

Tax consequences of cross-border investment in Japanese real estate

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6 February 2007

Japanese real estate



Japanese real estate at centre of a boom for offshore trusts
Australian fund managers are setting up Japan property trusts

 **THE AUSTRALIAN** *December 13, 2006*
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Why Japan?

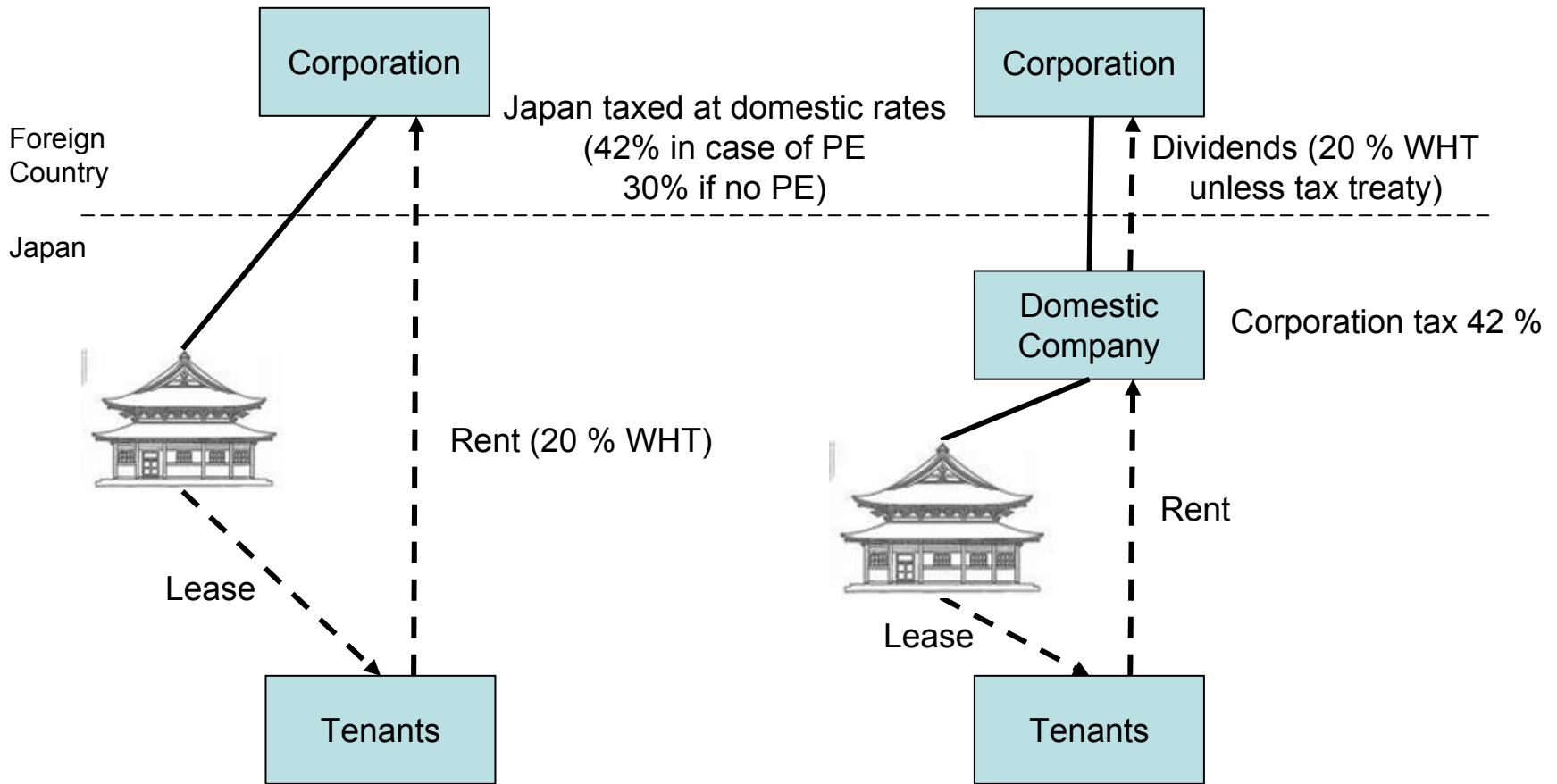
- Increasing confidence in Japanese economy
- Low interest rates
- Reduced property taxes
- Availability of investment properties

