

2026 Tax Reform

## Relaxation of the Requirements for the Permanent Establishment Exemption

*Articles 41-21 and 67-16 of the Special Taxation Measures Act*

December 23, 2025

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### Summary

On December 19, 2025, the ruling political parties in Japan issued their proposals for the 2026 tax law changes. These proposals will be discussed in parliament in the Spring of 2026. Traditionally, these proposals are broadly incorporated into the Japanese tax laws.

This year's proposals contain a provision clarifying the tax position in Japan for inbound Japan private equity investors in funds that are managed by Japan resident fund managers.

In this Alert, we will focus on this specific provision.

When foreign investors invest in Japan as limited partners in Japanese investment business limited partnerships (**IBLP**) or similar foreign limited partnerships (**LPS**) that are managed in Japan, the risk that this investment constitutes a permanent establishment (**PE**) in Japan for the limited partners (**LPs**) needs to be considered. In recognition of the fact that LPs, by their nature, generally have minimal involvement in the business of the LPS, the Japanese tax law permits the LPs to claim a special exemption (**PE Exemption**) that shields the foreign LP from having a PE in Japan, such that Income (and gains) generated in the LPS should not be treated as taxable in Japan.

However, the current requirements to obtain the PE Exemption have been viewed as being too stringent and potentially acting as a barrier to foreign investors investing in Japan.

In response, measures introduced under the 2026 tax reform are intended to relax the requirements for the PE Exemption, thereby expanding opportunities for foreign investors to utilize the PE exemption. As a result, it is anticipated that foreign investment into Japan will accelerate.



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## Overview of the Tax Reform

Under the 2026 tax reform, the requirements for the PE Exemption (*Articles 41-21 and 67-16 of the Special Taxation Measures Act*) will be made less restrictive. The filing requirements for the special exemption application form will also be reviewed. The requirements prior to and after the revision are as follows:

### Applicable Requirements Prior to the Tax Reform

- (1) Being a LP of the LPS.
- (2) Not engaging in certain acts as execution of business operations related to the LPS's business (such as approving the Execution of Operations).

↳ Acts Excluded from the Execution of Operations.

**Approval of self-dealing and similar transactions by the business executor.**

- (3) The ownership interest in the assets of the LPS must be less than **25%**.
- (4) Not having a special relationship with the general partner (GP) of the LPS.
- (5) **Not having a PE in Japan related to any business other than that of the LPS.**

### Applicable Requirements After the Tax Reform

- (1) (Unchanged)
- (2) Not engaging in certain acts as execution of business operations related to the LPS's business (such as approving the Execution of Operations).

↳ Acts Excluded from the Execution of Operations.

**(Additional) Approval of conflict-of-interest (COI) transactions.**

- (3) **Provided that an advisory board is established,** The ownership interest in the assets of the LPS must be less than **50%**.
- (4) (Unchanged)
- (5) **(Abolished)**

## (1) Background of the Establishment of the PE Exemption

As part of efforts to promote investment in(to) Japan, there were significant tax reforms implemented in 2009.

It was determined that foreign LPs in limited partnerships that are managed by Japan based fund managers (an arrangement that would typically create a nexus resulting in a PE in Japan), with minimal involvement in the execution of the partnerships' business, will be treated as non-residents or as foreign corporations without a PE in Japan.

## (2) Overview of the Current PE Exemption

■ **General Treatment:** When a foreign investor who is an LP invests in Japan through an LPS, the determination of a PE in Japan is based on the degree of joint business activity between the LP and GP/fund manager in Japan within the partnership, and taxation in Japan is applied accordingly.

Therefore, when the GP/fund manager executes the business operations of the LPS business from Japan, the LP is required to file and pay income tax and/or corporate tax in Japan, and a withholding tax of 20.42% must be applied to the profits distributed to the LP.

■ **Special Treatment:** Under the current system (please refer to the box above), an LP (the **Specified Foreign Partner**) who satisfies the requirements and submits the special exemption application form - thereby fulfilling the notification requirement (described later) - is deemed not to have a PE in Japan from the date of submission of the form. (*Special Taxation Measures Act, Article 41-21(5)*)

## (2) Overview of the Current PE Exemption (*cont'd*)

■ As a result, Specified Foreign Partners are not required to file and pay income tax and/or corporate tax on PE-attributable income in Japan. Furthermore, no 20.42% withholding tax is applied to profit distributions received by such partners (**PE Exemption**).

### Requirements for Submission of Notification Forms.

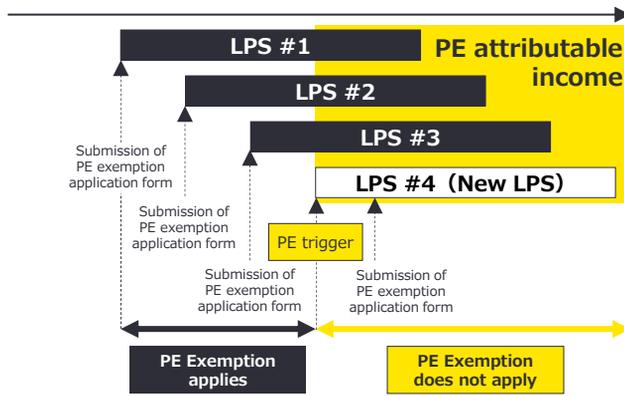
- (1) Submit the "Special Exemption Application Form," which includes the prescribed information, along with certain documents such as the investment partnership agreement, to the competent district tax office through the GP of the LPS.
- (2) If there is any change in the content of the special exemption application, submit a change notification form to the competent district tax office.
- (3) If five years have passed since the date of submission of the special exemption application form (or, in the case of a change, since the date of submission of the change notification form), submit a renewal application form to the competent district tax office.

