

Chambers

GLOBAL PRACTICE GUIDE

Definitive global law guides offering
comparative analysis from top ranked lawyers

Real Estate

Japan: Law & Practice
Mori Hamada & Matsumoto

chambers.com

2019

Law and Practice

Contributed by Mori Hamada & Matsumoto

Contents

1. General	p.4	4. Planning and Zoning	p.8
1.1 Main Sources of Law	p.4	4.1 Legislative and Governmental Controls Applicable to Strategic Planning and Zoning	p.8
1.2 Main Market Trends and Deals	p.4	4.2 Legislative and Governmental Controls Applicable to Design, Appearance and Method of Construction	p.8
1.3 Proposals for Reform	p.4	4.3 Regulatory Authorities	p.8
2. Sale and Purchase	p.5	4.4 Obtaining Entitlements to Develop a New Project	p.8
2.1 Categories of Property Rights	p.5	4.5 Right of Appeal Against an Authority's Decision	p.8
2.2 Laws Applicable to Transfer of Title	p.5	4.6 Agreements with Local or Governmental Authorities	p.8
2.3 Effecting Lawful and Proper Transfer of Title	p.5	4.7 Enforcement of Restrictions on Development and Designated Use	p.8
2.4 Real Estate Due Diligence	p.5	5. Investment Vehicles	p.9
2.5 Typical Representations and Warranties	p.6	5.1 Types of Entities Available to Investors to Hold Real Estate Assets	p.9
2.6 Important Areas of Law for Investors	p.6	5.2 Main Features of the Constitution of Each Type of Entity	p.9
2.7 Soil Pollution or Environmental Contamination	p.6	5.3 Minimum Capital Requirement	p.10
2.8 Permitted Uses of Real Estate Under Zoning or Planning Law	p.6	5.4 Applicable Governance Requirements	p.10
2.9 Condemnation, Expropriation or Compulsory Purchase	p.6	5.5 Annual Entity Maintenance and Accounting Compliance	p.10
2.10 Taxes Applicable to a Transaction	p.6	6. Commercial Leases	p.10
2.11 Legal Restrictions on Foreign Investors	p.7	6.1 Types of Arrangements Allowing the Use of Real Estate for a Limited Period of Time	p.10
3. Real Estate Finance	p.7	6.2 Types of Commercial Leases	p.10
3.1 Financing Acquisitions of Commercial Real Estate	p.7	6.3 Regulation of Rents or Lease Terms	p.11
3.2 Typical Security Created by Commercial Investors	p.7	6.4 Typical Terms of a Lease	p.11
3.3 Restrictions on Granting Security over Real Estate to Foreign Lenders	p.7	6.5 Rent Variation	p.11
3.4 Taxes or Fees Relating to the Granting and Enforcement of Security	p.7	6.6 Determination of New Rent	p.12
3.5 Legal Requirements Before an Entity Can Give Valid Security	p.7	6.7 Payment of VAT	p.12
3.6 Formalities When a Borrower is in Default	p.7	6.8 Costs Payable by Tenant at Start of Lease	p.12
3.7 Subordinating Existing Debt to Newly Created Debt	p.8	6.9 Payment of Maintenance and Repair	p.12
3.8 Lenders' Liability Under Environmental Laws	p.8	6.10 Payment of Utilities and Telecommunications	p.12
3.9 Effects of Borrower Becoming Insolvent	p.8		
3.10 Consequences of LIBOR Index Expiry	p.8		

6.11 Insuring the Real Estate that is Subject to the Lease	p.12	8. Tax	p.14
6.12 Restrictions on Use of Real Estate	p.12	8.1 VAT	p.14
6.13 Tenant's Ability to Alter and Improve Real Estate	p.12	8.2 Mitigation of Tax Liability	p.14
6.14 Specific Regulations	p.12	8.3 Municipal Taxes	p.15
6.15 Effect of Tenant's Insolvency	p.12	8.4 Income Tax Withholding for Foreign Investors	p.15
6.16 Forms of Security to Protect Against Failure of Tenant to Meet Obligations	p.12	8.5 Tax Benefits	p.15
6.17 Right to Occupy After Termination or Expiration of a Lease	p.13		
6.18 Right to Terminate Lease	p.13		
6.19 Forced Eviction	p.13		
6.20 Termination by Third Party	p.13		
7. Construction	p.13		
7.1 Common Structures Used to Price Construction Projects	p.13		
7.2 Assigning Responsibility for the Design and Construction of a Project	p.13		
7.3 Management of Construction Risk	p.13		
7.4 Management of Schedule-related Risk	p.14		
7.5 Additional Forms of Security to Guarantee a Contractor's Performance	p.14		
7.6 Liens or Encumbrances in the Event of Non-payment	p.14		
7.7 Requirements Before Use or Inhabitation	p.14		

Mori Hamada & Matsumoto has 12 partners (nine Tokyo-based partners and three experienced partners based in Singapore, Yangon and Bangkok) in its real estate team and two partners in its Japanese Reit (J-REIT) practice, as well as 50 other lawyers who are also involved in real estate-related matters. The lawyers have extensive experience, know-how and expertise across a broad range of fields, from real estate to structured finance, banking and financial regulations as well as J-REITs. Mori Hamada & Matsumoto has extensively developed its capabilities in real estate

investment and financing, and takes pride in its ability to manage large real estate investment transactions involving high-profile portfolios and multiple parties. The firm's real estate practice extends from traditional acquisition and leasing transactions to complex fund structures involving a special-purpose vehicle or a trust, or investment structures for overseas properties. Its work includes private real estate fund formation and property acquisition, real estate acquisition, development and disposition, real estate financing, J-REITs and investments in overseas properties.

Authors



Eriko Ozawa is a partner of the firm who practises in the areas of real estate, structured finance and banking.



Hiroki Aoyama is a partner of the firm who practises in real estate, structured finance and banking. He is a member of the Japan Association of Private Law and the Japan Association of the Law of Finance.



Naoki Ishikawa is a partner of the firm whose practice encompasses real estate, structured finance and energy. He is a member of the Japanese Council on International Trade.