- Taxation in Japan (overview)
- Investment vehicles / structures
- Case studies

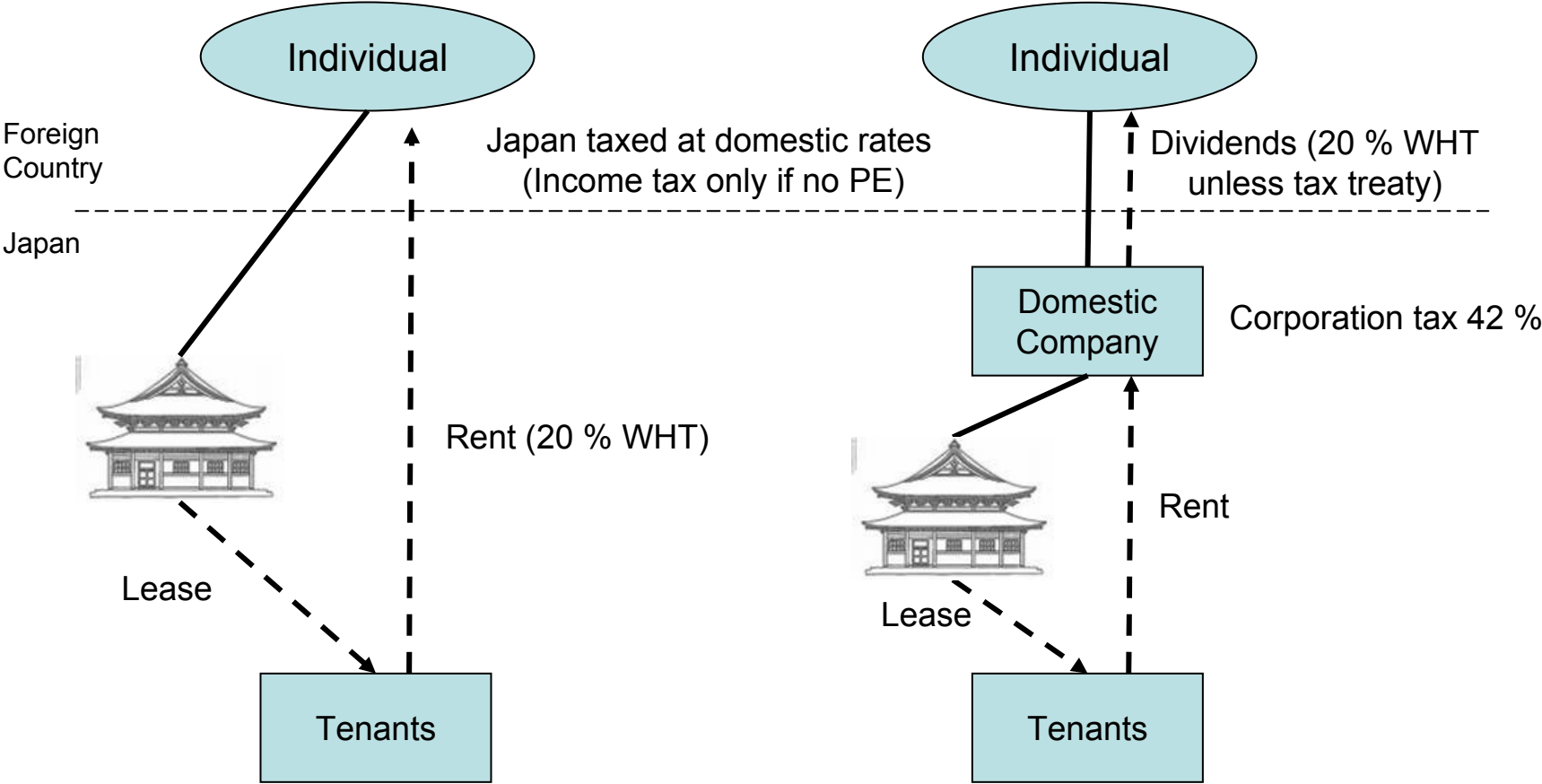
Taxation on real property investment

	Tax	Tax Base	Tax rate
Acquisition	Real property acquisition tax Consumption tax	Assessed value Acquisition cost	3% - 3.5% 5% (building only)
Holding	Fixed asset tax City planning tax	Assessed value Assessed value	1.4% 0.3%
Rental Income	<i>Individual taxpayer</i> Income tax Local tax	Net income	5 – 40% 10%
	<i>Corporate taxpayer</i> Corporation tax Local tax	Net income Corporation tax	30% approx. 12%
Disposition	<i>Individual tax payer</i> Income tax Local tax	Net income	15% / 30% 5% / 9%
	<i>Corporate taxpayer</i> Corporation tax Local tax Dividend withholding tax	Net income Corporation tax Profit distribution	30% approx. 12% 20%
Other	Stamp tax Registration and license tax Inheritance tax and gift tax	Amount on contract Value of property Value of property	Up to ¥600,000 Land 1%/Buildings 2% 10 - 50 %

Non-resident corporate investor



Non-resident individual investor



Vehicles / Structures for real estate investment in Japan

- **Tokumei Kumiai (“TK”)**

TK is a contractual agreement, whereby one or more silent partners (“TK investors”) contribute funds for the operation of a specific business (e.g. real estate investment) carried on by a Japanese operator (“TK Operator”).

