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# AMENDMENT TO JAPANESE REAL ESTATE JOINT ENTERPRISE ACT–WILL IT BENEFIT OVERSEAS INVESTORS? YES, IT WILL

An amendment to the Joint Enterprise Act,[1] which was enacted on June 17, 2013, has taken effect as from December 20, 2013. Under the amendment, if a special purpose company ("SPC") meets certain conditions as a business operator, it may readily conduct business by giving notification to the Ministry of Land, Infrastructure, Transport, and Tourism ("MLITT"). One of the most important requirements to utilize the new scheme under the amendment is that the investors must be "Special Investors" (explained in detail below). According to the recently published regulations, all foreign corporations fall under the category of "Special Investor,"and thus overseas investors are likely interested in knowing how they may utilize the new scheme under the amendment. This *Commentary* has been prepared in response to such interest of overseas investors.[2]

The TMK scheme[3] and the GK/TK scheme[4] have been used regularly by overseas investors as tax-efficient schemes for real estate investment in Japan. Of such schemes, the GK/TK scheme is subject to the regulations under the Joint Enterprise Act if the subject asset of the scheme is a fee simple estate ("GK/TK (real asset)"). Due to the regulatory constraint applied before the amendment was enacted, a scheme with ownership in the form of a trust beneficial interest is generally used in the case of the GK/TK scheme ("GK/TK (trust beneficial interest)"). Under the Joint Enterprise Law, prior to the amendment, the person operating the enterprise[5] was required to be licensed by the competent minister or prefectural governor, and various conditions of the license apply, such as the JPY 100 million minimum capital requirement, which is not realistic for most overseas investors.[6] Now, if certain requirements are met, an SPC (e.g., a GK with a small capital) can be a TK operator.

## BRIEF SUMMARY

- All foreign corporations may qualify as "Special Investors." As a result, the amendment will confer a real benefit on overseas investors.
- The amendment will significantly liberalize the regulations under the Joint Enterprise Act in the sense that an SPC can be a business operator and may conduct business without a license as long as it has notified the MLITT, although certain regulatory restrictions remain, such as the license requirement for basic terms of contracts.[7] Compared to the frequently utilized TMK scheme or GK/TK (trust beneficial interest) scheme, it does not seem particularly advantageous because of such requirements.
- The new scheme will become significant where the relevant property may not be entrusted for some reason, such as the existence of a defect.
- The tax benefits applicable to investment in certain types of real property might be attractive to investors.

## NEW INVESTMENT SCHEMES NOT FALLING UNDER PREVIOUS LICENSE SCHEME

In order to conduct business with only a notification to the MLITT as a special business operator (*tokurei jigyousha*) ("Special Business Operator"), one must meet the following requirements:[8]

- A Special Business Operator shall be a corporation (*houjin*) with the purpose of exclusively conducting the real estate specified joint enterprise business.
- A Special Business Operator shall delegate the business related to real estate transactions to a real estate specified joint enterprise operator ("Item 3 RE Business Operator"; *see below*) and the business for the solicitation for the execution of real estate specified joint business contracts to a real estate specified joint enterprise operator ("Item 4 RE Business Operator"; *see below*).
- Each business participant shall be a special investor (*tokurei toshika*)("Special Investor") with specialized knowledge and experience related to real estate investment, such as a bank or trust company (*see below*).
- A Special Business Operator shall conform to certain other requirements to protect the interests of other business participants.

**Item 3 Real Estate Business Operators.** Two business categories have been added to the real estate specified joint enterprises under Items 3 and 4 in Paragraph 4 of Article 2 of the Law. An Item 3 RE Business Operator "[conducts] business, in response to the entrustment by a Special Business Operator, related to real estate transactions being carried on under a real estate specified joint enterprise contract to which the Special Business Operator is a party" (Item 3). So-called "asset manager businesses" are thought to fall under such category.[9]

The person managing such enterprise as a business shall obtain a license from the competent government agency. The requirements for such license are the same as those stipulated for business operators under Items 1 and 2.

As a newly established regulation, it now stipulates a prohibition on self-dealing and subcontracting delegated business, and if such provisions are violated, the government may issue an instructional disposition, business-suspension order, or revocation of license.

**Item 4 Real Estate Business Operators.** An Item 4 RE Business Operator engages in "acts of agency or brokering of the execution of real estate specified joint enterprise contracts to which the Special Business Operator is a party." While this category is essentially identical to Item 2 under Paragraph 4 of Article 2, it is limited to contracts to which a "Special Business Operator" is a party.

Like an Item 3 RE Business Operator, an Item 4 RE Business Operator must obtain a license from the competent government agency; however, it is also required to obtain a Type II business registration under the Financial Instruments and Exchange Act.