Satoru Hasumoto is a partner of the firm and practises in the areas of real estate, structured finance and banking.

1. General

1.1 Main Sources of Law

The Civil Code provides the general legal framework for real property and real estate transactions, including ownership, co-ownership, superficies, easement and security interests, and for sale and purchase and leasing transactions.

In addition to the Civil Code, the Law on Unit Ownership of Buildings governs unit ownership (*kubun shoyu ken*) and the relationship among the unit owners of a multi-unit building, and the Land Lease and Building Lease Law applies to leases of buildings and leasehold interests or superficies in land for purposes of owning a building on a parcel of land. Since this law was enacted to enhance protection of the tenant's interest, some provisions are mandatory and cannot be circumvented by the parties to a land lease or building lease. Also, there are court rulings relating to land leases and building leases which have established legal doctrines that generally restrict the lessor's rights and protect the tenants. Thus, when reviewing a lease of Japanese real property from a lessor's perspective, one must remember that some contractual provisions may not work due to the mandatory provisions of the Land Lease and Building Lease Law, court rulings and established legal doctrines.

1.2 Main Market Trends and Deals

The Japanese real estate market has been active of late, attracting increasing attention domestically and from abroad.

In particular, driven by an increasing number of inbound tourists, there have been a number of acquisition transactions or development projects involving hotel properties. These properties are expected to be one of the most sought-after asset types among both Japanese and non-Japanese investors.

Also, many development projects of large-scale logistics properties have been completed or are underway.

1.3 Proposals for Reform

Several important reforms have been implemented in the last few years, the latest of which is the reform of the Real Estate Specified Joint Enterprise Law, under which real estate private funds using the widely-used GK-TK structure (see Section 5. **Investment Vehicles**, below) in Japan could be exempted from the existing permit requirements when acquiring outright ownership of real property by fulfilling a different set of requirements. That reform took effect on 1 December 2017.

In terms of future reforms, the Civil Code will be reformed, taking effect on 1 April 2020, which will affect many aspects of real estate transactions.

2. Sale and Purchase

2.1 Categories of Property Rights

Real property under Japanese law includes land and any fixtures on the land, ie, buildings that may be traded independently from the land. Land and buildings are independent real properties and can be separately traded, so the owner of the land and the owner of the building standing on that land can be different persons.

In the current Japanese market, the most common subject properties or interests for investment purposes are:

- fee simple ownership of the land or the building, or both;
- a combination of the right to use the land (leasehold interest or superficies) and fee simple ownership of the building;
- co-ownership (*kyo-yu*) of the land or the building, or both; and
- a combination of co-ownership of the land and unit ownership of private units in a multi-unit building.

Co-ownership refers to a type of ownership where one person owns a certain percentage interest in the entire property and other owners own the remaining percentage interests.

Unit ownership is a type of ownership recognised for a multi-unit building under the Law on Unit Ownership of Buildings. A unit owner is entitled to own exclusive private units in the building, to own and use common areas (such as the entrance hall of the building) jointly, with other unit owners, and to use the underlying land in the form of ownership interests, leasehold interests or superficies.

In addition, many real properties are held under trust arrangements, in which case the investor would acquire a trust beneficial interest (“TBI”) in respect of the entrusted real property. Under a trust arrangement, the real property is owned by the trustee (usually, a licensed trust bank in Japan) as part of the assets of the trust, and the investor becomes a beneficiary of the trust by acquiring the TBI.

2.2 Laws Applicable to Transfer of Title

The Civil Code generally governs the transfer of title. Other laws may also be relevant, depending on the ownership structure. For example, the Law on Unit Ownership of Buildings provides for certain rules on the transfer of unit ownership.

Specific restrictions may apply to specific types of real estate. One such restriction is the requirement under the Agricul-

tural Land Law that the acquisition of agricultural land is subject to governmental permission.

2.3 Effecting Lawful and Proper Transfer of Title How to effect a title transfer

A transfer of title to real estate is effected pursuant to an agreement between the seller and the buyer. Most sale and purchase agreements provide that the transfer of title takes effect upon the full payment of the purchase price by the buyer.

Registration of title to real estate

Japan has a real estate registration (*toki*) system where title to and certain other interests (such as mortgages) on real estate are registered. In practice, parties to a real estate transaction usually rely on the real estate registration because it is generally the best indication of the true owner of or holder of interest on a real property.

Registration of a title transfer

A transfer must be registered pursuant to the real estate registration system in order for it to be perfected. If a transfer of real property is not registered, the buyer cannot assert its title against a third party.

Title insurance

Title insurance is not commonly used in the Japanese real estate market.

2.4 Real Estate Due Diligence

A real estate due diligence process usually involves some or all of the following elements:

- *Document review*: documents to be reviewed include publicly available materials such as a certified copy of the real estate registration, as well as the contracts that have been entered into in respect of the subject property. An “explanation sheet of important matters” (*juyo jiko setsumei sho*) prepared by a broker or the seller is usually one of the major documents that should be reviewed, as it is supposed to provide an orderly overview of the property (including pre-closing or post-closing requirements under public laws applicable to the transfer of the property) and highlight issues relating to the property.
- *On-site inspection*: the buyer often retains, and brings to on-site inspections, an appraiser and a property inspector, who will prepare the necessary third party reports.
- *Question-and-answer sessions*: these are conducted in writing, by email or by telephone, or at face-to-face meetings.
- *Third party reports*: for commercial real estate, the buyer often arranges for professional service providers to prepare a real estate appraisal report and an engineering report. It is not uncommon to ask lawyers to perform a legal due diligence investigation as well. Furthermore, if the buyer does not anticipate receiving any explanation

sheet of important matters from the broker or the seller, then it is advisable for the buyer to retain a real estate adviser to prepare a property overview report to ascertain the various legal requirements applicable to the property.

2.5 Typical Representations and Warranties

Under the Civil Code, the seller is liable for any latent defect in the subject property. This defect liability may be limited by agreement on the scope, duration or amount of liability. Aside from such statutory liability, the seller and the buyer often agree on contractual representations and warranties regarding the subject property.