- **Tokutei Mokuteki Kaisha (“TMK”)**

TMK is a special purpose Japanese company created for securitization of certain specified assets. The number of registered TMKs in Tokyo / Osaka is currently 677.

- **Real Estate Investment Trust (“J-REIT”)**

Real Estate Investment Trust (*Toshi Houjin*) is commonly referred to as J-REIT, which is a special purpose Japanese company created for securitization of real estate. Currently 39 J-REITs are listed.

What is a TK?

Tokumei Kumiai (“TK”)

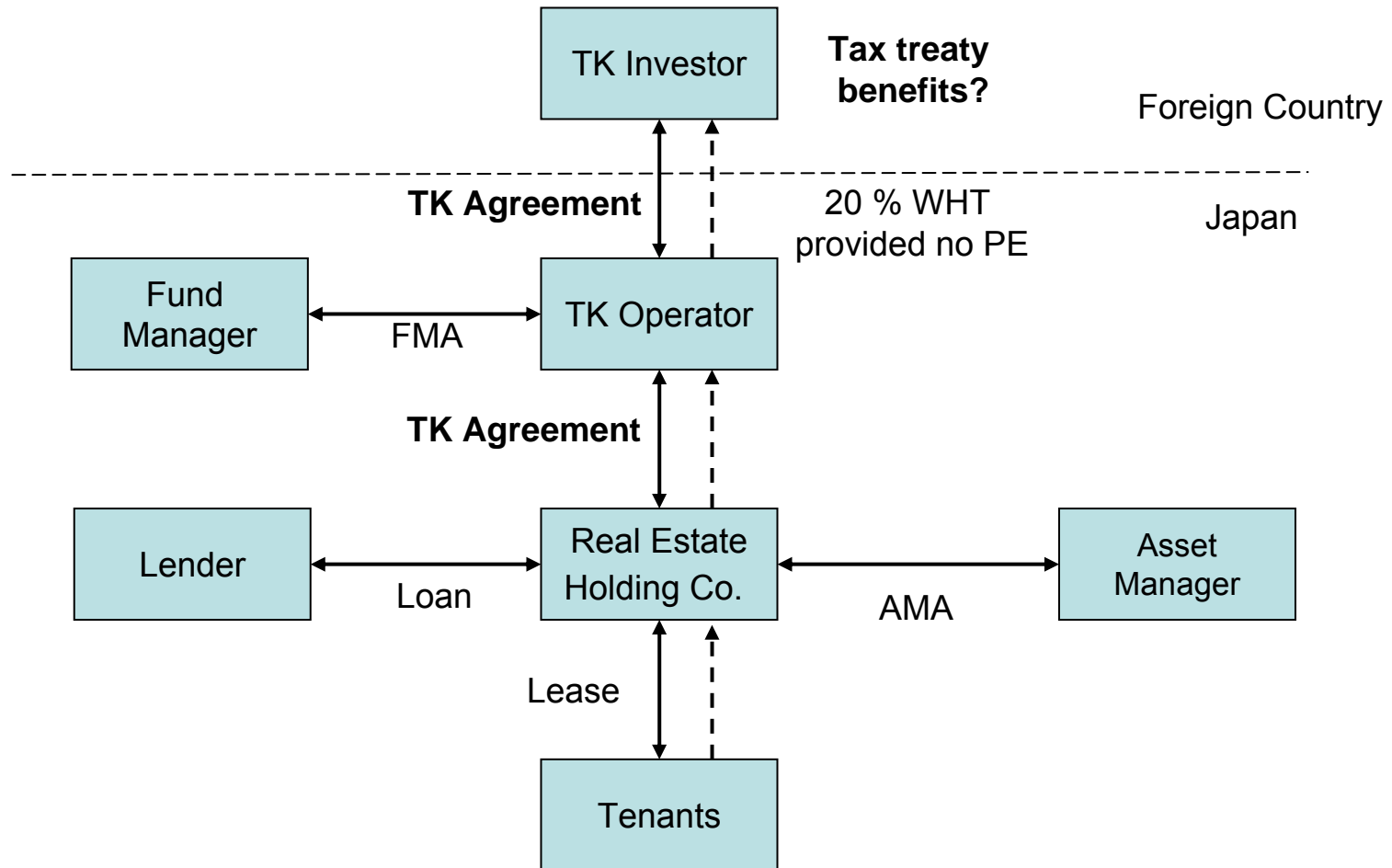
- Contractual relationship
- Silent partnership
- TK itself is not a taxable entity. If TK Operator distributes profit to TK investors, the distribution is deductible for TK Operator. In case losses are allocated to TK partners, the TK Operator is required to recognize corresponding taxable income.
- Liability limited to contribution
- No management relation TK Investor – TK Operator
- In case TK Operator has a business other than the TK business, bookkeeping should be done separately.