**Special Investor.** A "Special Investor" is defined as "a person stipulated by the relevant ministerial ordinance as a bank, trust company or any other person recognized as having specialized knowledge or experience related to investment

in real estate or a stock company whose amount of capital is no less than the amount determined by the competent government agency." The relevant ministerial ordinance defines the Special Investor with the definitions under the Financial Instruments and Exchange Act ("FIEA"). Not only Qualified Institutional Investors but also Specified Investors (*tokutei toshika*) under the FIEA are included in the definition of a "Special Investor," and "foreign corporations" fall under the category of Specified Investors under the FIEA.[10] As result, all foreign corporations are qualified as Special Investors.

## ISSUES WITH THE NEW SCHEME

**Notification.** While the amendment appears to lighten the requirements by replacing the need for a license with a notification to the authorities, the business at issue is, in fact, subject to the supervision of the competent government agencies through such notification. More specifically, the business is subject to prescribed supervision including the inspection of premises by the competent ministry for the Special Business Operator.[11]

**License for Basic Terms of Contract.** Any contract executed by a Special Business Operator is required to conform to the basic terms of contract submitted for the license of the Item 3 RE Business Operator. Any modification of the basic terms of contract requires permission, except for minor changes or additions. As a result, there is a concern that the terms of the contract will be rigid, and flexible investment might be difficult.

**Real Estate Brokerage Business Law.** The Real Estate Brokerage Business Law[12] ("RE Brokerage Law") has also been revised with regard to the "Special Business Operator," and the application of the licensing requirement under the RE Brokerage Law is excluded in regard to the Special Business Operator.

However, there will be a partial application of the RE Brokerage Law for a "deemed registered real-estate transaction manager." The main provisions to be applied are an obligation to make a business security deposit (Art. 25), the restriction on special provisions for warranty against defects (Art. 40), and the obligation to maintain security deposits, among others. A business security deposit (JPY 10 million for the headquarters) will need to be considered as an additional investment cost.

## TAX

A preferential treatment of real estate acquisition tax and registration tax has been introduced as a temporary measure applicable up to March 31, 2015. Please note, however, that not all of the new schemes can enjoy such preferential tax treatment and that the tax benefits will be applicable only to those investments that met certain criteria, including a requirement that the investments shall be made into eligible properties, such as, for example, (i) a building requiring reconstruction, extension, or renovation, (ii) a new, extended, or reconstructed building, and (iii) the ground on which these buildings are situated.[13] If the tax benefits apply, the valuation base for the real estate acquisition tax will be reduced by half, and the registration tax will be reduced to 1.3 percent (standard rate: 2.0 percent) for the registration of the transfer of title and 0.3 percent (standard rate: 0.4 percent) for the registration of the preservation of title.[14]

## COMPARISON WITH TMK SCHEME

The TMK scheme is a scheme permitted under the Asset Liquidation Act and is used by overseas investors as a way to obtain tax advantages with certainty. However, strict procedures for the submission or change of the asset liquidation plan in accordance with the Asset Liquidation Act are required, and the fulfillment of the conduit requirements—such as the issue of specified bonds—is also required. Accordingly, with regard to development deals or deals where numerous properties will be acquired on several occasions, the current trend leans toward the adoption of the GK/TK (trust beneficial interest) scheme, which allows for greater freedom. The GK/TK scheme (real asset) seems to offer nearly equal flexibility as compared with the GK/TK (trust beneficial interest) scheme as far as the above-mentioned strict procedures and conduit requirements are concerned, and it can be a replacement for the TMK scheme, although how the other aspects of the regulations mentioned above will play out is yet to be seen.

## COMPARISON WITH GK/TK (TRUST BENEFICIAL INTEREST) SCHEME

One important merit of the GK/TK (trust beneficial interest) scheme is the amount of freedom in the creation of schemes; however, the merit of the GK/TK (real asset) scheme under the Joint Enterprise Act diminishes in that not only the asset manager but also the TK operator are subject to supervision of the MLITT. Also, the advantage of the transfer tax (if acquired in the form of a trust beneficial interest, there is no real estate acquisition tax as long as it is held in the form of a trust beneficial interest) is no longer applicable, although certain tax benefits are applicable if the invested property meets the requirements. On the other hand, trust commissions are unnecessary in the case of the GK/TK (real asset) scheme; as such, it is necessary to balance the costs.

## CONCLUSION

Since all foreign corporations are considered "Special Investors," overseas investors have cleared the first hurdle to take advantage of this amendment to the Joint Enterprise Act. Nonetheless, since the applicable laws are still strict, it is expected that the use will be limited for the time being to investors for whom it is difficult to use the other two options (the TMK scheme and the GK/TK (trust beneficial interest) scheme). In addition, the tax benefits applicable to certain types of properties would be worth considering when selecting the scheme.

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## ENDNOTES

1 Act Concerning Designated Real Estate Joint Enterprises (Law No. 77 of 1994, as amended; "Joint Enterprise Act")

2 We reported the amendment to the Joint Enterprise Act in July 2013 in the form of a *Jones Day Commentary* titled "Amendment to Japanese Real Estate Joint Enterprise Act—Will It Benefit Overseas Investors?" This *Commentary* is an update to the previous version after the publication of the detailed regulations.

