

The impact of recent legislative developments on legal infrastructures of Japanese real estate investment

by Norio Maeda, Tomohiro Kandori and Yasuo Asami, Nishimura & Asahi

On December 24, 2010, the Financial Services Agency ('FSA') published its final version of the Action Plan for the New Growth Strategy (the 'Financial Action Plan'). The Financial Action Plan outlined various measures to be taken by the FSA to establish a framework to enable the finance industry to achieve its two major goals of (i) supporting the real economy; and (ii) itself leading the economy as a growing industry. These measures included relaxing the regulations applicable to the TMK structure, one of the major and frequently used real estate investment platforms.



In the same month, the Committee on Real Estate Investment Market Strategy, an advisory panel for the Minister of Land, Infrastructure, Transport and Tourism, also published a report (the 'MLIT Committee Report') that included various measures to develop the real estate investment market. These measures included (i) expansion of the tax code's definition of 'institutional investor', which can be a qualified purchaser of specified bonds issued by TMKs ('TMK Bonds'), in order to enable TMKs to receive more funds through the sales of TMK Bonds to investors being newly included as 'institutional investors'; and (ii) relaxing the licensing requirement under the Real Estate Specified Joint Enterprise Act (*fudosan tokutei kyodo jigyo hou* – the 'REJEA') applicable to investment into real estate under an anonymous partnership (*tokumei kumiai* – 'TK') arrangement.

The Financial Action Plan and the MLIT Committee Report were prepared as part of the efforts by the Japanese Government to relax regulations and enhance market activities after the Japanese market was hit by recent global economic turmoil. After the Financial Action Plan and the MLIT Committee Report were published, the Japanese Government started to make efforts to implement various measures to relax regulations and enhance market activities.

In this article, we would like to highlight certain recent key efforts by the Japanese Government to amend certain statutes, and discuss the major impact of those amendments on the TMK structure and the GK-TK structure, the two most frequently used real estate investment platforms in Japan. Before introducing the recent key efforts later in this article, we would like to briefly outline the TMK structure and the GK-TK structure below.

TMK structure

A TMK (*tokutei mokuteki kaisha*) is an entity incorporated under the Asset Liquidation Law (*shisan*

no ryudouka ni kansuru houritsu – the 'TMK Law'). This entity may only be used to liquidate or securitise assets. This investment platform is used to make investments into real estate, trust beneficiary interests in real estate ('TBI'), and loans and bonds that are backed by real estate. A TMK is typically funded by issuing TMK Bonds and preferred shares that meet certain tax qualifications required for preferential tax treatment of the TMK. If a TMK, its TMK Bonds, and its preferred shares are properly structured and the TMK meets certain other requirements under the tax code, the TMK is permitted to deduct from its taxable profits distributions to the preferred shareholders in addition to debt payments.

A TMK qualifies for preferential tax treatment if its TMK Bonds are purchased by an 'institutional investor' or other similar person or entity (a 'Tax II or its Equivalent Investor') as defined in the tax code. Certain 'qualified institutional investors' (QIIs) under the Financial Instruments and Exchange Law (*kinryu shohin torihiki hou* – the 'FIEL') and certain other QIIs meeting certain additional requirements fall under a Tax II or its Equivalent Investor. One of the important steps to set up a TMK structure is to find a QII that is also a Tax II or its Equivalent Investor.

When using a TMK structure, it is also important for the TMK to comply with strict regulations under the TMK Law. These regulations include a requirement to file an asset liquidation plan (*shisan ryudouka keikaku* – an 'ALP') with the regulatory authority. The ALP of a TMK outlines how its assets are to be liquidated or securitised. Once a TMK files its ALP, the TMK must operate in accordance with the ALP, which may also require the filing of amendments to the filed ALP. Thus, a TMK structure requires paying close attention to the regulations regarding the ALP.

GK-TK structure

A GK (*goudou kaisha*) is one of the types of corporate entities that may be formed under the Companies Act

(*kaisha hou*). In some respects, it is similar to an LLC but it is not a pass-through entity for tax purposes. When a GK is used as an asset investment vehicle, typically an investor leverages its investment by third-party loans and makes its own investment into the GK through a contractual TK arrangement (the investor in the TK arrangement is referred to as the 'TK Investor'). A TK arrangement qualifies for favourable tax treatment if the TK investor is a 'passive' investor with minimal control over the management of the GK and the contributed funds under the arrangement. If the TK arrangement qualifies, the GK is permitted to deduct from its taxable profits distributions to the TK investor in addition to debt payments. This tax-efficient combination of a GK and a TK arrangement is usually called a GK-TK structure.

