Grant Thornton

Japan Tax Bulletin

Taxation of a Nini Kumiai ("NK"), a form of partnership under the Civil Code

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An NK is a partnership stipulated in the Civil Code. NKs are sometimes used to design tax shelter products. This bulletin contains an overview of the legal framework of NKs in the Civil Code, tax treatments of NKs, discusses a court case where a judgement was made on a tax shelter structure using an NK and the anti-avoidance rules.

1. *Legal framework of an NK*

Articles 667 to 688 of the Civil Code provide the legal framework of an NK. A summary of these article is as follows:

- Partnership Contract

  A partnership contract becomes effective when each of the parties promises to make a contribution and engage in a joint undertaking.

- Co-Ownership in Partnership Property

  The contributions of the partners and other partnership property is co-owned by all partners.

- Methods of Deciding and Executing Business
  - ✓ The partnership business is decided by the majority of the partners and executed by each partner.
  - ✓ The decision and execution of the partnership business may be delegated to one or more partners or a third party, pursuant to the provisions of the partnership contract.
  - ✓ The person delegated as referred to in the preceding paragraph (hereinafter referred to as a "person who executes business") decides and executes the partnership business. In such a case, if there are two or more persons who execute business, the partnership business is decided by the majority of these persons who execute business and is executed by each of them.
  - ✓ Notwithstanding the provisions of the preceding paragraph, the partnership business is not precluded to be decided based on the consent of all partners or executed by all partners.
  - ✓ Notwithstanding the provisions of the preceding paragraphs, the ordinary business of a partnership may be performed by each partner or each person who executes business independently; provided, however, that this does not apply if other partners or persons who execute business raise objections prior to the completion of the business.

- Inspections by Partners of Status of Partnership Business and Property

  Each partner may inspect the status of the business and property of the partnership even if the partner does not have the right to decide and execute the business of the partnership.

- Allocation of Partners' shares of Profits and Losses
  - ✓ If parties have not specified the proportions of allocations of the partnership's profits and losses, these proportions are determined in accordance with the value of each partner's contribution.
  - ✓ If the proportions of allocation have been specified solely with respect to either profits or losses, it is presumed that those proportions are common to profits and losses.

As described above, an NK is not a legal entity nor juridical personality. All businesses are conducted in the names of partners and managing partners where appointed. All of an NK's properties are co-owned by partners and profits and losses of the NK are allocated to partners.

2. *Tax treatments of an NK*

There are no provisions about tax treatments of an NK in the tax laws and regulations, but the tax authorities have published interpretation circulars. Under the circulars, an NK is not a taxpayer, but the partners are taxpayers for the NK's income, taxable sales (VAT) and properties (property tax).

Income Tax Law Basic Circular 36.37 Kyo-20 provides tax treatments of an NK's income for individual taxpayers as follows:

The amount of profit or loss to be included in gross income or deductible expenses in computing the amount of various types of income of a partner of an NK etc. shall be calculated in accordance with the following method (1). However, if it is deemed difficult for the partner to calculate by method (1) and the partner has used using method (2) or (3) below continuously, such calculation shall be permitted.

(1) The method of calculating the amount of income, expenses, assets, liabilities, etc. related to such partnership business as these amounts for each partner in proportion to his/her share of the distribution.

(2) The method of calculating the amount of income, the amount of costs and expenses related to the income, and the amount of losses in relation to such partnership business as these amounts for each partner in proportion to its share of such income, costs and expenses.

If this method is utilized, each partner shall be subject to the provisions regarding tax-exempted income, dividend deductions, withholding tax credit with respect to final tax returns, etc., but not to the provisions regarding deductible allowances, reserves, etc., with respect to transactions, etc., in connection with such partnership business.

(3) The method allocating the amount of profits or losses calculated with respect to the Partnership Business to each partner in proportion to its share of the profits or losses of the Partnership Business.

In this case, the provisions concerning tax-exempt income, deductible allowance, reserves, dividend deductions, withholding taxes credit on final tax returns, etc. shall not apply to each partner with respect to transactions, etc. related to the partnership business.

The amount of profit or loss to be allocated to each partner shall be the amount for real estate income, business income, forestry income or miscellaneous income, depending on the principal business of the partnership business.

As an NK is tax transparent, the nature of income or loss in an NK's business is the same for partners. Losses from businesses producing real estate income, business income, and forestry income can be offset against other income, but that from producing miscellaneous income cannot be offset against other income.

Corporation Tax Law Basic Circular 14-1-2 provides the same as above.

3. *Tax shelter arrangement utilizing an NK*[1]

Individual investors made investments in an NK with the inducement of financial advisory firm. The NK purchased a second-hand aircraft with funds provided by investors and a non-recourse loan obtained from a financial institution with the aircraft mortgaged, and then it leased to an airline company. The NK produced losses for depreciation of the aircraft and interest expenses on the loan and allocated them to investors. The investors declared the losses were from a business producing real property income and offset them against other income, and consequently reduced their tax liabilities. The tax authorities argued that the NK contract was not in substance an NK contract but a contract regarding distributing profits over the lease period. The tax authorities' argument appears to be based on the fact that investors were not involved in the NK business but passive investors expecting small returns and tax saving effects. The court dismissed the tax authorities' argument.

There are some other court cases where an NK or other similar vehicles have been utilized to allocate losses, and there are cases where the court upheld the tax authorities' argument.

4. *Anti-Avoidance Rule*

After the aircraft leasing case above, an anti-avoidance rule to restrict using passive losses allocated by an NK etc. was introduced. Article 41-4 of the Special Taxation Measures Act provides that losses for producing real property income allocated by an NK to passive partners are disregarded.

[1] October 17, 2005 Nagoya High Court Decision