3 A *tokutei mokuteki kaisha* ("TMK") is a special Japanese corporate entity that may be established under the Act on Liquidation of Assets (the "Asset Liquidation Act") for the purpose of effecting the securitization of various assets (including real property, claimable assets, and certain shares in corporations, among others). If a TMK meets certain requirements and declares at least 90 percent of its annual distributable income as dividends, the TMK may treat the declared dividends as deductible expenses and thus may be a tax-conduit entity.

The equity of the TMK consists of specified equities and preferred equities. A TMK can be incorporated by specified equity. In order to form the equity portion of the capital structure, however, the TMK subsequently issues preferred equity securities (which are equivalent to preferred shares of a stock corporation). In addition to specified equity securities and preferred equity securities, the TMK ordinarily issues specified bonds and/or borrows specified loans for the purpose of acquiring assets or further developing the same.

The Asset Liquidation Act requires a TMK to file with the Financial Services Agency ("FSA"), through the Local Financial Bureau, a business commencement notification, together with the articles of incorporation and an asset liquidation plan ("ALP") before proceeding with an asset liquidation transaction. The TMK must conduct its asset liquidation business in accordance with the ALP and may engage in ancillary businesses, but no other kinds of businesses.

4 Under the GK-TK scheme, (i) a *godo kaisha* ("GK") is established under the Companies Act of Japan to be an SPV for the purpose of holding an asset or assets (typically, trust beneficial interest in real property), (ii) an equity investor or investors (the "TK Investor") enter into an anonymous partnership agreement (*tokumei kumiai* agreement; the "TK agreement") as described in the Commercial Code (Act No. 48, 1899) with the SPV, as a TK operator, to inject funds to the SPV for the acquisition of the SPV's asset, and (iii) an asset manager is appointed to provide asset management advice or make decisions on behalf of the SPV.

5 Only 25 companies, including major real estate companies, construction companies, and developers, were actually operating businesses (54 companies with prefectural governor license) as of July 1, 2013.

6 In regard to solicitations overseas, the Joint Enterprise Law does not apply. However, it is unclear to what extent the avoidance of such regulations will be utilized by funds conducting large-scale investment activities in Japan.

7 Such license shall be obtained by an Item 3 Real Estate Business Operator, and not by the Special Business Operator (as defined herein).

8 Except for the requirement to file a notification with the MLITT, the applicable regulations are not specifically more severe in substance than those applicable to GK/TK (trust beneficial interest) under the FIEA. In the case of a typical GK/TK (trust beneficial interest) scheme, the general rule is that in order to be a TK operator, GK shall be registered as an investment management business. However, most of the GK/TK (trust beneficial interest) schemes avoid the application of this requirement by delegating investment management to an entity registered as an investment management business under the FIEA. Further, the involvement of an agent having Type II business registration would be necessary for the solicitation of TK investors.

9 Such business categories have been added to account for the reality that an unspecified business operator will itself conduct such business.

10 Article 2, Paragraph 1, Item 5 of the Joint Enterprise Act Enforcement Ordinance; Article 2, Paragraph 31, Item 4 of the FIEA; and Article 23, Item 10 of the Definition Ordinance of the FIEA.

11 We infer that the supervision by the MLITT will not be more severe compared with that for TMK by the FSA, although the actual performance of administration by the MLITT remains to be seen.

12 Real Estate Brokerage Business Law (Law No. 176 of 1952, as amended).

13 We infer that this limited treatment comes from the original aim of this revised law, which is to develop a new investment scheme for renewing urban functions, such as making older houses earthquake-resistant, overhauling nursing-care facilities, and renewing (rebuilding, reforming, redeveloping) over-aged facilities in local cities. It should be noted that relevant tax regulations must be carefully examined before determining the eligibility for the preferential tax treatment as detailed requirements are set forth under the relevant tax regulations and that the scope of applicable properties is not the same between the two taxes.

14 With respect to the real estate acquisition tax, the benefits are not particularly advantageous in comparison with the case of TMK scheme, in which case the valuation base for the real estate acquisition tax will be reduced to 2 of 5. In the case of GK/TK (trust beneficial interest), no real estate acquisition tax is applicable, while the investor has to assume trust fees.

With respect to the registration tax, the benefits may be advantageous in comparison with the case of TMK scheme, in which the applicable reduced tax rate to the transfer of title is the same (i.e., 1.3 percent), while no tax benefits are applicable to the registration of preservation of title (i.e., the applicable rate is 0.4 percent (standard rate)). In the case of GK/TK (trust beneficial interest), the registration tax rate for the creation of trust is 0.3 percent (applicable up to March 31, 2015, and the standard rate is 0.4 percent), and the registration tax applicable to transfer of trust beneficial interest is JPY 1,000 per parcel of real estate, while no tax benefits are applicable to the registration of preservation of title (i.e., the applicable rate is 0.4 percent (standard rate)).