Top five thoughts to consider when investing in Japanese real estate
Introduction

One thing is for certain from a real estate perspective: all eyes are on Japan. There is a wide range of global investors, both core and opportunistic, looking to deploy capital in Japan. Domestic investors have dominated the market, but foreign investors have come back, boosting their share of total investment volume to 15% in 2014 from 9% the year before. Foreign capital invested over ¥1t into Japan’s property market in 2014, a 29% increase from the prior year and the highest level since 2008, according to analysts.

Depreciation of the yen against the US dollar and Japan’s monetary easing policy have been key factors influencing foreign buyers to invest in Japan. Others, who have been cautious because of their slowing economies back home, are looking to Japan for diversification. This, along with improved real estate market fundamentals, has helped fuel investor and lender confidence and made Japan more attractive.

According to analysts, Japan was the largest commercial real estate investment market in Asia-Pacific in 2014. Annual transaction volume in 2014 was up 14% overall over the previous year, the highest annual volume since the global financial crisis began.

Real estate investment trusts (REITs) have been the primary driver of investment activity. Six new listed Japanese REITs (J-REITs) were created in 2014, including the country’s first health care REIT, and more are preparing to list in 2015. Private REITs also expanded significantly.

Looking ahead, there will continue to be a lot of excitement generated by the Tokyo 2020 Olympics, proposed integrated resort legislation and the Government’s commitment to making Japan more attractive for business. All this spells opportunity for Japanese real estate owners/developers, investors and corporate occupiers.

This publication provides a high-level overview of some of the critical factors investors need to consider when contemplating real estate investment into Japan. We hope you enjoy our publication. If you have any questions or need further assistance, please contact any of the EY professionals listed at the end of the report.

Top five thoughts to consider when investing in Japanese real estate

1. State of the Japanese economy
2. Entering the Japanese real estate investment market
3. Typical Japanese real estate investment structures
4. Japanese real estate investment – summary of key taxes
5. Navigating Japanese real estate law

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Top five thoughts to consider when investing in Japanese real estate

1. Understanding the market: The real estate market in Japan is unique and differs significantly from that in other countries. Investors should conduct thorough research on the local market to understand the trends, regulations, and demand for real estate in Japan.

2. Location: Location is a crucial factor in determining the success of a real estate investment in Japan. Investors should consider the proximity to major business districts, transportation hubs, and residential areas to ensure high occupancy rates and rental yields.

3. Legal and tax considerations: Japanese real estate laws and taxation can be complex. Investors should consult with legal and tax experts to ensure compliance with all regulations and to optimize their tax liabilities.

4. Property maintenance: Real estate in Japan requires regular maintenance to ensure its value. Investors should consider the costs associated with property maintenance and the ongoing efforts required to keep the property in good condition.

5. Long-term planning: Real estate investments in Japan can be long-term ventures, with potential for appreciation over time. Investors should consider their long-term goals and financial stability to ensure the investment aligns with their objectives.

By considering these factors, investors can make informed decisions when investing in Japanese real estate and increase their chances of success.
1. State of the Japanese economy

The Japanese economy grew at a slower pace than initially estimated in the final quarter of 2014. According to industry analysts, Japan’s economy exited recession in the fourth quarter of 2014, with the economy expanding 0.4% from the prior quarter (1.5% from the prior year), still suggesting that demand remains weak.

In April 2013, the Bank of Japan set a time frame of two years to achieve its 2% inflation target, and with underlying inflation running around 0.5%, that won’t be met. As of March 2015, the Bank of Japan kept monetary settings unchanged.

Despite the Government’s efforts to stimulate the economy, a number of challenges remain. Businesses appear uncertain about Prime Minister Abe’s policies and whether recent improvements in domestic demand are here to stay. Although Japanese companies – particularly exporters – have enjoyed record profits resulting from the lower yen, they are hoarding cash rather than investing it. To be sure, business investment fell for the third consecutive quarter. This has a delaying effect on key decisions, including their willingness to provide employees with higher wages, which in turn can be drag on the economy. One thing is for certain: additional corporate investment will be needed to support future economic growth.

