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Japan Back In Spotlight For Real Estate Investment

Law360, New York (February 12, 2014, 1:47 PM ET) -- Japan is back in the spotlight for international real estate investors. Recent surveys indicate that Japan was the third most active market globally in 2013 after the U.S. and the U.K., with transaction volumes of approximately $40 billion, the highest since the financial crisis and nearly a 70 percent increase from 2012 (double in terms of local currency).[1] Tokyo is currently generally viewed as the top ranked city in the Asia-Pacific region for real estate investment.[2]

“Abenomics”, the aggressive monetary easing program implemented by Prime Minister Shinzo Abe to reverse two decades of economic weakness, is beginning to show results. A combination of the yen depreciating against the dollar by more than 20 percent during the last year, low-cost debt available from Japan domestic banks, an attractive real estate yield spread over treasuries, and rents and land prices that appeared to have bottomed out in Tokyo and in a number of other major Japanese cities, have all contributed to the appeal of the Japan market for foreign investors.

While the majority of real estate transactions in Japan involve acquisitions by local buyers,[3] there has also been a noticeable increase in activity by foreign institutional investors, including private and sovereign funds from the U.S., Europe, the Middle East and Asia. This article broadly covers the key threshold issues that these foreign investors consider when investing in Japan real estate: the asset acquisition structure, the investment structure, the financing decision, and the particular challenges facing an overseas investor in Japan.

Asset Acquisition: Fee Title or Trust Ownership

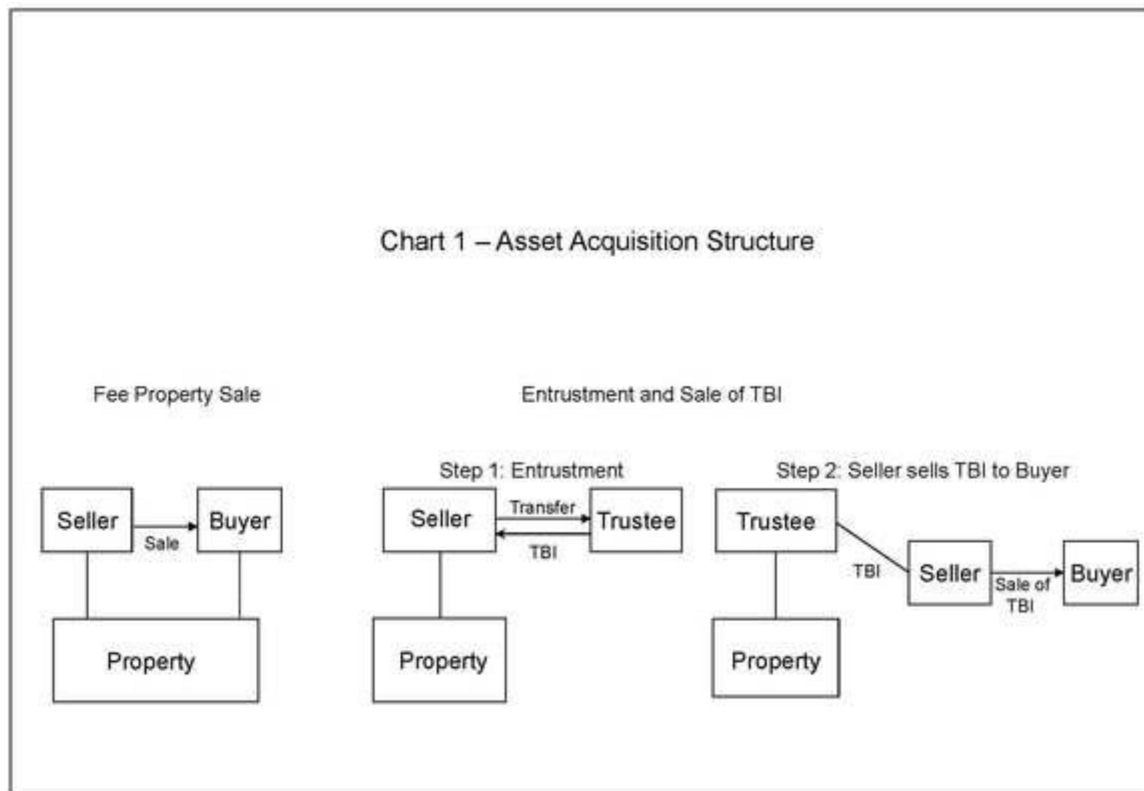
There are two main types of acquisition ownership in Japan: fee title and trust structure. (Please see Chart 1).

