47. Sato, Hideaki, "America Ni Okeru Chusho Kigyo Keitai No Tayohsei To Zeisei", *Zeiken*, No. 81 (1998), at 47.
48. Sato, Hideaki, "Kumiai Ni Yoru Toshi To Kazei", *Zeimu Jirei Kenkyu*, Vol. 50 (1999), at 66.
49. Decision of the Osaka District Court of 16 October 1998, Shomu Geppo, Vol. 45, No. 6 at 1153. This NK scheme was promoted by Merrill Lynch Capital Markets around 1989.
50. According to the Nikkei Newspaper of 21 September 1999, a growing number of individuals are becoming partners in NK structures in order to invest in venture firms. For example, D. Brain Capital has set up a limited liability partnership under the new law in order to solicit a total of 3 million yen to invest in the equity of Internet-related firms. See http://www.vimex.co.jp/efund/gaiyo.html (visited on 21 September 1999).
51. Masui, Yoshihiro, "Statutory Interpretation as a Process of Tax Law-Making: the Case of Japan", in Vogel, K. (ed.), *Interpretation of Tax Law and Treaties and Transfer Pricing in Japan and Germany* (1998), at 21.