

The Financial Services Agency (**FSA**) has summarized the following in this notice, where so called Carried Interest partnership profit distributions received by individual fund managers in relation to a partnership agreement that stipulates the distribution of partnership profits in excess of their interest holding ratio from the partnership business managed by the fund managers as its partners, will be taxed on a pass-through basis and treated as the income of the fund managers in accordance with the distribution ratio as stated in the partnership agreement (**Pass-through treatment**).

The FSA had sought comments on Section II from the National Tax Agency (**NTA**) regarding this Notice based on Section I, and the NTA had no objection to the FSA's view in this Notice.

In addition, a general example (or reference case) provided in accordance with the conditions in Section II is included in Section III, and where the NTA also raised no objections.

Furthermore, when fund managers receiving Carried Interest file their individual income tax returns, check sheets and calculation sheets which have been released in conjunction with this document should be enclosed with their individual tax returns to ensure that the conditions for this purpose are duly satisfied.

Notice

I. Basic Principle of Carried Interest

When an individual fund manager invests cash, etc., in an investment partnership business,¹ becomes a partner thereof and also has the authority to exercise influence on the decision-making over the investment partnership's business, the contribution to the investment partnership made by the fund manager should be higher than that of the limited partners who merely provide cash. Therefore, considering their contribution, there are many instances where the partnership agreement stipulates that the distribution of profits to the fund manager is to be in

¹ Investment partnership business means a partnership business formed for the purposes of acquiring and holding shares, etc., as prescribed in Article 37-10, Paragraph 2 of the Special Taxation Measures Act.

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excess of their interest holding ratio (often referred as **Carried Interest**) provided that the profits derived from the partnership business exceed a certain level of returns (hereinafter referred to as the **Hurdle Rate**).

Under 36/37-19 of the Basic Circular of Income Tax Act (hereinafter referred to as the **Basic Circular**), which stipulates the attribution of profits, etc., derived from the partnership business (*Nin-i Kumiai*, etc.), the taxation of partnership business for the partners is stipulated as follows. The amount of profits, etc., for the partner derived from the partnership business shall be the amount of profits, etc.² to be distributed according to the distribution ratio (where pass-through treatment applies and in accordance with the distribution ratio),³ unless the distribution ratio is not “economically rational.”

○ Basic Circular of Income Tax Act

(Attribution of profit, etc., derived from the partnership business for its partners)

36/37-19 The amount of profit or loss derived from a business operated by a partnership (*Nin-i Kumiai*, etc., hereinafter referred to as a partnership business through 36/37-20) of a partner shall be the amount of profit or loss to be distributed according to the distribution ratio of the amount of profit or loss of the partnership business.

However, this will not be the case if such distribution ratio is not economically rational when considering the situation of each partner's investment and/or the circumstances of their contribution to the partnership business.

(NOTE)¹ *Nin-i Kumiai* etc. shall mean partnerships established under partnership agreements stipulated in Article 667, Paragraph 1 (partnership agreement) of the Civil Code, investment business limited partnership agreements stipulated in Article 3, Paragraph 1 (investment business limited partnership agreement) of the Act on Investment Business Limited Partnership Agreement, and limited liability partnership agreements stipulated in Article 3, Paragraph 1 (limited liability partnership agreement) of the Act on Limited Liability Partnership Agreement, and partnerships similar thereto in foreign countries. The same applies until 36/37-20.

² The distribution ratio shall mean the ratio of distribution of profit and loss stipulated in the partnership agreement, or the ratio of distribution of profit

² Realized gains are subject to taxation.

³ Where the profit, etc., derived from the partnership business is based on the transfer of shares, etc., the income from the transfer of shares, etc. shall be treated as capital gain of the shares and subject to Separate Taxation.

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and loss stipulated in Article 674 of the Civil Code, Article 16 of the Act on Investment Business Limited Partnership Agreement (*mutatis mutandis* application of the Civil Code), and Article 33 of the Act on Limited Liability Partnership Agreement (profit and loss distribution ratio of partners). The same applies to until 36/37-20.

Where Carried Interest is stipulated in the partnership agreement as the distribution of the partnership's profit to the partners, in order to be subject to pass-through treatment according to the distribution ratio stipulated in the partnership agreement, it is required that the partners receive the distribution of the profits derived from the partnership business at an economically reasonable distribution ratio. Therefore, such basic concepts as "Economic Rationality," etc. will be examined in relation to the application of the Basic Circular below.

