

Japan's Tax Authority confirms tax treatment of US limited partnership as fiscally transparent entity

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Executive summary

On 9 February 2017, Japan's National Tax Agency (the NTA) posted a [notice](#) (Notice) on its website confirming that a US limited partnership (US LP) is treated as fiscally transparent for Japanese tax purposes when applying the US-Japan Income Tax Treaty¹ (the Treaty). Thus, a Japanese partner in a US LP is treated as deriving an item of income paid to the US LP and therefore, may be eligible to claim a benefit under the Treaty so long as other conditions are met. The Notice is helpful in clarifying the position of the Japanese Government given the uncertainty regarding the applicability of the Treaty as a result of a 2015 decision of the Japanese Supreme Court, which held that a Delaware LP would not be treated as fiscally transparent for purposes of Japanese law.

Detailed discussion

On 17 July 2015, the Japanese Supreme Court issued a decision (the Decision) holding that a Japanese investor (the Investor) could not claim its distributive share of the operating losses generated in the US through an LP formed under the *Delaware Revised Uniform Limited Partnership Act* in which the Investor was a partner, because the losses were created by the US LP's business operations without participation by the Investor. In reaching its decision, the Japanese Supreme Court analyzed whether: (i) the governing foreign law grants the entity a legal standing equivalent to that of a corporation as defined under

Japanese law; and (ii) the entity is attributed rights and obligations. The Supreme Court reasoned that the US LP would not be treated as fiscally transparent under Japanese law because the US LP undertook all business operations and held assets and liabilities under its own name, and neither business operations nor assets and liabilities could be clearly identified as those of the investor.

It was unclear how broadly the Decision applied and in particular, whether partners resident in Japan would be treated as deriving income through the US LP for purposes of claiming treaty benefits. In that regard, the Notice indicates that the NTA had received requests from taxpayers to clarify the tax treatment under Japanese law of items of income derived through a US LP.

The Notice settles this uncertainty and clarifies that the NTA treats an item of income paid to and through a US LP in which Japanese residents are partners as derived by the Japanese resident partners and subject to tax on a current basis in the hands of the partners, irrespective of distributions from the US LP. Further, the Notice provides that the character and source of the item of income in the hands of the Japanese partners of the US LP is determined as if such items were realized directly, provided that the US LP has not made an election to be classified as a corporation for US federal income tax purposes. As a result, a partner of a US LP that is resident in Japan may be eligible to claim the benefits under the Treaty on an item of income derived through a US LP, provided all other conditions to qualify for treaty benefits are met (for example, the Limitation on Benefits provision), because that income will be treated as income of the Japanese partner.

Implications

The Notice is an important development and confirms that according to the NTA, partners of a US LP that are resident in Japan are considered to derive income paid to or through a US LP. Therefore, provided that other conditions are met, partners resident in Japan may be eligible for treaty benefits. To the extent that amounts paid to or through a US LP were withheld upon because of the uncertain application of the Decision, it may be possible for the US LP's Japanese partners to seek a refund from the US Internal Revenue Service. In addition, withholding agents might want to apply the adjustments for over-withholding procedures as outlined in Internal Revenue Code Section 1461 regulations for amounts withheld in 2016.

Further, although the Decision related to an LP formed under the laws of Delaware, it was unclear whether it might apply to LPs formed under the laws of other US states. The Notice, however, is not limited to a US LP formed under Delaware law and therefore, appears to apply to US LPs generally.

Endnote

1. Convention between the Government of the United States of America and the Government of Japan for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital gains, signed 6 November 2003.

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