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Initial Thoughts on Classifying the Major Japanese Business Entities Under the Check-the-Box Regulations

*Christopher H. Hanna**

I. INTRODUCTION

VERY little has been written in the American tax literature on the United States' income tax classification of the major Japanese business entities. At first blush, this seems particularly surprising when one considers that Japan has the second largest economy in the world and has attracted a respectable amount of American investment. Probably the reason for the sparse literature, however, is that the classification of the major Japanese business entities, particularly the one or two that are actually used by American investors, seems to have been a relatively simple determination, even before the promulgation of the final entity classification regulations in December 1996.

This Article will briefly describe the major Japanese business entities. It will then discuss the classification of these entities both before (briefly) and after the promulgation of the final entity classification regulations. At the present time, it appears that the regulations have not had a great impact on the classification of Japanese business entities, at least in terms of any kind of dramatic change in classification from prior law. But only experience with the new regulations will demonstrate the impact of these regulations.

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II. OVERVIEW OF MAJOR JAPANESE BUSINESS ENTITIES

Under the Japanese income tax laws,[1] corporation (*"hōjin"*) refers to an organization that has juridical (or legal) personality under the Commercial Code, Civil Code, or any other laws.[2] In addition to the stock companies, it includes various partnerships, cooperatives, non-profit organizations, and other types of organizations. It does not include a simple partnership under the Japanese Civil Code (*"nin-i kumiai"*), which is generally a joint venture without legal personality carried on by taxpayers.[3] The term corporation also does not include a secret partnership or anonymous association under the Japanese Commercial Code (*"tokumei kumiai"*).[4] As a result, the *nin-i kumiai* and the *tokumei kumiai* are not subject to the Japanese corporate income tax.[5]

Corporations are classified into one of two categories: domestic and foreign. A domestic corporation (*"naikoku hōjin"*) is one maintaining its head office (*"honten"*) or principal office (*"shutaru jimusho"*) in Japan.[6]

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1. For purposes of this Article, any reference to Japanese income tax laws includes both the individual and the corporate income tax laws of Japan. Generally, the Income Tax Law (*"Shotokuzei Hō"*) applies to individuals, and the Corporate Tax Law (*"Hōjinzei Hō"*) applies to corporations, but certain withholding provisions of the Income Tax Law also apply to corporations. This Article will focus exclusively on the Japanese income tax laws at the national level and will not address issues relating to local tax law, the consumption tax, or tax treaties.

2. *See generally* TAX BUREAU OF THE MINISTRY OF FINANCE, AN OUTLINE OF JAPANESE TAXES 1995 74 [hereinafter MOF 1995]; YUJI GOMI, GUIDE TO JAPANESE TAXES 1995-96 ¶ 3-140, 39 (1995); Morio Uematsu, *Computation of Income in Japanese Income Taxation: A Study in the Adjustment of Theory to Reality in Law, in* JAPAN: THE LEGAL ORDER IN A CHANGING SOCIETY 566, 583 (Arthur Taylor von Mehren ed., 1963).

3. *See, e.g.*, JOHN W. DARCY, JAPAN-U.S. INTERNATIONAL TAX TRANSACTIONS ¶ 105.10 (1994) (citing CTL Basic Circular 1-1-1); GOMI, *supra* note 2, at 39; Ichiro Otsuka, *International Income Tax Problems of Partnerships: Japan, reprinted in* 50a CAHIERS DE DROIT FISCAL INTERNATIONAL [STUDIES ON INTERNATIONAL FISCAL LAW] 317 (International Fiscal Association ed., 1995); Uematsu, *supra* note 2, at 583. The income of a simple partnership is taxed to the partners, whether or not the income is actually distributed to them. *See* Civil Code, sec. 12, arts. 667-88 (dealing with simple partnership (nin-i kumiai) rules).

4. *See, e.g.*, DARCY, *supra* note 3, ¶ 105.10; GOMI, *supra* note 2, at 39; Otsuka, *supra* note 3, at 317; Uematsu, *supra* note 2, at 583. *See* Commercial Code, ch. IV, arts. 536-42 (dealing with rules for an undisclosed association or secret partnership (tokumei kumiai)).

5. *See, e.g.*, DARCY, *supra* note 3, ¶ 630; Takashi Kuboi & Yoichi Asakawa, *Partnering in Japan: Form of Entry and Recent Tax Issues*, 13 TAX NOTES INT'L 446, 447 (1996); Otsuka, *supra* note 3, at 318-19; Uematsu, *supra* note 2, at 583.

6. *See* Corporation Tax Law, art. 2(1)(iii) (translated in YUJI GOMI, JAPAN CORPORATION TAX LAW (1996)). Under the Commercial Code, the permanent establishment of a company is at the seat of its principal office. *See* Commercial Code, art. 54(2). Under the Civil Code, the permanent establishment of a company is at the seat of its principal office. *See* Civil Code, art. 50. The two provisions are translated identically by one translation service. But some commentators have noted that the Commercial Code is actually referring to the head office while the Civil Code is referring to the main office. *See* Uematsu, *supra* note 2, at 584 n.105; *see also* DARCY, *supra* note 3, ¶ 105.10. Nevertheless, it should be noted that principal office should mean the head office (under the Commercial Code) or main office (under the Civil Code) and not the principal place of business. *See* Uematsu, *supra* note 2, at 584 n.105; *see also* DARCY, *supra* note 3, ¶ 105.10. Under the United States-Japan Income Tax Treaty, the term "Japanese corporation" means a juridical person that has its head or main office in Japan or any organization without juridical personality treated for purposes of Japanese tax as a Japanese juridical person. *See* Conven-

A foreign corporation (*"gaikoku hōjin"*) is simply defined as a corporation that is not a domestic corporation.[7]

There are four primary Japanese organizations that are classified for tax purposes as corporations under the category of ordinary corporations and that are the focus of this article.[8] These are: the joint stock company (*"kabushiki kaisha"*); the limited company (*"yugen kaisha"*); the unlimited partnership company (*"gomei kaisha"*); and the limited partnership company (*"goshi kaisha"*). All four of these ordinary corporations are subject to the Japanese corporate income tax on their taxable income. Three of the business entities, the *kabushiki kaisha*, the *gomei kaisha*, and the *goshi kaisha*, are companies (*"kaisha"*) under the Commercial Code.[9] The *yugen kaisha* is a company under the Limited Company Law, which incorporates by reference many provisions of the Commercial Code applicable to the *kabushiki kaisha*.[10]

The joint stock company, or *kabushiki kaisha*, is organized under the Commercial Code.[11] It has been described in detail many times, and no attempt will be made to do so here.[12] It is used by large Japanese businesses and by an overwhelming number of foreign organizations conducting business in Japan, either as a wholly owned subsidiary or as a joint venture with Japanese partners.[13] All of the shareholders of the *kabushiki kaisha* have limited liability.[14] It is very similar to the United States corporation.

The limited company, or *yugen kaisha*, is organized under the Limited Company Law which, as noted earlier, incorporates by reference many provisions of the Commercial Code applicable to the *kabushiki kaisha*. It is commonly used by small Japanese businesses, such as family owned businesses.[15] It can be owned by a single member, but can have a maximum of only fifty members with limited exceptions.[16] All of the mem-

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tion for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, March 8, 1971, U.S.-Japan, art. 2(1)(e)(ii).

7. *See* Corporation Tax Law, art. 2(1)(iv).

8. *See generally* Corporation Tax Law, art. 2(1)(ix); MOF 1995, *supra* note 2, at 78; DARCY, *supra* note 3, ¶ 105.20.

9. *See* Commercial Code, arts. 52, 53, 54.

10. *See* Limited Company Law, art. 1.

11. *See* Commercial Code, ch. IV, arts. 165-456.

12. For a detailed description of the kabushiki kaisha in English, see, e.g., Griffith Way et al., *Business Operations in Japan*, *in* TAX MANAGEMENT A-5 to A-19 (BNA Portfolio 51-7th 1990); Michio Matsueda & Kazuo Ihara, *Business Organization*, *in* 4 DOING BUSINESS IN JAPAN pt. 7 (Zentaro Kitagawa ed., 1996); Yasuyuki Kawabata, *Japan*, *in* 2 TAXES AND INVESTMENT IN ASIA AND THE PACIFIC 9-24 (Supp. No. 138, 1996).

13. *See, e.g.*, DARCY, *supra* note 3, ¶ 105.20; Kuboi & Asakawa, *supra* note 5, at 446-47; Way et al., *supra* note 12, at A-5.

14. *See* Commercial Code, art. 200(1) ("The liability of a shareholder shall be limited to the value at which he has taken his own shares."); *see, e.g.*, DARCY, *supra* note 3, ¶ 105.20; Kuboi & Asakawa, *supra* note 5, at 447.

15. *See* DARCY, *supra* note 3, ¶ 105.20; Kuboi & Asakawa, *supra* note 5, at 447.

