A simpler future

Ko Hanamizu of Anderson Mori & Tomotsune outlines the future of special purpose vehicles used in Japanese real estate finance schemes

The 2008 financial crisis had a severe impact on the Japanese real estate market. The ensuing decrease in the value of real estate in Japan severely impacted the real estate finance market. Numerous loans secured by real estate were accelerated or defaulted. While new investments into real estate have been limited after the crisis, recently some distress funds and offshore investors have been purchasing defaulted loans and distressed assets.

Before the financial crisis, Japan enacted the Financial Instruments and Exchange Act (FIEA), which came into force on September 30 2007. The FIEA broadened the scope of the definitions of "securities" and "financial instrument businesses" and imposed stricter obligations and regulations on businesses and the real estate finance market in Japan. Most notably affected were GK-TK Schemes, which were the prevalent finance schemes before the FIEA was enacted. Subsequent to the enactment of the FIEA, these Schemes have become heavily regulated. As a result, TMK Schemes in which *tokutei mokuteki kaisha* are used as special purpose vehicles have become the preferred finance scheme in Japan's real estate finance market.

Typical structures

In the Japanese market, aside from investments into real estates through the use of real estate investment trusts (REITs), TMK Schemes or GK-TK Schemes are the most commonly used forms of real estate finance. When an investor plans to invest into real estate in Japan by obtaining part of its purchase proceeds through debt financing, the investor needs to consider which Scheme is most suited for the investment.

GK-TK Scheme

Under the GK-TK Scheme, a SPV will be established in the form of a *godo kaisha* (GK), which is a simple structured limited liability company incorporated under the Corporations Act of Japan. The GK will act as the borrower and the holder of the assets to be invested.

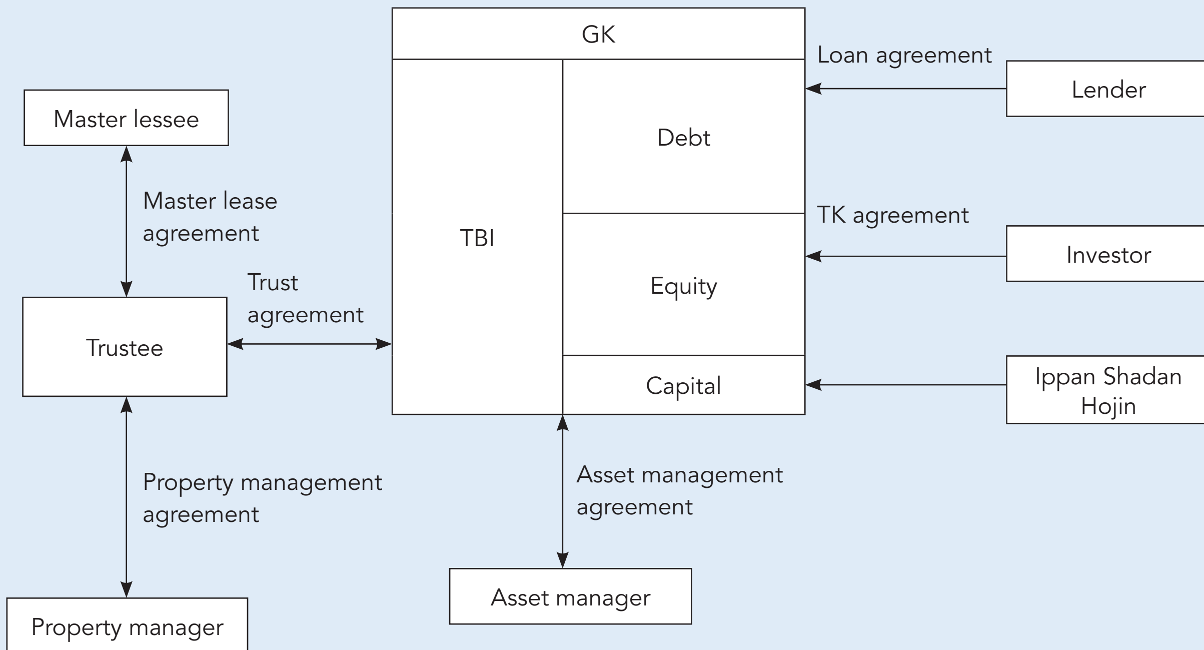
A parent SPV will contribute and hold capital on behalf of the GK to ensure the bankruptcy remoteness of the GK. Common examples of parent SPVs used in the GK-TK Scheme include (i) Cayman SPVs whose common shares are entrusted to a charitable trust and (ii) *ippan shadan hojins*, non-profit corporations incorporated under the Act on General Incorporated Associations and General Incorporated Foundations of Japan.

