J-LLC & J-LLP: Innovation of Business Organization Law in Japan

RIETI Feb. 27, 2006

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New Business Organizations

In 2005

Godo-kaisha (limited liability company; “J-LLC”)

(will be effective in May 2006)

Yugen-sekinin jigyo-kumiai (limited liability partnership; “J-LLP”)

(effective in Aug 2005)

LLC (and LLP) in the U.S.

J-LLC & J-LLP: Inspired by successful experiences of LLC and LLP in America

LLC (created by each State statute)

- Over one million, in 2003 (IRS)
- 45% of total new business filings (Friedman 2004)

Key Features of the U.S. LLC

- Flexible governance/profit-sharing structure
- Limited liability of members
- Pass-through taxation

In contrast, neither J-LLC nor J-LLP have all these features (as explained later)

(1) Flexible governance structure (free from mandatory rules)

- Control/cash-flow rights can be allocated by contracts, independent of the amount of financial contributions

←especially important for start-up businesses, where human assets are essential for success

(2) Limited liability (LL)

- Traditionally, legal scholarship has focused on the merits of LL for publicly-traded corporations
- Raising capital from public
- Facilitating trade of shares

Nevertheless, LL (in relation to contract creditors) can make sense even for closely-held businesses

LL for closely-held firms

- In some cases, creditors can be less-cost monitors and/or less-cost risk-bearers than equity-holders

- Instead of continuous monitoring of equity-holders, managers' behaviors can be disciplined by creditors each time when they decide whether or not to give credit to the firms
- Under unlimited liability regime, equity-holders may not know how much they will owe in bankruptcy, while under LL regime, each creditor knows the maximum amount of his/her loss

Potential cost of LL

- LL may encourage equity-holders to take too much risk at the expense of creditors

→ Such problems can be avoided/mitigated by contract creditors

BUT may be serious for TORT creditors

(3) Pass-through taxation

- In corporate taxation regime –

 1) gains to be taxed both at the levels of firms & members

 2) losses of firms cannot be off-set by gains of members

→ Tend to discourage risk-taking

Pass-through taxation (cont.)

- In pass-through taxation regime –

Firms be “disregarded” as tax entities, and gains and losses will be allocated to members

Start-up businesses and joint ventures often suffer losses at their early stages

→ Deductibility of such losses from gains of members is important

Japanese business organizations

- No organizations have those 3 features (flexible structures, LL, pass-through taxation) at once

Kabushiki-kaisha (stock corporations):

Law reforms have made its structure pretty flexible, but some regulations remain

Always corporate taxation

Cf. *Yugen-kaisha* (J-GmbH): will be integrated into *Kabushiki-kaisha* (in 2006)

Japanese business organizations (cont.)

- *Minpo-kumiai* (Partnership provided by Civil Act) :
  - pass-through taxation and flexible structure
  - but unlimited liability

- *Tokumei-kumiai* (Silent partnership)
  - LL for silent partners, but unlimited liability for owner-managers
  - pass-through taxation
  - Silent partners cannot participate in management

J-LLC/J-LLP and tax regime in Japan

- Difficulties in importing LLC into Japanese law (especially tax concerns)
- In Japanese tax law,

(A) All incorporated entities are taxed, whether or not their members enjoy LL

(B) Unincorporated organizations are disregarded in principle (pass-through). BUT if they are organized very similarly to corporations, they are taxed as if they were incorporated (so-called "*Jinkaku-no-nai-shadan*")

Legislative history of J-LLC/ J-LLP

- METI and supporters first promoted J-LLC, but…

  because J-LLC was characterized as an incorporated entity in Corporation Act, pass-through status was difficult to obtain

→ METI then promoted J-LLP, an unincorporated organization

In order to avoid being regarded as "*Jinkaku-no-nai-shadan*" by tax authority, J-LLP was intentionally structured *not* like corporations

Features of J-LLC

- Because J-LLC is an incorporated entity,
  it is likely to be taxed as a corporation (and its members are double-taxed).

On the other hand,

Members of J-LLC enjoy LL,

And almost unlimited flexibility of governance structure

Features of J-LLP

- Partners of J-LLP enjoy both LL and pass through status

→ In exchange of those benefits, J-LLP is "handicapped" in terms of its legal status and inflexible governance structure

- Legal status: J-LLP is not incorporated, not an "entity" (legally its is "aggregate" of its members)
- Governance structure: all partners MUST manage partnership affairs (LLP, Art 13) ← a mandatory rule

J-LLP not as corporation

- Registration (e.g., real property): cannot be registered not in the name of J-LLP. Must be registered as all partners jointly own such property
- J-LLP cannot convert/ merge into corporations (J-LLC or stock corporations)

In order to change its organization status, partners must set up new corporation and contribute assets/debts of J-LLP into the corporation

← capital gain realized and taxed

Mandatory participation in partnership management

- J-LLP Act, art.13

If any partner does not participate in management,

There is a risk that LLP agreement is made void, and all partners have unlimited liabilities for partnership debts.

Why mandatory participation?

- To prevent “unfair” avoidance of tax?

  Cf. IRS sec.469 (passive loss rules)

If partners share profits/losses of businesses, is it unfair for them to deduct the losses from their income?

Conclusion

- Rationality of limited liability & pass-through taxation
- But how about LL to tort creditors?