16. *See* DARCY, *supra* note 3, ¶ 105.20 (noting the change made in the Limited Company Law in 1990, which now allows a yugen kaisha to have only one member). Prior to the 1990 change, Limited Company Law art. 69(1)(v) stated that the *yugen kaisha* would dissolve whenever only one member remained.

bers of the *yugen kaisha* have limited liability.[17] It is similar in many ways to the *kabushiki kaisha*, except that it is generally smaller and its procedures and requirements are simpler.[18]

The *kabushiki kaisha* has been used much more frequently by foreign investors than the *yugen kaisha*.[19] Several commentators have noted, however, that the *yugen kaisha* seems to be the perfect Japanese business entity for foreign investors because of its simpler procedures and requirements.[20] But others have noted that the *yugen kaisha* is not a suitable entity for structuring foreign investment.[21] Commentators have given a number of reasons for the lack of interest in the *yugen kaisha* by foreign investors, including: (1) the lack of prestige associated with it; (2) difficulty in obtaining bank credit and developing business relationships (because of the lack of prestige); (3) delays in dealing with Japanese authorities because of their unfamiliarity with the *yugen kaisha*; (4) the lack of flexibility in certain corporate matters; and (5) in actual practice, the simpler procedural requirements may only be minimally simpler than the procedures for a *kabushiki kaisha*.[22]

The unlimited partnership company, or *gomei kaisha*, is organized under the Commercial Code.[23] It is similar in many respects to the United States general partnership. Its members have unlimited liability for the debts of the partnership.[24] More specifically, the partners are jointly and severally liable for the debts of the partnership if the assets of the partnership are insufficient to fully satisfy creditors.[25] In addition, a company cannot be a partner in the *gomei kaisha*.[26]

The limited partnership company, or *goshi kaisha*, is also organized under the Commercial Code.[27] Many of the provisions applicable to the *gomei kaisha* are also applicable to the *goshi kaisha*.[28] It is similar in many respects to the United States limited partnership. The articles of incorporation must specify which partners have limited liability and which partners have unlimited liability.[29] There must be at least one part-

17. *See* Limited Company Law, art. 17 ("The liability of a member, except as otherwise provided for in this Law, shall be limited to the amount of his contribution."); *see, e.g.*, DARCY, *supra* note 3, ¶ 105.20; Kuboi & Asakawa, *supra* note 5, at 447.

18. *See* Way et al., *supra* note 12, at A-19; Kuboi & Asakawa, *supra* note 5, at 447; DARCY, *supra* note 3, ¶ 105.20.

19. *See, e.g.*, DARCY, *supra* note 3, ¶ 105.20; Kuboi & Asakawa, *supra* note 5, at 446-48; Way et al., *supra* note 12, at A-5, A-20.

20. *See, e.g.*, Kuboi & Asakawa, *supra* note 5, at 447-48; Way et al., *supra* note 12, at A-20.

21. *See* DARCY, *supra* note 3, ¶ 105.20; *see also* Kuboi & Asakawa, *supra* note 5, at 448.

22. *See* Way et al., *supra* note 12, at A-20; *see also* YUKIO YANAGIDA ET AL., LAW AND INVESTMENT IN JAPAN 273 (1994).

23. *See* Commercial Code, ch. II, arts. 62-145.

24. *See id.* art. 80.

25. *See id.*

26. *See id.* art. 55; Limited Company Law, art. 4.

27. *See* Commercial Code, ch. III, arts. 146-64.

28. *See id.* art. 147.

29. *See id.* art. 148.

ner with unlimited liability and one partner with limited liability.[30] Partners with limited liability may make contributions only in the form of cash or property.[31] A company can be a limited partner but not an unlimited partner.[32] A limited partner may not participate in the management of the *goshi kaisha*.[33] If it does, it may be treated as a partner with unlimited liability.[34]

The *gomei kaisha* and the *goshi kaisha* are not popular with foreign investors because they have many disadvantages with very few advantages.[35] Many of the previously discussed disadvantages of the *yugen kaisha* relative to the *kabushiki kaisha* are equally applicable to the *gomei kaisha* and the *goshi kaisha*, such as the lack of prestige and the lack of familiarity with the *gomei kaisha* and *goshi kaisha*. In addition, all of the partners of the *gomei kaisha* have unlimited liability while at least one partner of the *goshi kaisha* has unlimited liability. Also, all of the partners of the *gomei kaisha* and the unlimited partners of the *goshi kaisha* cannot be companies, thereby limiting their use in the business world.[36] In the case of the *gomei kaisha*, a partner cannot engage in transactions of the same type of business as the *gomei kaisha* without the consent of all the partners, further limiting its use in the business world.[37] Finally, the *gomei kaisha* and the *goshi kaisha* are subject to the Japanese corporate income tax and, therefore, are not flow-through entities for tax purposes.[38]

In addition to the category of ordinary corporations, there are three more categories of organizations subject to the Japanese corporate income tax: public interest corporations (*"koeki hōjin"*),[39] cooperatives (*"kyōdō kumiai"*),[40] and non-juridical organizations (*"jinkaku no nai shadan"*).[41] Public interest corporations are generally religious, educational, or charitable corporations. Some examples of public interest corporations are the National Space Development Agency of Japan, National Health Insurance Organization, Securities Dealers Association, and the Japan Chamber of Commerce and Industry.[42] Cooperatives are

30. *See id.* art. 146; *see, e.g.*, Kuboi & Asakawa, *supra* note 5, at 447; Way et al., *supra* note 12, at A-21.

31. *See* Commercial Code, art. 150.

32. *See id.* art. 55; Limited Company Law, art. 4; *see, e.g.*, Kuboi and Asakawa, *supra* note 5, at 447; YANAGIDA ET AL., *supra* note 22, at 271.

33. *See* Commercial Code, art. 156; YANAGIDA ET AL., *supra* note 22, at 271.

34. *See* Commercial Code, art. 159; YANAGIDA ET AL., *supra* note 22, at 271.

35. *See, e.g.*, Kuboi & Asakawa, *supra* note 5, at 448; Way et al., *supra* note 12, at A-20, A-21; YANAGIDA ET AL., *supra* note 22, at 270-71.

36. *See* Commercial Code, art. 55; YANAGIDA ET AL., *supra* note 22, at 270-71.

37. *See* YANAGIDA ET AL., *supra* note 22, at 270.

38. One reviewer of this Article refers to the *gomei kaisha* as a "reverse S corporation" because of the unlimited liability of its members and the corporate level tax imposed on its earnings.

39. *See* Corporation Tax Law, art. 2(1)(vi).

40. *See id.* art. 2(1)(vii).

41. *See id.* art. 2(1)(viii).

42. *See generally* YUJI GOMI, JAPAN CORPORATION TAX LAW 323-33 (1996) (listing, in Japanese and English, the public interest corporations listed in schedule number two).

generally mutual aid organizations "established by persons engaged in specific occupations or by consumers."[43] Some examples of cooperatives are Federation of Fisheries Cooperative Associations, Consumer's Cooperative Union, and Forest Owners' Cooperative Associations.[44]

The last category is probably the most interesting. Non-juridical organizations are unincorporated organizations that have designated managers or representatives.[45] This category was formed in 1957 under the Juridical Persons' Tax Law (the predecessor of the Corporation Tax Law) because of a perceived abuse that was taking place.[46] A group of individuals would enter into a profit-making activity and act not as a mere collection of individuals but rather pursuant "to a single will and whose continued existence transcend[ed] the individuality of the various component members."[47] Because the organization of individuals did not have juridical personality, the organization was not subject to the Juridical Persons' Tax Law. It was also argued that the Income Tax Law did not apply to the organization because it was thought that the Income Tax Law applied only to natural persons.[48] Furthermore, it did not seem appropriate to tax the legal representatives of the organization under the Income Tax Law.[49] As a result, legislation was enacted in 1957 to remedy this loophole in the law.[50] From that point on, non-juridical organizations were treated as corporations for corporate income tax purposes.[51]

Even if an organization is classified as a corporation for Japanese income tax purposes, it may be subject to corporate income tax on only a portion of its income or, in some cases, may be entirely exempt from the corporate income tax. Generally, all domestic corporations are subject to the corporate income tax.[52] Foreign corporations are subject to corporate income tax only on income from sources within Japan.[53]

Ordinary corporations and cooperatives are taxed on their entire income.[54] Public corporations are not subject to the corporate income tax.[55] Public corporations include the Government of Japan, Japanese agencies and local public entities (such as prefectures and municipalities), and corporations established by government entities (such as the Government Housing Loan Corporation).[56] Public interest corporations, how-

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43. GOMI, *supra* note 2, at 152.
44. *See* GOMI, *supra* note 42, at 333-335 (listing, in Japanese and English, the cooperatives listed in schedule number three).
45. *See* Corporation Tax Law, art. 2(1)(viii).
46. *See generally* Uematsu, *supra* note 2, at 583-84.
47. *Id.*
48. *See id.*
49. *See id.*
50. *See id.*
51. *See* Corporation Tax Law, art. 3.
52. *See id.* arts. 4(1), 5, 6.
53. *See id.* arts. 4(2), 9.
54. *See id.* arts. 4(1), 5, 6.
55. *See id.* arts. 2(1)(v), 4(3).
56. *See* MOF 1995, *supra* note 2, at 80; *see also* GOMI, *supra* note 42, at 319-323 (listing, in Japanese and English, public corporations listed in schedule number one).

