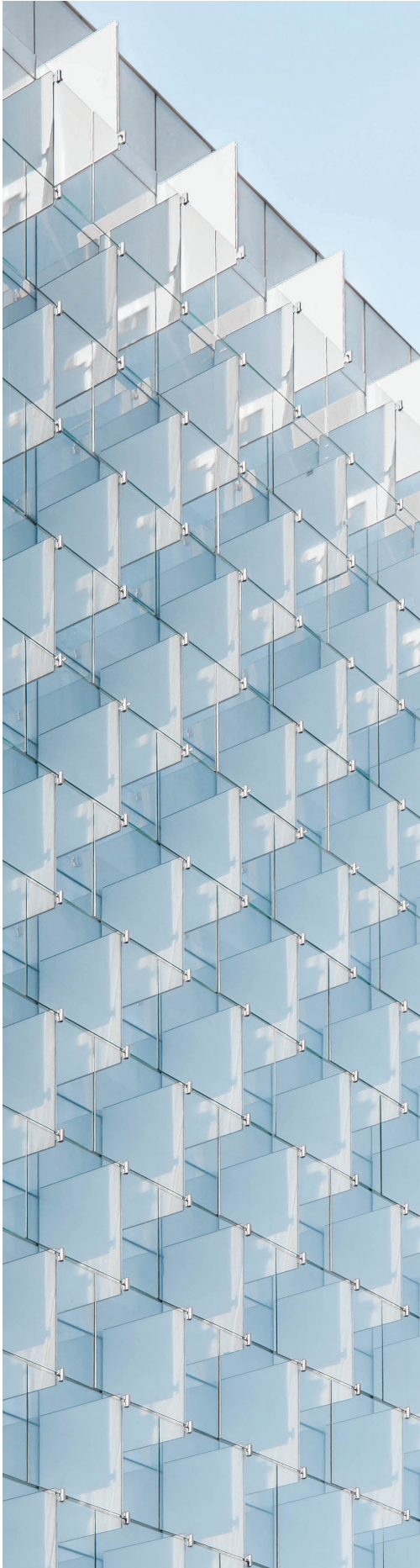




Real Estate Investment in Japan

THE LEGAL PERSPECTIVE



Introduction

The real estate market in Japan has been experiencing tremendous growth in recent years, evidenced by an influx of both domestic and foreign investments. There is likely further room for expansion of a market that is already one of the largest in the world, presenting many lucrative opportunities for interested investors.

The real estate market in Japan is known for its high level of transparency and legal predictability, generally enabling equal treatment of both domestic and foreign investors.

The Japanese government has recently introduced wide-ranging deregulation initiatives and implemented tax reforms designed to facilitate the domestic and foreign investment necessary for sustainable economic growth.

In 2016, the Japanese government announced a negative interest rate policy which targets a 0% long-term interest rate while limiting any associated financial burdens. As a result of this ultra-low interest rate and the yen's depreciation against the US dollar in the latter half of 2016, foreign investors flocked to the Japanese real estate market.

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1. Ownership of real estate

1.1. Forms of real estate ownership

Ownership of real property and trust beneficial interest (**TBI**) representing real property can be acquired. Ownership includes, without limitation, ownership of strata title (not a whole building but condominiumized part of a whole building). In addition to exclusive ownership, joint ownership is possible. The joint ownership extends to the entire real estate and not only to part of the real estate, and accordingly each owner of the joint ownership may use the

entire real estate based on its joint ownership. There is no ownership of real property for a certain period of each year. Therefore, timeshares are often structured using not ownership but “use right” of real property.

1.2. Restrictions on ownership by foreigners

There are no discrepancies between the legal restrictions applicable to foreign investors and those applicable to domestic investors other than the following reporting obligation.

Under the Foreign Exchange and Foreign Trade Control Law, foreign investors who purchase real estate from Japanese sellers for profit must report the purchase to the Minister of Finance within 20 days of the purchase.



2. Acquisition of ownership

2.1. Formal requirement

There are no formal legal requirements regarding the content and structure of a sale and purchase agreement (**SPA**) relating to real estate. The parties are therefore free to determine the content and structure of the SPA. The real estate broker must explain to the parties all detailed matters relevant to the property in writing before execution of the SPA.

2.2. Registration

Title to real estate is evidenced in the real estate registry maintained by the Legal Affairs Bureau. Since the purchaser cannot assert the title to third parties without registry of the transfer, the transfer of real estate is almost invariably registered at the time of the closing of the SPA.

2.3. Asset deals

General steps in the Japanese commercial real estate transaction processes are as follows:

STEP 1: INFORMATION COLLECTION

Real estate is sought by investors/purchasers. The most popular method of doing so is through consultation with a real estate broker.

STEP 2: BASIC INVESTIGATION AND SUBMISSION OF LOI AND CA

The purchasers then conduct a basic investigation of the target real estate. If purchasers are seriously interested in buying the property after a basic investigation such as an initial property tour or evaluation of a simple rent-based cash flow, the interested purchaser would then submit a letter of intent (**LOI**) proposing

a tentative purchase price along with a confidentiality agreement (**CA**) to the sellers in order to begin the due diligence process. The LOI is not considered a legally binding document but does generally represent a commitment to purchase the property subject to execution of an SPA.

STEP 3: DUE DILIGENCE

Due diligence is undertaken in order to estimate the physical and legal risk of the subject property.

STEP 4: DOCUMENTATION

Documents are then executed. The purchaser usually enters into a real estate SPA with the seller and receives a property disclosure statement regarding important issues from the real estate broker.

