Japanese real estate is becoming a more attractive market for international investors. There are a number of different investment structures for foreign investors, some of which are unique to Japan with no equivalent in other developed legal systems.

Interest in acquiring Japanese real estate, such as hotels, office buildings and retail complexes, is increasing due to Abenomics (the name given to the economic policies advocated by Prime Minister Shinzo Abe since the December 2012 general election) and the depreciation of the yen against major currencies. Japan expects to have a robust estate market at least through to the 2020 Olympics.

This article briefly outlines the most common investment structures considered by foreign investors wishing to acquire Japanese real estate. Each structure has different tax consequences for the investor so it is important to consult a tax specialist on each specific transaction. Some structures discussed below, particularly the “TMK” and the “GK-TK”, are unique to Japan, and there are no perfectly analogous structures in other developed legal systems.

Direct acquisition
Overview

In a direct acquisition, an offshore foreign investor directly or through an offshore special purpose company (SPC) acquires the target property or beneficial property interest in Japan. Generally speaking, there are no restrictions on foreign direct investment for real estate investment in Japan and direct offshore acquisitions by investors or SPCs are common.

Incorporation and governance

Since the investor or SPC is located offshore, neither incorporation of an on-shore acquisition entity in Japan nor Japanese laws regarding governance of Japanese legal entities are applicable.

Tax

When the offshore acquisition entity or investor receives income from the property or real estate beneficial interest (for example, rental income (except when the lessee is an individual and the property is used by the lessee or his/her relatives)), the income will be subject to withholding tax on payments determined in accordance with the applicable tax treaty between the offshore acquirer’s home jurisdiction and Japan. In addition, capital gains from the sale of real estate or beneficial interests in Japan will be subject to withholding tax at a rate of 10.21 per cent to the extent a purchaser has a withholding obligation (for example, a Japanese entity). Capital gains tax is also applicable and the current rate is 25.5 per cent for an offshore entity even without a permanent establishment (PE). The Japan–US tax treaty does not provide an exemption for capital gains in Japan, and capital gains tax is generally speaking not subject to exemptions under the applicable tax treaty with the home jurisdiction of the seller.

The offshore entity is required to file a notice with the Japanese National Tax Agency (NTA) within two months from the sale as well as a tax return to declare the capital gains within two months from the end of the fiscal year of the offshore entity. Separately, the acquisition of property or beneficial interests in property located in Japan by an offshore operator creates a potential risk of creating a PE. If the offshore investor creates a PE in Japan, it will be subject to ordinary corporate tax at a rate of 35.64 per cent on its net income. While acquisition of real estate in and of itself does not necessarily create a PE, since it is common to hire asset managers and the investor may be receiving ongoing payments from its holdings in Japan, the risk of creating a PE may be heightened. For this reason, many acquirers prefer to use an alternative structure to avoid the PE risk when acquiring property or property interests in Japan.

**Tokutei mokuteki kaisha (TMK)**

Overview

A **tokutei mokuteki kaisha** (TMK) is a special purpose limited liability company that was introduced in 1998 and can only be used for securitization of assets. Property rights can be securitized by a TMK through the issue of asset-backed securities (*shisan taio shoken*) to investors, usually in the form of equities or bonds. Profits are distributed to investors by way of dividends on equities or interest on bonds, depending on the nature of the security issued to investors by the TMK.

Incorporation of TMK; filings for acquisition of assets

Because of its special role as an investment vehicle for securitized assets and preferential tax features, TMKs are subject to stringent regulatory requirements. In order for a TMK to acquire the target assets or to issue asset-backed securities including preferred equities (*yusen shusshi*) or specified bonds (*tokutei shasai*) (as defined and regulated by the Act on Securitization of Assets), an asset liquidation plan (ALP) must be filed with the Financial Services Agency (FSA). An ALP should cover:

- the proposed business period of the TMK;
- the maximum number and type of the rights to be associated with the asset-backed securities and special purpose borrowings of the TMK;
- a description of the TMK’s specified assets and seller, and timing of when such assets will be acquired;
- the manner in which the TMK’s assets are to be managed and disposed of;
- certain matters relating to borrowings of the TMK; and
• other matters prescribed by relevant cabinet ordinances.

Any changes to the plan stipulated in an ALP must be filed with the FSA.