In March 2015, the consumer confidence index increased to 41.7 from 40.7 in February, partly due to the delay in the consumption tax increase planned to take place in October 2015. In addition, falling oil prices helped make up for the loss in consumer purchasing power from the lower yen. However, small businesses continue to suffer from the increased costs of imported goods.

Japan’s unemployment rate remained fairly steady around 3.5%. The weaker yen is supporting the price competitiveness of Japan’s export manufacturers, which is boosting employment in manufacturing and transport. The rise in wholesale and retail trade and services employment provides positive signs about domestic demand.

On a more positive note, the Government is fully committed to promoting tourism in Japan, making the 2020 Olympics a success and getting the economy back on track, which is giving Japan the worldwide attention it deserves.

Looking ahead, the decline in commodity prices, the potential for robust growth in exports and the tightening in the labor market should all contribute positively to Japan’s economy.

Key economic indicators – Japan

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Value</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population</td>
<td>127m</td>
<td>Dec-14</td>
</tr>
<tr>
<td>Foreign exchange rate (vs. US$)</td>
<td>119</td>
<td>Apr-15</td>
</tr>
<tr>
<td>GDP growth (annualized)</td>
<td>1.5%</td>
<td>Nov-14</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>3.5%</td>
<td>Feb-15</td>
</tr>
<tr>
<td>Consumer confidence index</td>
<td>41.7</td>
<td>Mar-15</td>
</tr>
<tr>
<td>Wage growth</td>
<td>0.5%</td>
<td>Feb-15</td>
</tr>
<tr>
<td>Consumer price index</td>
<td>103</td>
<td>Feb-15</td>
</tr>
<tr>
<td>Manufacturing PMI</td>
<td>49.7</td>
<td>Apr-15</td>
</tr>
<tr>
<td>Retail sales growth</td>
<td>-1.7%</td>
<td>Feb-15</td>
</tr>
<tr>
<td>Housing starts</td>
<td>-3.1%</td>
<td>Feb-15</td>
</tr>
<tr>
<td>Foreign tourist arrivals (monthly)</td>
<td>1.526m</td>
<td>Mar-15</td>
</tr>
</tbody>
</table>

Source: Trading Economics; EY

Despite the Government’s efforts to stimulate the economy, a number of challenges remain. Businesses appear uncertain about Prime Minister Abe’s policies and whether recent improvements in domestic demand are here to stay. Although Japanese companies – particularly exporters – have enjoyed record profits...
2. Entering the Japanese real estate investment market

When entering Japan’s real estate market for the first time, a thorough understanding of the local market and the competitive landscape is essential to a successful investment strategy. Today, the outlook for the Japanese economy as a whole and the real estate market in particular is much more positive, as investors continue to work through the key issues that resulted from the global financial crisis. Against the backdrop of ample capital liquidity, the competition for property acquisition, particularly for large-scale investment-class properties, remains fierce. Listed and private REITs, which are able to leverage low-yield capital over the mid to long term, as well as insurance companies and large-scale developers, are actively investing. In addition, many overseas investors, who have previously invested in high-yield, nonperforming asset investments are finding fewer opportunistic investment opportunities in Japan, and therefore are shifting back toward core investments.

In the five central municipal areas in Tokyo, the estimated net operating income (NOI) yield on office buildings bought or sold in 2014 was in the low 4% range. It was in the 3% range for large S-class properties — around the same level previously recorded in 2008. Since there is limited leeway in future cap rate compression, flexibility in investment strategies will be needed going forward. The strategies may include, for example, more aggressive valuation scenarios that anticipate higher rent growth and large-scale renovations, as well as expanded scopes of investment to include new asset classes, lower-grade assets, outlying properties and corporate acquisitions.