ever, are taxed, but only on income from profit-making activities.[57] A non-juridical organization is taxed like a public interest corporation, that is, only on its income from profit-making activities.[58]

Japan also has special rules for a family corporation (*"dozoku kaisha"*), which is defined as a corporation with three or fewer shareholders owning fifty percent or more of its stock.[59] An example of a family corporation is a wholly owned subsidiary. The general consequence of family corporation status is that the Japanese tax authorities can deny certain transactions of a family corporation that they determine unreasonably decrease the corporation's tax liability.[60]

III. TWO OTHER JAPANESE BUSINESS ENTITIES

As described above, Japan has four major business entities: *kabushiki kaisha*, *yugen kaisha*, *gomei kaisha*, and *goshi kaisha*, all of which are categorized as ordinary corporations under the Japanese corporate income tax system. Japan also has several other categories of corporations (public interest corporations, cooperatives, public corporations, and non-juridical organizations), which will not be discussed further in this Article. But there are two additional business entities that are somewhat unusual in that they are treated as flow-throughs or conduits for Japanese income tax purposes (or generally the equivalent of flow-through entities), similar in many respects to United States partnerships. These two entities are the *nin-i kumiai* and the *tokumei kumiai*. It should be noted that these two entities are not in widespread use in Japan, and, as a result, there are many unresolved issues, particularly tax issues, with respect to the use of these entities.[61] It will be interesting to see whether these two entities, particularly the *tokumei kumiai*, will become more popular during the next ten or twenty years in a manner similar to the rise in popularity of the limited partnership in the United States in the 1970s and continuing with the limited liability company in the 1990s.[62]

The first flow-through entity is the *nin-i kumiai*, which is a Civil Code

57. *See* Corporation Tax Law, arts. 2(1)(vi), 4(1), 7. If the public interest corporation is a foreign corporation, then it is taxed only on its income from profit-making activities arising from sources in Japan. *See id.* arts. 4(2), 9, 10. Profit-making activities are defined to be businesses prescribed by Cabinet Order, such as selling or manufacturing businesses, carried on continuously by maintaining a business establishment. *See id.* art. 2(1)(xiii).

58. *See id.* arts. 4(1), 7. If the non-juridical organization is a foreign corporation, then it is taxed only on its income from profit-making activities arising from sources in Japan. *See id.* arts. 4(2), 9, 10.

59. *See id.* art. 2(1)(x).

60. *See id.* arts. 67, 132. If the family corporation is a personal family corporation, additional anti-abuse provisions are applicable.

61. *See generally* Otsuka, *supra* note 3, at 317.

62. The *tokumei kumiai* has been used quite extensively with respect to the Japanese leveraged lease transaction. *See, e.g.*, DARCY, *supra* note 3, ¶ 630.20; Richard S. Koffey & Richard L. Umbrecht, *Japanese Cross-Border Leasing into the United States*, 43 TAX LAW. 149 (1989); Todd M. Landau, *Japan's New Wave of Advantages*, 7 INT'L TAX REV., March 1996, at 40. The *tokumei kumiai* is currently the pass-through entity of choice for the Japanese version of the MIPS (monthly income preferred securities) transaction.

association.[63] It is a contract of partnership that becomes effective when each of the parties (*"kumiai in"*) has agreed to carry on a joint undertaking by making a contribution to the partnership.[64] The contribution may be in the form of cash, property, or services.[65] The contribution made by each partner and the other property of the partnership belongs to all the partners jointly.[66] Corporations may be partners in the *nin-i kumiai*, which is not recognized as a corporation (company) under the Commercial Code.[67] It is treated as an aggregate of the partners and not as a separate legal entity.[68]

The conduct of the affairs of the partnership is decided by a majority of the partners.[69] However, one or more persons may be appointed to conduct the affairs of the partnership.[70] As a result, the *nin-i kumiai* is "essentially a contractual relationship among the members with respect to a common undertaking, and thus bears some resemblance to an American partnership."[71] One commentator has pointed out that the *nin-i kumiai* has four common basic features of a partnership:

> (1) a contractual arrangement, (2) between two or more persons (individuals or legal entities), (3) with a view to sharing profits ([or] losses as the case may be), and (4) in cooperation with and on a proportionate basis for each of them resulting in a personal relationship in a commercial or professional activity.[72]

The *nin-i kumiai* is not a separate taxable entity and is not subject to the Japanese corporate income tax.[73] In addition, it does not file a tax return.[74] In the absence of an agreement, the allocation of profits and losses is made in proportion to the value of the contribution of each partner.[75] As a result, it appears that an agreement can be entered into among the partners to allocate profits and losses in a manner different than their relative contributions to the partnerships. If an allocation is entered into for only the sharing of profits (or losses), then that allocation ratio is presumed to apply both to profits and losses.[76] It appears that the partners can specify an allocation ratio for profits and a different allocation ratio for losses. It also appears that the partnership can amend the

63. *See* Civil Code, arts. 667-88.
64. *See id.* art. 667.
65. *See id.* art. 667(2).
66. *See id.* art. 668.
67. *See* Kuboi & Asakawa, *supra* note 5, at 447; Way et al., *supra* note 12, at A-22.
68. *See* Kuboi & Asakawa, *supra* note 5, at 447; Otsuka, *supra* note 3, at 317-18.
69. *See* Civil Code, art. 670(1).
70. *See id.* art. 670(2).
71. Way et al., *supra* note 12, at A-22.
72. Otsuka, *supra* note 3, at 318.
73. *See, e.g.*, Darcy, *supra* note 3, ¶ 105.10 (citing to CTL Basic Circular 1-1-1); Gomi, *supra* note 2, at 39; Otsuka, *supra* note 3, at 317-19; Uematsu, *supra* note 2, at 583. The income of the *nin-i kumiai* is taxed to the partners, whether or not the income is actually distributed to them.
74. *See* Kuboi & Asakawa, *supra* note 5, at 447; Otsuka, *supra* note 3, at 320; Way et al., *supra* note 12, at A-22.
75. *See* Civil Code, art. 674(1).
76. *See id.* art. 674(2).

association contract to change the allocation ratios from time to time.[77]

Each partner must include in its taxable income its ratable share of the *nin-i kumiai*'s profit (or loss) during the partner's year, which includes the last day of the *nin-i kumiai*'s accounting period.[78] In other words, the *nin-i kumiai*'s profit (or loss) flows through to the partners on the last day of the *nin-i kumiai*'s accounting period.[79] The partner must include its ratable share of the profit even if no distribution of the profit has been made by the *nin-i kumiai.*[80] This must be done annually.[81] The timing of the flow through of profits and losses appears to be almost identical to the rule in the United States for partnerships.[82]

The partners are liable for the obligations of the *nin-i kumiai* in proportion to how they share losses, which is generally based on their contributions to the *nin-i kumiai* unless the association contract otherwise provides.[83] A creditor who was unaware of the loss sharing agreement among the partners at the time his claim came into existence may exercise his right against each partner in equal shares.[84]

The second type of flow-through entity is the *tokumei kumiai* (secret or anonymous association), which is formed under the Commercial Code.[85] It is not really a flow-through entity but is generally equivalent to one. It is similar in some respects to the United States limited partnership; however, for Japanese legal purposes, it is not exactly a partnership or a corporation.[86] It has been compared to the German *"stille gesellschaft"* and

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77. The Japanese income tax system, like the United States, has adopted the principle of substance over form. Care must be taken in structuring a transaction so that it will not be successfully challenged by the Japanese National Tax Administration. *See* Income Tax Law, art. 12; Corporation Tax Law, art. 11; MOF 1995, *supra* note 2, at 27; Dean A. Yoost & Richard R. McGinnis, *Using Japan's Tokumei Kumiai*, 7 INT'L TAX REV., Nov. 1996, at 15, 16.

78. *See* DARCY, *supra* note 3, ¶ 630.10 (citing CTL Basic Circular 14-1-1); Kuboi & Asakawa, *supra* note 5, at 447 (citing ITL Basic Circular 36.37-19 and CTL Basic Circular 14-1-1); Masatami Otsuka & Kenju Watanabe, *Japan*, *in* BUTTERWORTHS INTERNATIONAL TAXATION OF FINANCIAL INSTRUMENTS AND TRANSACTIONS, 2.17 (1994) (citing ITL Basic Circular 36.37 and CTL Basic Circular 14-1-1); Way et al., *supra* note 12, at A-53 (citing CTL Basic Circulars 14-1-1 and 14-1-2).