II Basic Concepts of "Economic Rationality," etc.

Regarding economic rationality, as stated in the Basic Circular, each partnership agreement will be specifically examined "by considering the situation of each partner's investment and/or the circumstances of its contribution to the partnership business." In this context, for example, if the following requirements are met, for the application of the Basic Circular, Carried Interest should be subject to pass-through treatment according to the distribution ratio stipulated in the partnership agreement and that, in general, it has economic rationality, etc.

In addition, the following requirements are based on the assumption that the partnership agreement (refer to **Definition of Terms**) is a *Nin-i Kumiai*, etc. stipulated in the Basic Circular and that there shall be no difference between the partnership agreement and the substance of management thereof.

1. Partnership agreement for *Nin-i Kumiai* etc.

- Conclusion of a partnership agreement and management of the partnership assets are carried out in accordance with relevant laws and regulations

In addition to the conclusion of a partnership agreement, the content of the agreement and the management of the partnership assets should meet that of legal reasonableness. Therefore, it is required that (i) the conclusion of a

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partnership agreement and its contents thereof are based on relevant laws and regulations which are the legal basis for the partnership agreement, and (ii) the general partner (hereinafter referred to as the **GP**) is qualified to conduct the investment management business in accordance with the Financial Instruments and Exchange Act when managing the partnership assets.

- The fund manager invests cash and/or other assets in the investment partnership

In order to be subject to pass-through treatment, it is assumed that the fund manager invests cash and/or other assets in the investment partnership. Since Carried Interest is the distribution of profits received by the fund manager as a partner considering their contribution to the investment partnership business, it is required to hold the status as a partner by investing cash and/or other assets in the investment partnership.⁴

2. “Distribution of Profits”

- Carried Interest is stipulated in the provision of distribution of profits under the partnership agreement.

In order to treat Carried Interest as a distribution of profits derived from the partnership business, it is required that the nature of Carried Interest is specified in the partnership agreement. Therefore, it is required that Carried Interest is to be set forth in the provisions that provide for the distribution or allocation of profits⁵ under the partnership agreement, and Carried Interest is allocated as a distribution of partnership profits to its partners.⁶

3. “Economic Rationality”

- Conditions for distribution stipulated in the partnership agreement are not arbitrary

In order to be economically rational, it is required that the distribution conditions

⁴ Labor contributions are not subject to this Notice because some of the partnership agreements are not permitted under the applicable law of the partnership agreement.

⁵ It is also possible to prescribe in the provision of “distribution of assets of the partnership”.

⁶ It should be noted that Carried Interest is a distribution of partnership profits, which differs from compensation for the provision of services (i.e., a fee).

stipulated in the investment partnership agreement are not arbitrary. The distribution conditions set forth in the investment partnership agreement are considered as one of the most conflicting items between the limited partners who only provide funds (hereinafter referred to as the **General LP**) and the fund manager who receives Carried Interest. Therefore, in order to be regarded as non-arbitrary distribution conditions, it is required that (i) the partnership agreement has been concluded with the agreement of all the partners of the partnership and (ii) the partners of the partnership consist of multiple persons who have conflict of interest with other partners.

However, it should be noted, for example, that the conditions for distribution cannot be regarded as non-arbitrary if the provisions on Carried Interest can be determined and/or changed only by the fund managers and their specially related persons.

- Contents of the partnership agreement are based on common market practices

To be economically rational, it is required that the contents of the investment partnership agreements are based on domestic and/or overseas common market practice. For example, in the provision that stipulates the distribution and allocation of partnership profits, there are many cases⁷ where the distribution of the profits according to the interest holding ratio is made when a certain Hurdle Rate is reached and for the excess, the 20% of that is distributed to the fund managers and the remaining 80% is distributed to the partners⁸ other than the fund managers. Since such distribution or allocation method (including the distribution ratio) are included in many partnership agreements, it should be regarded as important evidence supporting the common market

⁷ Refer to page 52 and thereafter of “a sample investment business limited partnership agreement and its explanation” (March 2018, Ministry of Economy, Trade and Industry). Regarding the distribution of Carried Interest, according to the views of multiple specialists (lawyers, Certified Public Accountants and Certified Tax Accountants, etc.) consulted by the FSA, the practice whereby 20% of the excess of Hurdle Rates is distributed to the fund managers and the remaining 80% is distributed to other investors has been applied by many foreign investment funds as a common market practice.