Given the conditions outlined above, developing an investment strategy that aligns with one’s own corporate strategies will be critical for building an investment pipeline and portfolio of high-quality assets. For investors who are confident in their own company’s brand and sourcing capabilities, and are willing to commit to the Japanese market over the long term, establishing their own investment platform (that includes having the right number of staff with the right capabilities) can be a powerful long-term strategy. If the emphasis is to quickly enter the market and immediately start investing, another alternative would be to formulate investment objectives from outside Japan and establish a minimum number of representatives in Japan while leveraging the capabilities of local Japanese partners and service providers to assist with sourcing and underwriting deal opportunities.

Japan does not formally capture information on actual transactions. Therefore, investors must often rely on third party published sources. Although listed REITs periodically publish valuations and other content for investment properties, these valuations are not based on actual transactions and tend to lag behind actual market conditions, and that lag appears to be increasing.

To more accurately ascertain market trends, collect the necessary investment information and get access to a wider variety of investment opportunities, it is important to understand the agent-oriented business model, wherein an agent, working in collaboration with local partners, brings potential investment opportunities to a company’s attention. It is therefore important to build strong, mutually beneficial business relationships with these agents. Midscale and larger investment proposals often involve large brokerage firms that are related to the large real estate companies or trust banks, which are allowed to be involved in Japanese real estate transactions. In Japan, brokerage firms may represent both sellers and buyers and may legally bill both parties for agency processing fees. These practices are an embedded, customary component of the market. When sourcing properties in Japan, overseas investors need to find a balance between what is required to comply with global investment standards and what’s required to meet customary Japanese market practices.

In the future, more real estate investment opportunities are likely to arise as Japanese companies continue to pursue business structure reforms, including decentralization and business reorganizations. To achieve the required investment objectives, investors will need a thorough understanding of the local market and the competitive landscape. Having the right partner who knows and understands the local market, the regulatory regime, the local culture and customary practices is more important now than ever.
3. Typical Japanese real estate investment structures

Purchasing property, particularly in a foreign country, can be complex. It’s important to allow enough time early in the process, to thoroughly evaluate and understand the most viable structuring alternatives.

Here are two commonly used Japanese real estate investment structures, along with a summary of the key differences.

TK-GK\(^2\) (silent partnership) structure

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**Legal characteristics:**

- Tokumei kumiai (TK) is a contractual relationship defined in the commercial code of Japan, where a TK investor contributes money to fund a TK operator’s business in exchange for the right to receive profit from the business.
- TK investor’s liability is limited to its contribution. TK investor has no right to execute the TK business.

**Japanese tax consequences to a foreign TK investor:**

- TK operator recognizes all of the income and expenses of TK business, and profits/losses allocable to TK investors are either deducted from or added to the taxable income.
- TK profit distributions to the TK investor are subject to 20.42% Japanese withholding income tax.
- 20.42% withholding tax rate in the TK structure may be reduced under certain income tax treaties with Japan.

**Other considerations:**

- There is a risk that the TK could be recharacterized to a nin’i kumiai (NK), which is similar to a general partnership, if the TK investor is deemed to be conducting TK business jointly with the TK operator.

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1. **GK:** Godo kaisha
2. **TBI:** Trust beneficiary interest is issued by a trust bank licensed in Japan. This is a common practice in Japan to manage certain transaction taxes, such as real estate acquisition/registration tax.

Source: EY
Legal characteristics:

- **Tokutei mokuteki kaisha (TMK)** is a corporation incorporated under the law concerning liquidation of assets, more specifically, the Law on the Securitization of Specified Assets by a special purpose company (SPC) (SPC law).

- It is subject to various legal requirements (such as filing of the asset liquidation plan to the local financial bureau) prescribed in SPC law.

Japanese tax consequences to a foreign TMK equity holder:

- TMK is subject to corporate income taxes. However, if a TMK satisfies certain requirements, the dividends distributed to its equity holders are deducted from the taxable income.

- The dividends paid by TMK are subject to 20.42% Japanese withholding income tax.

- Withholding income tax rate may be reduced or exempted under certain income tax treaties.

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3. **PIC**: Preferred investment certificate (preferred stock-type equity); more than 50% of PIC must be offered in Japan.