Typically, a GK-TK structure is used to make investments into TBI, and loans backed by real estate. If a GK holds real estate directly by raising funds from TK investors, it will generally be subject to a licensing requirement under the REJEA. Therefore, the GK-TK structure is usually structured to invest into TBI, not real estate itself. It should also be noted that the GK-TK structure is not usually used for investments into bonds backed by real estate. Because a GK is less likely to be a QII or a Tax II or its Equivalent Investor, the GK-TK structure is not usually considered suitable for investments into bonds backed by real estate (since they are often TMK Bonds that need to be held by a Tax II or its Equivalent Investor).

In addition to the licensing requirement under the REJEA, a GK-TK structure that is used to invest into TBI will subject the GK to the strict registration requirement under the FIEL, unless an exception applies. One of the exceptions is the so-called QII exemption (the 'QII Exemption') that essentially requires (i) that there be at least one QII among the TK investors; (ii) that the number of non-QII TK investors, if any, be 49 or less; (iii) that none of the TK investors is a disqualified investor (selected examples of disqualified investors are as follows: an operator of a TK arrangement with any TK investor who is not a QII, and a 'special purpose vehicle' with any shareholder who is not a QII); and (iv) that the GK as the operator of the TK arrangement file with the regulatory authority a simple notification regarding the QII Exemption.

Recent efforts to amend statutes

Amendment to FIEL – expansion of definition of QII

A Cabinet ordinance under the FIEL defines a QII. The definition provides for various types of QIIs. Since before the amendment introduced in this section, financial institutions such as banks, securities

companies, and insurance companies have been included in the definition of QII. Certain other QIIs permitting investment vehicles to become QIIs have also been included in the definition of QII such as (i) an entity that holds ¥1bn or more of securities and has obtained the status of QII after filing a simple QII notification; and (ii) an investment business limited partnership (*toushi jigyo yugen sekinin kumiai* – an 'IBLPS') under the Investment Business Limited Partnership Act (*toushi jigyo yugen sekinin kumiai keiyaku ni kansuru houritsu*).

The definition of QII was amended effective from May 1, 2011, to include the following new types of QIIs (a) and (b):

- (a) A TMK that meets any one of the following qualifications (i) through (iii), and has obtained the status of QII after filing a simple QII notification:
- (i) holds securities of ¥1bn or more;
 - (ii) has entered into a trust agreement regarding its assets (the assets shall be limited to securities offered only to QIIs) with a trust company or the like that is a QII, to delegate management and disposition of the assets, and has obtained its shareholders' meeting approval for its filing of a QII notification; or
 - (iii) delegates management and disposition of its assets (the assets shall be limited to securities offered only to QIIs) to a registered discretionary investment manager that sold the assets to it or that has the financial and human resources to appropriately manage and dispose of the assets, and has obtained its shareholders' meeting approval for its filing of a QII notification.
- (b) A foreign pension fund that meets the following qualifications (i) and (ii), and has obtained the status of QII after filing a simple QII notification:
- (i) operates outside Japan and is primarily engaged in managing and making payments under retirement pensions, retirement allowances, or other similar arrangements; and
 - (ii) holds net assets of ¥10bn or more as reflected in its balance sheet or other equivalent financial statement of its most recent business year.

Under the tax code, after an amendment made together with the foregoing amendment to the FIEL, the definition of the Tax II or its Equivalent Investor is expanded, and includes the TMK described in (a) above (only if the assets held by the TMK are limited to certain TMK Bonds backed by real estate or TBI, or certain other assets) and the foreign pension fund described in (b) above.

Amendment to TMK Law – relaxing regulations regarding ALP

The amendment law of the TMK Law was promulgated on May 25, 2011. Although, as of the end of August 2011, its effective date is yet to be determined by the Cabinet, the following are the major amendments to relax regulations regarding the ALP under the amendment law:

Relaxing the requirement for a TMK to file an amendment to the ALP

Once the amendment law becomes effective, a TMK will no longer need to file certain minor amendments to its ALP even when the ALP that was filed is amended.