Taxation of TK investors

- Withholding tax of 20% on TK Distributions
 - Non-resident investor without PE: final tax
 - Non-resident investor with PE: taxed at ordinary rates with tax credit
- Tax treaty qualification: “Other income” (e.g. Dutch-Japan treaty)
 - Effective Japanese tax burden: 0 %
- Tax treaty developments
 - US - Japan, UK - Japan
 - Netherlands - Japan
 - Australia - Japan

- Tax authorities hostile towards “tax evasion structures”
- Audit by Japanese tax authorities:
 - TK Investor acting merely as nominee: “look through”
 - TK Investor part of jointly operated partnership with TK Operator: permanent establishment in Japan with 42 % tax burden
- Policy Japanese tax authorities:
 - Watch closely, tackle severely
 - Court case: 30 September 2005 TDC

TK – structure



What is a TMK?

Tokutei Mokuteki Kaisha (“TMK”)

- TMK is a special purpose Japanese company for securitization of certain specified assets (e.g. real estate investment)
- Asset Liquidation Plan
- TMK is subject to the ordinary corporation tax (approx. 42%)
- A qualified TMK is – subject to certain conditions - allowed to deduct dividends from its taxable income. Remaining profits after the deduction of dividends are subject to ordinary corporation tax
- The domestic dividend withholding tax rate is 20%. Reduction under a tax treaty may be available
- TMK is entitled to a reduced registration tax of real property of 0.8% (from 1%). Real estate acquisition tax is reduced to 1% (from 3%)

Taxation on TMK investors

Capital gains on disposition of TMK shares

- Domestic taxation depends on ownership (5/25-rule):
 1. Shareholding of 25% or more in TMK at any time during the last 3 years preceding the end of the book year of the sale; **and**
 2. At least 5% of TMK interests is sold.
- Real estate holding company ($\geq 50\%$ real estate), threshold will be:
 1. More than 5% of the shares (listed)
 2. More than 2% of the shares (privately held)
- If sale is subject to taxation, domestic tax rate is 30% (corporations) or 20% (individuals)
- However, capital gain may be exempt under tax treaties
 - Netherlands-Japan: yes
 - Australia-Japan: no

Conditions for tax qualification TMK

10 conditions for tax qualification:

1. Formed pursuant to Art. 8 of the Asset Liquidation Law.
2. TMK conducts business in line with the Asset Liquidation Plan and does not conduct any other business.
3. TMK entrusts management and disposal of specified assets to a separate third party entity with knowledge and experience, or places assets into a trust with a third party trustee for the management of the assets.