Fee title is direct outright ownership of the property; it is basically the same as fee title ownership in the U.S. Trust ownership, on the other hand, is a method in which the property is entrusted by the seller into a trust at closing and the trustee becomes the holder of the property in fee title.

Upon entrustment, the seller receives a trust beneficial interest in the trust (TBI), and the seller transfers the TBI to the buyer. After the closing, the buyer owns the TBI and the trustee continues to hold the property in fee title. The trust structure is favorable from a tax perspective: the registration tax and acquisition tax levied on a typical transfer in fee title does not apply to the transfer of a TBI.[4]

While the trustee in a trust structure requires a payment of fees for its services, nevertheless the trust structure is often chosen by investors because the tax savings more than outweigh the fees ordinarily

charged by trustees, particularly for larger transactions.



Investment Structure: GK-TK or TMK

There are two structures commonly used for private real estate transactions in Japan: the GK-TK structure and the TMK structure.

GK-TK Structure

In this structure, a Japanese subsidiary, typically a godo kaisha (GK) — a Japanese limited liability company — holds title to the TBI.[5] (Please see Chart 2).

Most of the investment capital for the transaction is provided by the investor through a tokumei kumiai (TK), which is a silent partnership in which one or more silent investors (TK investors) makes a contribution into an operating company (TK operator) in return for a share in the profit/loss of a specified business (TK business), conducted by the TK operator.

The TK operator is effectively a pass-through vehicle as it receives a pretax deduction for income allocated to each TK investor. The TK operator's taxable income is subject to Japan national and local taxes in the aggregate amount of approximately 39 percent. However, the TK distribution to an offshore investor is subject to an attractive reduced 20.42 percent withholding tax in the absence of treaty protection.

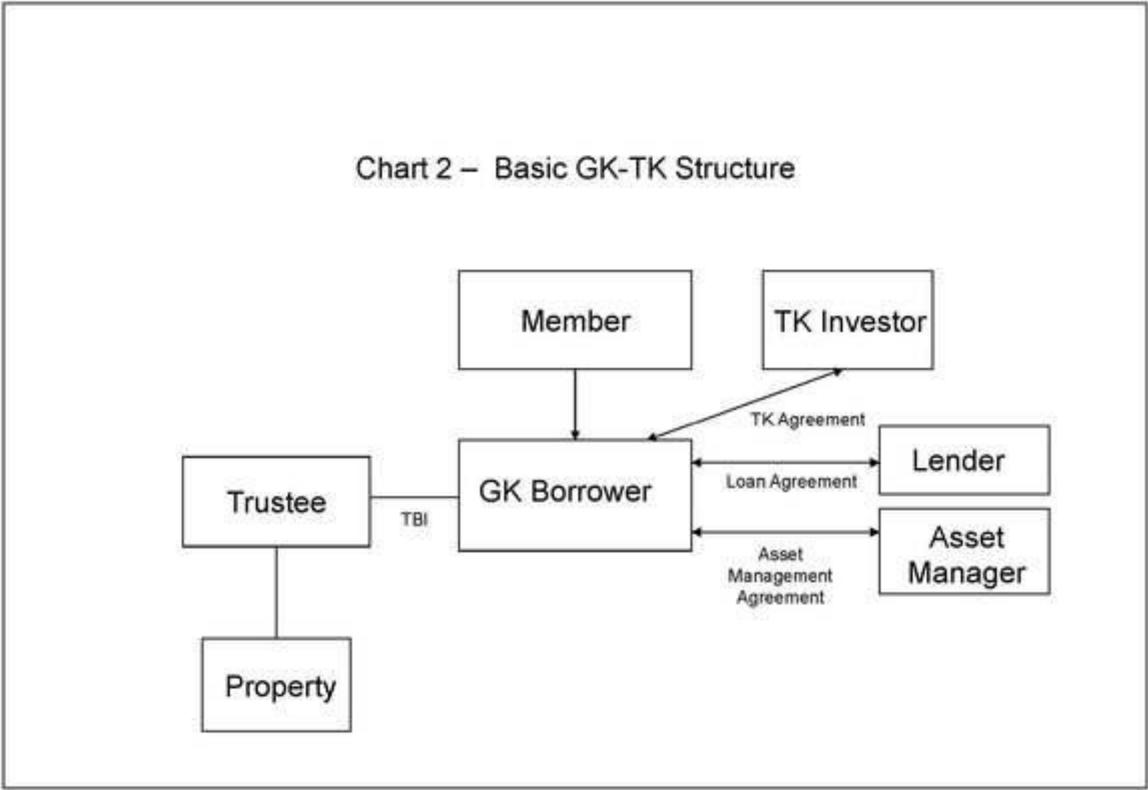
Several features of the tokumei kumiai structure are important to note: The legal title to the asset is held by the TK operator rather than the TK investor. The investment by the TK investor is not equity in the TK operator itself, but rather simply a bilateral contract (TK agreement).