STEP 5: CLOSING

The sale and purchase then closes. The closing is completed once the seller has received payment from the purchaser and the purchaser has received from the seller the documents required for registration of the transfer of the ownership.

2.4. Corporate vehicles for acquisition

Other than direct investment by a foreign investor,

- TMK (*tokutei-mokuteki-kaisha*);
- TK-GK (*tokumei-kumiai – godo-kaisha*);
- a real estate specified joint enterprise; and
- real estate investment trusts (**J-REIT**)

are popularly used as a structure for foreign investors' real estate investments in Japan.

TMK

A TMK is a statutory vehicle under the Act on Securitization of Assets. A TMK needs to file with the relevant local finance bureau a business commencement report, including without limitation, an asset liquidation plan (**ALP**). An amendment to an ALP requires strict procedures, e.g. obtaining consent from all the interested parties, and for such amendment (other than a minor amendment) filing with the local finance bureau is again required. A TMK acquires real property itself or TBI representing real property raising funds as specified equity, preferred equity, specified bond, specified loan, and the like, manages them and repays debts and distributes to equity holders from cash flows derived from the real property or TBI.

GK-TK

Godo kaisha (**GK**) is a company under the Companies Act in which members (equity holders) and managements are not separated, unlike a joint stock corporation (*kabushiki kaisha*). A GK is a vehicle to acquire TBI representing real property with silent partnership (*tokumei-kumiai*, **TK**) investment from TK investor(s) and loan(s) from lenders. If a GK acquires real property itself instead of TBI representing real property, a license or notification with the authority under the Real Estate Specified Joint Enterprise Act is required, which will be discussed in "Real Estate Specified Joint Enterprise using GK-TK" below.

Real Estate Specified Joint Enterprise using GK-TK

Under a GK-TK structure, if a GK acquires real property itself (not TBI representing real property) in order to distribute profits from the real property to TK investor(s), a GK generally needs to obtain a real estate specified joint enterprise operator license, requirements for which are strict and difficult to be met by a special purpose company. As an exemption, if a GK entrusts certain business activities relating to real estate transactions and solicitation of TK investment to licensed real estate specified joint enterprise operators (and in the case where the GK performs the land development or certain types of construction work exceeding a certain amount, TK investor(s) need to be the Special Investors (as defined in the Real Estate

Specified Joint Enterprise Act) who are deemed to have knowledge about investment), the license is not required subject to a filing of a Special Enterprise (*tokurei-jigyo*) with the authority. In addition, in the 2017 amendments, two more exemptions where the license is not required (a filing is required) were added which are:

- Small Real Estate Specified Joint Enterprise (*shokibo-fudosantokutei-kyodo-jigyo*) – where (i) the investment amount of each investor does not exceed JPY1 million and (ii) the total amount invested by all the investors does not exceed JPY100 million; and
- Enterprise for Qualified Special Investors (*tekikaku-tokureitoshikagentei-jigyo*) – where all the investors involved are those

specified in the ministerial ordinance as persons who “especially” have professional knowledge and experience in relation to real estate investment. The Qualified Special Investors (as defined in the Real Estate Specified Joint Enterprise Act) are different from the Special Investors.

J-REIT

J-REIT is a statutory vehicle in the form of an investment trust or investment corporation under the Act on Investment Trusts and Investment Corporations, the latter of which is usually used in Japan. Investment equity of an investment corporation may be listed. An investment corporation acquires real property itself or TBI representing real property.



3. Other rights to property

Other than ownership, the following rights are available for use of real estate.

Superficies (*chijoken*)

Superficies is a right for use of a land and can be established based on an agreement with the owner of the land. Different from leases, superficies can be transferred to a third party without the owner's consent unless otherwise provided in the agreement with the owner. In practice, the term of superficies is usually agreed longer than

that of leases. In this regards, superficies are preferred in the situation where long-term use of a land is necessary. However, as described in section 7, "Leases" below, as for the use of a land that aims to own a building on the land, long-term use can be secured by the special law.