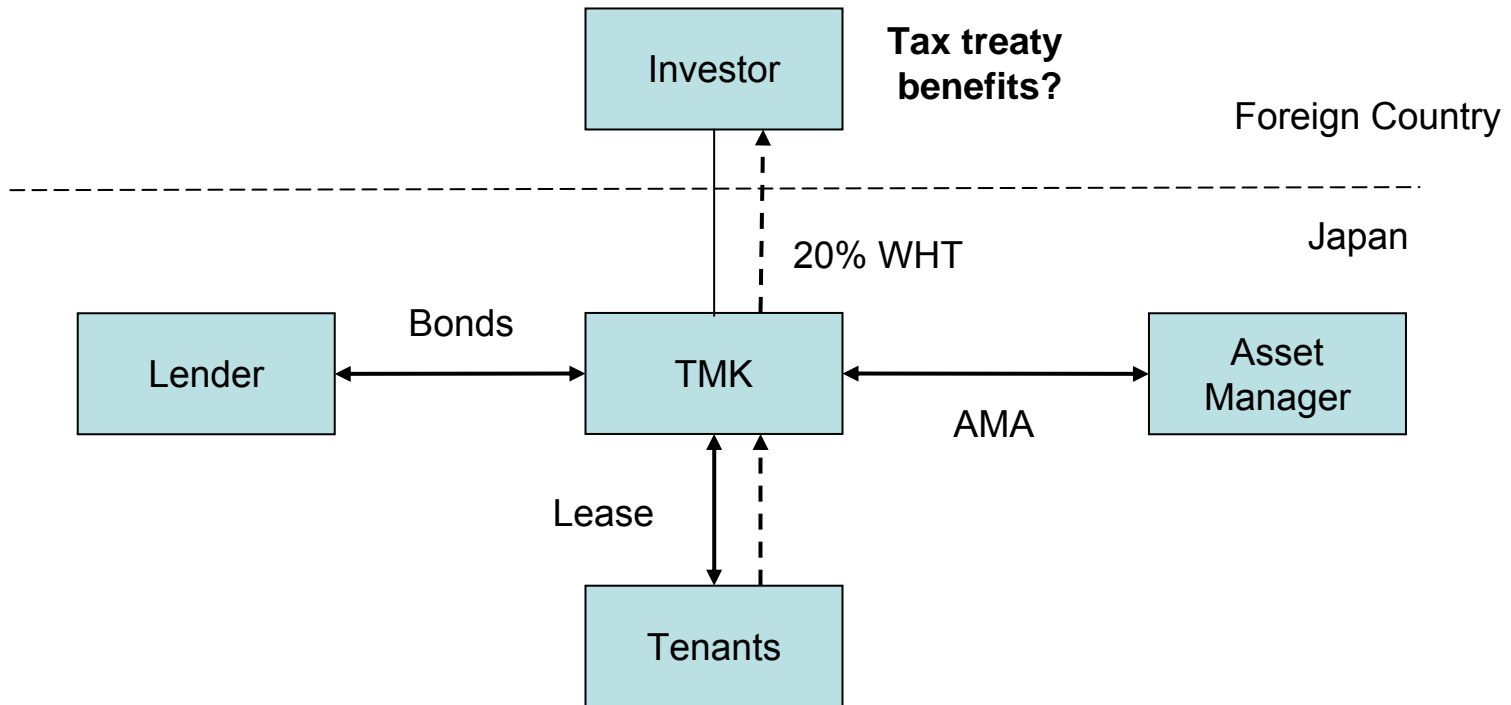
Conditions for tax qualification TMK - continued

4. One of the following conditions must be met:
 - a) The TMK issues specified bonds in the amount of JPY 100 million or more through a public offering;
 - b) Specified bonds are subscribed only by qualified institutional investors (i.e., Japan licensed banks);
 - c) Preferred investment certificates are subscribed by 50 or more investors in a Japanese public offering (i.e. primarily Japan offered);
 - d) Preferred investment certificates are subscribed to only by qualified institutional investors.

Conditions for tax qualification TMK - continued

5. If there is a public offering of bonds or preferred stock, more than 50% of the debt/equity instruments must be subscribed to in Japan.
6. TMK is not a family corporation under Japanese tax law.
7. TMK does not own any assets other than the specified assets.
8. TMK's fiscal year does not exceed one year.
9. Loans to TMK, if any, must be from a qualified institutional investors only (never from shareholders of the TMK or affiliates of shareholder).
10. More than 90% of the TMK's distributable amount for the fiscal year has been distributed as a dividend to equity holders.

TMK - structure



What is a J-REIT?

J-REIT / *Toshi Houjin* (“J-REIT”)

- Two types: Trust and Corporation
- J-REIT is subject to the normal corporate income tax (approx. 42%)
- A qualified J-REIT is – subject to certain conditions - allowed to deduct dividends from its taxable income. Remaining profits after the deduction of the dividends are subject to ordinary corporation tax
- J-REIT is entitled to a reduced acquisition tax of real property of 1% from 3%. Real estate registration tax is reduced to 0.6%

J-REIT - qualifications for dividend deduction

The following 11 conditions are to be met:

1. Registration of J-REIT with the Financial Services Agency
2. One of the conditions below must be met:
 - a) The shares are publicly offered at the time of incorporation and the total issued amount at the time is JPY 100 million or more; or
 - b) At fiscal year-end, the issued shares are held by 50 or more shareholders, or held solely by qualifying financial institutions.
3. The total issued shares are offered primarily in Japan

Qualifications for dividend deduction – continued

4. The fiscal year of J-REIT must be a period of one year or less
5. J-REIT does not violate Art. 63 of the Investment Corporation Law
6. A licensed Fund Manager
7. A qualifying Custodian
8. J-REIT is not a family corporation under Japanese tax law
9. J-REIT does not hold 50 % or more of shares in another corporation
10. If J-REIT borrows funds, the loan provider must be a qualifying financial institution
11. The amount of declared dividends exceeds 90% of the amount of distributable profits

Taxation on J-REIT investors

Individuals

	Shareholding	Japanese resident individuals	Non-resident individuals (no PE)
Profit distribution	5% or more	20% WHT dividend income is subject to the normal income tax.	20% WHT
	less than 5%	10% WHT (1) dividend income does not need to be reported in income tax return.	7% WHT (2)
Capital gains	regardless of the shareholding percentage	10% (3)	n/a
	more than 5%	n/a	15%
	5% or less	n/a	no income tax

(1) The rate of 10% applies to dividends received on or before March 31, 2008. Thereafter, 20% applies.