The primary remedies for statutory liability and seller's misrepresentations are termination of the purchase agreement and compensation for damages (or indemnity). Many sellers, however, negotiate the exclusion of the termination of the agreement as a post-closing remedy available to the buyer.

2.6 Important Areas of Law for Investors

The primary laws relating to real estate transactions include the following:

- laws governing private parties' rights and obligations are the Civil Code, the Law on Unit Ownership of Buildings, the Land Lease and Building Lease Law, and the Real Estate Registration Law;
- laws regarding regulations and public policy are the City Planning Law, the Construction Standards Law, the Soil Contamination Countermeasures Law, the Real Estate Transaction Business Law, and local government ordinances;
- laws related to trusts and TBI transactions are the Trust Law, the Trust Business Law, and the Financial Instruments and Exchange Law; and
- the Foreign Exchange and Foreign Trade Law relates to foreign investments.

2.7 Soil Pollution or Environmental Contamination

The buyer may be responsible for soil pollution or environmental contamination of a property. If the soil contamination is likely to harm human health, the land will be designated as an area requiring action (*yo sochi kuiki*) under the Soil Contamination Countermeasures Law, and the landowner is required to take the necessary measures to remedy the contamination. The measures to be taken depend on the class of hazardous substances found on the land, and on the state and degree of contamination. In practice, the removal of contaminated soil is the prevailing remedial method.

That said, a prefectural governor may order the polluter, rather than the owner, to take the required countermeasures if (i) it is clear that the soil contamination was caused by that polluter, who is not the owner, (ii) the prefectural

governor determines that it is appropriate for that polluter to take countermeasures, and (iii) the owner agrees.

2.8 Permitted Uses of Real Estate Under Zoning or Planning Law

The City Planning Law is the main source of zoning regulations. An "explanation sheet of important matters" prepared by a broker or the seller would address the zoning restrictions applicable to the subject property under the City Planning Law. A buyer may also consult with relevant governmental bodies to ascertain the applicable local or specific zoning or planning regulations.

The extent to which a project may involve dealing with governmental bodies varies significantly on a case-by-case basis.

2.9 Condemnation, Expropriation or Compulsory Purchase

The Land Expropriation Law provides for the requirements and procedure for expropriation by governmental bodies of privately owned real estate. Owners of expropriated assets are generally entitled to reasonable compensation. The two major elements of the whole process are a confirmation that the project necessitating the expropriation serves public interest, and the determination of the amount of compensation.

2.10 Taxes Applicable to a Transaction

Asset deal

The outright transfer of real property (asset deal) is subject to real estate acquisition tax (*fudosan shutoku zei*), registration and licence tax (*toroku menkyo zei*), consumption tax (*shohi-zei*) and stamp duty. Depending on the type of real property and the timing of the transactions, and subject to some exceptions, the tax rates are as follows:

- registration and licence tax: 1.5% to 2% of the taxable base of the property, which is the property value recorded in the tax rolls for purposes of fixed assets tax (the "Taxable Base");
- real estate acquisition tax: 3% to 4% of the Taxable Base;
- consumption tax: 8% of the purchase price of the building (10% from October 1, 2019); and
- stamp duty: up to JPY600,000 (or up to JPY480,000 under the current special tax treatment).

Corporation tax is also imposed on net income if the seller is a corporation.

Share deal

In the case of a share deal, corporate sellers are subject to corporation tax but not consumption tax, real estate acquisition tax, or registration and licence tax. Moreover, the share purchase agreement is basically not subject to stamp duty.

Allocation of responsibilities for taxes

Typically, the real estate acquisition tax, the registration and licence tax and the consumption tax are borne by the buyer, and the corporation tax is borne by the seller. The responsibility for the stamp duty is allocated based on agreement between the buyer and the seller.

Special methods to mitigate tax liability

For tax treatments that can be accomplished by using a trust structure or a *tokutei mokuteki kaisha* (“TMK”), please see Section 8.2 Mitigation of Tax Liability.

2.11 Legal Restrictions on Foreign Investors

There are no legal restrictions on the acquisition of real property in Japan by non-residents, except that those buyers are required to make a post-transaction filing pursuant to the Foreign Exchange and Foreign Trade Law.

3. Real Estate Finance**3.1 Financing Acquisitions of Commercial Real Estate**

As further elaborated in Section 5. Investment Vehicles, there are three commonly used investment structures in real estate investments, and financing structures vary depending on the investment vehicles used for the transaction:

- under the GK-TK structure, the acquisition is financed via *tokumei kumiai* (“TK”) and bank loans;
- the financing instruments used for a TMK structure are preferred shares, “specified bonds” and “specified loans”; and
- investment corporations or *toshi hojin* (“J-REIT”) issue equity units and bonds, and take out loans, to finance their real estate acquisition.

Financing structures for share deals vary depending on the purpose and nature of the deal.

3.2 Typical Security Created by Commercial Investors

A mortgage is the most typical security interest created by a borrower who holds outright ownership of real estate. If the borrower and the lender intend to enter into financing transactions on a continual basis, a revolving mortgage may be created instead. If the borrower holds an interest in real estate in the form of a TBI, a pledge over the TBI is the principal security interest in place of a mortgage. Some lenders may require pledges over insurance claims.

3.3 Restrictions on Granting Security over Real Estate to Foreign Lenders

There are no special restrictions on granting security over real estate to foreign lenders. However, a licensing requirement applies if a foreign financial institution lends money

in Japan as part of its money lending business, unless the institution is a licensed bank in its home country and has a Japanese branch. Thus, foreign institutions that do not satisfy those requirements often consider purchasing bonds, rather than making loans. Investors must note that bonds issued by Japanese corporations must be unsecured, unless special procedures are taken in accordance with the Secured Bond Trust Law.

Interest payments to non-resident lenders are generally subject to withholding taxes.

