

NEW FUND STRUCTURE AVAILABLE FOR REAL ESTATE INVESTMENT IN JAPAN – SHOULD THE TKGK STRUCTURE BE REASSESSED?

AMENDMENT TO THE REAL ESTATE SPECIFIED JOINT ENTERPRISE ACT

On 1 December 2017, amendments to the Real Estate Specified Joint Enterprise Act of Japan (the "**RE JE Act**") took effect. Under these amendments a new structure for investment in hard asset real estate ("**Physical Real Estate**") (as opposed to trust beneficiary interests representing real estate) is made available. Under the RE JE Act, this new structure is called a "Qualified Special Exception Investor Business" or *tekikaku tokurei touseika gentei jigyo* ("**QSEIB**"). While only certain types of investors can participate in a QSEIB, its availability increases the structural options available in respect of real estate investment in Japan.

This Client Briefing outlines the QSEIB and its impact on real estate investment in Japan.

WHAT IS THE RE JE ACT?

The RE JE Act regulates investment in Physical Real Estate. If a person engages in the business of acquiring Physical Real Estate, with contributions from investor(s) pursuant to a TK agreement (*tokumeikumiai*) or a partnership agreement (*nin-i kumiai*), and distributing the profit earned by the purchase and sale of Physical Real Estate, such business constitutes a real estate specified joint enterprise ("**RE JE**") and the person engaging in such business (an "**RE JE Operator**") has to obtain permission under the RE JE Act.

In practice, a TKGK structure¹ is often used for real estate investment in Japan, but if the subject of investment is Physical Real Estate, the GK as an RE JE Operator (which acquires Physical Real Estate) is required to obtain permission under the RE JE Act (unless exempted). However, it is practically impossible for a special purpose company (SPC) like the GK to obtain permission due to requirements (such as holding a license under the Building Lots and Buildings Transaction Business Act and having sufficient financial foundation and personnel structure) which an SPC cannot as a matter of course fulfil. Therefore, in place of a TKGK structure, structures for investing in trust beneficiary interests representing real estate or TMK structures are usually used.

Key issues

- What is the RE JE Act?
- What was the background to the introduction of the QSEIB?
- What is a QSEIB?
- Enhanced User-friendliness of the QSEIB
- Who are QSEIs?
- How will the QSEIB affect real estate investment in Japan by overseas investors?

¹ A GK (*godo kaisha*) is a Japanese LLC often used for acquiring real estate (or trust beneficial interests in real estate) and as a bankruptcy remote SPC. TK stands for *tokumei kumiai* and is loosely translated as "silent partnership". Investors inject equity by way of TK investments into a GK which acquires real estate assets. This investment structure is called a TKGK structure.

WHAT WAS THE BACKGROUND TO THE INTRODUCTION OF THE QSEIB?

The RE JE Act was previously amended in 2013 to make it more user-friendly by creating an exemption from the permission requirement under the RE JE Act. Under the exemption, the permission requirement is replaced with a report filing requirement if an SPC is the operator of the business; the business relating to real estate transactions is outsourced to a licensed person and solicitation of investments is commissioned to a licensed person; the investors are limited to certain sophisticated investors.

However, the exemption has not been widely used. One of the reasons is that the SPC is subject to some of the restrictions under the Building Lots and Buildings Transaction Business Act such as the requirement for making a deposit of JPY10 million with a deposit office (*kyotakusho*) and the requirement for maintaining defect warranty (in the case of a seller) for at least two years after the closing. Please see our previous client briefing issued in February 2014 for details of the amendment to the RE JE Act in 2013². As a consequence, further amendments were made to the RE JE Act with effect from 1 December 2017, to promote the use of RE JEs.

WHAT IS A QSEIB?

A QSEIB is an RE JE whose investors are limited to certain categories of persons who have expert knowledge and experience regarding investment in real estate. These persons are called "Qualified Special Exception Investors" ("**QSEIs**") or *tekikaku tokurei touseika*. A QSEIB can operate an RE JE without permission under the RE JE Act.³ This makes it possible to use the TKGK structure for investment in Physical Real Estate.

In order to engage in a QSEIB using the TKGK structure, the GK as a RE JE Operator needs to delegate all the business operations in connection with real estate transactions to a building lots and building transactions business dealer (*takuchi tatemono torihiki gyosha*) ("**BLBTB Dealer**") (unless the GK itself is a BLBTB Dealer). Since the GK is normally an SPC which does not hold a BLBTB Dealer licence, the above delegation of the business operations becomes, as a matter of course, necessary. This Client Briefing focuses on the QSEIB conducted with such delegation (the "**SPC type QSEIB**").

