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

Low interest rate policies being spearheaded by Japan are becoming a global trend, and the real estate industry is enjoying a bountiful season thanks to property prices continuing to rise. The real estate market in Japan is showing no signs of slowing down, and while there are external factors like the U.S.-China trade war to consider, the demand for offices and hotels based in urban areas is strong. All signs point to the uptrend which started during the second half of 2013 continuing for the near future.

The stability of real estate investments is also supported by the listed REIT market, as in May of 2019 the TSE REIT index was set to 1950, an increase of over 10% compared to last year’s index of 1750. During this time, TOPIX fell from 1800 to 1550, so high expectations for the real estate market as an investment market make it stand out. TSE REIT has also reflected optimism in the market, and since May of 2019 two more companies have had IPOs, bringing the total number of listed REIT to 63. At that time, market capitalization was greater than 14 trillion yen, surpassing the 13 trillion yen market capitalization of the TSE First Section’s listed real estate businesses (as of the end of April 2019).

Despite the increase of interest rates by the FRB partially fueled by a favorable United States economy, the exchange rate for the yen during the year through May was very stable, with only a slight fluctuation range of 0.008850 dollar to 0.009174 dollar. As a result, the real estate market in Japan and its high dollar yield is appealing to foreign investors. With the growth of the real estate market over the past six years, foreign investors’ faces have become diverse, and in addition to the traditional Western investors, investors from Southeast Asia and China have been entering the market. The diversity of this investor base gives a sense of security to the liquidity of real estate and has an overall positive impact on the real estate market.

In addition, the 2020 Tokyo Olympics, the Osaka Expo in 2025, and the development of integrated resorts in Japan will all stimulate the market and create attractive investment opportunities for investors in the future.

This guide introduces high-level points of consideration that investors should take note of when considering real estate investment in Japan. If you have any questions about the content, please feel free to contact EY’s respective professionals. We hope that we can help make your endeavors in Japan successful.

Satoshi Abe
Japan Real Estate, Hospitality & Construction Industry Leader
1. State of the Japanese economy

The Japan economy, which has been steadily expanding despite the low growth rate from Q3 of 2012 until Q4 of 2017, since then has been a continued repetition of price growth and negative growth. According to the World Bank, the economic growth rate in 2019 is projected to be 0.9%, but the potential growth rate is estimated to be nearer to 0.8%, according to the Bank of Japan (BOJ). Considering Japan has some of the world's fastest aging population, and the declining birthrate as well as the decline in the total population has resulted in labor shortages. Similarly, the social security system is an undue burden on the current generation, which is feared to create a bottleneck for economic growth in the future. The challenge for Japan is the low potential growth, and there is no quick fix to remedy this. Whether the potential growth rate can rise depends on whether Mr. Abe invests his political assets in controversial issues like deregulation for new technologies, reform on social security and tax reform while the Abe administration is stable in the medium to long term.

In April 2013, BOJ set the inflation rate target at 2 percent, but the target has not been achieved yet and the nominal wage growth rate remains low. As a result, BOJ is strongly committed to achieving the price stability target and are likely to continue to promote monetary easing, therefore continuing to maintain long-term interest rates around 0%.

Despite the unemployment rate of 2.4% and the labor market tightening, wages are slow to rise. Because a long-term inflationary mindset permeates Japan, it has a low rate of inflation. Therefore, Prime Minister Abe announced an increase of the minimum wage up to 3% in 2016, hoping to improve employment and further clarify the upward trend of labor costs. As a result, management's interest is focused on promoting employment to women and the elderly and labor-saving investments, hoping to expand the growth rate of Japan's human capital. On the other hand, tax hikes such as consumption taxes and personal income taxes, and the increase in the burden of social insurance premiums that will continue through 2020, are counteracting disposable income increase to large extent.

Along with the Rugby World Cup in 2019, the Summer Olympics in 2020 and the Osaka Expo in 2025, an all-inclusive resort in Japan is expected to be developed by 2025, meaning the topics of investment, consumption, and tourism are quite heated. The current concern for 2019 is the impact on consumption by the increase from 8% to 10% of the consumption tax rate scheduled for October 2019. Similarly, the rise of protectionism in the United States resulting from their trade war against China, as well as Brexit, is thought as a turning point of global economic slowdown accompanying the rise of uncertainty.

For the former, as a result of the Abe administration taking various measures to mitigate the decline in consumption after the tax hike, the IMF announced in January 2019 that the growth outlook for 2019 and 2020 was 1.1% and 0.7%. As of October 2018, it has been revised upwards of 0.2% respectively. With that said, the tax hikes are expected to create a fiscal stimulus greater than the increase in the government's revenue, causing little need for concern at this time.

