

Basic Structure of Real Estate Finance in Japan



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A. Introduction

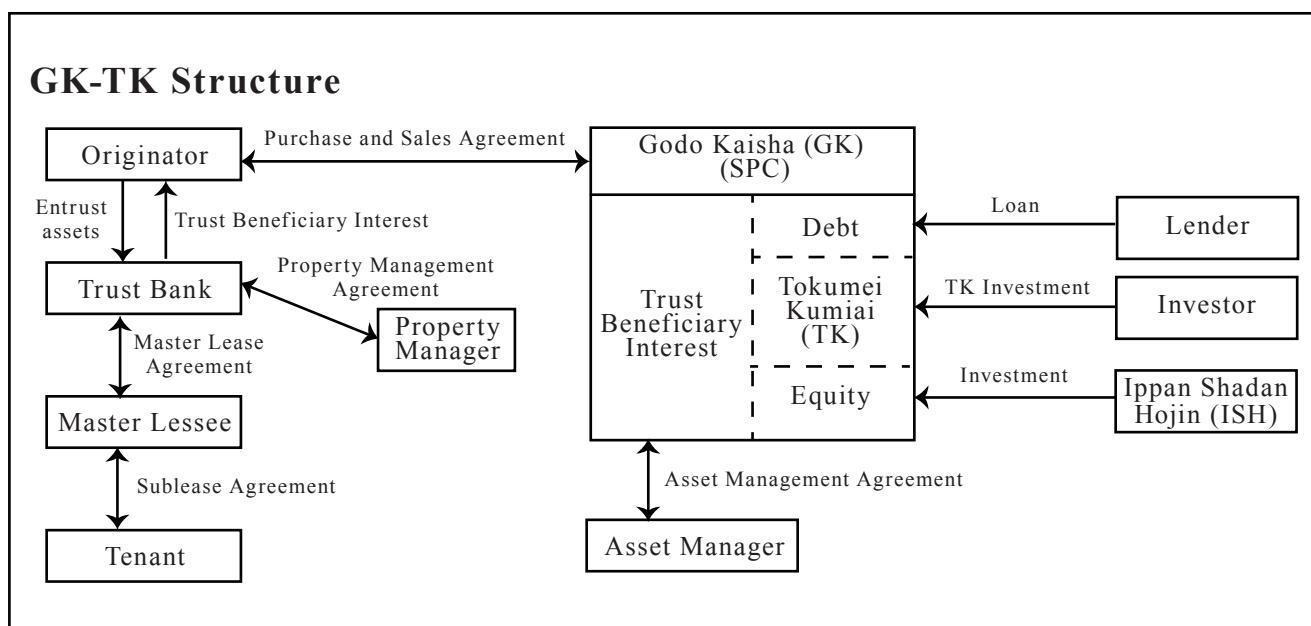
The Japanese real estate investment market is continuously expanding despite the spread of COVID-19. In recent years, it has been attracting a great deal of interest from overseas investors, especially due to the weak yen.

The basic investment structures in the Japanese real estate investment market are the GK-TK structure, the TMK structure, and the REIT structure. This article will introduce the GK-TK structure and the TMK structure, which are available for foreign investors who may prefer short-term investments.

B. GK-TK Structure

a. The Basics

In the GK-TK structure, a *godo kaisha* (“**GK**”) (limited liability company) is used as a special purpose company (“**SPC**”) where investors can invest in by way of *tokumei kumiai* (“**TK**”) (silent partnership) investments. When a GK is established, an *ippan shadan hojin* (“**ISH**”) (a general incorporated association) is also established to invest in the GK and hold all its equity. The GK generally acquires a trust beneficiary interest in the real estate from the originator (i.e., the original owner of the title or interests in the subject real estate).



The main reasons for this arrangement are (a) to avoid acquiring direct title over the real estate, which would violate the Act on Specified Joint Real Estate Ventures,¹ and (b) to avoid the imposition of real estate acquisition tax.