(2) The rate of 7% applies to dividends received on or before March 31, 2008. Thereafter, 15% applies.

(3) The rate of 10% applies until December 31, 2007. Thereafter, 20% applies

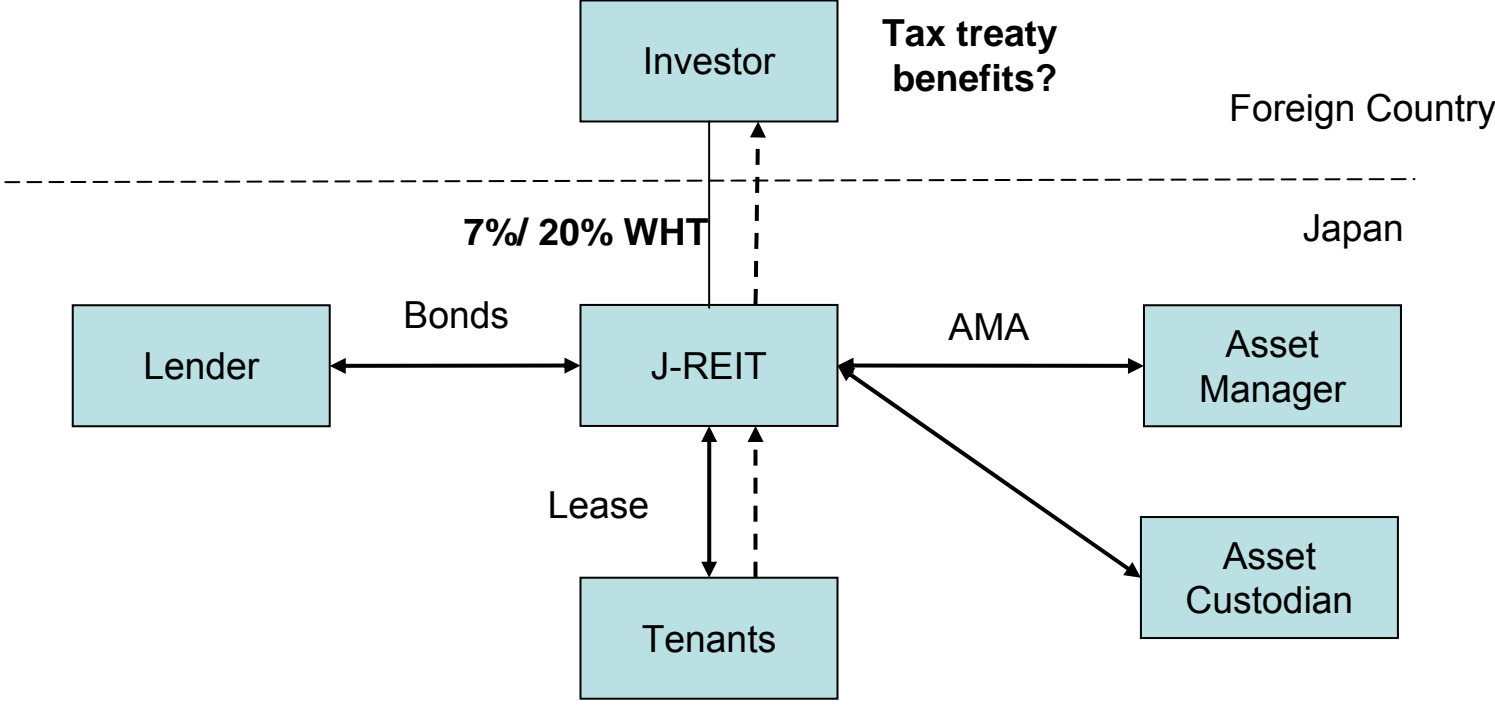
Taxation on J-REIT investors – continued