⁸ After preferentially distributing to partners other than the fund managers up to the Hurdle Rates, the fund managers receive distribution first to the amount equivalent to the Hurdle Rates (so-called **Catch-up**), and there are often cases in which 20% of the profits after Catch-up are distributed to the fund managers and the remaining 80% is distributed to the partners other than the fund managers.

practice indirectly.

- A fund manager contributes to the investment partnership business

To be economically rational, it is required that the fund manager contributes to the investment partnership business. Since Carried Interest is the distribution of profits received by the fund manager as a partner considering his/her contribution to the investment partnership business, it is an important factor that the fund manager contributes to the investment partnership business. For example, the fund manager is regarded as contributing to the investment partnership business if the fund manager has the authority⁹ to exercise a significant impact over the investment decisions of the investment partnership business and actually exercise the authority to give rise to profits related to the partnership business.

[Definition of Terms]

Partnership agreement	<p>The following agreements prescribed in Article 281, Paragraph 5 of the Enforcement Order of the Income Tax Act or Article 178, Paragraph 5 of the Enforcement Order of the Corporation Tax Act:</p> <ul style="list-style-type: none"> (i.) Partnership agreements stipulated in Article 667, Paragraph 1 of the Civil Code (<i>Nin-i-Kumiai</i>) (ii.) Investment business limited partnership agreement stipulated in Article 3, Paragraph 1 of the Act on Investment Business Limited Partnership Agreement (<i>Toushi-Jigyo-Yuugen-Sekinin-Kumiai</i>) (iii.) Limited liability partnership agreements stipulated in Article 3, Paragraph 1 of the Act on Limited Liability Partnership Agreement (<i>Yuugen-Sekinin-Jigyo-Kumiai</i>) (iv.) Agreements similar to those mentioned in (i) to (iii) above in foreign countries
Investment management business	<p>The following investment management businesses:</p> <ul style="list-style-type: none"> (i.) Investment management business prescribed in Article 28, Paragraph 4 of the Financial Instruments and Exchange

⁹ For example, the authority to engage in the acts prescribed in Article 26-30, Paragraph 1 of the Enforcement Order of the Special Taxation Measures Act should be one of the powers that has a significant impact on investment decisions in the investment partnership businesses.

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	<p>Act of a Financial Instruments Business Operator, etc. prescribed in Article 34 of the Act</p> <p>(ii.) Special business for qualified institutional investors, etc. prescribed in Article 63, Paragraph 2 of the Financial Instruments and Exchange Act of a notifier of special business prescribed in Paragraph 5 of the Article</p> <p>(iii.) Special business for foreign investors, etc. prescribed in Article 63-8, Paragraph 1 of the Financial Instruments and Exchange Act of a notifier of special business for foreign investors, etc. prescribed in Article 63-9, Paragraph 4 of the Act</p> <p>(iv.) Special business during transition period prescribed in Article 3-3, Paragraph 5 of the Supplementary Provisions of the Financial Instruments and Exchange Act (including committing acts prescribed in Paragraph 7 of the Article in the course of business) of a notifier (excluding one to whom the proviso of Paragraph 1 of the Article applies (including the cases where it is applied mutatis mutandis in Paragraph 7 of the Article)) pursuant to Paragraph 1 of the Article (including the cases where it is applied mutatis mutandis in Paragraph 7 of the Article)</p> <p>(v.) Investment management business prescribed in Article 28, Paragraph 4 of the Financial Instruments and Exchange Act of a person approved by the Commissioner of the FSA pursuant to Article 16, Paragraph 1, Item 17 of the Cabinet Office Ordinance on Definitions under Article 2 of the Financial Instruments and Exchange Act</p>
Specially related person	<p>In principle, an individual who has a special relationship as prescribed in each item of Article 275 of the Enforcement Order of the Income Tax Act or each item of Article 4, Paragraph 1 of the Enforcement Order of the Corporation Tax Act; or a corporation with a special relationship as prescribed in each item of Paragraph 2 of the Article with a partner, such as a relative of a partner</p>

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III Specific example

A specific example based on the basic concepts of Section II is provided as follows.