The GK acquires equity through a *tokumei kumiai* (TK) investment, which is a bilateral contractual arrangement under the Commercial Code of Japan. This is used to form a commercial venture between a passive investor (the TK Investor) and a business proprietor (the TK Operator). The business operations of the TK are managed solely by the TK Operator. The TK Investor is entitled to distributions from the profits of the commercial venture.

The GK will generally enter into an asset-based financing arrangement with a lender in order to purchase the target asset. More often than not, the lender is a money lending business operator registered under the Money Lending Business Act of Japan, or a bank.

"In order to avoid licensing obligations, the company will tend not to own real estate directly under the GK-TK Scheme"

Figure 1: Typical structure of the GK-TK Scheme



The GK usually acquires the asset in the form of a trust beneficiary interest whose trust asset is the target real estate. Accordingly, if the target asset is not held within a trust, the seller will be required to establish a trust by entering into a trust agreement with a trust bank or a trust company before transferring the asset to the GK.

In order to avoid licensing obligations, the GK will tend not to own real estate (known as hard assets) directly. If the GK, which is also the TK Operator, owns a hard asset, the GK will be required to adhere to the regulations under the Real Estate Specified Joint Enterprise Act and as such obtain the necessary licences applicable under the Act. Additionally, if the GK invests directly into a hard asset, the GK may also be required to obtain a licence under the Building Lots and Buildings Transaction Business Act.

"A transfer of the title of real estate is subject to a substantial percentage of tax"

TMK Scheme

Under the TMK Scheme, a TMK will be established as a SPV to acquire the target asset. TMKs are corporations which have a separate legal personality. While GKs are incorporated under and governed by the Corporations Act, TMKs are incorporated under and governed by the Securitisation Act.

As is the case with the GK-TK Scheme, in order to ensure the bankruptcy remoteness of the TMK, all common shares in the TMK will typically be contributed and held by a Cayman SPV, *ippan shadan hojin*, or other SPV. The voting rights in a shareholders' meeting of the TMK are vested in common shareholders, with the exception that preferred shareholders have limited voting rights in some significant matters. The subscription amount of the common shares is usually limited to a nominal amount and the subscription money will not be used to purchase the asset.