ENHANCED USER-FRIENDLINESS OF THE QSEIB

In addition to permission under the RE JE Act no longer being required, the QSEIB also provides the following improvements from the investor's standpoint:

Firstly, if an SPC type QSEIB is used (i.e. all the business operations in connection with real estate transactions are delegated to a BLBTB Dealer), the RE JE Operator engaging in the real estate transactions will not be required to hold a BLBTB Dealer licence.

Secondly, unlike as previously required, acting as an intermediary with respect to the execution of an RE JE agreement (such as a TK agreement) between the RE JE Operator and a QSEI does not require permission for an RE JE or a

² https://www.cliffordchance.com/briefings/2014/02/amendment_to_therealestatejointenterpriseac.html (English) / https://www.cliffordchance.com/briefings/2014/02/amendment_to_therealestatejointenterpriseac0.html (Japanese)

³ While permission is not required, prior notification is still required under the RE JE Act.

Type 2 licence under the Financial Instruments and Exchange Act. This is a significant relaxation of the regulations.

Thirdly, the code of conduct applicable to the QSEIB is significantly relaxed as compared with that applicable to other types of RE JEs.

WHO ARE QSEIS?

Investors in a QSEIB are limited to QSEIs. Set out below are examples of QSEIs.

- Real Estate Specified Joint Enterprise Operators (*fudosan tokutei kyodo Jigyo sha*)
- General Real Estate Investment Advisors (*sogo fudosan toshi komon gyousha*)
- Licensed BLBTB Dealers
- Type 1 Financial Instruments Business Operators (*dai isshu kinyushohin torihiki gyosha*), Investment Management Business Operators (*toshi unyo gyosha*) (each as defined under the FIEA) and any other foreign business operator which is incidental to each of the foregoing and has submitted a notification to the JFSA
- Investment Corporations (*toshi hojin*) and Foreign Investment Corporations (*gaikoku toshi hojin*) (each as defined under the FIEA)
- Deposit-Taking Financial Institutions including Banks and Shinkin Banks (*shinyo kinko*), and Foreign Financial Institutions which have submitted notifications to the JFSA
- Insurance Companies and Foreign Insurance Companies (as defined under the FIEA)
- Investment Limited Partnerships ("ILPS")

HOW WILL THE QSEIB AFFECT REAL ESTATE INVESTMENT IN JAPAN BY OVERSEAS INVESTORS?

Where TK investors were limited to overseas investors, the TKGK structure has been used in practice for the acquisition of Physical Real Estate in Japan by means of having the TK agreements executed outside Japan (relying on a view that such TK agreements, being executed outside of Japan, do not obstruct the application of the RE JE ACT). Therefore if investors in a TKGK structure are limited to overseas investors, the use of a QSEIB may not strictly be required. However, a QSEIB can be useful if there is a co-investor in Japan, since it would be difficult to avoid the application of the RE JE Act by having the TK agreement with such co-investor executed outside Japan.⁴

A major limitation of the QSEIB is the significant restriction on the scope of investors. In this respect, the following may be possible ways for other investors to obtain QSEI status:

- In the case of an overseas fund's investment, it may be able to obtain QSEI status as a Foreign Investment Corporation (*gaikoku toshi hojin*) which is a fund in the form of a corporation incorporated outside Japan and issues securities similar to those issued by an Investment Corporation.

⁴ A QSEIB can also be useful should doubts about the legality of off-shore execution of TK agreements to which overseas TK investors are parties be a structural impediment. Please contact us if you are interested in this issue.

For this reason, a QSEIB may be useful in the case of an investment by an overseas corporate-type fund having co-investor(s) in Japan that cannot execute the TK Agreement outside Japan.

- An ILPS (*toshi jigyo yugen sekinin kumiai*) also qualifies as a QSEI. If necessary, therefore, a QSEIB can be used by forming an ILPS for investors unable to obtain QSEI status participating in the ILPS with QSEIs. The use of an ILPS in order to utilise a QSEIB would complicate the investment structure, but such structure may become useful if a TMK structure cannot be used for some reason.

The introduction of the QSEIB is welcome as it increases the structuring options where the investment target is Physical Real Estate, but the extent and success of its application remains to be seen given the limitations as described above.

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