[Notes]

1. The partnership agreement and its operational status shall be consistent throughout.
2. If the underlying facts differ, the treatment can differ.

(Facts)

Overview of Fund Z

Fund Z is a limited partnership (**LPS**) formed by Company A, as the GP, a Japanese investment management company (registered as an investment management business under Financial Instruments and Exchange Act), for the purpose of investing in the global financial capital markets. As the GP of Fund Z, Company A conducts the business operations of Fund Z, and B, an officer and/or employee of Company A, has substantial authority to make investment decisions over portfolio companies and the execution of investments by Fund Z as the fund manager. Many domestic and foreign investors simply provide funds and do not have authority over the execution of the management and operation of Fund Z as General LPs. In addition, Company A's officer and/or employee, B, participates as a special limited partner (hereinafter referred to as the **Special LP**) of Fund Z, who has the authority for execution of operation and investments as the fund manager of Fund Z. Fund Z falls under the category of *Nin-i Kumiai*, etc., of the Basic Circular.

The GP (Company A), the Special LP (Company A's officer and/or employee, B), and the General LP invest cash at 5%, 5%, and 90%, respectively, in Fund Z.

Contents of the partnership agreement

The following provisions are set forth in the partnership agreement of Fund Z for the distribution of the partnership profits.

- The Hurdle Rate is set at 8% and the partnership profits are distributed in proportion to the interest holding ratio until the partnership profits reach

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the Hurdle Rate.

- For the profits exceeding the Hurdle Rate, 20% of the excess is distributed to the Special LP and the remaining 80% is distributed to the partners other than the Special LP, considering the contribution of the fund manager.
- Provisions regarding Carried Interest cannot be determined and/or changed only by the fund manager and its specially related persons.

Others:

- The partnership agreement is concluded with the agreement of all partners, including the General LPs, Company A and B.
- No General LP is a specially related person of B.
- B, an officer and/or employee of Company A, receives distribution of the partnership profits from Fund Z as a Special LP, and also receives a salary from Company A under an employment contract as an officer and/or employee of Company A.

Considering the above facts comprehensively, the distribution of partnership profits received by Company A's officer and/or employee, B, should be subject to pass-through treatment in accordance with the distribution ratio stated in the partnership agreement.

1. Partnership agreement for *Nin-i Kumiai*, etc.

- Fund Z falls under the category of *Nin-i Kumiai*, etc., of the Basic Circular.

In addition, Company A is registered as an investment management business under the Financial Instruments and Exchange Act in order to conduct investment management for Fund Z, and as such subject to regulation on the duty of care and fiduciary responsibility under the Financial Instruments and Exchange Act.

- It can be said that B, whose purpose is to invest cash in Fund Z, participates as a partner of Fund Z.

2. "Distribution of Profits"

- Since Carried Interest (the 20% of the excess of Hurdle Rates is distributed to the Special LP) is set forth in the provision of the distribution of partnership profits, the Carried Interest received by the fund manager under the

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partnership agreement is the distribution of partnership profits rather than the compensation for providing services.

3. "Economic Rationality"

- In negotiating the terms of the partnership agreement of Fund Z, there are many General LPs who are not specially related persons with B, and as a result of negotiations amongst multiple partners who have conflict of interest against of each other, the distribution of profits to Special LP in excess of the interest holding ratio is agreed.

In addition, any change in the provisions relating to the Carried Interest shall require the agreement of the partners, including the General LPs, and such conditions shall not be determined and/or changed only by the fund manager and their specially related persons.

Therefore, the distribution ratio cannot be said to be arbitrary.

- For the profits exceeding the Hurdle Rate, 20% is distributed to the Special LP and the remaining 80% is distributed to the partners other than the Special LP. It is regarded as a common condition for Carried Interest (refer footnote 7).
- It can be said that B contributes to the partnership business because B has and executes the authority to make decisions over portfolio companies and investment execution by Fund Z.

Therefore, the distribution of partnership profits received by Company A's officer and/or employee B should be qualified for pass-through treatment under the Basic Circular and the amount of profits to be distributed in accordance with the distribution ratio set forth in the agreement should be attributable to the respective partners, including that of B.

(NOTE) B, a Special LP, receives a salary from Company A as an officer and/or employee of Company A. However, that salary is based on the employment contract between Company A and B, and that taxation should differ from the distributions under the partnership agreement.

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