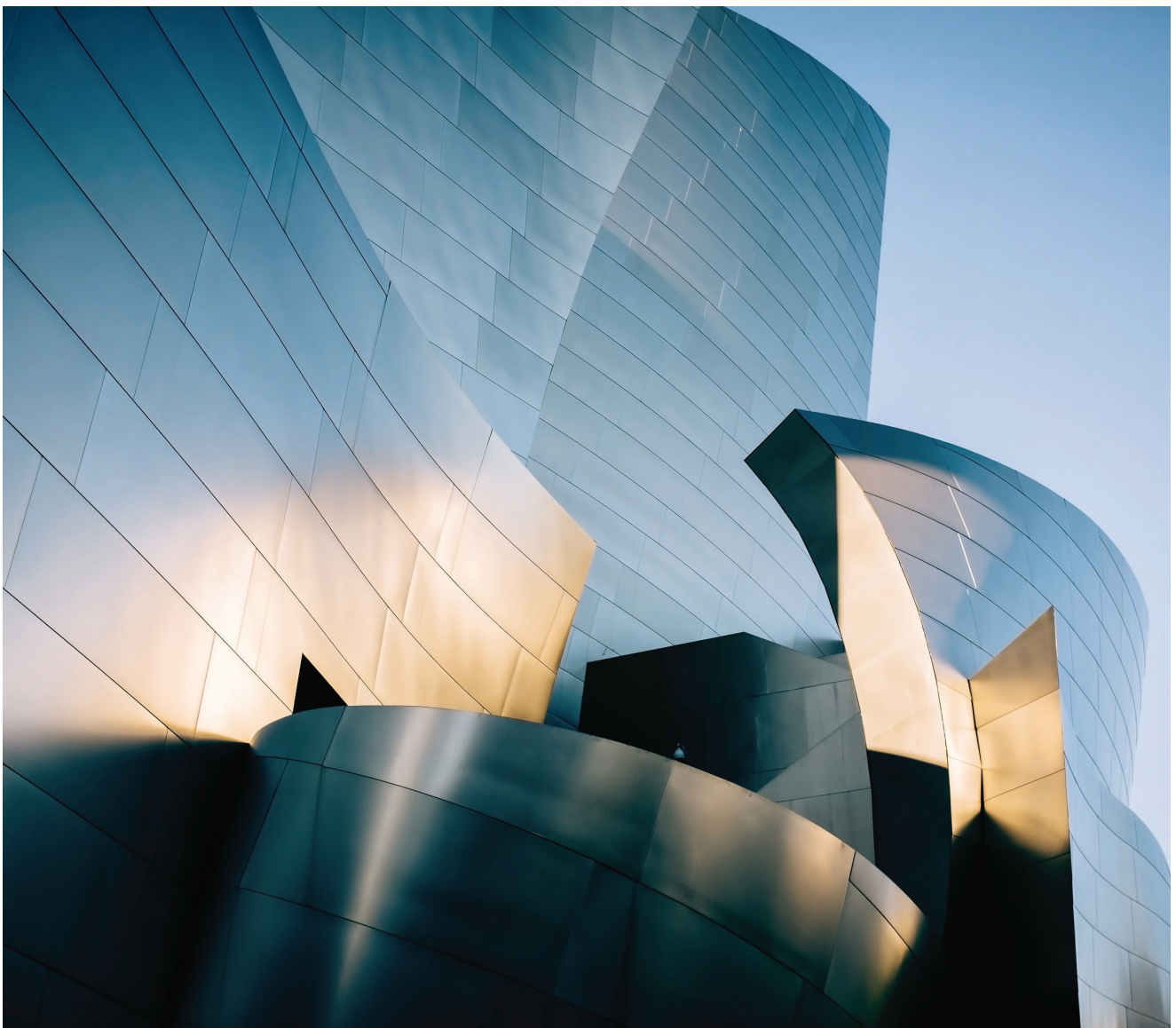
Leases

A lease is a contractual right for use of both of a land and a building. Please see section 7, "Leases" below for details.

Servitude (*chiekiken*)

Servitude is a right to use a land for the benefit of another land. A typical situation of use of servitude is that servitude is put on a land in order to get a way from another land which does not face a public road.

With regard to a mortgage right, please see section 9, "Real Estate Finance".



4. Construction

4.1. Legal framework

The main laws governing and regulating contracts for design and construction works are as follows:

- Civil Code – This law stipulates general rules applying to any contracts, including design and construction contracts, and related arrangements between the parties;
- Building Standard Act (BSA) – This act stipulates land usage requirements and building standards; and
- Construction Business Act (CBA) – This act stipulates requirements for construction business operators.

There are four major requirements that building or engineering contractors must comply with prior to any construction work:

- License for construction business – Companies engaging in construction business are required to obtain license from the Ministry of Land, Infrastructure, Transport and Tourism (the MLIT) or the relevant prefectural government (if an office for construction business is located in such prefecture only) under the CBA;
- License for design works – Design works of buildings are required to be done by a licensed architect under the Act on Architects and Building Engineers. There are several types of licenses specified in the act, varying upon building size and purposes of the building;
- Construction permit (*kenchiku-kakunin*) – An owner of a building needs to submit to the local government an application for construction permit under the

BSA. The owner is required to obtain construction permit prior to the commencement of any building works; and

- Development permit (*kaihatsu-kyoka*) – Aside from the construction permit, an owner is also required to obtain a development permit from the prefectural government under the City Planning Act (the CPA) if alteration of the zoning, shape or quality of land mainly for the construction of buildings is to take place within certain districts as specified in the CPA.

4.2. Forms of contract/procurement methods

There are standard contract forms for private works prepared by a Japanese joint association of contractors, and the like (the Contractors Association). Although use of such forms is not mandatory, in most cases, these forms are, sometimes with several amendments, used by the parties when entering into a construction or engineering contract in Japan. For public works, there are also commonly used standard contract forms which are prepared by the MLIT. It is not common to use any international contract form for constructions in Japan.

The main parties involved in a construction contract are a building owner and a construction company. Designers and other professionals are sometimes retained directly by an owner and sometimes by a main construction company. In most large-scale constructions, sub-contractors and/or a construction joint venture is used. In the case of sub-contract, a master-contractor is usually responsible for all of the sub-contractors' work.

Risks borne by a contractor in a construction contract are usually in relation to failure to build, defective work or delay.

In general, a contractor that is unable to perform its obligations because of a force majeure event is not liable for consequences of such event so long as the contractor exercises due care of a good manager.

4.3. Implementing contract

PAYMENT

Parties can freely decide on methods and terms of payments in a construction or design contract. In small and short-term projects, payments are commonly made at the completion of the construction work. In large and long-term projects, payments are commonly made at the completion of agreed stages of construction. In public works, a certain percentage of the contract price is often paid to a contractor before starting the construction.

DELAY

It is common to specify a completion date (subject to force majeure events) in construction contracts. Construction contracts normally set out a provision for dealing with delays, including liquidated damages as compensation and/or termination right.