In principle, the TK investor's liability is limited to its contributions as set forth under the TK agreement. The TK investor is not permitted to actively participate in the management of the TK business.

If a TK investor were to participate in the management of the TK operator's business, the TK could be recharacterized as a Japanese general partnership (nin' i kumiai) with respect to the TK investor, which could have both negative tax implications (i.e., permanent establishment risk leading to payment of full national and local taxes) and negative legal implications (i.e., risk of being deemed a general partnership with the TK investor being subject to unlimited liability for the debts and obligations of the TK operator).

From the investor's perspective, the passive and silent nature required of the TK investor is a drawback since, as the party who contributes most of the capital on the transaction, the investor generally seeks to have input on decision-making.

This issue is often partially resolved by attaching a business plan to the TK agreement, which establishes certain limited fixed parameters on how the TK operator may conduct the business (e.g., minimum price floors or return hurdles required for disposition of the asset).[6]



TMK Structure

A tokutei mokuteki kaisha (TMK) is a special-purpose company formed under a specific statutory regime,

originally introduced to promote securitization transactions. (Please see Chart 3).

A TMK is subject to tax on its taxable income at the entity level at the full Japan income tax rate of approximately 39 percent, but it may deduct dividend payments to investors from its current taxable income if certain statutory and tax requirements are satisfied, which results in favorable tax treatment for the investors.