Corporations

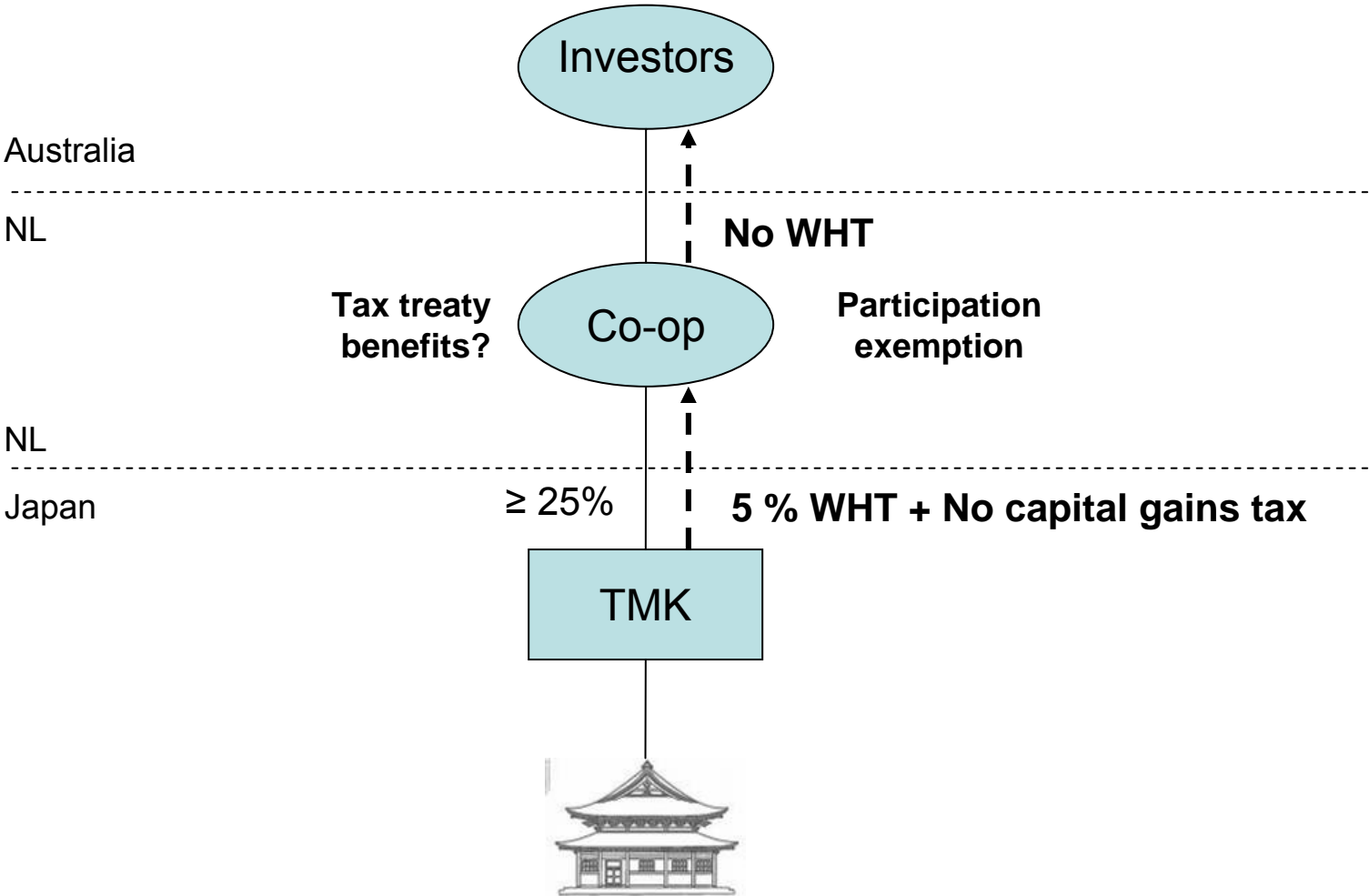
	Shareholding	Japanese resident corporations	Non-resident corporations (no PE)
Profit distribution		7% WHT (1) Dividend is subject to the normal corporate income tax (with tax credit)	7% WHT (1)
Capital gains	regardless of the shareholding percentage	42%	n/a
	more than 5%	n/a	30%
	5% or less	n/a	no income tax

(1) The rate of 7% applies to dividends received on or before March 31, 2008. Thereafter, 15% applies.