VARIATIONS

The standard construction contract form includes a provision to deal with variations to the works and specifies which party may request variations:

- Variation ordered by owner – Under the standard construction contract form, the owner has the right to request variations to the works, and the contractor is entitled to additional time and money accordingly; and
- Variation driven by contractor – Under the standard construction contract form, the contractor does not have the right to request variations to the works.

COMPLETION

The BSA requires owners to submit an application for completion inspection of the completed works to a designated inspection agency that will certify that the completed building and its premises abide by the relevant building regulations. These regulations cannot be overridden by agreement between the parties.

4.4. Liability

LIMITATION PERIOD

The general limitation period for a party to bring a claim in the courts for breach of a contract is five years from the breach. The limitation period for defect liability under the Civil Code is (i) for stone, metal, concrete or similar buildings, ten years from the delivery and (ii) for wooden buildings, five years from the delivery, which is shortened in the standard construction contract form to (i) two years and (ii) one year, respectively, unless such defects have been caused by the contractor's wilful misconduct or gross negligence; provided that for residential buildings, ten years from the delivery under the Housing Quality Assurance Act.

DEVELOPER'S LIABILITY TO END USER

The contractor is liable to the owner (end-user) which is party to the construction contract for any

physical damage or economic loss suffered by the owner in accordance with the general defect liability rules. In addition, the owner may request the contractor to repair defect(s) of the building. Even though there is no contractual relationship between the contractor and the owner, tort liability of the contractor could be sought by the owner in some cases. Or, in some cases, subrogation by the owner could be an option.

In the case where the owner is an individual executing a contract not for business, the contractor's liability for damages cannot be excluded totally by any agreement between the parties. In the case of structural defect(s) of a new residential building, defect liability of the contractor (and the seller) cannot be excluded by any agreement between the parties. Under the Product Liability Act, the manufacturer of a product is liable for damages caused by a defect even if there is no negligence on the part of the manufacturer. This act does not apply to real properties, but applies to building equipment, and the like.

OTHER LIABILITY TO END USER

For sub-contractors, there is usually no contractual relationship with the owner (end-user). For an architect, designer or consultant, it depends on each case. Even though there is no contractual relationship between the contractor and the owner, tort liability of the contractor could be sought by the owner in some cases. Or, in some cases, subrogation by the owner could be an option.

RIGHTS OF PURCHASERS, TENANTS AND BANKS

Due to lack of contractual relationship with the contractor, third parties may not seek the contractor's contractual liability.

Tort liability of the contractor could be sought by a third party in some cases. Or, in some cases, subrogation by a third party could be an option.

4.5. Dispute resolution

DISPUTE RESOLUTION IN COURT

There are no specific courts dealing with construction disputes. Construction disputes are dealt with by normal civil courts, therefore, decisions of the courts can be appealed.

ARBITRATION

The Construction Works Dispute Settlement Board (the **CWDSB**) was established under the BSA, which provides for settlement of construction disputes through mediation (*assen*), conciliation (*chotei*) or arbitration (*chusai*). In domestic deals, the CWDSB is often used, and in CWDSB about 30% is settled through arbitration. There is an arbitration agreement form to submit disputes to the CWDSB prepared by the Contractors Association.

Arbitration is more flexible in procedures than litigation through the courts and less time is required to obtain a resolution. In addition, arbitrators are usually experts in construction matters.

The CWDSB's arbitration is not very expensive because reward of arbitrators is not paid by the parties in the dispute.

ALTERNATIVE DISPUTE RESOLUTION PROCEDURE (ADR)

As mentioned above, in addition to arbitration, mediation and conciliation are also available in the CWDSB. Though the CWDSB was established under the BSA, use of ADR or the CWDSB is not mandatory.

5. Zoning and planning laws

5.1. Applicable legislation and governance

Strategic planning/zoning in Japan is governed by a combination of national and local regulations. The national regulations mainly consist of (i) the BSA and (ii) the CPA.

The CPA divides lands in Japan into two types: City Planning Areas, which are regulated by the CPA; and Non-City Planning Areas, which are not regulated by the CPA.

The City Planning Areas further consist of Urbanization Promotion Areas where development is promoted and Urbanization Restricted Areas where development is restricted.

The CPA designates 13 zoning districts within Urbanization Promotion Areas, and such zoning districts are largely categorized as three types: residential districts, commercial districts and industrial districts. The BSA governs types of buildings which can be built in each zoning districts designated by the CPA, such as use purposes, building coverage ratio and floor area ratio of a building.

CONTROLS ON SPECIFIC NEW CONSTRUCTION AND REFURBISHMENT

The BSA and the CPA control the new construction and refurbishment. Except for a few types of construction specified in the BSA, a construction permit from the relevant local government or the designated inspection agency is required before any construction of a new building or any refurbishment of an existing building.

Apart from the construction permit under the BSA, the contractor must obtain permission from the relevant local government under the CPA for certain large-scale construction works within the Urbanization Promotion Area.

CONTROLS ON DETAILED DESIGN

Both the CPA and the Landscape Act regulate the design and appearance of the landscape of designated scenic zones, whereas methods of construction generally are not regulated.

DESIGNATED USE

The CPA governs the use purposes of new buildings as well as existing buildings and permitted use purposes of a building depends on the district where the building is built or located.

As mentioned above, there are largely three types of districts: residential districts, commercial districts and industrial districts. For example, hospitals, schools and nursery homes are prohibited in some industrial districts and large-scale supermarkets can only be built in certain commercial districts.