3.4 Taxes or Fees Relating to the Granting and Enforcement of Security

Formal (ie, non-provisional) registration of a mortgage is subject to a registration and licence tax, at the rate of 0.4% of the secured amount. Because this tax can be substantial depending on the secured obligation, some lenders permit the borrower to make a provisional registration only, which costs JPY1,000 for each real property. Once the mortgage is formally registered based on the provisional registration, the mortgagee enjoys priority over other mortgagees who register their mortgages after the provisional registration. However, provisional registration is of little use unless formal registration is completed based on the provisional registration. Therefore, lenders need to ensure that they are always in possession of all documents necessary to allow them to formally register the mortgage.

Judicial foreclosure of a mortgage involves various costs. The applicant has to prepay up to JPY2million (in the case of the Tokyo District Court) to a competent court, which will be credited to the court's expenses.

3.5 Legal Requirements Before an Entity Can Give Valid Security

If there are minority shareholders in a company that is providing security to secure a debt owed by its parent company, the directors of the security provider usually obtain the consent of said minority shareholders to ensure that the directors are not deemed to be in breach of their fiduciary duty and duty of care.

3.6 Formalities When a Borrower is in Default

In the case of a borrower's default, a mortgagee would typically accelerate the entire outstanding debt pursuant to the credit agreement. After the secured obligation becomes due, the mortgagee may judicially enforce the mortgage by submitting the real estate registration certificate on which the mortgage is registered. The priority of the mortgage vis-à-vis other mortgages is determined based on the order of mortgage registration.

3.7 Subordinating Existing Debt to Newly Created Debt

Unless the existing lenders with perfected security interest agree, they do not become subordinated to any newly created non-preferred debt.

3.8 Lenders' Liability Under Environmental Laws

Because a financier such as a lender is not an “owner” for purposes of the Soil Contamination Countermeasures Law, a lender is not responsible for soil contamination investigations and countermeasures, unless it acquires the land from the borrower in default through the enforcement of a security.

According to a notice issued by the Ministry of Environment, even if the borrower assigns its land to a lender for the purpose of security (*joto-tampo*), the borrower but not the lender is deemed to be the “owner” of the land and will be responsible for any investigations and countermeasures under the Soil Contamination Countermeasures Law.

3.9 Effects of Borrower Becoming Insolvent

The creation of a security interest by a financially distressed borrower may be invalidated (by the insolvency trustee or the debtor-in-possession under the theory of bankruptcy avoidance) if the security interest was created to secure existing debt:

- after the filing of an insolvency petition with respect to the borrower (and the creditor knew that the petition had been filed);
- during the period when the borrower is “unable to pay” (ie, unable to pay its debts generally when they fall due) (and the creditor knew that the borrower was unable to pay, or that the borrower did not pay its debts generally when they fell due); or
- 30 days or less before the borrower became “unable to pay”, and the borrower voluntarily created such security interest in favour of a specific creditor (and the creditor knew that such creation of security would prejudice other creditors).

The perfection of a security interest may also be avoided even where the creation of security interest itself may not be avoided, pursuant to the criteria set out above. This is to prevent the holder of a security interest that has been hidden for a long time from obtaining priority over general creditors after the borrower gets into a financial crisis. The requirements of such avoidance include the perfection being made after the suspension of payments or the filing of an insolvency petition, and not being made within 15 days of the creation of the security interest.

3.10 Consequences of LIBOR Index Expiry

The Tokyo Interbank Offered Rate (TIBOR) is widely used as a benchmark to determine the base rate for floating inter-

est rates, so the expiration of the LIBOR index is not really expected to have a significant impact on real estate financing transactions in Japan.

4. Planning and Zoning

4.1 Legislative and Governmental Controls Applicable to Strategic Planning and Zoning

The City Planning Law is the main source of planning and zoning regulations. Local ordinances are also relevant.

4.2 Legislative and Governmental Controls Applicable to Design, Appearance and Method of Construction

The Construction Standards Law is the primary law regulating the construction of new buildings and the refurbishment of existing buildings. The law establishes minimum standards concerning building sites, structures, equipment and building use.

4.3 Regulatory Authorities

Under the Construction Standards Law, the confirmation of authorised entities regarding the details of construction or refurbishment must be obtained for the construction of new buildings or any major refurbishment of existing buildings. Authorised entities include local governments, such as cities, towns and villages, and private building agencies accredited by the government.

4.4 Obtaining Entitlements to Develop a New Project

A building developer or building owner must apply for confirmation from the relevant local governments or government-accredited private building agencies. The detailed requirements for such confirmation, including the steps to be taken vis-à-vis third parties, may differ under the relevant local ordinances.

4.5 Right of Appeal Against an Authority's Decision

Theoretically, it is not impossible to litigate against an authority's decision, although such litigation is not commonly seen in practice.

4.6 Agreements with Local or Governmental Authorities

Unless the development project involves a property or facility that is currently or was previously owned by a governmental body, it is not common to enter into agreements with governmental bodies to facilitate a development project.

4.7 Enforcement of Restrictions on Development and Designated Use

The contractor of a building under construction in violation of the Construction Standards Law or the City Planning Law,

or the owner of a building that has been constructed thus, may be ordered to suspend the construction or to demolish or refurbish the building, or otherwise to ensure compliance of the building with legal requirements.

5. Investment Vehicles

5.1 Types of Entities Available to Investors to Hold Real Estate Assets

Generally speaking, real property tends to be owned directly by joint-stock companies (*kabushiki kaisha* or “KK”), the most popular form of corporate entity available under the Companies Law.

When it comes to real estate investment, there are three typical investment structures – the GK-TK structure, the TMK structure and the J-REIT structure – each of which uses a different type of entity to acquire property.

Among these three structures, the GK-TK structure and the TMK structure are primarily used to acquire a specific asset or portfolio identified at the outset. The TMK structure is more often preferred by non-Japanese investors.

However, the J-REIT is used as a going-concern vehicle for real estate investment, the asset portfolio for which can be continually expanded or replaced with new assets.

The main features of each structure are discussed below.

GK-TK structure

A GK-TK structure usually involves three types of vehicles:

- the fund is formed as a limited liability company (*godo kaisha* or “GK”);
- the GK is to acquire and hold one or more TBIs in a real estate trust (“Property Trust”); and
- the GK obtains quasi-equity investment from a TK investor under a TK agreement, and takes out a loan from a third party financial institution.