Japan provides for three methods in which the partner of the *nin-i kumiai* accounts for its ratable share of the income or loss. The first method is referred to as the net income method, net result method, or simply the net method. As its name implies, the partner reports its share of the net income or net loss of the *nin-i kumiai.* The second method is referred to as the partial flow-through method or hybrid method. Under this method, the partner reports its share of revenues and expenses. The third method is the pass-through method or flow-through method. Under this method, the partner reports its share of each item of the *nin-i kumiai's* revenues, expenses, assets, and liabilities. *See, e.g.*, DARCY, *supra* note 3, ¶ 630.10; Kuboi & Asakawa, *supra* note 5, at 446-47; Otsuka & Watanabe, *supra* note 78, at 47-48; Way et al., *supra* note 12, at A-52 to A-53.

79. *See, e.g.*, DARCY, *supra* note 3, ¶ 630.10; Kuboi & Asakawa, *supra* note 5, at 447; Otsuka, *supra* note 3, at 320-21; Way et al., *supra* note 12, at A-53.

80. *See* DARCY, *supra* note 3, ¶ 630.10; Otsuka, *supra* note 3, at 320-21.

81. *See* Otsuka & Watanabe, *supra* note 78, at 2.17.

82. *See* I.R.C. § 706(a) (1997).

83. *See* Civil Code, arts. 674-75; Way et al., *supra* note 12, at A-22.

84. *See* Civil Code, art. 675.

85. *See* Commercial Code, arts. 535-42.

86. *See* Yoost & McGinnis, *supra* note 77, at 15.

the French *"association commerciale en participation."*[87]

In the *tokumei kumiai*, the entrepreneur (*"eigyosha"*) enters into contracts with investors (*"tokumei kumiai in"*) who contribute cash or property in exchange for a share of profits.[88] Each investor enters into a separate contract with the entrepreneur.[89] There is no contractual relationship among all the investors.[90] The cash or property contributed by the investors becomes the property of the entrepreneur.[91]

The entrepreneur conducts the business entirely on its own behalf. The investors do not participate in the administrative affairs of the business or represent the business.[92] The entrepreneur owns all the assets (including those contributed by the investors) and is liable for all the debts of the business.[93] The investors have limited liability to the extent of their contributions unless the *tokumei kumiai* contract provides for an investor to bear responsibility for a portion of the liabilities.[94] An investor may transfer its interest in the *tokumei kumiai* with the consent of the entrepreneur, or without consent, if the *tokumei kumiai* contract so provides.[95]

For Japanese income tax purposes, the entrepreneur reports all of the profits (or losses) of the *tokumei kumiai* and then deducts the portion of the profits allocated to the investors.[96] The investor is treated as receiving its share of the profits on the last day of the *tokumei kumiai*'s year. As a result, an investor must report its share of the *tokumei kumiai*'s profit in its taxable year, which includes the last day of the *tokumei kumiai*'s year, even if no actual distribution of profits takes place.

When the *tokumei kumiai* distributes the profits to the investors, the distribution is subject to withholding under the Japanese income tax laws,

87. *See, e.g.*, Otsuka & Watanabe, *supra* note 78, at 1.2.1.4; Uematsu, *supra* note 2, at 583 n.94.

88. *See* Commercial Code, arts. 150, 535, 542. Many times the investors also agree to share in the losses, if any, of the *tokumei kumiai. See generally* HUGH J. AULT, COMPARATIVE INCOME TAXATION 292 (1997); Kuboi & Asakawa, *supra* note 5, at 448; Otsuka & Watanabe, *supra* note 78, at 1.2.1.4; Gary M. Thomas, *Structure of Japanese Operations and Other Selected Japanese Tax Issues, in* INTERTAX, Jan. 1992, at 33, 36-37; Yoost & McGinnis, *supra* note 77, at 15.

89. *See* Otsuka & Watanabe, *supra* note 78, at 1.2.1.4; Yoost & McGinnis, *supra* note 77, at 15.

90. *See* Way et al., *supra* note 12, at A-23; Yoost & McGinnis, *supra* note 77, at 15.

91. *See* Commercial Code, art. 536.

92. *See id.* arts. 156, 542.

93. *See id.* arts. 536(2), 537; *see, e.g.*, Kuboi & Asakawa, *supra* note 5, at 448; Otsuka, *supra* note 3, at 318; Otsuka & Watanabe, *supra* note 78, at 1.2.1.4; Way et al., *supra* note 12, at A-23.

94. *See* Commercial Code, arts. 153, 156, 536, 537, 542; *see, e.g.*, Kuboi & Asakawa, *supra* note 5, at 448; Otsuka, *supra* note 3, at 318; Way et al., *supra* note 12, at A-23; Yoost & McGinnis, *supra* note 77, at 15.

95. *See* Yoost & McGinnis, *supra* note 77, at 16.

96. *See, e.g.*, Otsuka, *supra* note 3, at 318 (citing ITL Basic Circular 36.37-21 and CTL Basic Circular 14-1-3); Yoost & McGinnis, *supra* note 77, at 16 ("The allocation of profits or losses to the investor under a TK agreement is considered a deductible expense or taxable income for the proprietor.")

unless the number of investors is less than ten.[97] As a result, most *tokumei kumiai* are formed with nine or fewer investors.[98]

The *nin-i kumiai* and the *tokumei kumiai* are not in widespread use in Japan at the present time.[99] Many of the reasons for the lack of interest in these two entities are the same reasons given for the lack of interest in the *yugen kaisha*, such as the lack of prestige and the lack of familiarity. Other reasons given for the lack of interest in the *nin-i kumiai* and the *tokumei kumiai* include the difference in tax culture, differences between book and tax accounting, and the reporting of financial performance on a single-company basis as opposed to a consolidated basis.[100] In addition, the *nin-i kumiai* has several serious disadvantages that the *tokumei kumiai* does not. For example, all of the members of the *nin-i kumiai* have unlimited liability. In addition, foreign members of the *nin-i kumiai* may be treated as having a permanent establishment in Japan if the *nin-i kumiai* itself is treated as having a permanent establishment in Japan, while foreign investors in the *tokumei kumiai* apparently will not be treated as having a permanent establishment in Japan.[101]

97. *See* DARCY, *supra* note 3, ¶ 630.20 (citing ITL Art. 210 and ITL Enf. Order Arts. 288(1)(i), 327); Otsuka, *supra* note 3, at 321 (citing ITL Art. 161(12) and ITL Enf. Order Art. 288); Yoost & McGinnis, *supra* note 77, at 16.

98. *See, e.g.*, DARCY, *supra* note 3, ¶ 630.20; Robert Tomkin, *Lease-Backs on Offer in Finance Boutiques*, JAPAN ECONOMIC JOURNAL, Apr. 13, 1991, at 10. Apparently, there is support for the position that if a *tokumei kumiai* is conducting business in Japan and the 20% withholding tax applies (because there are ten or more investors), it will be the only tax that applies to an American investor if the American investor does not have a permanent establishment in Japan. If so, this may be more advantageous than having an American investor subject to the progressive Japanese income tax rates. As a result, a *tokumei kumiai* may be intentionally structured to have ten or more investors. *See* Otsuka & Watanabe, *supra* note 78, at 2.18.

99. *See, e.g.*, Kuboi & Asakawa, *supra* note 5, at 448; Otsuka, *supra* note 3, at 332. *But see supra* note 62.

100. *See* Kuboi & Asakawa, *supra* note 5, at 448.

101. *See* Otsuka, *supra* note 3, at 328-29; Otsuka & Watanabe, *supra* note 78, at 2.18. The Japanese National Tax Administration appears to take the position that the income from a tokumei kumiai conducting business in Japan will be taxed to an American investor even if the American investor does not have a permanent establishment in Japan because the term "Industrial or Commercial Profits" in article 8 of the U.S.-Japan Income Tax Treaty does not include income from a *tokumei kumiai* conducting business in Japan. The income of the *tokumei kumiai* conducting business in Japan is taxed to an American investor as income from the utilization or holding of assets in Japan. *See* Corporation Tax Law, art. 138(11); Corporation Tax Law Enforcement Order 177(1)(iv); Article 6(9) of the U.S.-Japan Income Tax Treaty; Darcy, *supra* note 3, ¶ 405.20 (citing CTL Enf. Order Art. 177(1)(iv) and ITL Enf. Order Art. 280(1)(iv)); Otsuka, *supra* note 3, at 3.4; Otsuka & Watanabe, *supra* note 78, at 2.18. The taxation of an American investor is in sharp contrast to the taxation of a United Kingdom investor or Swiss investor. Apparently the income from a *tokumei kumiai* conducting business in Japan is completely exempt from Japanese income taxation under the Japan-United Kingdom Income Tax Treaty for U.K. investors and the Japan-Switzerland Income Tax Treaty for Swiss investors if the U.K. or Swiss investors do not have a permanent establishment in Japan. *See* Darcy, *supra* note 3, ¶ 1270; Otsuka & Watanabe, *supra* note 78, at 2.18 n.342.