4. **SIC**: Specified investment certificate (common stock-type equity); more than 50% of SIC must be offered in Japan (except for SIC without a right to dividend/residual property distributions).

5. **Tax QII**: Certain type of institutional investor defined in the tax law. It generally includes registered financial institutions and other types of institutional investors that satisfy certain conditions.

Source: EY
### Key differences: TK-GK structure vs. TMK structure

<table>
<thead>
<tr>
<th>Description</th>
<th>TK-GK structure</th>
<th>TMK structure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of asset/applicable regulation</td>
<td>TBI or real estate assets (provided certain conditions are met)/financial instruments and exchange law (FIEL)</td>
<td>Real estate assets or TBI/FIEL and SPC law</td>
</tr>
<tr>
<td>Formation/setup</td>
<td>Relatively quick and easy bilateral contract</td>
<td>More complex, more time and effort; asset liquidation plan required</td>
</tr>
<tr>
<td>Regulatory oversight</td>
<td>Less regulated</td>
<td>More regulated; more onerous government filings</td>
</tr>
<tr>
<td>Costs</td>
<td>Lower setup and maintenance costs (audit, tax and legal)</td>
<td>Higher setup and maintenance costs (audit, tax and legal)</td>
</tr>
<tr>
<td>Deal size</td>
<td>Used for deals all sizes</td>
<td>Tend to be used for deals over US$50m</td>
</tr>
<tr>
<td>Foreign equity restriction</td>
<td>None</td>
<td>More than 50% equity must be issued onshore</td>
</tr>
<tr>
<td>Decision-making/control</td>
<td>Investors need to be silent/passive</td>
<td>Investors can be active equity holders</td>
</tr>
<tr>
<td>Investor liability</td>
<td>Limited to investor contribution</td>
<td>Limited to equity contribution</td>
</tr>
<tr>
<td>Operation (primarily asset management and property management)</td>
<td>Conducted by TK operator (Qll exemption); can contract to third parties</td>
<td>TMK prohibited from conducting management and disposition of assets itself; must contract to third parties</td>
</tr>
<tr>
<td>Financing</td>
<td>Loan agreement; loans from TK investor not advisable</td>
<td>Specified bond issuance to tax Qll required; higher financing costs</td>
</tr>
<tr>
<td>Flexibility/timing of cash distribution</td>
<td>More flexible</td>
<td>Cash repatriation by way of capital reduction takes time</td>
</tr>
<tr>
<td>Effective tax rate foreign investors/ equity holders</td>
<td>Profit distributions subject to Japanese withholding tax; may be reduced under certain income tax treaties (provided certain conditions met)</td>
<td>Dividends subject to Japanese withholding tax; may be reduced under certain income tax treaties (provided certain conditions met)</td>
</tr>
<tr>
<td>Japanese taxation of entity</td>
<td>TK operator subject to corporate income tax on taxable income after deducting the profit allocated to TK investors</td>
<td>TMK subject to corporate income tax on taxable income after deducting distributed dividends (TMK must satisfy certain requirements)</td>
</tr>
</tbody>
</table>

Source: EY
## 4. Japanese real estate investment – summary of key taxes

Before making any major property investment, it’s important to know and understand the types of taxes that could apply as well as the potential impact those taxes could have on your investment. Below is a summary of the key Japanese taxes.