In the case of a real estate held in trust, a master lease agreement is executed between the trust bank and the master lessee, and a sublease agreement is executed between the master lessee and the tenant. The property management of the real estate is entrusted by the trust bank to a property manager, while the management and operation of the GK's assets is entrusted by the GK to an asset manager.

The acquisition of the trust beneficiary interest in the real estate is financed through a loan from a lender in addition to the TK investments made by the investors. The investment made in the GK by the ISH at the time of the establishment of the GK is small and only a formality.

b. Notable Points

The use of a TK investment has several advantages. First, the liability of the TK partners is limited to the extent of their respective TK investments, which means they have limited liability. In addition, in principle, the TK partnership itself is not taxed (pass-through taxation). At the GK level, the amount of dividends given to the TK partners can be included as deductible expenses (pay-through taxation), and the taxation will take place at the TK partner level. However, if a TK partner is an overseas investor and it does not have a permanent establishment in Japan, then the distribution of profits to such overseas investor will be subject to withholding tax at the GK level, which means that the receipt of profits by the

overseas investor will not be subject to taxation in Japan. It should be noted that the nature of such TK partnership may be negated depending on the extent and manner in which a TK partner is involved with the operating entity (i.e., the GK).

In principle, a GK must be registered as a Type-II financial instruments business and an investment management business under the Financial Instruments and Exchange Act² (“FIEA”) if it conducts private placements of TK investments and acquires trust beneficiary interests using the funds raised through the TK investments. However, since it is not practical for a GK to itself obtain registration under the FIEA, one of two methods is often used. The first method is to outsource the private placement of TK investments to a private placement agent and the investment management (acquisition of the trust beneficiary interests) to an investment management agent, thereby avoiding having to register the GK under the FIEA since the GK is not directly taking such actions. The second method is for the GK to file a notification for specially permitted services for qualified institutional investors, etc. Under the FIEA, such notifier is allowed to conduct the private placement of TK investments and perform investment management without need of registration. The first method has the disadvantage of having to incur outsourcing costs for the private placement agent and investment management agent, while the second method has the disadvantage of being subjected to restrictions on conduct under the FIEA due to the filing of a notification for specially permitted services for qualified institutional investors, etc. Therefore, careful consideration should be made in choosing one of these two methods.

1. Act No. 77 of June 29, 1994.

2. Act No. 25 of April 13, 1948.

C. TMK Structure

a. The Basics

In the TMK structure, a *tokutei mokuteki kaisha* (“**TMK**”) (special purpose limited liability company) is used as the SPC where investors can invest in by way of preferred equity.

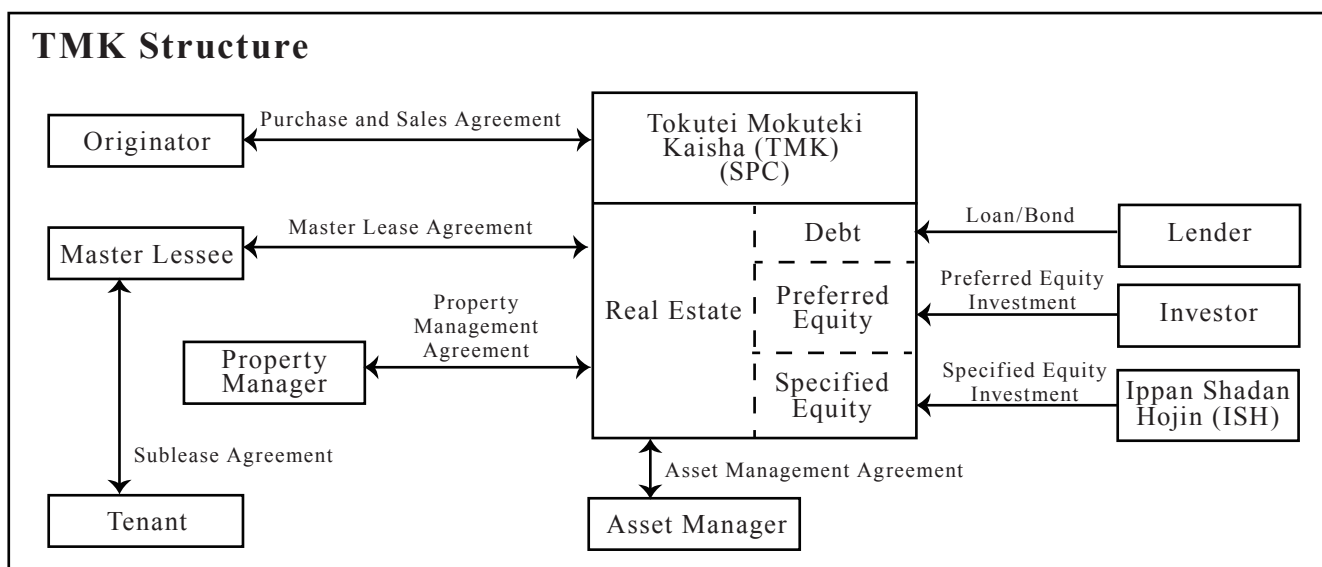
When the TMK is established, an ISH is also established to invest in the TMK and hold all of its specified equity.³