The following table summarizes the six major Japanese business entities:

Name of Entity	American Counterpart	Liability of Members	Subject to Japanese Corporate Tax
Kabushiki Kaisha	Corporation	Limited	Yes
Yugen Kaisha	Corporation or Limited Liability Company	Limited	Yes
Gomei Kaisha	General Partnership	Unlimited	Yes
Goshi Kaisha	Limited Partnership	Unlimited for Some Members and Limited for Others	Yes
Nin-i Kumiai	General Partnership	Unlimited	No
Tokumei Kumiai	Nothing is Really Comparable in the United States	Unlimited for the Entrepreneur and Limited for the Investors	No

IV. UNITED STATES CLASSIFICATION OF JAPANESE BUSINESS ENTITIES PRIOR TO THE CHECK-THE-BOX REGULATIONS

Prior to the promulgation of the new final entity classification regulations, the Internal Revenue Service classified an organization based on six factors: (1) associates, (2) objective to carry on business and divide the profits from the business, (3) continuity of life, (4) centralization of management, (5) limited liability, and (6) free transferability of interests.[102] Because the first two characteristics were common to associations[103] and partnerships, only the last four factors were relevant in determining whether an entity would be classified as an association or a partnership.[104] If there was a preponderance of the last four factors (more than two), then the entity would be classified as an association.[105] Otherwise, the entity would be taxed as a partnership.[106] These same four factors were used to classify foreign entities, which were considered to be unincorporated organizations.[107] In making this determination, the Service stated that local law would control the determination of whether a factor was present.[108]

102. *See* Treas. Reg. § 301.7701-2(a)(1) (as amended in 1996) (superseded effective January 1, 1997).

103. An association is taxed as a corporation. *See* I.R.C. § 7701(a)(3) (1994).

104. *See* Treas. Reg. § 301.7701-2(a)(2) (as amended in 1996) (superseded effective January 1, 1997).

105. *See* Treas. Reg. § 301.7701-2(a)(3) (as amended in 1996) (superseded effective January 1, 1997).

106. *See id.*

107. *See* Rev. Rul. 88-8, 1988-1 C.B. 403; *see generally* JOEL KUNTZ & ROBERT PERONI, U.S. INTERNATIONAL TAXATION ¶ B7.02[3] (1996).

108. *See* Rev. Rul. 88-8, 1988-1 C.B. 403; *see generally* KUNTZ & PERONI, *supra* note 107, ¶ B7.02[3].

As stated earlier, very little has been written on the classification of Japanese business entities. In addition, the Internal Revenue Service has issued very little guidance in the area.[109] One possible reason for the sparse literature is that there appears to have been little disagreement on how to classify the major Japanese business entities for U.S. classification purposes, with the possible exception of the *yugen kaisha.*

The Internal Revenue Service has issued a private letter ruling on the classification of a *yugen kaisha.* In Private Letter Ruling 78-41-047 (July 14, 1978), *X*, a domestic corporation whose stock was traded on the New York Stock Exchange, was engaged in the development, manufacture, and sale of farm machinery. *Y* was a closely held Japanese corporation that conducted no operations in the United States, but sold its products in the United States through a distributor. *X* and *Y* formed *M*, a *yugen kaisha*, whose principal activity would be to conduct research and development for the benefit of *X* and *Y*. *X* and *Y* each had a fifty percent interest in *M*. The total capital of *M* would be fifty million yen divided into 50,000 shares.

The Service cited to Treasury Regulation section 301.7701-2(a)(2) in concluding that *M* had associates and an objective to carry on business and divide the profits from the business. In order not to be classified as an association taxable as a corporation under Treasury Regulation section 301.7701-2(a)(3), *M* must not have a preponderance of the following four corporate characteristics: (1) continuity of life, (2) centralization of management, (3) limited liability, and (4) free transferability of interests.[110]

The Service concluded that *M* did not possess the corporate characteristic of continuity of life because, under the articles of incorporation, *M* would terminate in the event of a shareholder's bankruptcy or insolvency. In addition, the Service concluded that *M* did not possess the corporate characteristic of free transferability of interests because, under the Limited Company Law, pursuant to which the *yugen kaisha* was formed, and under its articles of incorporation, shares in *M* could be transferred only with the consent of all the parties. As a result, the Service determined that the *yugen kaisha* would be treated as a partnership for federal income tax purposes.

At one time, the Service, in a chart in its Internal Revenue Manual, also addressed the classification of foreign business entities.[111] The Service stated that the chart was only a source of information and that it was

109. The Service refused to issue rulings on the classification of a foreign entity in a number of cases. *See, e.g.*, Rev. Proc. 96-7, 1996-1 C.B. 559; Rev. Proc. 96-3, 1996-1 C.B. 456; Rev. Proc. 80-22, 1980-1 C.B. 654. These revenue procedures have been superseded. *See generally* Bruce N. Davis & Steven R. Lainoff, *U.S. Taxation of Foreign Joint Ventures*, 46 TAX L. REV. 165, 171-72 (1991); KUNTZ & PERONI, *supra* note 107, ¶ B7.02[4].

110. Priv. Ltr. Rul. 78-41-047 (July 14, 1978) (citing Treas. Reg. § 301.7701-2(a)(3) (as amended in 1996)).

111. *See* Internal Revenue Manual, Part IV-Audit, Exhibit 500-4 (withdrawn in August 1991). The chart has been partially reproduced in Virginia M. Tarris & R. Arnold Handler, *Foreign Income: Foreign Partnerships and Partners, in* TAX MANAGEMENT A-13 to A-22 (BNA Portfolio No. 910) (1993).

not bound by it.[112] In the chart, the Service generally treated a *kabushiki kaisha* as a corporation.[113] The Service also treated a *yugen kaisha* as a corporation.[114] The Service generally treated a *gomei kaisha* and *goshi kaisha* as partnerships.[115] The Service has since withdrawn its chart in the Internal Revenue Manual.[116]

V. THE CHECK-THE-BOX REGULATIONS

A. OVERVIEW

On March 29, 1995, the Internal Revenue Service, through IR-95-29 and Notice 95-14, indicated possible simplification of the existing entity classification rules.[117] The Service proposed simplification that, in essence, would provide a qualifying entity an elective regime with regard to entity classification. Certain entities would automatically be treated as corporations, but most entities would be allowed to select whether to be taxed as a corporation or as a partnership. This would apply to both domestic and foreign entities. A notice of public hearing was published in the Federal Register on May 10, 1995.[118] Written comments were received and a public hearing was held on July 20, 1995.

On May 9, 1996, the Treasury Department issued proposed regulations under section 7701, implementing Notice 95-14.[119] In the proposed regulations, the Treasury adopted an elective regime for classifying certain business organizations, the so-called "check-the-box" approach. The Treasury stated that the existing entity classification regime had become too formalistic. Written comments were received and a public hearing was held on August 21, 1996.

On December 17, 1996, the Treasury Department issued final regulations under section 7701 that classify certain business organizations under an elective regime.[120] The final regulations make some changes to the proposed regulations but retain the major principles of the earlier regulations. The regulations have been thoroughly discussed by a number of commentators, and only a brief summary of the major principles will be discussed.[121]

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112. *See* KUNTZ & PERONI, *supra* note 107, ¶ B7.02[5]; Tarris & Handler, *supra* note 111, at A-13.

113. *See* DARCY, *supra* note 3, ¶ 105.20; Tarris & Handler, *supra* note 111, at A-18.

114. *See* Davis & Lainoff, *supra* note 109, at 170 & n.16; Tarris & Handler, *supra* note 111, at A-18.

115. *See* DARCY, *supra* note 3, ¶ 105.20; Davis & Lainoff, *supra* note 109, at 170 & n.17; Tarris & Handler, *supra* note 111, at A-18.

116. *See* Davis & Lainoff, *supra* note 109, at 170-71.

117. *See* I.R.S. Notice 95-14, 1995-1 C.B. 297.

118. *See* 60 Fed. Reg. 24,813.

119. *See* PS-43-95, 1996-1 C.B. 865; Simplification of Entity Classification Rules, 61 Fed. Reg. 21,989 (1996) (to be codified at 26 C.F.R. pt. 301).

120. *See* T.D. 8697, 1997-2 I.R.B. 11; Simplification of Entity Classification Rules, 61 Fed. Reg. 66,584 (1996).