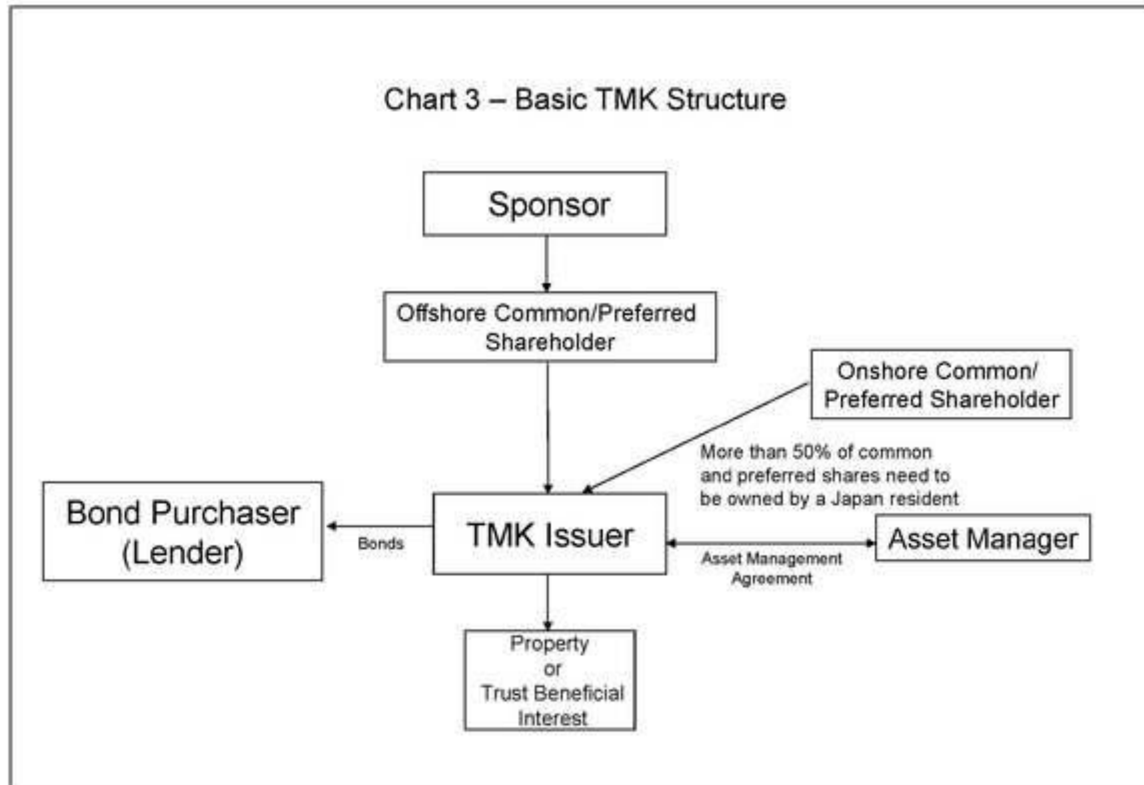
These requirements include, among others:

(1) the TMK must conduct its business and acquire assets in accordance with an asset liquidation plan that is filed with the local government agency,

(2) the method of raising financing must meet certain conditions, of which the most regularly used by investors is that the TMK issue specified bonds through an offering to only qualified institutional investors (QIIs) that satisfy special requirements under the tax laws (tax QII), and

(3) at least 90 percent of the TMK's distributable income for each fiscal year must be paid out as dividends to equity holders.

The TMK structure requires that more than 50 percent of common shares and more than 50 percent of preferred shares be issued onshore in Japan. A Japanese subsidiary or Japanese branch of an offshore entity is generally used to meet this requirement.[7] Importantly, unlike with a TK investment, the investors in a TMK do not need to remain passive and can retain decision-making regarding the real estate or TBI.[8]



GK-TK Versus TMK

Investors faced with the decision of whether to use a GK-TK structure or a TMK structure generally weigh the following factors:

(1) *Effective Tax Rate of Each Structure*. The effective tax rate of each structure is specific to the home jurisdiction of the investors and the applicable tax treaty with Japan. For example, certain jurisdiction such as Singapore and Luxembourg, offer lower withholding tax rates for the TMK structure than the TK structure.

(2) *Decision-Making*. In the TMK structure, the investors are able to be active decision makers, while in the GK-TK structure, the investors need to be silent investors.

(3) *Regulatory Oversight and Flexibility*. The TMK is less flexible, more regulated and subject to more filings with governmental authorities. As noted previously, the TMK is required to file an asset liquidation plan with the government. A TMK transaction requires a period of time (often 2-3 weeks) between signing the purchase and sale contract and closing the acquisition from the seller. In contrast, the TK agreement in a GK-TK structure is a private contract and can be prepared relatively quickly and easily. With a GK-TK structure, the seller and purchaser can sign the purchase and sale contract and close the acquisition on the same day.

(4) *Costs and Deal Size*. In general, the TMK structure requires higher transaction costs (legal, tax, audit) to set up and maintain than the GK-TK structure. While GK-TK deals are used for deals of all sizes, the higher costs of the TMK structure means that they tend to be used for deals in excess of $20 million.