The TMK can acquire the real estate from the originator by directly owning the title thereto or by way of holding a trust beneficiary interest therein. One of the advantages of the TMK structure is that there are no restrictions under the Act on Specified Joint Real Estate Ventures, and the TMK can acquire title to the real estate directly, and by doing so, trust costs can be saved. The tax burden is higher for owning the real estate directly than for holding a trust beneficiary interest therein since an acquisition tax

will be imposed, subject to special measures for tax reduction under certain conditions.

In case the real estate is acquired through direct ownership thereof, a master lease agreement is executed between the TMK and the master lessee, and a sublease agreement is executed between the master lessee and the tenant. The property management of the real estate is entrusted by the TMK to a property manager; and the management and operation of the TMK’s assets is entrusted by the TMK to an asset manager. On the other hand, if the real estate is only held in trust, then it will have the same structure as the GK-TK structure.

The acquisition of the title to the real estate is financed through a loan (specified borrowing) and a bond (specified bond) from a lender in addition to the preferred equity investments made by the investors. The specified equity investment made in the TMK by the ISH at the time of the establishment of the TMK is small and only a formality.⁴



3. If the investors are overseas investors, then they would invest in the TMK and hold the specified equity thereof to reduce dividend taxation through the application of tax treaties.

4. In addition, the Act on the Securitization of Assets (Act No. 105 of June 15, 1998) prohibits the acquisition of specified assets, such as real estate, with money obtained through specified equity investments.



b. Notable Points

A TMK must file a notification of commencement of business and an asset securitization plan with the Director-General of the Local Finance Bureau when commencing business, and the TMK may only engage in the business of asset securitization as described in the asset securitization plan and business incidental thereto. It may not engage in other businesses.

The amount of the dividends issued to the preferred equity investors can be considered deductible expenses (pay-through taxation) if certain requirements are met at the level of the TMK, and taxation will be carried out at the level of the preferred equity investors.

The private placement of preferred equity investments and specified bonds by a TMK is subject to restrictions on conduct under the FIEA, but it is difficult for a TMK to comply with these restrictions. Therefore, in practice, the handling of the private placement of preferred equity and specified bonds is entrusted to a Type-I financial instruments business agent.

If a TMK acquires title over the real estate itself, then it must execute an agreement for the management and disposal of specified assets with an asset manager, who is licensed as a real estate broker under the Real Estate Brokerage Act,⁵ and entrust the management of the real estate thereto. On the other hand, if a TMK acquires instead a trust beneficiary interest in the real estate, then it is not legally required to execute such agreement for the management and disposal of specified assets. However, since the TMK is only an investment vehicle, in practice, it still entrusts to the asset manager the management of the assets. The asset manager is required to be registered as an investment advisory business or investment management business under the FIEA depending on the type of its involvement.

5. Act No. 176 of June 10, 1952.

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