About the author

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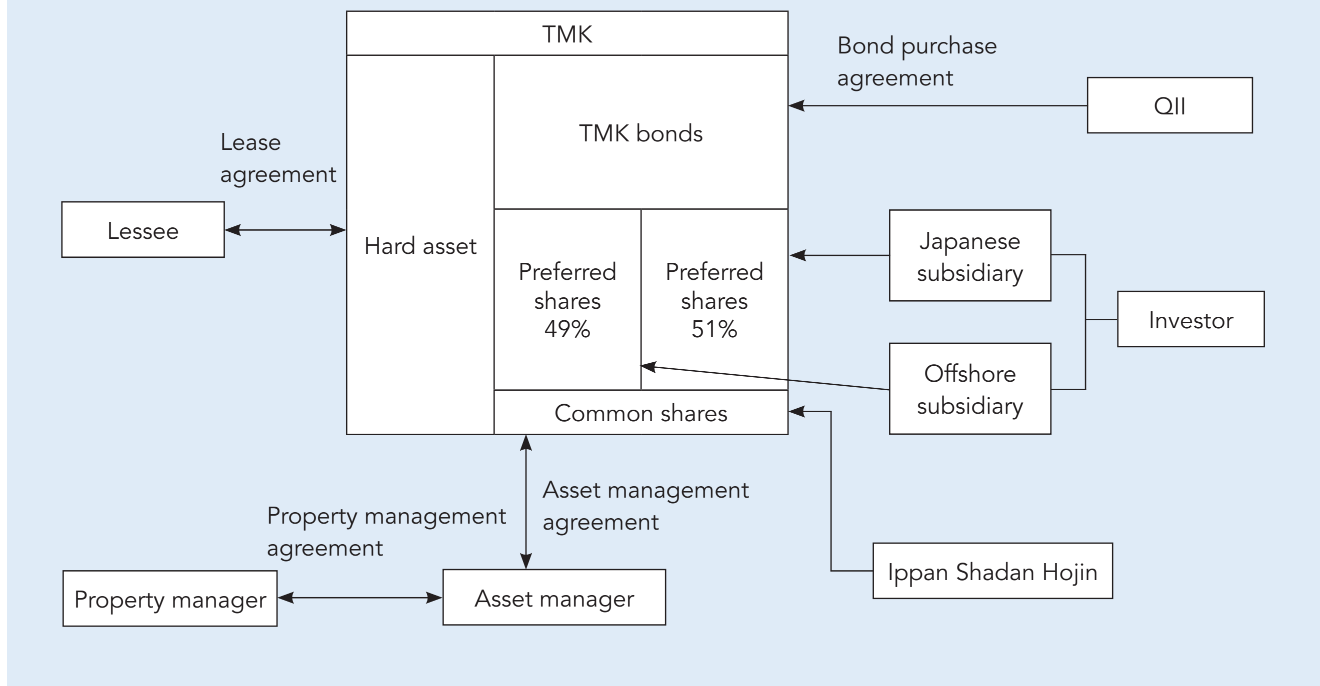
Figure 2: Typical structure of the TMK Scheme



If certain qualifying conditions are met, the TMK will be entitled to deduct the amount of dividends distributed to its shareholders from the taxable income of the TMK. In order for the TMK to enjoy this deductibility of dividends, in principle the TMK must issue more than 50% of its common shares to Japanese residents. However, even if more than 50% of the common shares are held by a non-resident of Japan, the deductibility of dividends will still be available if the non-resident common shareholder waives its rights to receive dividends.

Other than the nominal amount contributed by the common shareholder, the TMK will predominately raise equity through issuing preference shares to investors. As is the case with common shares, in order to enjoy the benefit of the deductibility of dividends, more than 50% of the preferred shares in the TMK must be issued to Japanese residents. In order to satisfy this requirement, an offshore investor will generally set up a subsidiary in Japan in the form of a GK or other company. The newly-incorporated Japanese subsidiary will then acquire 51% of the preferred shares in the TMK, while the remaining 49% of the preferred shares will be issued directly to the offshore investor or its offshore subsidiary.

Under the Securitisation Act, the acquisition of funds through debt financing by the TMK to purchase the target assets must be made either through specified loans (*tokutei kariire*, or TMK Loans) or specified bonds (*tokutei shasai*, or TMK Bonds). Under the requirements for the deductibility of dividends, the TMK must either (i) issue TMK Bonds whose aggregated subscription amount is more than ¥100 million ($1.3 million) through a public offering; or (ii) issue TMK Bonds solely to Qualified Institutional Investors (QIIs) as defined in the Act on Special Measures Concerning Taxation. The definition of the QII includes banks, insurance companies, securities firms and certain other institutional investors. In practice, most TMK Bonds are issued by way of private placement in order to avoid the application of the disclosure obligations under the FIEA, and the holders of such TMK Bonds are generally limited to the QIIs as per the terms and conditions of the TMK Bonds in order to fulfil condition (ii) above.