RESPONSIBLE AUTHORITIES

In general, local governments are responsible for regulating the development and use purposes of land parcels. Local governments have authority under the BSA and the CPA to grant construction permit to contractors.

OTHER RELEVANT STATUTORY PERMITS

This depends on the nature of the development and should be determined on a case-by-

case basis. Legal requirements may include various kinds of environmental permits. For example, if development involves use of agricultural land, permission from the agricultural committee under the Agricultural Land Act will be required.

5.2. Obtaining permission for development

PERMISSION FOR NEW CONSTRUCTION OR DESIGNATED USE

The contractor must file an application for a construction permit granted by the relevant local government. The applicant must file an application form together with supporting documents such as blue prints and layouts of the building. The authorities will then consider if the applicant's construction plan is compliant with the building regulations.

THIRD-PARTY OBJECTIONS

Third parties are, if they have legal interest, entitled to object to a construction permit or any decision relating to it by the relevant local government and can appeal to the court to dismiss any construction permit or decision. However, such legal interest is interpreted very strictly.

REVIEW BY OTHER BODIES

A decision (i.e. permission or rejection) by the local government can be reviewed (i) by a court or (ii) by a construction examination committee which is an internal body established by a local government when the applicant appeals against the decision.

TIMING

This depends on the type of the building the contractor intends to construct or the particular authority making the decision. However, in general, it takes approximately one to two months from the receipt of an application for the construction permit.

RIGHTS OF APPEAL

There is a right of appeal against the relevant local government's decision in respect of a construction permit. For example, under the BSA, if an applicant has an objection to a rejection of the application, the applicant can appeal to the construction examination committee. If a decision by the committee is still not acceptable to the applicant, it is possible to appeal to the MLIT.

Regardless of whether recourse based on this process has been exhausted, the applicant can bring an action to the court.

STATUTORY AGREEMENTS

The relevant local government sometimes requires a developer to enter into an agreement. For example, some local governments in Tokyo require, for certain constructions, a contractor to execute several agreements with the local government before starting construction of a building in order to ensure that the contractor complies with the local government's guidelines for town development.

5.3. Validity of permissions and enforcement**VALIDITY PERIOD**

There is no specific period of validity of permissions specified under the BSA.

ENFORCEMENT

If a contractor breaches any building regulation, the relevant local government and the MLIT may order the contractor to take measures necessary to correct the breach. Such measures include: (i) suspension of the construction and (ii) demolition, removal or reconstruction of the building.



6. Environmental liability

The general legislations dealing with environmental issues and promoting sustainable development for building construction are as follows:

- Soil Contamination Countermeasures Act – Under this act, a person who intends to develop a land which is 3,000 m² or more must submit a notification to the relevant local government at least 30 days prior to commencement of the land development. The land developer must conduct soil contamination investigation in the case where the relevant local government determines there is a danger that the land is contaminated.
- Air Pollution Act – This act requires construction companies to take measures necessary to prevent scattering asbestos or dust at construction sites.
- Noise Regulation Act – This act prohibits construction companies from carrying out certain noise-producing building works in certain areas specified in the act. Construction companies must also submit a notification to the relevant local government prior to any construction work using a large machinery, piling machine etc.
- Vibration Regulation Act – This act prohibits construction companies from carrying out certain vibration-producing building works in certain areas specified in the act. Construction companies must also submit a notification to the relevant local government prior to any construction using a piling machine, etc.



7. Leases

7.1. Legal characteristics of lease

TYPES OF LEASE

Under Japanese property law, there are two basic forms of commercial leases: (i) an ordinary lease, and (ii) a fixed-term lease.

Ordinary leases and fixed-term leases are distinguished by the parties' intention regarding termination at the end of the lease term. In the case of a fixed-term lease, the parties terminate the lease at the end of the lease term; however, in the case of an ordinary lease, the lessee may continue the lease even after the end of the lease term. Under an ordinary lease, the lessee is provided more protection as the lessor may not demand that the lessee vacate the premises at the end of the lease term unless specific due reasons for the demand exist.

LENGTH OF LEASES

The lease term of a commercial lease depends on the nature and type of the lease. The terms for office or retail leases typically range from two to five years. In most ordinary leases, we often see an automatic renewal clause for an additional term of the same or a shorter length.

APPLICABLE LAWS TO LEASES

The Civil Code and the Act on Land and Building Leases (ALBL) are the main laws governing leases in Japan. The Civil Code provides several rules that govern the content that the parties do not clearly agree in the lease agreement. The ALBL provides several mandatory provisions which the parties cannot contract away, such as:

- a lessor's renewal obligation (unless there is a due reason) in the case of an ordinary lease;
- prohibition of a lessor's early termination of the lease (unless there is a due reason); and
- a lessee's right to adjust the rent of an ordinary lease in accordance with economic circumstances.

7.2. Lessees' rights to possession

SECURITY OF TENURE ORDINARY LEASE

In principle, the lessee possesses the right to continue occupation of the premises after the expiry of the lease, provided that no due reason exists for the lessor to deny a renewal of the term for an ordinary lease. Where due reason exists for non-renewal, the lessor must provide the lessee with six months prior notice of non-renewal. When considering the existence and validity of any due reason for non-renewal, courts typically consider, including but not limited to, the following factors:

- whether there are circumstances requiring non-renewal of the lease (e.g. renovation of the premises as a result of disrepair);
- whether there is necessity for the lessee to use or benefit from the premises; and
- whether the lessor will pay eviction compensation to the lessee and the amount of such compensation.