Financing

Japan has an active nonrecourse real estate financing market with funds readily available from Japanese banks and a few foreign financial institutions with platforms in Japan. The structure of the financing in a transaction depends on the asset acquisition structures and investment structures discussed above.

The typical loan for a GK-TK structure is evidenced by a loan agreement executed by the borrower (GK) and the lender (promissory notes are seldom executed). The collateral/ancillary loan package for a property in fee is a mortgage, equity pledge, pledge of rents, pledge of insurance and certain contract collateral (e.g., on asset management agreements, interest rate caps) and nonpetition letters.

A sponsor nonrecourse carveout letter from a creditworthy entity (e.g., a fund) for bad acts and environmental liabilities is often, though not always, requested. When the asset is held in trust, rather than in fee, the collateral/ancillary loan package includes a pledge of beneficiary interest instead of a mortgage, and an assignment of rents and pledge of insurance are not provided, but the rest of the collateral package is similar to that of a fee title transaction.[9]

One point to note is that the lender in Japan receives a first priority pledge of the equity in the borrower; this stands in contrast with the practice in the U.S. where a senior lender would ordinarily not receive an equity pledge in the borrower.[10]

For a TMK, the typical financing is driven by the requirement, discussed above, that a TMK issue bonds to obtain the favorable tax treatment of deductibility of dividends. A bondholder holding a TMK bond receives a statutory preferential statutory lien called an ippan tampo, which is a weak lien ahead of

unsecured creditors but below other secured creditors, such as a mortgage or a pledge.

In order for the bondholder to obtain additional security for the bonds beyond the ippan tampo, it would require satisfying the requirements under the Japan Secured Bond Law that a special bond trustee be retained to hold the collateral; this is a cumbersome procedure that most financing providers have thus far not undertaken.[11]

Some financing parties view the ippan tampo statutory lien as sufficient, since the TMK is a special-purpose company that should not, in principle, undertake other activities, including granting liens on its assets. However, it is also increasingly common to see financing providers structure TMK transactions as a combination of loan and bond, with the loan portion being secured by a similar collateral package mentioned above for the GK-TK, and the bond portion being limited to an ippan tampo.[12]

In addition, some bondholders in the market require additional contractual agreements in connection with the bonds, which mimic security agreements without providing a perfected security interest (and thus triggering the Secured Bond Law) and instead rely on covenants by the borrower-side parties to perform in the event that the bondholder exercises its rights in the event of default.

As a practical matter, most lenders in Japan are able to provide financing to either a GK-TK structure or a TMK structure, and such lenders are able to meet the requirements in a TMK structure that the holders of bonds be a tax QII.

The Regulatory Regime

There are a wide range of laws that regularly impact real estate transactions in Japan, including the Financial Instruments and Exchange Law, the Building Lots and Buildings Transaction Business Law, the Land and Building Lease Law, the Real Estate Syndication Law, and the Civil Code.

However, one regulatory regime that merits special discussion is the FIEL, which governs transactions related to securities (which includes TBIs) and issuers of collective investment schemes (which includes TK interests). The FIEL requirements are technical but, as a practical matter, investors are often able to utilize certain exemptions that permit the retention of an asset manager licensed as an adviser pursuant to which the asset manager offers advice to, but not discretion to act for, the asset owning entity.

This approach is often preferable for foreign investors to the alternative requirement under the FIEL of retaining a local discretionary manager that would have discretionary authority in a number of important major decision areas, such as acquisition and sale of the TBI.[13]

Challenges

Foreign groups investing in Japanese real estate are often faced with a number of challenges. First, many counterparties (including sellers, purchasers, Japan trust banks and Japan lenders) are not comfortable working in English and prefer Japanese-only documentation.

As a result, summaries or full translations of documents are often prepared, which leads to increased transaction costs. Second, the concept of escrow is relatively new in Japan, with only a few institutions offering such services and most Japanese transaction participants having no experience with escrow.