A GK is one of the ordinary corporate forms available under the Companies Law, with all equity holders (members) of the GK bearing limited liability. As there is no specific minimum capital requirement, the paid-in capital of a GK is usually nominal (such as JPY100,000).

For tax and other regulatory or practical reasons, real property is often traded under trust arrangements in Japan, i.e., property is acquired in the form of a TBI rather than an outright purchase of the property. In that case, the real property is owned by the trustee of the Property Trust (usually, a licensed trust bank in Japan) for the benefit of the GK as beneficiary.

A TK is one of the forms of partnership available under the Commercial Code and is formed by an agreement between the GK as operator and a TK investor. As a legal matter, the funds contributed by the TK investor belong to the GK as operator, and all acts of the TK business are done in the name of the GK.

TMK structure

A TMK structure involves a specified purpose company (*tokutei mokuteki kaisha* or TMK), which is a corporate entity specifically designed to acquire a specific asset (such as real estate assets) by issuing asset-backed securities under the Asset Liquidation Law.

The best feature of a TMK is that, by fulfilling certain requirements, it will be eligible for special favourable tax treatment that is not available to a KK or a GK. The downside is the imposition of various regulatory requirements and special restrictions under the Asset Liquidation Law.

In most cases, a TMK finances the acquisition of real estate assets (which can be actual real properties or TBIs) by issuing preferred shares and obtaining third party debt.

The TMK’s equity consists of “specified shares” and “preferred shares”, with no minimum capital requirement. Specified shares are similar to ordinary voting shares of a KK. The amount of specified shares is nominal and is not supposed to be used for the acquisition of real estate assets, and the preferred shares comprise most of the TMK’s equity.

The third party debt is usually obtained in the form of “specified bonds” or “specified loans”.

J-REIT structure

A J-REIT is a type of investment fund in a corporate form under the Investment Trust and Investment Corporation Law, which is set up to acquire real estate assets (whether actual real properties or TBIs).

Similar to a TMK, a J-REIT can be eligible for special favourable tax treatment that is not available to a KK or a GK, but it is subject to various regulatory requirements and restrictions under the Investment Trust and Investment Corporation Law.

A J-REIT’s equity is issued in the form of investment units, and the minimum equity requirement is JPY100 million.

The investment units of a J-REIT can be listed and traded on a stock exchange. As of 13 February 2019, there were 62 publicly listed J-REITs in Japan.

5.2 Main Features of the Constitution of Each Type of Entity

Please see above.

5.3 Minimum Capital Requirement

Please see above.

5.4 Applicable Governance Requirements

Governance requirements vary, depending on the structure.

GK-TK structure

The governance of a GK is simpler and more flexible than a KK, and the characteristics of the operations and governance of a GK are intended to be more similar to those of a limited partnership. In most cases, a GK is incorporated with one corporate entity being the sole managing member representing the GK, and such managing member appoints an individual (operating manager or *shokumu shikkosha*) to act as its representative and perform the duties of a managing member.

In a GK-TK structure, the GK is structured as a special purpose company that has no human resources. Thus, it is intended that the GK retain an asset manager, who takes a lead role in the GK's activities. Such asset manager must be a registered investment adviser or manager under the Financial Instruments and Exchange Law.

TMK structure

A TMK must always have at least one director and one statutory auditor. In addition, one accounting auditor is usually required to be appointed, who must be either a certified public accountant or an auditing firm.

Certain fundamental matters with respect to a TMK require the approval of its shareholders (in the form of a resolution). In general, only specified shareholders have voting rights at shareholders' meetings.

The management and disposal of the real estate assets owned by the TMK must be subcontracted to a third party, which must be a trust company or certain other service provider experienced in asset management and permitted under the Asset Liquidation Law. In practice, there are two types of asset management, depending on whether the TMK acquires actual real properties or TBIs:

- actual real properties: the TMK needs to retain an asset manager who is licensed to engage in a real estate transaction business under the Real Estate Transaction Business Law; and
- TBIs: the trustee of a Property Trust is responsible for the management and disposal of the real estate assets, and the TMK needs to retain an asset manager who is a registered investment adviser or manager under the Financial Instruments and Exchange Law.

J-REIT structure

A J-REIT must have at least one corporate officer, supervisory officers outnumbering the directors (by at least one

person), a board of officers and an accounting auditor, which must be either a certified public accountant or an auditing firm.

The fundamental matters with respect to a J-REIT are quite limited, and require the approval of its unitholders (in the form of a resolution).

Pursuant to the Investment Trust and Investment Corporation Law, a J-REIT must retain (i) an asset manager who is a registered investment manager under the Financial Instruments and Exchange Law and a licensed real estate transaction business provider with a discretionary agency permit under the Real Estate Transaction Business Law, (ii) an asset custodian and (iii) an administrative agent.

5.5 Annual Entity Maintenance and Accounting Compliance

Maintenance cost varies significantly on a case-by-case basis. However, generally speaking:

- the cost to maintain a TMK structure is higher than for a GK-TK structure;
- the cost to maintain a J-REIT structure is significantly higher than for a GK-TK structure or a TMK structure; and
- the cost to maintain a publicly listed J-REIT is higher than for a private J-REIT.

6. Commercial Leases

6.1 Types of Arrangements Allowing the Use of Real Estate for a Limited Period of Time

Leases are the most common arrangements by which to use another person's land or building, but superficies (*chijo-ken*) is a common alternative.

The purpose of a lease is not limited, and leases are available for both land and buildings. In contrast, superficies is available only to own buildings or trees.

In general, holders of superficies are in a stronger position than leaseholders against the landowner, as they are holders of a "real right". For instance, the landowner owes the superficies holder a duty to co-operate in the registration of the superficies which is required for perfection, but the lessor does not owe such a duty to the tenant.

6.2 Types of Commercial Leases

There are two types of land or building leases based on the lease term, namely a general lease and a fixed-term lease.

A general lease is subject to renewal, which the lessor is entitled to refuse only when there is a justifiable reason, taking into account the lessor's and the tenant's respective needs to

use the property, the history of the lease, the present use of the property, and the amount of compensation being offered by the lessor to the tenant to vacate the property.

