



JONES DAY  
**COMMENTARY**

## AMENDMENT TO THE JAPANESE REAL ESTATE JOINT ENTERPRISE ACT: WILL IT BENEFIT OVERSEAS INVESTORS?

The TMK scheme<sup>1</sup> and the GK/TK scheme<sup>2</sup> are typically used 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<sup>3</sup> if the subject asset of the scheme is a fee simple estate (“GK/TK (real asset)”).

Due to the regulatory constraint, a scheme with ownership in the form of a trust beneficial interest is generally used<sup>4</sup> in the case of GK/TK scheme (“GK/TK (trust beneficial interest)”). If the Joint Enterprise Law is applied, the person operating the enterprise is required to be licensed by the competent minister

1 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.

2 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.

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

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

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.<sup>5</sup>

On June 17, an amendment to the Joint Enterprise Act was enacted. 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”). The amendment will become effective as from the date designated by the cabinet order and shall be within six months from its promulgation (i.e., six months from June 21). This development appears to be of great interest to overseas investors who may wish to know whether they can utilize this new scheme under the Joint Enterprise Act. We have prepared this *Commentary* to address this question.

At this time, it is still unclear whether overseas real estate funds will qualify as “special investors.” Unless overseas real estate funds can qualify as such, the amendment appears to confer nearly no benefit to overseas investors. We will not know for sure until the relevant ministerial ordinance is issued, which should become available at the same time as the amendment goes into effect near the end of this year. Thus, it is necessary to continue monitoring the developments until that time, including the process of public commentary with respect to the relevant cabinet order and ministerial ordinance this fall.

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 contracts.<sup>6</sup> Compared to the frequently utilized TMK scheme or GK/TK (trust beneficial interest) scheme, it does not seem particularly advantageous. Most real estate investors will not find the new scheme worth considering if they

can turn to the GK/TK (trust beneficial interest) scheme. As a result, the new scheme will become significant where the relevant property may not be entrusted for some reason, such as the existence of a defect.<sup>7</sup>

## NEW INVESTMENT SCHEMES NOT FALLING UNDER THE 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:

- 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 (*tokutei toshika*) (“Special Investor”) with specialized knowledge and experience related to real estate investment, such as a bank or trust company (see *below*); and
- A Special Business Operator shall conform to certain other requirements to protect the interests of other business participants.

**Item 3 RE 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

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<sup>5</sup> Only 24 companies, including major real estate companies, construction companies, and developers, are actually operating (56 companies with prefectural governor licenses) as of March 31, 2013.

<sup>6</sup> Such license shall be obtained by a real estate specified joint enterprise operator, and not by the Special Business Operator.

<sup>7</sup> In the case of the GK/TK (trust beneficiary interest), it is necessary to pay trust commissions, while real estate acquisition tax will not apply. In the case of the GK/TK (real estate), real estate acquisition tax applies, while no trust commissions are payable. Those cost factors will be another factor in choosing the scheme.

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.<sup>8</sup>

The person managing such enterprise as a business shall obtain a license of 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 establishes a prohibition on self-dealing, etc. and the prohibition on subcontracting delegated business, and if such provisions are violated, there may be an instructional disposition, business-suspension order, or revocation of license.

**Item 4 RE Business Operators.** An Item 4 RE Business Operator engages in “acts of agency or brokering of the execution of real estate specified joint enterprise contract to which the Special Business Operator is a party.” While this category is essentially identical to Item 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 of 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.” Both the tax laws and the Financial Instruments and Exchange Act provide definitions for professional investors, including institutional investors and qualified institutional investors. Overseas investors can qualify as institutional investors or qualified institutional investors under Japanese law by submitting a notification to the authorities

if certain requirements are met. On the other hand, as the relevant ministerial ordinance is not yet available, the definition of “Special Investor” remains unclear. Whether overseas investors may be considered “Special Investors” will depend on the scope of the definition of “Special Investor.”

## 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.

**License for Contract.** Any contract executed by the Special Business Operator is required to conform to the standard contract submitted for the license of the Item 3 RE Business Operator. Any modification of the standard contract requires permission. As a result, there is a concern that the terms of the contract will become rigid, and flexible investment will be impossible.

**Real Estate Brokerage Business Law.** In the supplementary provisions of the current revised bill, the Real Estate Brokerage Business Law<sup>9</sup> (“RE Brokerage Law”) will also be revised in regard to “Special Business Operator,” and the application of the licensing requirement under the RE Brokerage Law will continue to be excluded.

However, there will be partial application of the RE Brokerage Law for a “deemed registered real-estate transaction manager.” The main provisions to be applied are the 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 and so on. A business security deposit (JPY 10 million for headquarters) will need to be considered as an additional investment cost.

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<sup>8</sup> Such business categories have been added to account for the reality that the unspecified business operator will itself conduct such business.  
<sup>9</sup> Real Estate Brokerage Business Law (Law No. 176 of 1952, as amended).

## COMPARISON WITH OTHER SCHEMES

**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 fulfilling 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 several times, the current trend leans toward the adoption of the GK/TK (trust beneficial interest) scheme, which allows for greater freedom. In contrast, the GK/TK scheme (real asset) does not seem to offer sufficient flexibility to be an adequate replacement for the TMK scheme.

**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 GK/TK (real asset) scheme under the Real Estate Specified Joint Enterprise Act greatly diminishes such merit. Also, the advantage of 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 available. On the other hand, trust commissions are unnecessary in the case of the GK/TK (real asset) scheme. Overall, it is critical to weigh the various considerations when contemplating the use of the GK/TK schemes.

## CONCLUSION

Before overseas investors begin considering the implications of the amendment to the Joint Enterprise Act, it would be important to know whether overseas investors could qualify as “Special Investors,” the definition of which is not yet available. Even if overseas investors could be considered as “Special Investors,” the amendment appears to be of limited use as the legal requirements remain strict. For the time being, making investments in real estate in Japan remains a challenge to overseas investors, who are unable to take advantage of the TMK scheme and the GK/TK (trust beneficial interest) scheme.

## LAWYER CONTACTS

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