No minimum capital is required to establish a TMK. Because the equities or bonds issued by a TMK fall under the definition of a security in Japan’s Financial Instruments and Exchange Act (FIEA), a TMK generally uses a licensed securities broker or asset management company in order to offer the equities or bonds or to manage the capital invested by investors.

A TMK may be incorporated within approximately one month. However, in order for a TMK to acquire the target assets or to issue asset-backed securities, a sufficiently detailed ALP must be filed with the FSA. In practice, it usually takes about three months for a TMK to be incorporated and ready to acquire assets.

**Governance**

The purpose of a TMK is limited to acting as an asset-holding and asset-disposition vehicle, and all operations and management of the TMK’s assets, including solicitation for investment and management of invested capital, are generally outsourced by the TMK to outside service providers. Two types of members are permitted for a TMK:

i. specified members, who hold specified equities (tokutei shussi); and
ii. preferred equity members, who hold the preferred equities.

Specified members have voting rights and supervise the operations of the TMK. Preferred equity members have preferred rights to receive the dividends and/or distribution of residual assets though they usually have only very limited voting rights.

A TMK must have at least one director (torishimariyaku) and one statutory auditor (kansayaku) but there is no residency requirement for the director or auditor. In addition, if certain requirements are met (for example, the TMK issues preferred equities) an accounting auditor (kaikei-kansanin) is required. Further, a TMK is subject to several disclosure requirements regarding the TMK’s assets in order to ensure investors are protected.

**Tax**

If a TMK is “tax qualifying” it may take a deduction against taxable income for any dividends paid to its members. This means that, in theory, if the TMK distributes all of its taxable income it will not have any income that would be subject to corporate tax. A TMK must satisfy all of the following criteria to be considered a tax-qualifying TMK:

• The TMK is properly registered in terms of the Act on Securitization of Assets;
• The TMK issues either:
  o specified bonds of 100 million yen or more through a public offering;
  o specified bonds that are expected to be held exclusively by qualified institutional investors (QIIs);
  o preferred equities that are subscribed for by 50 or more investors; or
  o preferred equities subscribed for exclusively by QIIs.
• The TMK’s fiscal year may not exceed one year.
• More than 50 per cent of any preferred equities or bonds issued must be issued in Japan.

In order for a TMK to be tax qualifying (for example, dividends to be deductible against taxable income in a given fiscal year) it must satisfy all of the following conditions, among others, for that fiscal year:

• The TMK must conduct its business in accordance with its ALP and not engage in any other business or hold any assets except as specified in its ALP;
• The TMK must contract with third parties for management of the property or enters into a trust agreement with a third party trustee for management of the property; and
• The TMK must declare and pay as a dividend over 90 per cent of its “distributable profit” in that fiscal year. The “distributable profit” amount is based on income determined in accordance with JGAAP.

If the TMK does not qualify for the preferential tax treatment it will be taxed on corporate income at the effective tax rate at 35.64 per cent. In addition, distributions of profits are still subject to Japanese withholding tax at a rate of 20.42 per cent, subject to exemption or reduced withholding tax rates under applicable tax treaties.
For a real estate acquisition by a TMK, a reduced tax rate is available in respect of registration and permit tax and real estate acquisition tax. The registration tax on a real property transfer is reduced from 0.2 per cent to 0.13 per cent when a TMK acquires the property. The tax base for real estate acquisition tax is reduced to 40 per cent of the property value where the property acquisition completed by 31 March 2015.

**Godo kaisha (GK)**

**Overview**

A godo kaisha (GK) structure is similar to a limited liability company under US law. It allows more flexibility in regards to corporate governance and management decisions than does a TMK or a conventional corporation (kabushiki kaisha (KK)). The annual corporate governance requirements costs are generally lower (in comparison with a TMK or KK) as there are few formal corporate governance requirements to be observed.

**Incorporation**

No minimum capital is required. The GK is established by filing with the Legal Affairs Bureau and may be incorporated within approximately one month after the executed incorporation documents are received.