J-REIT - structure



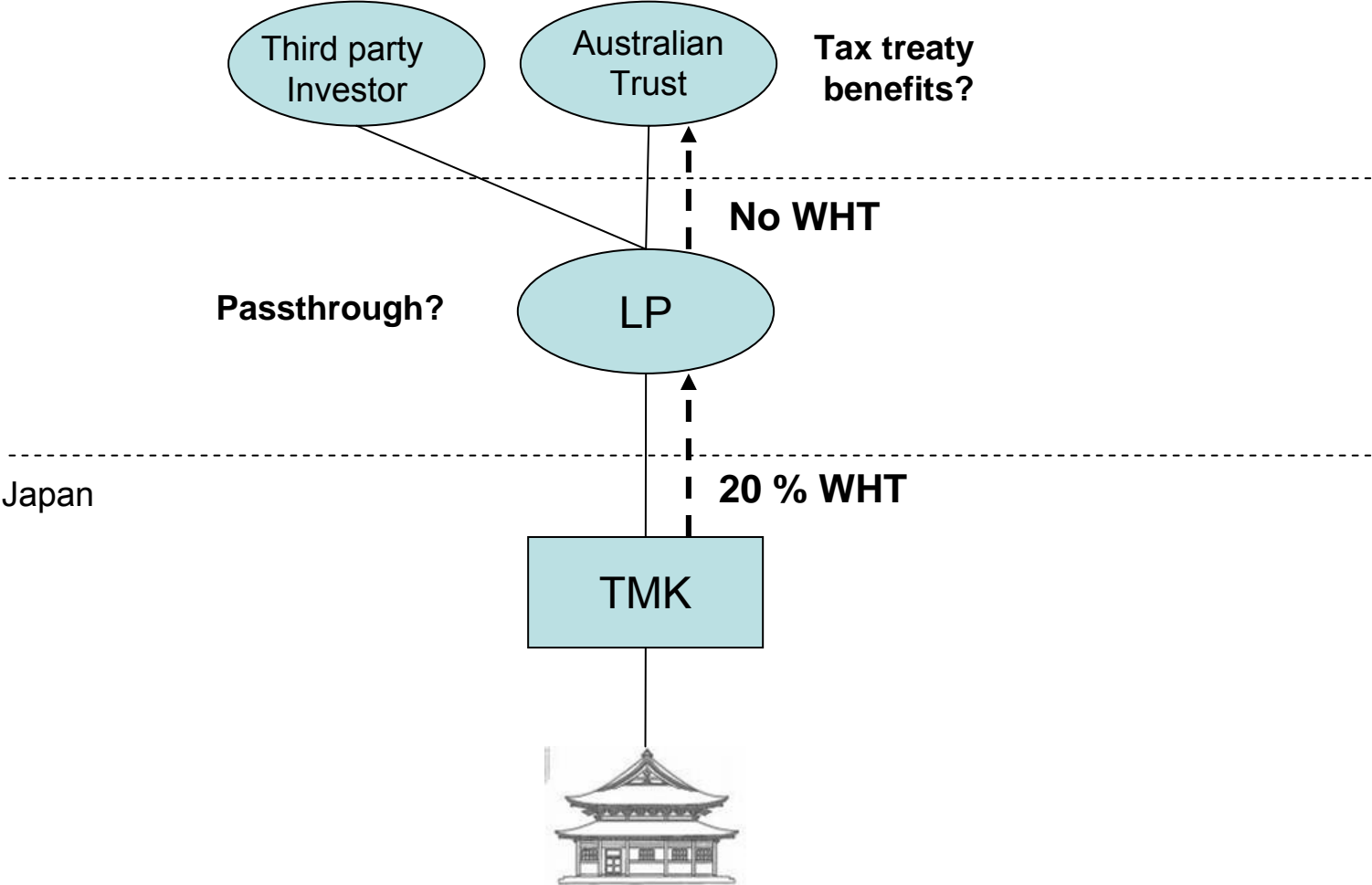
Case Study I: Dutch Co-op - TMK



Case Study I: Dutch Co-op - TMK

- Beneficial tax treatment for TMK in Japan: dividends deductible
- If Dutch-Japan tax treaty benefits for Co-op:
 - 5 % withholding tax on dividends from TMK to Co-op
 - No Japanese capital gains tax→ Substance
- Participation exemption for shareholding in TMK (≥ 90 % real estate investment): income and capital gains on TMK tax exempt for Co-op
- No dividend withholding tax on distributions of profit by Co-op

Case Study II: LP - TMK



Case Study II: LP - TMK

- Beneficial tax treatment for TMK in Japan: dividends deductible
- Qualification LP from Japanese perspective
- Qualification Trust from Japanese perspective
- benefits of Japan-Australia tax treaty?
 - Reduction of dividend withholding tax to 15 %
 - But no capital gains tax protection

Japan considered as a high-tax jurisdiction (42 % corporation tax), but tax cost on real estate investment can be kept at manageable level with careful planning

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