For the latter, the decline in exports from China to United States will lead to a slowdown in exports to China of parts and raw materials, and it is inevitable that there will be a temporary disruption to the existing supply chain. It is also true that negotiations on the Japan-US Goods trade Agreement (TAG: Trade Agreement on Goods) will begin in September 2018, and this negotiation will have a significant impact on the Japan economy. However, in December of 2018 with the TPP11 (Comprehensive and advanced Agreement on the Trans-Pacific Partnership), and in February 2019 with the EUEPA (Economic Partnership agreement) Japan is rapidly advancing on establishing a free trade system. According to Japanese government studies, the effects of this are expected to improve consumer sentiment through the improvement of Japan's business environment and the reduction in consumer prices, and boost GDP by 1.5% and 1%.

Thus, although it is inevitable for Japan's economy to be affected by internal and external economic factors, continued efforts to establish a free trade system are expected to have a positive impact on Japan's economy, and strong economic growth is anticipated.

Key economic indicators — Japan

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<tbody>
<tr>
<td>Population</td>
<td>Statistics Bureau</td>
<td>127m</td>
<td>111.22</td>
<td>0.8%</td>
<td>40.5</td>
<td>101.3</td>
<td>50.2</td>
<td>0.6%</td>
<td>2.9%</td>
<td>3.119m</td>
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<td>Foreign exchange rate (vs. US$)</td>
<td>Bank of Japan</td>
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<td>IHS Markit Ltd</td>
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<tr>
<td>Real GDP growth (annualized)</td>
<td>Cabinet Office</td>
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<td>METI</td>
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<td>Unemployment rate</td>
<td>Cabinet Office</td>
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<tr>
<td>Consumer confidence index</td>
<td>Cabinet Office</td>
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<td>Nominal Wage growth</td>
<td>MHLW</td>
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<tr>
<td>Consumer price index</td>
<td>Statistics Bureau</td>
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<tr>
<td>Nikkei Japan Manufacturing PMI</td>
<td>IHS Markit Ltd</td>
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<tr>
<td>Retail sales growth</td>
<td>METI</td>
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<tr>
<td>Housing starts</td>
<td>METI</td>
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<tr>
<td>Foreign tourist arrivals (monthly)</td>
<td>JNTO</td>
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In April 2013, BOJ set the inflation rate target at 2 percent, but the target has not been achieved yet and the nominal wage growth rate remains low. As a result, BOJ is strongly committed to achieving the price stability target and are likely to continue to promote monetary easing, therefore continuing to maintain long-term interest rates around 0%.

Top five thoughts to consider when investing in Japanese real estate | 1
2. **Entering the Japanese real estate investment market**

With the backdrop of the strong Japanese economy with the ample liquidity brought about by long lasting low interest rate policy, investors' confidence in the Japanese real estate market has been unwavering. The vacancy rate and investment yields of office property in metropolitan areas have already reached a historic low level. In addition, investment in hotel and hospitality properties, boosted by anticipated demand for accommodation brought about by the government-led tourism marketing campaigns, and investment in distribution facilities, boosted by an expansion of demand due to online shopping, are steadily increasing.

In such an environment, investors seeking to invest in the Japanese real estate market should pay close attention to the competitive environment, prospects for the future, and the risk tolerance they are able to bear. In general, foreign investors have a higher demand for returns than domestic investors, and their investment periods tend to be shorter than domestic investors as well. However, as acquiring investment properties often requires working alongside domestic investors, it is essential for foreign investors to formulate investment strategies and calculate risk levels for any potential investments while considering these points.

For example, the investment market for S-Class and A-class properties in metropolitan areas has been booming, so there is a strategy to avoid those segments and to seek investment in regional large cities, or to do sourcing of B-class and under properties. There may also be a strategy to expand investment targets from traditional real estate such as offices and commercial facilities, to emerging investment properties such as elderly care facilities, urban storages, data centers, and mobile relay stations (cell towers). In the midst of fierce acquisition of acquiring finished property, there is also the option of taking a certain amount of development risk, including adding development property in the investment scope. In addition, investment opportunities may expand if the overall goal is not just the full asset acquisition of a property, but investing in shares of asset holding companies or just the partial acquisition of strata-title assets. Similarly, if investment funds that allow long horizon of investment periods are prepared, it is possible to increase the price competitiveness of a target acquisition.

While investment opportunities will increase if the risk of any investment is greater, it is quite important that all members involved in the acquisition process have a common understanding about their tolerance of the investment risk. Acquisition procedures including sourcing, underwriting, documentation and execution in unfamiliar foreign real estate market must be managed with disciplines based on such risk tolerance.