**Governance**

The Ministry of Justice announced a change to administrative guidance effective as of 16 March 2015 to abolish the requirement that a GK must have at least one resident managing member (or a manager (Shokumu Shikkosha) as described below). While the residency requirement for managing members has been abolished, for practical and operational reasons it may still be necessary to have a managing member who resides in Japan. If the managing member is a legal entity, an individual—called a manager (shokumu shikkosha)— must be appointed to manage the corporate affairs of the GK on behalf of that legal entity. In principle, each managing member can represent the GK. However, a representative member may be appointed from among the managing members. Regular general meetings of members are not required.

The charter documents and other documents are filed with the Legal Affairs Bureau. A GK’s company name, business purposes, the amount of capital, the names and addresses of representatives of its member (if the representative is a legal entity), the name and address of the managing member and its method of public notice are disclosed in the GK’s company register and are publicly available.

Liability of the member of a GK to creditors is limited to the amount of equity participation.

**Tax**

The GK is popular with US parent companies because while the GK is taxed in Japan as a non-pass-through corporation on its income, a GK can be a disregarded entity (referred to as “check the box”) for US tax purposes. The GK’s income is subject to local and national corporate tax at the effective tax rate of 35.64 per cent. A distribution of dividends by the GK is subject to withholding tax at the rate of 20.42 per cent subject to exemption or reduced tax rates under applicable tax treaties. The GK does not enjoy preferential tax treatment on real estate investments as does the TMK or GK-TK (discussed below) and distributions from a GK to its parent company may be subject to withholding taxes.

**GK-TK**

**Overview**

This structure is (i) a GK property holding company together with (ii) an operating agreement, which together constitute a tokumei kumiai (TK). A TK is a form of (silent) partnership based on agreement between the TK investors and the GK as the TK operator. Under a GK-TK structure, a GK is established as a special purpose company whose purpose is to hold assets (such as fee property interests, trust beneficial interests (TBI), etc). Once an investor is identified, the investor enters into a TK agreement with the GK as the TK operator. The GK acts in a similar way to a general partner in a limited partnership under US law.

Pursuant to the TK agreement, the investor provides funds to the GK in exchange for the GK’s obligation to
distribute a share of the profits arising from the GK’s business. The investor’s role is limited to that of a passive investor with contractual rights under the TK agreement. The TK investor’s liability is, accordingly, limited and the investors are not liable for obligations arising from the GK’s business exceeding the amount of their respective contributions.

**Incorporation**

The incorporation process for a GK is straightforward as discussed above. Once the GK is formed, the TK investors will enter into the TK agreement with the GK. The TK agreement may be signed any time after the GK is formed and the GK and investor wish. The TK agreement is not filed or made publicly available.

**Governance**

The same simplified governance rules for ordinary GKs also apply to a GK-TK. In addition, since a GK-TK is supposed to be for passive investment by the silent partners this means that the operator—the GK itself—is the only party that is permitted to be active in the management and operations of the GK business.

In order for a GK (acting as a TK operator) to solicit investments and manage invested capital (which are treated as securities under the FIEA), the GK must either be licensed under the FIEA or fall within a permitted exemption. One exception to this requirement is if the TK investors include at least one QII and less than 50 non-QIIs, in which case only a simple notice filing of self-offering is required. To avoid this permit or filing obligation, a GK can outsource such investment solicitation and management to a licensed third party (for example, a licensed securities broker). There is a separate real estate permit required under the Real Estate Specified Joint Enterprise Act for a GK-TK to solicit, invest in direct real property interests and distribute profits therefrom, unless certain requirements for an exemption are met. If an investment is through TBIs (rather than directly in real estate) an exemption is available.

**Tax**

Similar to a TMK structure, when a GK makes distributions to investors pursuant to the TK agreement such distributions can be treated as deductions (as defined by the NTAs published regulations) against the GK’s income. To qualify for this treatment, the TK agreement should specify that the investors’ role is limited to passive investment. In practice, it is common for the management of the GK operator to be outsourced or handled by an affiliate of the investors. While the distributions of profits (dividends) may be treated as deductions against corporate income such distributions are still subject to withholding tax at 20.42 per cent, subject to reductions available under applicable double tax treaties. In summary, the GK-TK offers benefits very similar to a TMK in that:

i. distributions to investors may be deducted against corporate income, limiting corporate tax liability to a very small amount; and

ii. Withholding tax can be reduced if the investor is offshore by locating the investor in a jurisdiction with beneficial double tax treaty benefits.

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