Relaxing the requirement for a TMK to obtain an additional report regarding the purchase price of an asset described in the ALP

Under the current TMK Law, before a TMK may acquire an asset, it must obtain not only an appraisal report regarding the asset to reference in the ALP, but also an additional report regarding the purchase price of the asset to also reference in the ALP. The amendment law abolishes the requirement to obtain the additional report.

Efforts to amend the Real Estate Specified Joint Enterprise Act

The Ministry of Land, Infrastructure, Transport and Tourism is making efforts to amend the REJEA to relax the licensing requirement under the REJEA. The Ministry is considering the creation of a TK investment structure for real estate investments, which would exempt the operator of a TK arrangement that holds real estate itself from the current licensing requirement under the REJEA, if the operator delegates its investment management to a company that is licensed under the REJEA. However, according to the Minister of Land, Infrastructure, Transport and Tourism, further discussion will be necessary before submitting the draft amendment law to the Japanese Diet for approval.

Impact on TMK structure and GK-TK structure

Impact on TMK structure

Impact of the expansion of the definition of QII

As outlined above, TMK Bonds qualify the TMK for preferential tax treatment when they are purchased by a Tax II or its Equivalent Investor. Therefore, expansion of the definitions of QII and Tax II or its Equivalent Investor as described above is expected to encourage investments into TMK Bonds, and ultimately encourage real estate investments through the TMK structures.

In particular, use of TMKs as the investment vehicles for TMK Bonds backed by real estate or TBI

is expected to increase. Before the expansion, it was easier to establish an IBLPS as a QII and a Tax II or its Equivalent Investor (please see above) to be used as an investment vehicle for TMK Bonds. However, an IBLPS may be deemed a permanent establishment of a foreign investor under the tax code, if the foreign investor holds a certain majority stake in the IBLPS. After including TMKs that meet certain qualifications as QIIs, a foreign investor investing into real estate through TMK Bonds may wish to rely on a TMK rather than an IBLPS as its purchase vehicle of TMK Bonds, if an IBLPS is not a tax-efficient investment structure for the investor.

Impact of the amendment law of the TMK Law

The current TMK Law is generally considered to impose heavy administrative burdens on the TMK structure due to the regulations regarding the ALP. The reduction of the administrative burdens under the amendment law of the TMK Law as described above is expected to increase the use of the TMK structure for real estate investments.

Impact on GK-TK structure

Impact of the expansion of the definition of QII

As outlined above, a GK-TK structure that invests into TBI will be exempt from the registration requirement under the FIEL, if it meets the requirements for the QII Exemption. Because the QII Exemption requires at least one QII investor in the structure, the expansion of the definition of QII as described above is expected to increase the use of the QII Exemption in GK-TK structures investing into TBI. In particular, the expansion of the definition of QII to include a foreign pension fund is expected to contribute to the increased use of the QII Exemption, because foreign pension funds qualifying as QII may help prevent disqualification under the QII Exemption's requirement (iii) described above.

Impact of relaxing the licensing requirement under the REJEA

As described above, the Ministry of Land, Infrastructure, Transport and Tourism is considering an amendment to the REJEA subject to further discussion. Although it would be difficult at this moment to predict whether or not the amendment will actually be approved by the Diet, if its underlying concept, which has been published, of relaxing the licensing requirement under the REJEA were approved by the Japanese Diet without any additional requirements, the amendment would increase the use of the GK-TK structure for investments into real estate itself. We will need to pay continuous attention to the ongoing efforts of the Ministry and see how the discussion about the amendment develops.

Conclusion

As discussed above, the recent key efforts by the Japanese Government to amend certain statutes are expected to increase the use of the TMK structure and the GK-TK structure, and therefore encourage real estate investments in Japan. We hope that increased real estate investments will contribute to the revival of the Japanese economy following the massive earthquake in March 2011.

Nishimura & Asahi

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Authors:

Norio Maeda, Partner

Tel: +81 (3) 5562 8580

Email: n_maeda@jurists.co.jp

Tomohiro Kandori, Associate

Tel: +81 (3) 5562 8713

Email: t_kandori@jurists.co.jp

Yasuo Asami, Associate

Tel: +81 (3) 5562 9977

Email: y_asami@jurists.co.jp

Nishimura & Asahi

Ark Mori Building

1-12-32 Akasaka

Minato-ku

Tokyo 107-6029

Japan

Tel: +81 (3) 5562 8500

Fax: +81 (3) 5561 9711/12/13/14

Email: info@jurists.co.jp

Web: www.jurists.co.jp/en