121. *See, e.g.*, Reuven S. Avi-Yonah, *To End Deferral as We Know It: Simplification Potential of Check-the-Box*, 74 TAX NOTES 219 (1997); Bruce Davis, *International Tax Planning Under the Final Check-the-Box Regulations*, 26 TAX MGMT. INT'L J. 3 (1997);

Generally, the regulations place an organization into one of three major categories: "nothing," trust, or business entity.[122] The first category is disregard of the organization or, in other words, treating the organization as a "nothing."[123] This category focuses on whether an organization is an entity separate from its owners.[124] Even if the organization is recognized as an entity under local law, it will not necessarily be treated as an entity separate from its owners for federal tax purposes.[125] In addition, "[a] joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits" from it.[126] Certain organizations that have a single owner can elect "to be recognized or disregarded as entities separate from their owners."[127]

If a separate entity exists, then the next issue is whether it is classified as a "trust under [Treasury Regulation] § 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code" (such as a real estate mortgage investment conduit (REMIC) or a qualified settlement fund (QSF)).[128] If the separate entity is not classified as a trust or otherwise subject to special treatment, then it will be a business entity.[129] A business entity with two or more members is classified as either a corporation or partnership for federal tax purposes.[130] A business entity with one owner is classified as a corporation or is disregarded.[131] If the business entity is disregarded because it has one owner, it will be treated in the same manner as a sole proprietorship, branch, or division of the

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Hugh M. Dourgan et al., *"Check the Box"—Looking Under the Lid*, 75 TAX NOTES 1141 (1997); Michael J. Grace, *Proposed "Check-the-Box" Regulations Would Streamline but Not Eliminate Entity Classification Process*, 37 TAX MGMT. MEMORANDUM 295 (1996); David S. Miller, *The Tax Nothing*, 74 TAX NOTES 619 (1997); Roger F. Pillow et al., *Check-the-Box Proposed Regs Simplify the Entity Classification Process*, 85 J. TAX'N 72 (1996); Michael L. Schler, *Initial Thoughts on the Proposed "Check-the-Box" Regulations*, 71 TAX NOTES 1679 (1996); Joni L. Walser & Robert E. Culbertson, *Encore Une Fois: Check-the-Box on the International Stage*, 15 TAX NOTES INT'L, July 7, 1997, at 53; Francis J. Wirtz, *Check-the-Box: The Proposed Regulations on Entity Classification*, 74 TAXES 355 (1996).

122. *See generally* Schler, *supra* note 121, at 1679-80.

123. *See* Treas. Reg. § 301.7701-1(a)(1), (2) (as amended in 1996); Schler, *supra* note 121, at 1680 (coining the term "nothing"); Miller, *supra* note 121.

124. *See* Schler, *supra* note 121, at 1680.

125. *See* Treas. Reg. § 301.7701-1(a)(1), (3) (as amended in 1996).

126. Treas. Reg. § 301.7701-1(a)(2) (as amended in 1996).

127. Treas. Reg. § 301.7701-1(a)(4) (as amended in 1996).

128. Treas. Reg. § 301.7701-2(a) (as amended in 1996). Generally, a trust does not have associates or an objective to carry on business for profit. *See* Treas. Reg. § 301.7701-1(b) (as amended in 1996); Schler, *supra* note 121, at 1685 (questioning whether Treasury inadvertently changed the meaning of trust in the new regulations).

129. *See* Treas. Reg. § 301.7701-2(a) (as amended in 1996).

130. *See id.* The term "corporation" is defined in the regulations as a business entity falling into one of eight categories. *See* Treas. Reg. § 301.7701-2(b) (as amended in 1996). The term "partnership" is defined in the regulations as a business entity that is not a corporation under Treasury Regulation section 301.7701-2(b) and that has at least two members. *See* Treas. Reg. § 301.7701-2(c)(1) (as amended in 1996).

131. *See* Treas. Reg. § 301.7701-2(a) (as amended in 1996). "A business entity that has a single owner and is not a corporation under [Treasury Regulation section 301.7701-2(b)] is disregarded as an entity separate from its owner." Treas. Reg. § 301.7701-2(c)(2)(i) (as amended in 1996).

owner.[132]

A business entity will fit into one of two subcategories. It may automatically be treated as a corporation for federal tax purposes.[133] Business entities automatically classified as corporations include domestic corporations, insurance companies, certain banks, and certain foreign entities that are listed in the regulations.[134]

If a business entity is not automatically a corporation, then it is an "eligible entity."[135] An eligible entity with at least two members can elect to be classified as an association (and therefore a corporation) or as a partnership.[136] An eligible entity with only one member "can elect to be classified as an association [and therefore a corporation] or to be disregarded as an entity separate from its owner."[137]

If an eligible entity does not make an election, then a default rule applies.[138] The default classification for a domestic eligible entity is partnership if it has two or more members and it is disregarded as an entity if it has only one owner.[139] The default classification for a foreign eligible entity is a little more complex.[140] If the foreign eligible entity has two or more members and at least one member does not have limited liability, then it is a partnership.[141] If the members of the foreign eligible entity all have limited liability, then it is an association and, therefore, a corporation.[142] If the foreign eligible entity has one owner who does not have limited liability, then it is disregarded as an entity separate from its owner.[143]

In determining whether a member of a foreign eligible entity has limited liability, the statute or law pursuant to which the foreign entity was organized must be analyzed.[144] If the statute or law allows the organizational documents to specify whether members will have limited liability, then the organizational documents must also be consulted.[145] "[A] member of a foreign eligible entity has limited liability if the member has no personal liability for the debts of or claims against the entity."[146] "A member has personal liability if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity"

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132. *See* Treas. Reg. § 301.7701-2(a) (as amended in 1996).
133. *See* Treas. Reg. § 301.7701-2(b) (as amended in 1996).
134. *See id.* (listing eight categories of business entities which are automatically treated as corporations for federal tax purposes).
135. *See* Treas. Reg. § 301.7701-3(a) (as amended in 1996).
136. *See id.*
137. *Id.*
138. *See* Treas. Reg. § 301.7701-3(b) (as amended in 1996).
139. *See* Treas. Reg. § 301.7701-3(b)(1)(i), (ii) (as amended in 1996).
140. *See* Treas. Reg. § 301.7701-3(b)(2) (as amended in 1996).
141. *See* Treas. Reg. § 301.7701-3(b)(2)(i)(A) (as amended in 1996).
142. *See* Treas. Reg. § 301.7701-3(b)(2)(i)(B) (as amended in 1996).
143. *See* Treas. Reg. § 301.7701-3(b)(2)(i)(C) (as amended in 1996).
144. *See* Treas. Reg. § 301.7701-3(b)(2)(ii) (as amended in 1996).
145. *See id.*
146. *Id.*

from the member.[147]

The government has also provided special rules for certain foreign business entities listed as per se corporations. An entity will not be treated as a per se corporation if:

(i) The entity was in existence on May 8, 1996;

(ii) The entity's classification was relevant . . . on May 8, 1996 [relevant means that the classification affects the liability of any person for federal tax or information purposes];

(iii) No person (including the entity) for whom the entity's classification was relevant on May 8, 1996, treats the entity as a corporation for purposes of filing such person's federal income tax returns, information returns, and withholding documents for the taxable year including May 8, 1996;

(iv) Any change in the entity's claimed classification within the sixty months prior to May 8, 1996, occurred solely as a result of a change in the organizational documents of the entity, and the entity and all members of the entity recognized the federal tax consequences of any change in the entity's classification within the sixty months prior to May 8, 1996;

(v) A reasonable basis (within the meaning of [I.R.C.] section 6662) existed on May 8, 1996, for treating the entity as other than a corporation; and

(vi) Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification of the entity was under examination (in which case the entity's classification will be determined in the examination).[148]

The Treasury has provided rules for existing entities (those in existence on January 1, 1997, when the new regulations became effective) and has also given detailed procedural requirements under the new regulations, for example, the time and place for making the election.[149]

B. THE FOUR MAJOR JAPANESE BUSINESS ENTITIES[150]

The *kabushiki kaisha* is the overwhelming choice of Japanese business entities by American investors in Japan. It is also the easiest to classify under the final regulations. It is clearly an entity separate from its owners and is not a trust. As a result, it is a business entity under the final regula-

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147. *Id.*

148. Treas. Reg. § 301.7701-2(d)(1) (as amended in 1996). A binding contract rule is also provided for a foreign business entity formed after May 8, 1996, but pursuant to a written binding contract on May 8, 1996. *See* Treas. Reg. § 301.7701-2(d)(2) (as amended in 1996). A foreign business entity that is grandfathered can lose its status under certain conditions. *See* Treas. Reg. § 301.7701-2(d)(3) (as amended in 1996); *see, e.g.*, Henry J. Lischer, Jr., *Elective Tax Classification for Qualifying Foreign and Domestic Business Entities Under the Final Check-the-Box Regulations*, 51 SMU L. REV. 99 (1997).

149. See Treas. Reg. § 301.7701-3(b)(3) and -3(f)(2) (as amended in 1996) for rules for existing entities. See Treasury Regulation section 301.7701-3(c) (as amended in 1996) for the procedural requirements under the new regulations.

150. It is assumed that each Japanese business entity discussed is a new entity formed on or after January 1, 1997.

tions. In addition, the *kabushiki kaisha* is the only Japanese business entity listed on the list of foreign entities automatically classified as a corporation.[151] As a result, the *kabushiki kaisha* is not an eligible entity entitled to elect its classification.[152] This should not come as a surprise to American investors.