A fixed-term lease allows for three alternative arrangements for land leases (each a “Fixed-Term Land Lease”), as follows:

- those relating to land on which a building is built for business or residential purposes and that have a term of at least 50 years are not renewable, and must be executed in writing;
- those relating to land on which a building used only for business purposes (ie, not for residential purposes) is built and that have a term of at least 30 years but under 50 years are not renewable, and must be executed by way of notarial deeds; and
- those relating to land on which a building used only for business purposes (ie, not for residential purposes) is built and that have a term of at least ten years but under 30 years are not renewable, and must be executed by way of notarial deeds (a “Category 3 Fixed-Term Land Lease”).

A “Fixed-Term Building Lease” is also available, which is not renewable and will terminate upon the expiry of the lease term.

6.3 Regulation of Rents or Lease Terms

General lease

In a general lease for land or buildings, lease terms that are contrary to or reduce certain statutory protections or rights granted to the tenant under the Land Lease and Building Lease Law are void. These statutory protections and rights include the following:

- the lessor must have a justifiable reason to refuse a renewal of the lease;
- the tenant may demand that the rent be decreased in response to market conditions and cannot be deprived of the right to demand a decrease of the rent even if they explicitly agree not to exercise that right;
- in the case of a land lease only, the leasehold interest in the land is perfected without registration if the land tenant owns a registered building on the leased land;
- in the case of a land lease only, the land tenant has the right to request the landlord to purchase the building upon the termination of the land lease; and
- in the case of a building lease, the leasehold interest in the building is perfected without need of registration if the leased building is delivered to the tenant.

Save as discussed above, the rent and other terms of the general lease are freely negotiable and not regulated or subject to a voluntary code.

Fixed-term lease

The tenant may be deprived of the protections and rights under items (a) and (d) discussed above under a Fixed-Term Land Lease, and of the protections and rights under items (a) and (b) under a Fixed-Term Building Lease.

6.4 Typical Terms of a Lease

The initial term of a land lease for owning a building is required by law to be at least 30 years, and tends to range from 30 years to 50 years, except where the land lease is a Category 3 Fixed-Term Land Lease.

Building leases are typically for a much shorter term. Office space leases are often for a short term, most commonly two to five years while building leases for retail or commercial facilities tend to be longer and could be for ten to 20 years.

The maintenance and repair of the premises actually occupied by the tenant are typically the responsibility of the tenant. However, if certain renovation works are required by the tenant before it can start using the premises, the allocation of the responsibility and the cost for such works are negotiated before entering into the lease agreement.

Monthly payment is the most typical payment term.

6.5 Rent Variation

Lease agreements usually schedule a regular rent review, which is conducted every three to five years in many cases. During a rent review, the parties will negotiate an increase or decrease in the rent for the next three to five years.

Aside from a contractual rent review, the Land Lease and Building Lease Law entitles either party to a lease to demand that the rent be increased or decreased in response to market conditions. If the parties cannot come to an agreement, a court may order an adjustment after considering the following:

- any change in tax or other liabilities imposed on the leased real estate (or the underlying land in the case of a building lease);
- the value of the leased real estate (or the underlying land in the case of a building lease), and other relevant economic conditions; and
- rents in neighbouring areas.

If the court determines that the rent should be decreased, the lessor will be ordered to return any excess rent and pay interest at the rate of 10% per annum on the excess amount.

If the lessor and tenant specifically agree not to increase the rent for a certain period, the lessor cannot exercise its right to demand an increase in the rent but, with respect to a land lease and a general building lease, the tenant cannot be deprived of the right to demand a decrease in the rent,

even if it has explicitly agreed not to exercise that right under the lease.

However, a different rule applies to a Fixed-Term Building Lease, under which the lessor and the tenant may exclude the application of the rule on rent adjustment described above by setting forth express provisions on rent revisions.

6.6 Determination of New Rent

6.7 Payment of VAT

Consumption tax (which is equivalent to VAT) is payable on the rent on building leases other than for residential purposes. The rent on land leases is exempted from consumption tax.

6.8 Costs Payable by Tenant at Start of Lease

Typical costs payable by a tenant at the start of a lease include a deposit (often calculated by a multiple of the monthly rent, depending on the type of the lease and the real estate), brokerage fees, insurance premiums and other expenses, such as for replacement of the keys.

6.9 Payment of Maintenance and Repair

The maintenance and repair costs of common areas are paid by the building owner, primarily from the money paid by tenants as common area fees.

6.10 Payment of Utilities and Telecommunications

Utilities and telecommunications serving a property occupied by several tenants are paid for by the building owner, primarily from the money paid by tenants as common area fees.

6.11 Insuring the Real Estate that is Subject to the Lease

Typically, a tenant pays for insurance covering damage caused by accidents occurring in the real estate and by fire and, in some cases, earthquake and flood.

6.12 Restrictions on Use of Real Estate

There may be contractual restrictions on how a tenant uses the real estate, restrictions on the use of common areas, and prohibitions on the handling of hazardous materials or explosives.

6.13 Tenant's Ability to Alter and Improve Real Estate

The extent to and the conditions under which the tenant is permitted to alter or improve the real estate are entirely up to the agreement between the lessor and the tenant.

6.14 Specific Regulations

There are no specific regulations or laws that apply to leases of particular categories of real estate.

6.15 Effect of Tenant's Insolvency

In the case of a bankruptcy procedure (*hasan tetsuzuki*) or a corporate reorganisation procedure (*kaisha kousei tetsuzuki*), a bankruptcy trustee - or a debtor in possession in the case of a civil rehabilitation procedure (*minji saisei tetsuzuki*) - has a statutory right to determine whether to terminate the lease agreement or to continue the lease by performing its obligations.