In some TMK Schemes, debt financing is obtained solely by issuance of TMK Bonds. However, from the perspective of a financier, TMK Loans are preferable to TMK Bonds. TMK Bonds contain restrictions which limit the ability of a lender to possess security interests over the assets of the TMK for the benefit of the TMK Bonds. Under the Secured Bonds Trust Act, in order to create security interests over certain assets to secure the payments of bonds, including TMK Bonds, the title holder of the assets has to enter into a trust agreement with a trust company or a trust bank in relation to management and enforcement of the security interests. Since compliance with the Secured Bonds Trust Act is arduous and costly, creation of security interests for the benefit of the holders of TMK Bonds in accordance with the Secured Bonds Trust Act is rarely used in the market.

In practice, TMK Bonds are secured solely by the statutory lien which is automatically created under the Securitisation Act upon purchase. In contrast to TMK Bonds, security interests created for the benefit of the TMK Loans are free from the limitations under the Secured Bonds Trust Act. Since the statutory lien under the Securitisation Act is generally believed to be subordinated to mortgages or pledges created over the assets of the TMK in priority of payments, in some deals not only are TMK Bonds used, but TMK Loans are also used as a means of debt financing.

The TMK is able to acquire the target asset either in the form of a hard asset or trust beneficiary interests. This is because the Real Estate Specified Joint Enterprise Act does not apply to TMK Schemes. Further, under the Securitisation Act, TMKs are explicitly exempt from the regulations under the Building Lots and Buildings Transaction Business Act and therefore, and most notably, avoid the licensing obligations set out in each respective Act.

Advantages of TMK Schemes

Before the FIEA took effect in 2007, GK-TK Schemes were heavily used compared to TMK Schemes. This was predominantly due to the notably higher costs and setup times required of TMK Schemes. Under the Securitisation Act, before the commencement of business, a TMK is required to file a notification of commencement of business, together with additional documentation including an asset liquidation plan which describes the

TMK's plan to acquire the target asset, to a Local Finance Bureau of the Ministry of Finance.

The plan must cover:

(i) the period of the plan;

(ii) details of the securities issued by the TMK (including TMK Bonds, common shares and preference shares) and the TMK Loans borrowed by the TMK;

(iii) details of the assets to be purchased, including the timing of the acquisition and the name of the seller;

(iv) details concerning the administration and disposition of the assets; and

(v) details of loans other than the TMK Loans (if any).

In contrast to TMK Schemes, in principle there were no compulsory filing obligations required under the GK-TK Schemes. Since the inception of the FIEA, however, GK-TK Schemes have been subject to more onerous regulations. While the regulations under the FIEA also apply to TMK Schemes in certain circumstances, it is generally believed that TMK Schemes now have greater benefits in relation to the regulations when compared with GK-TK Schemes.

Hard asset v beneficial interest

In Japan, a transfer of the title of real estate is subject to a substantial percentage of registration tax and real estate acquisition tax. In contrast, a transfer of a trust beneficiary interest (TBI) whose trust asset is real estate is only subject to nominal registration tax. Therefore, from a tax viewpoint, it can be said that investments into TBIs are a more appealing method of investing in real estate.

On the other hand, in respect of regulations, investments into hard assets are preferable to investments into TBIs. TBIs generally fall within the definition of securities under the FIEA. Accordingly, investments into TBIs will be subject to the regulations under the FIEA. Since GK-TK Schemes usually take investments in the form of TBIs, investments by a GK will be subject to the regulations under the FIEA, including those relating to investment management. Pursuant to these, the GK will be required to be registered with the Financial Services Agency of Japan, unless the GK satisfies one of the exemptions. In addition, where an asset manager provides asset management services in conjunction with the GK, then the asset manager will also be subject to FIEA regulations relating to investment management or investment advisory.

As discussed above, TMKs are capable of acquiring hard assets without being subject to the regulations within the Real Estate Specified Joint Enterprise Act or the Building Lots and Buildings Transaction Business Act. In relation to TMKs which invest into hard assets, the FIEA regulations will apply only to issuances and solicitations of the securities issued by the TMKs such as TMK Bonds, common shares and preference shares. Neither the TMK nor its asset manager will be subject to the regulations relating investment management or investment advisory under the FIEA. In that sense, the TMK Schemes allow investors to choose an option to invest in hard assets in order to limit the application of the FIEA regulations.