The *yugen kaisha* would appear to be an entity separate from its owners and does not seem to be a trust. As a result, it appears to be a business entity and, in addition, an eligible entity and is thus entitled to elect its classification under the regulations. If the *yugen kaisha* has two or more members (it is generally limited to fifty members with a few exceptions), it can elect association or partnership status. If the *yugen kaisha* has only one member, which is permitted, it can elect association status or elect to disregard its separate existence. The default rules generally appear to be straightforward. Because all of the members of the *yugen kaisha* have limited liability, it should be treated as an association under the default rule. Consequently, it is important for members to make the election if they wish to avoid association classification for the yugen kaisha.

The *gomei kaisha* also appears to be a separate entity and does not seem to be a trust. As a result, it is a business entity and, in addition, an eligible entity and is thus entitled to elect its classification under the new regulations. The *gomei kaisha* appears to be required to have at least two members[153] and, therefore, can elect either association or partnership status. The default rule appears to be straightforward. Because the members of the *gomei kaisha* do not have limited liability, it should be treated as a partnership under the default rule.

The *goshi kaisha* appears to be a separate entity and does not seem to be a trust. As a result, it is also a business entity and, in addition, an eligible entity and so entitled to elect its classification. The *goshi kaisha* must have at least two members and, therefore, can elect either association or partnership status.[154] The default rule appears to be straightforward. Because at least one member of the *goshi kaisha* does not have limited liability, it should be treated as a partnership under the default rule.

C. THE TWO FLOW-THROUGH TYPES OF ENTITIES[155]

The nin-i kumiai appears to be a separate entity even though it is not a company provided for in the Commercial Code and is not a separate en-

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151. *See* Treas. Reg. § 301.7701-2(b)(8)(i) (as amended in 1996).

152. A *kabushiki kaisha* in existence on May 8, 1996, may attempt to qualify under Treasury Regulation section 301.7701-2(d)(1) (as amended in 1996) to avoid corporate classification.

It has also been suggested that a *kabushiki kaisha* may be able to avoid its per se corporation classification by "domesticating" as a Delaware limited liability company and then electing partnership status.

153. *See* Commercial Code, arts. 94(4), 95(2); Kawabata, *supra* note 12, at 25.

154. *See* Commercial Code, arts. 146, 162.

155. It is assumed that each Japanese business entity discussed is a new entity formed on or after January 1, 1997.

tity for purposes of the Japanese corporate income tax. It is, however, an entity provided for in the Civil Code. In addition, there is a contractual arrangement among the participants, and the participants are carrying on a business and dividing the profits from the business. As a result, the *nin-i kumiai* appears to be a separate entity.

The *nin-i kumiai* also appears to be a business entity as it does not appear to be a trust. Because the *nin-i kumiai* is not on the list of per se corporations, it should be an eligible entity and entitled to elect its classification. The *nin-i kumiai* appears to be required to have at least two members and, therefore, can elect either association or partnership status.[156]

The default rule appears to be straightforward. The members of the *nin-i kumiai* do not appear to have limited liability as defined in the regulations. They are each responsible for a portion of the debts of the partnership in proportion to how they share losses.[157] If the creditor is unaware of how the members share losses, then the creditor may proceed against each member in equal shares.[158] The members of the *nin-i kumiai* are not jointly and severally liable for all debts of the entity.[159] Rather, each member has unlimited liability for a certain proportion of the debts of the *nin-i kumiai*.[160] This seems to fall within the situation discussed by the Treasury in the preamble to the final regulations.[161] The Treasury, in the preamble, modified the regulations from the proposed version to provide that "a member does not have limited liability if the member, by virtue of being a member, has personal liability for all or any portion of the debts of the entity."[162] Because not all of the members of the *nin-i kumiai* have limited liability, it should be treated as a partnership under the default rule.

The *tokumei kumiai* presents greater difficulty under the regulations than the other major Japanese business entities primarily because there is nothing comparable to it in the United States legal system. It is not entirely clear whether the *tokumei kumiai* is a separate entity under the regulations.[163] It is an entity that is provided for in the Commercial Code. However, it is not a separate entity for Japanese legal purposes, and it is not a separate entity for Japanese corporate income tax purposes.[164] The *tokumei kumiai* has been described as a contractual undertaking to share profits of a business conducted entirely by one

156. *See* Civil Code, art. 667; Otsuka, *supra* note 3, at 318 (The *nin-i kumiai* must have at least two members.).
157. *See* Civil Code, arts. 674-75.
158. *See id.* art. 675.
159. *See* T.D. 8697, 1997-2 I.R.B. 11, 14; 61 Fed. Reg. 66,584, 66,586 (Dec. 18, 1996).
160. *See id.*
161. *See id.*
162. *Id.*
163. *See generally* WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 3.08[2][a] (3d ed. 1996) ("Probably the most ambiguous aspect of the check-the-box regulations is the definition of an 'entity.'").
164. *See, e.g.*, DARCY, *supra* note 3, ¶ 630.20; Way et al., *supra* note 12, at A-23.

entrepreneur.[165] There is, however, no contractual undertaking among all the parties to the *tokumei kumiai.*[166] Rather, there are individual contracts between the entrepreneur and each investor.[167] The entrepreneur conducts the business entirely on its own behalf. The entrepreneur owns all the assets of the *tokumei kumiai* and, therefore, the *tokumei kumiai* lacks the characteristic of joint or co-ownership of property. The entrepreneur is responsible for all the debts of the *tokumei kumiai.* The investors do not take part in the management of the *tokumei kumiai.* The only significant rights the investors have are the contractual rights to a portion of the profits (or losses) of the *tokumei kumiai* and the contractual rights, upon termination of the *tokumei kumiai*, to the investors' contributions, less any accumulated losses.[168] The *tokumei kumiai* terminates upon the bankruptcy of the investor (as well as the bankruptcy of the entrepreneur).[169]

The profits and losses of the *tokumei kumiai* do not flow through to the investors. Rather, the entrepreneur reports all of the profits (or losses) of the *tokumei kumiai* on its income tax return and then deducts the portion of the profits allocated to the investors pursuant to each contract with the investors. As a result, each investor reports its share of the profits or losses as agreed to in its contract with the entrepreneur.

It would be helpful if the Treasury or the Internal Revenue Service issued guidance on the separate entity issue.[170] One possible result is that the *tokumei kumiai* is a single separate entity because, when viewed as a whole, there is arguably a contractual arrangement in which the participants (entrepreneur and investors) are carrying on a business and dividing the profits from the business.[171] Under this view, it would be wise if each *tokumei kumiai* contract that an entrepreneur enters into with

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165. *See* DARCY, *supra* note 3, ¶ 630.20; *see also* Otsuka, *supra* note 3, at 318 ("A Tokumei [Kumiai] is a contractual arrangement in which one or more investors contribute money or other assets in the activities of an entrepreneur who is to engage in business with a view to sharing profits with the investors.")

166. *See* Way et al., *supra* note 12, at A-23; Yoost & McGinnis, *supra* note 77, at 15.

167. One reviewer of this Article stated that she was aware of a least one *tokumei kumiai* in which there was only one contract, which was signed by the entrepreneur and all the investors.

168. *See* Commercial Code, arts. 153, 535, 541, 542; Yoost & McGinnis, *supra* note 77, at 15-16.

169. *See* Commercial Code, art. 540(3).

170. The *tokumei kumiai* appears to be similar to the German *stille gesellschaft. See* Otsuka & Watanabe, *supra* note 78, at 5. See also HARVARD LAW SCHOOL, WORLD TAX SERIES, TAXATION IN THE FEDERAL REPUBLIC OF GERMANY 5/5.2 (2d ed. 1991) for a detailed description of the two types of *stille gesellschaft.* The Internal Revenue Service has issued a number of private letter rulings with respect to the *stille gesellschaft. See, e.g.*, Priv. Ltr. Rul. 83-09-062 (Nov. 29, 1982) (*stille gesellschaft* is a partnership); Priv. Ltr. Rul. 80-12-063 (Dec. 27, 1979) (same); Priv. Ltr. Rul. 79-35-019 (May 29, 1979) (same); Priv. Ltr. Rul. 79-08-004 (Aug. 23, 1978); Priv. Ltr. Rul. 79-37-054 (June 14, 1979). In Gen. Couns. Mem. 38,199 (Dec. 14, 1979), the Chief Counsel's Office expressed concern over the classification of the *stille gesellschaft* and questioned whether the participants ("silent partners") are partners for federal income tax purposes.