- If the bankruptcy trustee of the tenant or the tenant as debtor in possession opts for the termination of the lease, the treatment of the unpaid rents depends on when the due date arose: unpaid rents accruing before the commencement of the relevant insolvency procedure are treated, in principle, as general insolvency claims and are therefore subject to the insolvency procedure and subordinated to preferential claims, while rents that become due after the commencement of the insolvency procedure are paid from the insolvency estate in preference to other general insolvency claims and are not subject to the insolvency procedure.
- If continuation of the lease is chosen instead, unpaid rents accruing before the commencement of the relevant insolvency procedure would be treated as general insolvency claims, although there is a different academic view that treats such unpaid rents as preferential claims. Furthermore, if the lease is continued, the rents that are due on or after the commencement of the relevant insolvency procedure are paid from the insolvency estate in preference to other general insolvency claims.

In practice, lease agreements often provide for the lessor's right to terminate the lease upon the commencement of an insolvency procedure on the part of the tenant. However, there are a few legal precedents that reject such a contractual provision, so the validity of such a provision remains arguable and, in practice, it is widely understood that the lessor should not rely on such a provision.

Further, if the tenant is subleasing the leased property to a person who holds a leasehold interest that is perfected, then the above-mentioned statutory right of the bankruptcy trustee (and the debtor in possession) does not apply vis-à-vis the subtenant. If the insolvent tenant chooses to terminate its lease vis-à-vis the landlord, it inevitably causes a breach of its obligation to lease vis-à-vis the subtenant. Therefore, in practice, the insolvent tenant may not be able to opt for the termination of the lease if it is subleasing the leased property.

6.16 Forms of Security to Protect Against Failure of Tenant to Meet Obligations

Typically, a tenant is required to pay a deposit at the start of the lease as security for any failure to pay in the future. A typical lease agreement contains a provision that allows the landlord to utilise the deposit to cover any outstanding obligation of the tenant.

6.17 Right to Occupy After Termination or Expiration of a Lease

A tenant is obliged to vacate and return the leased property on or before the expiration or termination of the lease term if the lease is not renewed. Lease agreements typically provide for the payment of liquidated damages in the form of monthly rents equal to twice the last agreed monthly rent, for the period from the day after the expiry or termination of the lease term up to the day the tenant actually vacates the leased real estate.

Generally, the lessor does not have to do anything to ensure that the tenant timely vacates the property, as long as the lease duly expires or terminates. However, there is a special requirement in a Fixed-Term Building Lease that the lessor must provide written notice of the expiry of the lease term from one year to six months prior to the expiry date in order to oblige the tenant to vacate the leased property by the end of the lease term.

6.18 Right to Terminate Lease

Typically, lease agreements provide that the following events give the landlord a right to terminate the lease:

- breach of obligation by the tenant, such as the failure to pay rent;
- commencement of an insolvency procedure by the tenant;
- occurrence of events that constitute grounds for the commencement of an insolvency procedure, such as being “unable to pay” (ie, unable to pay debts generally when they fall due); and
- issuance of an order for compulsory execution, petition for auction sale or compulsory disposition for delinquent public charges.

Having said this, the court takes the view that the lessor is entitled to terminate the lease only if the tenant’s breach amounts to a destruction of the relationship of trust between the lessor and the tenant, regardless of any provision in the lease agreement. Therefore, in practice, it is widely accepted that the lessor will not be able to terminate the lease simply by relying on the termination provision of the lease agreement.

A statutory right to terminate in the case of the tenant’s insolvency is discussed in Section 6.15 **Effect of Tenant’s Insolvency**, above.

6.19 Forced Eviction

In order to force a tenant to leave, the lessor must first obtain a court judgment ordering the tenant to vacate the leased property on the basis of the termination of the lease. If the tenant does not comply with the judgment, the lessor will need to file a petition for compulsory enforcement against the tenant to compel it to surrender the leased property.

The length of time necessary to obtain such a judgment and to complete a compulsory enforcement largely depends on the tenant’s response in court hearings and the tenant’s reaction to the requirement to surrender, and varies from a few months to one year.

6.20 Termination by Third Party

Leases cannot be terminated by any third party, including central government or municipal authorities.

7. Construction

7.1 Common Structures Used to Price Construction Projects

The most typical construction price structure is the fixed price arrangement, whereby the parties agree on the price at the signing of the construction contract, taking into account estimated costs and expenses as well as the contractor’s profit. For a large construction project, the price adjustment mechanism may be implemented to reflect fluctuating procurement prices of materials or services linked to the cost element of the construction price.

7.2 Assigning Responsibility for the Design and Construction of a Project

Typically, design and construction works are provided under separate independent agreements, ie, the owner tends to enter into a design contract with a design company and a construction contract with a construction company. Each contract’s terms and conditions are usually prepared and negotiated based on general terms and conditions made available as templates by the pertinent industry associations in Japan.

7.3 Management of Construction Risk

The general terms and conditions of a typical construction contract that are made available jointly by the pertinent industry associations (the “Form Terms and Conditions for Construction Contracts”) provide for the construction contractor’s obligation to take out insurance, and for defect liability.

With respect to insurance, the Form Terms and Conditions for Construction Contracts require the contractor to purchase and maintain fire insurance or contractor’s all risk insurance for the completed portion of the work, materials and building equipment and other materials delivered to the construction site. The details of the insurance coverage are left for the parties to agree.

With respect to defect liability, the Form Terms and Conditions for Construction Contracts provide that the owner may demand that the contractor repair the defect, and/or pay damages. In principle, the contractor’s liability is subject to a time limitation of one to two years, depending on

the construction materials (such as wood, stone, metal or concrete). However, in the case of a newly constructed residential building, the defect liability period for certain major structural works is mandatorily set at ten years after the delivery of the building, pursuant to the Housing Quality Assurance Law, a special law to ensure the quality of residential buildings.

7.4 Management of Schedule-related Risk

Schedule-related risks can be managed by the payment of liquidated damages by the contractor. Such contractual arrangements are allowed under Japanese law, and the courts are bound by the amount of liquidated damages agreed, without having to ascertain the actual damages incurred.

In particular, the Form Terms and Conditions for Construction Contracts provide that if the contractor fails to deliver the completed work by the due date for any reason attributable to the contractor, the owner may claim liquidated damages calculated at 10% per annum of the agreed construction price (less a portion of the construction price equivalent to the part of the work already completed and delivered), calculated on the basis of the number of days delayed.