FIXED-TERM LEASE

In the case of a fixed-term lease, the lessee does not possess the right to continue occupation of the premises after the expiry of the

lease. The lessor is required (i) to explain in writing to the lessee the nature of a fixed-term lease prior to the commencement of the lease, and (ii) to send expiry (non-renewal) notice to the lessee 6 to 12 months prior to the expiry date of the lease term.

RECOVERING REAL ESTATE FROM LESSEE

In order to ensure that a lessee leaves on the date originally agreed, a lessor must execute a fixed-term lease (as opposed to an ordinary lease) and fulfil the obligations enumerated in the Fixed-term Lease section above concerning termination of a fixed-term lease. The parties often agree that should the lessee not vacate the premises at the end of the fixed lease term, the lessee shall pay to the lessor damages equivalent to twice the original rent amount.

EARLY TERMINATION WITHOUT CAUSE

As for a lease agreement with a definite term, if a lease does not specify the lessor's right to early termination without cause, the lessor may not terminate the lease early. Where the lease does contain such a clause, a due reason must also be provided by the lessor in order to terminate the lease early. A due reason for purposes of early termination is difficult to establish. In addition, six months' prior notice of the early termination must be provided to the lessee by the lessor.

EARLY TERMINATION WITH CAUSE

Where there exists cause for the lessor's early termination of the lease (e.g. due to the lessee's breach of the lease), the lessor

may only terminate the lease early if the “trust relationship” between the lessor and the lessee has been destroyed as a result of the cause. The destruction of the trust relationship can be classified as a due reason for termination.

TERMINATION BY A THIRD PARTY

The national and local governments in Japan possess the right to acquire property (including, without limitation, properties under leasehold) for certain public projects on a compulsory basis pursuant to the Land Expropriation Act and/or other relevant acts. The lessor and the lessee are entitled to receive certain compensation for the expropriation. The process normally takes one to three years.

FINANCIAL SECURITY

In order to set a financial security against a failure by the lessee to meet its obligations, parties are basically free to agree on a form of the financial security. A lessor usually requires from a lessee a security deposit (*shikikin*) in the amount of several months’ rent and sometimes also requires a guaranty of the lessee’s obligations by a third party. As for providing a penalty against the failure, in the event that the lessee is an individual, the lessor may not provide a penalty exceeding an amount of average damage that the lessor will incur by the failure by the lessee, under the Consumer Contract Act.

7.3. Managing leased real estate

USE BY LESSEE

Restrictions on how the lessee uses the leased property can be imposed by the lessor. The underlying purpose for use of the premises is usually agreed between the lessor

and the lessee and evidenced in the lease agreement. The lessee may not use the premises for any non-agreed purpose (e.g. if the agreed use purpose is as a residence, the lessee is prohibited from using the premises as an office or for other commercial purposes). In a commercial lease, it is often agreed that the lessee may only use the premises during the specified hours and that the lessee shall not cause nuisance to other tenants or the neighborhood, etc.

ALTERATIONS

A lessee typically agrees not to alter or improve the premises without a lessor’s consent except in the case of minor alterations or improvements, such as changing the wallpaper or partitioning the premises. In addition, many lessors require the lessee to use the lessor’s contractor for alterations or improvements even where the lessor consents to such alterations or improvements. At the end of the lease term, the lessee is obligated to return the premises to the lessor in their original condition at its own expense upon expiration of the lease term.

TRANSFERRING LEASE

Under Japanese law, a lessee is not entitled to transfer the lease or sublease the premises to a third party without the lessor’s consent.

If the lessee wishes to transfer ownership of its own building located on a leased parcel of land but the lessor does not consent to the transfer of the lease or sublease of the land without due reason, the lessee may seek the court’s permission to transfer ownership of its own building in lieu of the land parcel lessor’s consent.

7.4. Rent

FIXED OR VARIABLE RENTS

A fixed, variable (e.g. rent which is based on the sales revenue of retail leased premises), or mixed rent amount may be agreed to by the parties in a lease agreement.

Under the ALBL, both a lessor and a lessee possess the right to increase or decrease the rent amount if the current rent has become unreasonable. In the case of an ordinary lease, the parties can contract away the lessor’s right to an increase in rent, but cannot contract away the lessee’s right to decrease the rent. In the case of a fixed-term lease of a building, however, both of these rights may be contracted away.

CHANGES IN RENT

Under the ALBL, if the current rent amount has become unreasonable and the parties cannot reach an agreement regarding a new amount, the parties must first apply for mediation to resolve the dispute before turning to the courts for resolution.

Should the court become involved, it will take several factors into account when determining a new reasonable rent amount:

- whether the current rent amount differs significantly from rent amounts in similar leases located in the same vicinity;
- the appraised market rent as determined by a real estate appraiser;
- any changes in taxation rates relating to the premises; and
- any fluctuations in real estate prices or other economic circumstances.

VAT ON RENT

Commercial leases of buildings are subject to Japanese consumption tax at a rate of 10%. Residential leases and land leases (with the exception of parking leases and the land leases with a fixed-term less than one month) are exempted from Japanese consumption tax.

7.5. Costs other than rent**INITIAL COSTS****Security deposit**

In most cases, a lessee is obliged to pay a security deposit when executing a new lease. The security deposit amount differs depending on the location of the premises and on the nature and type of lease involved (e.g. residential, office, restaurant, hotel). In the case of a residential lease, the amount is often equivalent to one to three months' rent.

Key money

For a residential lease, the lessee is sometimes required to pay the lessor key money in an amount often equivalent to one to two months' rent. Key money differs from the security deposit in that key money will not be returned to the lessee upon expiration of the lease.