<table>
<thead>
<tr>
<th>Tax</th>
<th>Acquisition and setup</th>
<th>Holding</th>
<th>Exit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Corporate income tax</strong></td>
<td></td>
<td>• Effective tax rate is approximately 33% to 35% on income from leasing of real property/trust beneficiary interest (TBI); for fiscal periods beginning on or after 1 April 2015.</td>
<td>• Effective tax rate is approximately 33% to 35% on sale of the real property/TBI (capital gains are included in taxable income as ordinary income). • Effective tax rate on sale of equity interest of real property holding corporation by a foreign corporate shareholder (without a PE in Japan) is 24.951% for the fiscal years beginning on or after 1 April 2015 (assuming certain conditions are met).</td>
</tr>
<tr>
<td><strong>Consumption tax</strong></td>
<td></td>
<td>• 8% of building/fixed asset price (excluding land)</td>
<td>• 8% of building/fixed asset price (excluding land)</td>
</tr>
<tr>
<td><strong>Withholding tax on dividends and loan interest income</strong></td>
<td></td>
<td>Dividends</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Payment to resident: 20.42% (20% on or after 1 January 2038)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Payment to nonresidents or foreign corporations (without a PE in Japan): 20.42% (20% on or after 1 January 2038); may be reduced under relevant tax treaty</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Payment to resident: none</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Payment to nonresidents or foreign corporations (without a PE in Japan): 20.42% (20% on or after 1 January 2038); may be reduced under relevant tax treaty</td>
<td></td>
</tr>
<tr>
<td><strong>Transaction/transfer tax</strong></td>
<td></td>
<td>• Real property acquisition tax of 3% on land and 4% on building (various special rules for reduced tax rates). Transfer of TBI: none. • Registration and license tax of 1.5% on land and 2% on building (various special rules for reduced tax rates). Transfer of TBI: nominal amount.</td>
<td>• Real property tax of 1.7% (including 0.3% city planning tax) on the land and building. • Depreciable assets tax of 1.4% on the depreciable assets.</td>
</tr>
</tbody>
</table>

Source: EY
5. Navigating Japanese real estate law

Below is a summary of the key concepts of Japanese real estate law. Having legal counsel on the ground who knows and understands the local real estate laws and how to apply them to actual cases will be critical to the success of any transaction.

- A foreign corporation and a Japanese subsidiary of a foreign corporation may, in principle, own real estate in Japan on its own.
- An owner of real estate may freely utilize and dispose of the real estate, subject to certain limitations by laws, and there is no duration restriction.
- Japanese real property law differs from legal systems in some countries where the state owns land and private citizens have only right of land use (fixed term). Rather, it resembles “fee simple” under common law.
- Land and buildings are treated as separate real estate. Accordingly, a landowner may be different from the building owner. It is not uncommon even in the case of city-center redevelopment that a landowner leases land to a third-party lessee. Then the lessee constructs its self-owned building on the land and subsequently leases it.
- Real estate may be stratified – for example, on a room-by-room basis for an apartment or on a floor-by-floor basis for an office building.
- Real estate may be held in the form of a TBI by entrusting the real estate to a trust bank as well as a hard asset. If the TK-GK structure on page 5 is adopted, it is practically mandatory to hold real estate in the form of TBI for regulatory reasons.
- A mortgage may be established using the real estate as collateral. A mortgagee may collect a monetary claim from auction or voluntary sale (if agreed upon with the debtor) of the real estate in default of debt secured by the mortgage; however, title or possession of the real estate does not transfer to the mortgagee. A pledge may be established as collateral in the case of a TBI.
- There is a real estate registration system in Japan, and an owner or a mortgagee needs to register its right in order to assert such a right to a third party. However, unlike registration systems in some countries, such as the Torrens system, a registered owner is not always the true owner, and accordingly an investigation of rights is necessary before acquisition.
- An owner of a building may be liable for damages arising out of defects in construction or maintenance of the building regardless of whether the owner was negligent or not.
- Real estate lease system generally favors lessees. Land leases are quite different from building leases. The duration of a land lease is 30 years (minimum). Historically, it has been difficult to refuse renewal of a lease, even after expiration of the term, as long as a building on the land still exists. Likewise, it has been difficult for lessors to terminate a building lease or refuse its renewal, and accordingly lessees could continue to rent if they desire. However, a new type of lease, without renewal, was recently introduced for both land and buildings and has become prevalent.
- Investment in infrastructure assets, such as roads and water, has attracted investors’ attention. Although these assets are real estate-related, they are different from ordinary real estate for rent in many aspects, and special consideration is required for each asset class.

Having legal counsel on the ground who knows and understands the local real estate laws and how to apply them to actual cases will be critical to the success of any transaction.
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