On the other hand, the Form Terms and Conditions for Construction Contracts allow the contractor to seek an extension of the due date if there is any justifiable reason, such as a force majeure event or a need for adjustment of the works. If the delay is caused by any reason not attributable to the contractor and the owner agrees to extend the due date, the owner is not entitled to liquidated damages.

7.5 Additional Forms of Security to Guarantee a Contractor's Performance

For domestic construction projects, additional forms of security such as performance bonds or parent guarantees are not common. Normally, it is difficult to get major construction companies to provide additional security.

7.6 Liens or Encumbrances in the Event of Non-payment

The law grants contractors the right to retain (*ryuchi ken*) or refuse to deliver the completed building in the event of non-payment, as long as the contractor has possession of the building. This right to retain does not require any registration.

Construction contracts typically provide for the payment of the last instalment of the construction price in exchange for the delivery of the completed building.

7.7 Requirements Before Use or Inhabitation

The Construction Standards Law requires the owner to obtain an inspection certificate (*kensa zumi shou*) before it is allowed to use a newly constructed building. The process is as follows:

- The owner must apply for inspection by the relevant local government or government-accredited private building agency within four days of the completion of the construction.
- The inspection will be carried out within seven days of the application being accepted.
- If it is confirmed that the construction and the site comply with relevant laws and regulations, the inspection certificate will be issued.

8. Tax

8.1 VAT

The sale of a building is subject to consumption tax (equivalent of VAT) at the rate of 8% of the purchase price of the building (10% from October 1, 2019). The sale of land is not subject to consumption tax.

Although the seller is liable for the consumption tax under tax law, in practice the buyer is contractually obliged to pay an amount equivalent to the consumption tax on top of the purchase price of the building.

In general, sellers whose taxable sales did not exceed JPY10 million in the penultimate taxable year are exempt from consumption tax.

8.2 Mitigation of Tax Liability

The most common method to mitigate tax liability is to use a trust structure where the investor purchases the TBI in a Property Trust rather than the outright ownership of the real property itself. Please also see Sections 2.1 **Categories of Property Rights** and 5.1 **Types of Entities Available to Investors to Hold Real Estate Assets**, above.

In doing so, generally:

- the registration and licence tax for the establishment of a Property Trust is reduced from 1.5% (for land) or 2.0% (for buildings) of the Taxable Base of the property (which is applicable in an outright purchase of real property) to 0.3% (for land) or 0.4% (for buildings) of the Taxable Base of the property. In addition, JPY 1,000 is paid for each TBI transfer; and
- the real estate acquisition tax is reduced from 1.5% (for building land), 3.0% (for non-building land and residential buildings) or 4.0% (for non-residential buildings) of the Taxable Base of the property (which is applicable in an outright transfer of real estate) to zero.

Alternatively, by using a TMK as an acquisition vehicle:

- the registration and licence tax is reduced to 1.3% of the Taxable Base of the property; and

- the real estate acquisition tax is effectively reduced to 0.6% (for building land), 1.2% (for non-building land and residential buildings) or 1.6% (for non-residential buildings) of the Taxable Base of the property because, in computing real estate acquisition tax, the TMK is allowed to reduce the Taxable Base of the property to 40% of the regular taxable base.

8.3 Municipal Taxes

In Japan, there are no universal municipal taxes paid on the occupation of business premises, save in certain major cities where taxes (of a relatively low amount) are imposed on the basis of the size of the taxpayer's premises or the amount of salaries paid.

The main municipal taxes paid on real estate per se are fixed asset tax (*kotei shisan zei*) and a city planning tax (*toshi keikaku zei*), which are imposed on every owner of real estate, irrespective of its purpose. However, there are limited exemptions for the above municipal taxes in certain designated areas where the municipal government is promoting certain industry sectors.

8.4 Income Tax Withholding for Foreign Investors

Income tax withholding for foreign investors

There is income tax withholding for non-resident individuals and foreign corporations.

Taxation on rental income

Rental income from real estate is subject to corporation tax if the lessor is a foreign corporation or to income tax if the lessor is a non-resident individual. In 2019, the applicable corporation tax rate is 15% (for small income of a small enterprise) or 23.2% (in other cases), plus a local corporation tax of 4.4% of the amount of the corporation tax (10.3% for the taxable year commencing on or after October 1, 2019), while the applicable progressive income tax rates range from 5% to 45%, plus a special income tax for reconstruction of 2.1% of the amount of the income tax.

If the lessor is a non-resident individual or foreign corporation, the tenant is required to withhold 20.42% of the rent, payable to the tax authority no later than the tenth day of the month following the date of the payment of the rent. Withholding is not required if the tenant is a natural person using the property as a residence for himself or his relatives. Any amount withheld by the tenant from the rent can be used as a deduction for corporation or income tax.

There is no exemption for taxation on rental income from real property in Japan.

Taxation on gains from the disposition of real property

Capital gains from the disposition of real property in Japan are subject to corporation or income tax in the same manner as rental income, which is described above.

If the owner of the real property to be sold is a non-resident individual or foreign corporation, the buyer is required to withhold 10.21% of the purchase price, payable to the tax authority no later than the tenth day of the month following the date of payment of the purchase price. Withholding is not required if the purchase price does not exceed JPY100 million and the buyer will use the property as a residence for himself or his relatives. Any amount withheld by the buyer from the purchase price can be used as a deduction for corporation or income tax.

There is no exemption for taxation on capital gains from the disposition of real property in Japan.

8.5 Tax Benefits

A depreciation deduction is available for a person who owns a building. The depreciation expense is allocated to each taxation year equally or by a declining rate for the life of the building as prescribed by law, depending on the structure and purpose of the building. Land is not a depreciable asset.

Mori Hamada & Matsumoto

Marunouchi Park Building,
2-6-1 Marunouchi,
Chiyoda-ku,
Tokyo 100-8222,
Japan

MORI HAMADA & MATSUMOTO

Tel: +81 3 6212 8330
Fax: +81 3 6212 8230
Email: mhm_info@mhmjapan.com
Web: www.mhmjapan.com