Insurance premium

Lessees are often required to purchase home insurance to protect their own personal property in the event of fire damage and/or to protect against claims by third parties.

Stamp duty (land lease)

In the case of a commercial building lease, stamp duty is not payable. However, in the case of a land lease, stamp duty is payable and the amount levied depends on the amount of the key money paid.

COMMUNAL COSTS

A lessor pays for the maintenance and repair of common areas used by several lessees. The amount of such charges is usually included in the charged rent or billed separately to the lessees as communal or management fees based on the areas maintained.

REPAIRING LEASED SPACE

A lessor is responsible for the maintenance and repair of the building structure under the Civil Code. Regarding maintenance and repair of ordinary wear and tear of the premises, the terms of the lease agreement will dictate the responsibility. In many commercial leases, the lessees are responsible for such maintenance and repair.

COSTS OF UTILITIES**RESIDENTIAL LEASE**

Generally, lessees are responsible for their own utilities and telecommunications services and respective payments to such service providers.

COMMERCIAL LEASE

The burden of utilities costs depends on the nature of the building and the lease. In some cases, a lessor enters into contracts with suppliers for utilities but the actual costs are then transferred to the lessees. In other cases, lessees enter into utilities contracts directly with suppliers.

INSURANCE

Usually a lessor pays the cost of insuring the real estate, with coverage for fires and earthquakes typically included.

A lessee is often required to purchase supplemental home insurance to protect their personal property from fire damage and to protect against third-party claims.



8. Tax

8.1. Taxation of real estate sales and purchases

For asset deals, the relevant tax and transaction costs are as follows:

REAL ESTATE ACQUISITION TAX

Real estate acquisition tax is imposed on people who acquire real estate in Japan.

This tax rate ranges from 3% to 4% of the tax-assessed value of lands and buildings. However, this tax is not imposed on an acquisition of TBI. If certain types of acquisition vehicles are used, lower tax rates will apply.

REGISTRATION TAX AND RELEVANT FEES

Registration tax is imposed on people when they register transfer of the title to real estate. This tax rate ranges from 1.5% to 2% of

the tax-assessed value of lands and buildings. In the case of an acquisition of TBI, it is JPY1,000 per registration. If certain types of acquisition vehicles are used, lower tax rates will apply.

Typically, since the registration is arranged by a judicial scrivener (*shiho-shoshi*) representing a purchaser, a fee for their services is required. The aforementioned tax and accompanying fees are usually payable by a purchaser.

STAMP TAX

Stamp tax is imposed on each sets of an SPA. The amount of this tax depends on the purchase price of the real estate and can amount to JPY600,000 per each set. In the case of an acquisition of TBI, it is JPY200 per each set. Each party usually bears the stamp tax for the set of an SPA by such party.

CONSUMPTION TAX

A sale and purchase of buildings (not lands) are subject to Japanese consumption tax at a rate of 10%.

The same rates will apply in the case of an acquisition of TBI. The amount of the consumption tax is usually added on the purchase price.

FIXED ASSET TAX AND CITY PLANNING TAX

Fixed asset tax and city planning tax is payable by persons owning real estate as of January 1 of each year.

The fixed asset tax rate is usually 1.4% of the tax-assessed value of the property and the city planning tax rate is usually 0.3% of the tax-assessed value of the property.



If a transaction is conducted in the middle of a year, since these taxes for such whole year are imposed on the seller owning the real estate as of 1 January of such year, the buyer usually pays to the seller the amount of the taxes for the period from the closing date until 31 December of such year.

BROKERAGE FEE

When a broker assists a buyer or a seller to execute an SPA, the buyer or the seller must pay respectively a brokerage fee. The maximum legally permissible fee is 3% of the purchase price plus JPY 60,000 each party.

In Japan, it is not unusual for one broker to receive a brokerage fee from both the seller and the buyer.

8.2. Taxation of share deals

For share deals which is buying real estate via the shares in the owning company, most of the relevant taxes applicable to asset deals are not imposed. The relevant ones for such deals are as follows:

BROKERAGE FEE

When a broker assists a buyer or a seller to execute an SPA, the buyer or the seller must pay respectively a brokerage fee. In Japan, it is not unusual for one broker to receive a brokerage fee from both the seller and the buyer.

8.3. Taxation of income

When an offshore acquisition entity or investor receives rental income (except when the lessee is an individual and the property is used by the lessee or his/her relatives) or income from TBI, the income will be subject to withholding tax on payments in accordance with the applicable tax treaty between the offshore acquirer's home jurisdiction and Japan.

Separately, the acquisition of property or TBI in property located in Japan by an offshore operator creates a potential risk of creating a permanent establishment (**PE**). If the offshore investor creates a PE in Japan, it will be subject to ordinary corporate tax at an effective tax rate (**ETR**) of 30.62% on its net income. While acquisition of real estate in and of itself does not necessarily create a PE since it is common to hire asset managers and the investor may be receiving ongoing payments from its holdings in Japan, the risk of creating a PE may be heightened.

GK

The income of a GK is subject to corporate tax at an ETR of 30.62%. A GK does not enjoy preferential tax treatment on real estate investments available to GK-TKs and TMKs.

GK-TK

A GK is subject to corporate tax for taxable income. However, under the GK-TK structure when a GK makes distributions to investors pursuant to a TK agreement, such distributions can be treated as deductions against the GK's income (as defined by the National Tax Agency's published regulations) and could reduce taxable income (Pay-Through). To qualify for this treatment, the TK agreement should specify that the TK investors' role is limited to passive investment.