The market practice traditionally has been that a deposit provided by the purchaser upon execution of a

purchase and sale agreement be held by the seller until closing. However, foreign investors are naturally concerned about risks for the purchaser due to seller insolvency or misuse of funds.

Third, title insurance is not available in the Japanese market. Foreign investors nevertheless have become comfortable with the system and regularly undertake property (including boundary) diligence as part of any acquisition.

However, some of the above challenges are also faced by investors entering other foreign markets. Overall, we expect that Japan will continue to be the focus of attention for foreign investors for the foreseeable future.

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[1] Press Release, Jones Lang LaSalle, JLL confirms 2013 strongest year on record for Asia-Pacific commercial real estate investment markets (Jan. 15, 2014); Report, DTZ, Property Times Japan Q4 2013 (Jan. 20, 2014).

[2] Report, PWC and Urban Land Institute, Emerging Trends in Real Estate Asia Pacific 2014 (November, 2013).

[3] Japan real estate investment trust (J-REITS) have been particularly active buyers in major real estate transactions during the last year.

[4] There is a registration tax due upon entrustment but at a very reduced rate (currently 0.3 percent). There is no acquisition tax due upon entrustment. This compares favorably to a transfer in fee title where the regular acquisition tax is generally (subject to certain exceptions) 4 percent (currently reduced to 3 percent) and registration tax is generally (subject to certain exceptions) 2 percent (currently reduced to 1.5 percent for land).

[5] There are regulatory restrictions that make it difficult to hold property in fee in the GK–TK structure, and subject to limited exceptions, investors generally hold the property through a trust when acquiring through a GK-TK structure.

[6] Structuring a GK-TK investment generally involves discussions with tax advisers on how to implement a type of veto right on major decisions that would be permissible under the TK structure without it being viewed as the TK investor participating in the management of the business. In addition, the requirement that the TK investor remain passive puts a practical restriction on the TK investor group from owning the TK operator. The determination of the ownership of the TK operator is generally a threshold issue for TK investors, and solutions may include having a local Japanese partner or charitable trust vehicle serve as owner of the TK operator.

[7] If the common shareholder waives its rights to receive economics, then all the common shares may be held offshore and the requirement that a majority of common shares be held onshore will not apply.

[8] Aside from the GK-TK and the TMK, we note it is legally permissible to have an overseas entity directly acquire a real estate asset in Japan, but due to a number of potential technical, legal and tax concerns, this method is generally not used and instead a Japanese entity is regularly formed to acquire the asset.

[9] In a trust structure, the trustee could provide a mortgage to the lender, but the market practice in Japan is that such a mortgage is not required. However, it is typical that the borrower provides a conditional mortgage agreement that would take effect in the event the trust is terminated during the term of the financing and the fee title reverted to the borrower. A conditional pledge of insurance and conditional pledge of rents is also sometimes provided by borrower to lender that would take effect in the event of a trust termination.

[10] The security package for mezzanine financing in Japan is structured as a second priority pledge on all the collateral including the asset held by the borrower and the equity in the borrower.

[11] There have a few large transactions in the last year utilizing the secured bond trustee structure. It is not clear yet whether these deals signal a wider acceptance of this approach in other transactions.

[12] The ratio of loan amount to bond amount is a point to be confirmed with tax advisers. Another approach that is sometimes seen in the market is to use a guaranty structure, whereby the bondholder (or its affiliate) provides a guaranty of repayment of the bond, and the TMK indemnifies such guarantor, with the security agreements providing security on such indemnification obligation, rather than the bonds themselves.

[13] In a GK-TK structure, a “QII exemption”, one of the major exemptions under the FIEL, requires there must be at least one TK investor that is a qualified institutional investor and there must be less than 50 TK investors that are not qualified institutional investors. For both a GK-TK structure and a TMK structure, where an asset manager with an investment advisory registration is retained (rather than a discretionary investment manager), the asset owning entity must be capable of making a decision based on the asset manager’s advice.

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