## (3) Concerns Regarding the Current System

■ If, during the term of the investment partnership agreement, an LP ceases to satisfy any of the requirements for being a Specified Foreign Partner, that LP will no longer be eligible for the PE exemption for that LPS from the date on which the requirements are no longer met. Additionally, even if the LP subsequently satisfies the requirements again, the exemption cannot be claimed again. (*Special Taxation Measures Act Article 42-21(6), Enforcement Order Article 26-30(13)*)

### (3) Concerns Regarding the Current System (cont'd)

- For example, if an LP who is a Specified Foreign Partner enters into a new investment partnership agreement with an LPS (a “New LPS”) and fails to submit the special exemption application form for the New LPS, resulting in the LP losing its status as a Specified Foreign Partner, then from the date that status is lost (the PE recognition date), the LP will no longer be eligible for the PE-related tax exemption. This is not only in relation to income from the New LPS but also for income from other existing LPSs. Furthermore, this loss of eligibility cannot be remedied thereafter (See Figure 1).



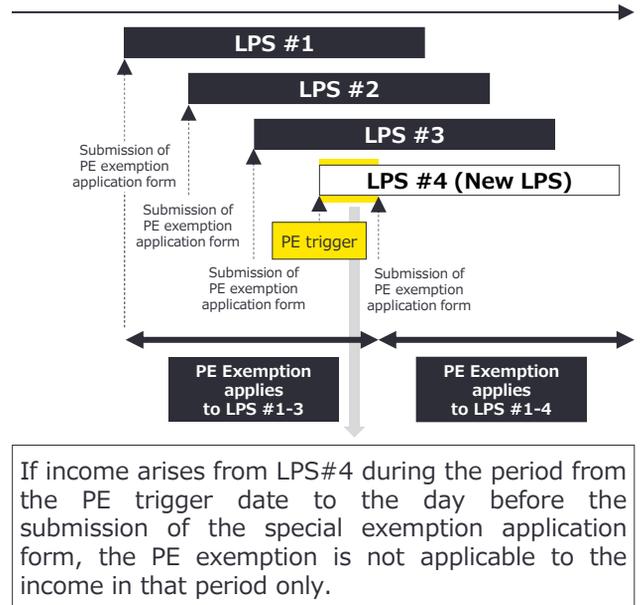
- Income arising from LPS #1-4 is subject to filing and payment of income tax and corporate tax.
- A withholding tax of 20.42% is required on the distribution of profits received by the LP from LPS #1-4.

**Figure 1. Treatments Prior to the Tax Reform**

- Due to concerns that certain advisory or approval actions by LPs, usually performed by the Advisory Board (i.e., Limited Partner Advisory Committee (LPAC), a consultative body for the governance of LPSs), might be considered as execution of business operations of the LPS, restrictions arose on the governance structure of funds using LPSs as fund vehicles.
- Furthermore, regarding the restriction that ownership interest must be less than 25%, there were concerns that, in cases where a fund closes in multiple rounds, relatively large anchor investors could not participate in the initial closing, and that this restriction could hinder the establishment of feeder vehicles tailored to investor requirements.

### (4) Impact of the Tax Reform

- By abolishing the requirement of “Not having a PE in Japan related to any business other than that of the LPS” from the conditions for applying the PE Exemption, even if an LP fails to submit the special exemption application form for a New LPS, the LP will only lose eligibility for the PE-related tax exemption with respect to income from that New LPS. The LP will continue to enjoy the exemption for income from existing LPSs (see Figure 2).



If income arises from LPS#4 during the period from the PE trigger date to the day before the submission of the special exemption application form, the PE exemption is not applicable to the income in that period only.

**Figure 2. Treatments After the Tax Reform**

- Furthermore, if the LP submits the special exemption application form for the new LPS, the LP will be eligible for the exemption on income from that new LPS from the date of submission.
- In addition, by excluding the approval of conflict-of-interest transactions by the Advisory Board from being considered as execution of business operations of the LPS, LPs can participate in approving GP conflict-of-interest matters through the Advisory Board, thereby strengthening fund governance while mitigating the tax risks for LPs.
- Finally, by raising the ownership interest threshold for LPs to qualify for the PE Exemption from less than 25% to less than 50%, provided that an Advisory Board is established for the LPS, more flexible fund closings and feeder vehicle structures should become possible.

### (5) Conclusion

If the 2026 tax reform proposals are enacted as expected then the opportunities for foreign investors to utilize the PE Exemption will be expanded, and it is expected that the inflow of investments by foreign investors into Japan will continue to accelerate in the future.

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