"One of the purposes of the amendments is to eliminate some of the limitations and restrictions imposed on the schemes"

Applicable FIEA regulations

As mentioned in the preceding section, asset managers in the GK-TK Schemes are subject to FIEA regulations in respect of either their investment management business or their investment advisory business.

Asset managers which provide asset management services in connection with TMKs which directly hold hard assets will not be subject to FIEA regulations on either their investment management business or their investment advisory business. In contrast, asset managers which provide asset management services with the TMKs whose assets are TBIs will be subject to such regulations.

Under the GK-TK Schemes, GKs are subject to the FIEA regulations which relate to investment management. As such they are required to be registered with the Financial Services Agency, unless the GKs satisfy one of the exemptions to such registration requirements.

In contrast, TMKs are not subject to the regulations pertaining to investment management, even if TMKs invest in TBIs. Therefore, even in cases where investments are made in the form of TBIs, the TMK Schemes are less regulated by the FIEA and more flexible in terms of structuring when compared to the GK-TK Schemes.

2011 amendments

Following the commencement of the FIEA in 2007, TMK Schemes are seen as more advantageous than GK-TK Schemes as the application of the regulations under the FIEA are limited.

The Securitisation Act has, however, imposed limitations and restrictions on the operation of TMKs. One of the purposes of the 2011 Amendments is to eliminate

Table 3: Significant differences between TMK and GK-TK Schemes

	TMK Scheme	GK-TK Scheme
Filing with the regulator	Notification of commencement of business together with asset liquidation plan must be filed with the competent Local Finance Bureau.	No filing with the regulator is necessary except for the filings required under the FIEA regulations.
Type of asset	Hard asset or TBI	TBI
FIEA regulations applicable to asset manager	If the investment is made directly into hard asset(s), the FIEA regulation will not apply to the asset management by the asset manager.	The FIEA regulation will apply to the asset management by the asset manager and the asset manager must be registered with the FSA.
FIEA regulations applicable to SPV	If the investment is made directly into hard asset(s), the FIEA regulation will not apply to the TMK other than the regulations applicable to the issuances and solicitations of the securities issued by the TMK.	The FIEA regulation can be applicable to the GK in relation to its acquisition and disposition of TBI, unless qualifying conditions of one of the exemptions are met.

some of the limitations and restrictions imposed on TMK Schemes, in order to make them more flexible and user-friendly. The 2011 Amendments are expected to come into force by November 25 2011. Although they were enacted on May 25, details of the Amendments are to be set forth by the enforcement orders and ordinances which are expected to be enacted by the effective date of the amendments. Some of the key amendments are as follows:

Acquisitions of ancillary assets

Under the current Securitisation Act, TMKs must entrust furniture, fixtures and equipment and other assets which are ancillary to the target real estate with a trust bank or a trust company. Since trust banks and trust companies are hesitant in accepting entrustments of furniture, fixtures and equipment, and other movables, this requirement makes it difficult for TMKs to purchase real estate which accompanies such movable assets (typically hotels and serviced apartments).

Following the 2011 Amendments, certain ancillary assets are exempt from the trust obligations. Subsequently, it is anticipated that acquisitions by TMKs of hotels, service apartments and other real estates accompanying furniture, fixtures and equipment will become more feasible. The exact scope of the ancillary assets which are to be exempt from the trust obligations will be set forth in the enforcement orders and ordinances which are under preparation by the regulator.

Abolition of the limitation on use of TMK Loans

Under the Securitisation Act, the use of the proceeds from TMK Loans is in principle restricted to acquisitions of the target assets. There has been extensive debate regarding whether such proceeds can be used for other purposes such as refinancing of current debt.

The 2011 Amendments have abolished the restriction on the use of the proceeds from the TMK Loans. Consequently, TMKs are likely to be entitled to use proceeds from TMK Loans for purposes other than acquisitions of the target assets, within the amount specified within the asset liquidation plan.