171. *See* Treas. Reg. §301.7701-1(a)(2) (as amended in 1996). But see text accompanying *infra* notes 179-85 for a discussion of the entrepreneur being characterized as a debtor and the investors being characterized as creditors.

each investor contains language stating that the entrepreneur and all the investors intend the creation of a single separate entity (with the entrepreneur and all the investors as owners), and all the parties intend for the *tokumei kumiai* to be treated as a partnership (or an association, if that is the classification that is desired) for purposes of the United States check-the-box regulations.[172]

If the *tokumei kumiai* is not a single separate entity with two or more owners, then perhaps it is simply a single-owner organization that can elect to be recognized or disregarded as an entity separate from its owner.[173] There appears to be a difference of opinion as to whether a branch can make an election under the check-the-box regulations and be treated as an entity separate from the legal entity of which it forms a part.[174] This same issue may arise with respect to a sole proprietorship because it is not clear if a sole proprietorship is a separate entity under the check-the-box regulations.[175] If the *tokumei kumiai* is treated as having a single owner, then it is similar in many respects to a branch (or division) or sole proprietorship, depending on whether the entrepreneur is a domestic corporation, foreign corporation, or an individual. If it is viewed as a branch (or division) or sole proprietorship, an issue arises as to whether the *tokumei kumiai* can check the box and, for example, elect

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172. See generally McKee, *supra* note 163, at ¶¶ 3.02[1], 3.02[5][b][v] for a discussion of the importance of the intention of the parties in determining the existence of a partnership.

173. *See* Treas. Reg. § 301.7701-1(a)(4) (as amended in 1996).

The regulations do not contain any guidance on when a business enterprise owned by a single member will constitute a separate entity so as to enable the owner to elect to have it treated as an association or disregarded as a tax nothing. The preamble to the proposed regulations state that

> [m]any commentators requested guidance concerning the classification of an unincorporated business entity with a [single] owner . . . . [T]he proposed regulations permit a business entity with a [single] owner that is not required to be classified as a corporation to elect to be classified as an association or to have the organization disregarded as an entity separate from its owner . . . .

PS-43-95, 1996-1 C.B. 865, 868. But this does not directly address the issue of when a business enterprise owned by a single member will constitute a separate entity. *See, e.g.*, Wirtz, *supra* note 121, at 358.

> The examples in the [proposed] regulations all involve arrangements between two or more persons. The proposed regulations do not contain any guidance on when a business enterprise involving only a single-member arrangement will be, at least preliminarily, treated as a separate entity whose owner may elect to have it treated as an association or ignored for tax purposes.

Id.; Grace, *supra* note 120, at 301 ("The proposed regulations do not contain any guidance on when a business enterprise owned by one person will qualify as a separate entity . . . . Based on the regulations' structure, single-owner organizations presumably must satisfy the general threshold test for a separate entity.").

174. *See* Walser & Culbertson, *supra* note 121, at 56.

175. Traditionally, a sole proprietorship is not thought of as a separate entity from its proprietor. *See, e.g.*, George K. Yin, *The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the "Check-the-Box" Regulations*, 51 SMU L. Rev. 125 (1997).

association status.[176]

A different way of approaching the separate entity issue is to treat each contract that the entrepreneur enters into with each investor as a separate entity. For example, if an entrepreneur enters into five contracts with five different investors, then this would be treated as five separate entities. This approach may be consistent with the view that there is no contractual undertaking among all the parties to the *tokumei kumiai.* Rather, each investor enters into a separate contract with the entrepreneur. The terms of the contract may vary from investor to investor, or the terms may be identical. This approach is one way of handling the separate entity issue, although it may conflict with the Japanese view of the *tokumei kumiai.* For example, when the *tokumei kumiai* distributes the profits to the investors, the distribution is subject to withholding under the Japanese income tax laws unless the number of investors is less than ten. This is one factor which implies that the Japanese view the *tokumei kumiai* as a single entity. Again, it would be helpful if the Treasury or the Service provided guidance on this issue.

If the *tokumei kumiai* is a separate entity and not a trust,[177] then it is a business entity. It is not on the per se list of corporations, and, therefore, it is an eligible entity entitled to elect its classification. An issue arises as to whether the investors are members of the *tokumei kumiai* or whether the entrepreneur is the only member. Although not identical, this appears to be a similar issue as to whether the *tokumei kumiai* is a separate entity. It also appears to be a much more difficult issue to resolve.[178] In the preamble to the final regulations, the Treasury recognized the continuing issue of whether an entity has more than one owner and responded that it is based on all the facts and circumstances.[179] As a result, the extensive body of cases and rulings must be consulted in distinguishing a partnership from a lender-borrower or lessor-lessee relationship.[180] Japanese tax authorities and commentators also recognize this issue and have suggested that "[i]f the purported partner is to receive a percentage of his contribution or some other fixed amount, for [Japanese] tax purposes he might be treated as having a lending relationship with the purported en-

176. If the Treasury distinguishes among branches, divisions, and sole proprietorships on the separate entity issue, then it may be necessary for the Treasury to define each of the three terms in the regulations.

177. It seems a bit of a stretch to argue that the *tokumei kumiai* is a trust. The purpose of the *tokumei kumiai* is not to vest in the entrepreneur responsibility for the protection and conservation of property for the benefit of the investors. Rather, the entrepreneur and investors are more in the nature of participants or associates engaged in a joint enterprise for the conduct of a business for profit. *See* Treas. Reg. §§ 301.7701-1(b) and -4(a) (as amended in 1996). But see text accompanying *infra* notes 179-85 for a discussion of the entrepreneur being characterized as a debtor and the investors being characterized as creditors.

178. See *supra* note 170 for a similar issue with respect to the German *stille gesellschaft.*

179. *See* T.D. 8697, 1997-2 I.R.B. 11, 13; 61 Fed. Reg. 66,584, 66,585 (1996).

180. See generally McKEE, *supra* note 163, ¶¶ 3.03[3], 3.03[4] for a discussion in distinguishing partnerships from lender-borrower relationships and lessor-lessee relationships.

trepreneur."[181] They have suggested that "[c]onversely, a purported lending relationship may in fact constitute an anonymous partnership arrangement [*tokumei kumiai*] if the purported lender is to receive a percentage of profits earned by the entrepreneur."[182] In other words, the investors may be treated as creditors or lessors, and the entrepreneur is the debtor or lessee.[183] It would be helpful if the Treasury or the Internal Revenue Service provided specific guidance on this issue with respect to the *tokumei kumiai*.[184]

If the entrepreneur is the only member, then perhaps the *tokumei kumiai* can elect association status or elect to be disregarded as an entity separate from the entrepreneur.[185] If the investors are also treated as members of the *tokumei kumiai*, then the *tokumei kumiai* can elect to be an association or a partnership.

Under the default rules, the *tokumei kumiai* will either be disregarded as an entity separate from the entrepreneur or it will be treated as a partnership because the entrepreneur does not have limited liability. This classification will again depend on resolution of the issue of whether the investors are treated as members.

VI. CONCLUSION

Applying the new entity classification regulations to the major Japanese business entities used by American investors seems to be relatively straightforward. Only experience with the new regulations will expose any difficulties with them. The Japanese business entity that poses the greatest difficulty under the final regulations is the *tokumei kumiai*. It would be helpful if the Treasury provided guidance on whether the *tokumei kumiai* is a separate entity and whether the investors are treated as members of the *tokumei kumiai*.[186] This may become of some impor-

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181. Otsuka & Watanabe, *supra* note 78, at 1.2.1.4 n.41 (citing to Income Tax Basic Circular 36.37 kyō-21); Otsuka, *supra* note 3, at 320 ("However, when an investor of a Tokumei [Kumiai] is to receive a fixed amount of distribution from the Tokumei [Kumiai] even if the business of the Tokumei [Kumiai] produces no profits, the distribution will be treated as interest on a loan provided to the Tokumei [Kumiai] by the investor.").

182. Otsuka & Wantanabe, *supra* note 78, at 1.2.1.4 n.41 (citing to Special Taxation Measures Law-C, arts. 63(6)-2, 63-2(6)-2).

183. One commentator has written that the entrepreneur reports an investor's contribution as a liability on its balance sheet thus leading, in some sense, to the idea of a creditor/debtor type of arrangement. *See* Landau, *supra* note 62, at 40-43. Several reviewers of this article have suggested that an investor's contribution is not neatly characterized as either equity or liability on the balance sheet but rather falls somewhere in between the two, as a quasi-liability. *See also* Yoost & McGinnis, *supra* note 77, at 15 ("The TK agreement should not provide a minimum profit guarantee for the investor, so as to avoid reclassifying the arrangement as a mere loan.").

184. It may be possible that the issue of whether the investors are members of the tokumei kumiai or simply creditors will have to be decided on a case-by-case basis. The relationship between entrepreneur and investors varies from one *tokumei kumiai* to another and may actually vary within a single *tokumei kumiai*.

185. *See supra* notes 173-75 and accompanying text.

186. In the preamble to the final regulations, the Treasury indicated that protective elections can be made if, for example, there is uncertainty about an entity's status as a business entity. *See* T.D. 8697, 1997-2 I.R.B. 11, 15; 61 Fed. Reg. 66,584, 66,587 (1996).

tance if the *tokumei kumiai* increases in popularity, which is possible because of the limited liability it provides to investors, the lack of a permanent establishment in Japan to foreign investors, the pass-through nature of the profits of the *tokumei kumiai*, and the consolidated return-like effect it generates in a country (Japan) where consolidated returns are not yet permissible.