For investors entering the Japanese real estate market, securing sourcing routes is a major challenge. Compared to Western counterparts, Japan is not proceeding with the disclosure of relevant information, including real estate transaction information, and there are strict information protection regulations and language barriers to consider. It is not easy for any overseas investors to enter a new market and source an investment property on their own. Most real estate transactions over a certain scale involve major Japanese or foreign brokerage firms, or trust banks that are authorized to engage in a brokerage business. In Japan, these brokerage companies are allowed to represent both the seller and the buyer, and earning brokerage fees from both side is established as a market practice, as well as being legally acceptable. It may seem somewhat strange for overseas investors, but in order to effectively find investment projects in Japan, it is necessary to find a balance between global investment standards and the practices in the local real estate market. Accordingly, one of the viable options for sourcing and co-investing in Japanese investment properties is to find a local real estate players and establish strategic partnerships. In proceeding a good partnership, seeking mutually beneficial and sustainable relationships, not necessarily for the goal of any immediate projects, is quite important.
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\(^1\) (silent partnership) structure

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. There is no need to actually pay cash to TK investors in order to deduct or add the TK distribution from or to 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.
TMK (special-purpose vehicle) structure

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.

[Japan SPC]

- Japan SPC is subject to corporate income taxes. Application of thin capitalization and earnings stripping rules should be noted.
- The dividends and interest paid by Japan SPC are subject to 20.42% Japanese withholding income tax.
- Withholding income tax rate may be reduced or exempted under certain income tax treaties.

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.
6. **Japan SPC**: Godo kaisha, or Japanese branch of foreign entities, are generally used as a Japan SPC.

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><strong>Type of asset/applicable regulation</strong></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><strong>Formation/setup</strong></td>
<td>Relatively quick and easy bilateral contract</td>
<td>More complex, more time and effort; asset liquidation plan required</td>
</tr>
<tr>
<td><strong>Regulatory oversight</strong></td>
<td>Less regulated</td>
<td>More regulated; more onerous government filings</td>
</tr>
<tr>
<td><strong>Costs</strong></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><strong>Deal size</strong></td>
<td>Used for deals all sizes</td>
<td>Tend to be used for deals exceeding tens of millions dollars</td>
</tr>
<tr>
<td><strong>Foreign equity restriction</strong></td>
<td>None</td>
<td>More than 50% equity must be issued onshore</td>
</tr>
<tr>
<td><strong>Decision-making/control</strong></td>
<td>Investors need to be silent/passive</td>
<td>Investors can be active equity holders</td>
</tr>
<tr>
<td><strong>Investor liability</strong></td>
<td>Limited to investor contribution</td>
<td>Limited to equity contribution</td>
</tr>
<tr>
<td><strong>Operation (primarily asset management and property management)</strong></td>
<td>Conducted by TK operator (QII 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><strong>Financing</strong></td>
<td>Loan agreement; loans from TK investor not advisable</td>
<td>Specified bond issuance to tax QII required; higher financing costs</td>
</tr>
<tr>
<td><strong>Flexibility/timing of cash distribution</strong></td>
<td>More flexible</td>
<td>Cash repatriation by way of capital reduction takes time. More than 90% of distributable profit needs to be distributed in order to deduct dividend distributions from the TMK’s taxable income.</td>
</tr>
<tr>
<td><strong>Effective tax rate foreign investors/equity holders</strong></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><strong>Japanese taxation of entity</strong></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>
</table>
| Corporate income tax     | —                                                                                     | • Effective tax rate is approximately 30% to 35% on income from leasing of real property/trust beneficiary interest (TBI); for fiscal periods beginning on or after 1 April 2019. | • Effective tax rate is approximately 30% 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 2019 (25.59% for fiscal years beginning on and after 1 October 2019) (assuming certain conditions are met). |
| Consumption tax          | • 8% (10% on and after 1 October 2019) of building/fixed asset price (excluding land) | • 8% (10% on and after 1 October 2019, excluding rental income from lease contracts that meet certain conditions and were entered into during the period from 1 October 2013 to 31 March 2019) of rental income of commercial building; payable by tenant  
   • Rental income of land and residential building is non-taxable | • 8% (10% on and after 1 October 2019) of building/fixed asset price (excluding land) |
| Withholding tax          | —                                                                                     | Dividends                                                                 | Loan interest income                                                                                                                  |
| on dividends and loan    |                                                                                       | • Payment to resident: 20.42% (20% on or after 1 January 2038)             | • 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 |
| interest income          |                                                                                       | • 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 | —                                                                                                                                   |
| Transaction/             | • Real property acquisition tax of 3% on land and residential buildings, and 4% on non-residential buildings (various special rules for reduced tax rates). Transfer of TBI: none.  
   transfer tax            | • 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. | • Stamp duty ranging from JPY 200 to JPY 600,000 on contracts related to real property transfer (maximum of JPY 480,000 regarding contracts entered on and before 31 March 2020) |

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 until the mortgage has been executed. 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 for the purpose of owning buildings 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.
integrated real estate, hospitality and construction network of any professional services organization, with more than 12,000 professionals providing assurance, advisory, tax and transaction advisory services to real estate owners, developers, investors, lenders and users.
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