TMK

A TMK is also subject to corporate tax. If a TMK is tax qualified, it may take a deduction against taxable income for any dividends paid to its shareholders (Pay-Through). This means that, in theory, if a TMK distributes all of its taxable income it will not have any income that would be subject to corporate tax. A TMK must satisfy certain criteria to be considered a tax-qualified TMK.

TAXATION ON DISTRIBUTIONS

Even though GK-TKs and TMKs may enjoy the Pay-Through treatment relating to corporate taxes, a distribution to foreign investors by a GK or a TMK is subject to withholding tax at a rate of 20.42%; however, it is also subject to an exemption or reduced tax rates available under applicable tax treaties.

8.4. Taxation of disposals

DIRECT ACQUISITION

Capital gains on a sale of real property or TBI in Japan will be subject to withholding tax at a rate of 10.21% to the extent a purchaser has a withholding obligation (for example, a Japanese entity).

Capital gains tax is also applicable and the current rate is 23.2% or higher for an offshore entity, including those without a PE. Most tax treaties between Japan and other jurisdictions do not provide an exemption for capital gains from real estate in Japan, and capital gains tax is generally not subject to exemptions under the applicable tax treaty with the seller's home jurisdiction.

GK

Capital gains attributable to a GK are subject to corporate tax. Dividends distributed to its members are not deductible.

For an offshore investor, capital gains on the sale of GK equity are not subject to withholding tax, but are subject to corporate tax even if the offshore entity has no PE in Japan.

GK-TK

A GK under the GK-TK structure is subject to corporate tax on capital gains. However, distributions to investors can be treated as deductions against the GK's income as described above.

TMK

A tax-qualified TMK can also enjoy a deduction against income arising from sale of assets, as described above.

OTHER COSTS OF DISPOSALS

- Brokerage fee – A brokerage fee (maximum 3% of the transaction price plus JPY60,000) is often paid to real estate agents. This is covered by any party appointing a broker.
- Registration agent fee – Disposal registration is handled by a judicial scrivener in Japan, so the fee for this agent must be allocated by the parties. Normally a buyer covers this fee.



9. Real estate finance

9.1. Forms of security

TYPES OF SECURITY

The most common form of security over real estate is mortgage (*teitoken*), including without limitation, revolving mortgage (*ne-teitoken*). Mortgage in general is a fixed charge and it entitles the mortgagee to take possession of the asset and dispose of it with priority as against other unsecured creditors. Mortgage is perfected by registration in the land or building registries.

It is sometimes the case that security is granted over the rental income from a property by way of an assignment whereby the tenants are directed to pay the rental income to the lender if necessary. Or, a bank lender sometimes requires the borrower to open its bank account with the lender and to have the tenants pay the rental income to such bank account so that the lender may set off its credits against the borrower, if necessary.

A corporate borrower can also create and perfect with registration, security by way of transfer (*joto-tampo*) over assets other than real estate. This security could be floating security over a class of assets which in the course of the borrower's business changes from time to time and which may be disposed of without consent of the lender. Pledge over the same assets is possible; however, registration system is not available for perfection thereof. It is sometimes the case that a lender takes both mortgage over real estate and security by way of transfer or pledge over other assets in or around the real estate.

REAL ESTATE AS SECURITY

Real estate includes land, buildings erected on it and objects that are attached to the real estate and form an integral part thereof. It is also possible to take security over other assets, e.g. fittings, furniture and moveable objects that do not form an integral part of real estate.

Title to land can be either freehold, superficies, leasehold or emphyteusis (*eikosakuken*) (although the last is rarely encountered). Mortgage can be taken over freehold, superficies and emphyteusis, whereas pledge can be taken over leasehold which is not very popular though.

TRUSTS

The key characteristic of a trust is that it allows legal ownership and beneficial interest to be separated. Trustees become the legal owners of the trusted property as far as third parties are concerned and beneficiaries can expect the trustees to manage the trust property for their benefit pursuant to the agreement with the trustee and statutory mandatory provisions. This is well recognized under Japanese law, and commonly used to enjoy tax benefits, to avoid real estate-related licence requirement, and the like.

TRADING OF DEBT

Debt is commonly traded between lenders. Domestic loan transfers are commonly documented using standard form agreements made available by the Japan Syndicate and Loan-Trade Association which consist of a master agreement for all transactions between the parties and an individual agreement for a

specific transaction between the parties. In the case of discrepancy between the two documents, the tailored individual agreement will prevail for the specific transaction. For more complex transactions, a more bespoke form of sale and purchase agreement is typically used. The ability of lenders to transfer debt to other lenders is a matter for negotiation on a transaction-by-transaction basis.

In addition, there are several ways of transferring debt:

- Assignment of rights: Subject to contractual restrictions, an assignment of rights can be completed without consent of the debtor. Partial assignments are also possible. Perfection can be accomplished through notice to or acknowledgement by the debtor on an instrument bearing a certified date or through registration in the case of a corporate seller.
- Assignment of contractual status: Subject to consent of the debtor, a total or partial assignment of a lender's contractual status, including any or all rights and obligations, is possible. A transfer of a revolving loan includes a transfer of the lender's obligation to lend money to the debtor and therefore cannot be accomplished only through an assignment of rights.
- Novation: A novation results in the formation of a new contract between the continuing party and the transferee, while the transferor is released from all its obligations.

- **Sub-participation:**
Sub-participation is a transfer of the economic interest in a loan without changing the legal relationship between the existing parties. Sub-participations involve a purchaser taking on double credit risk, being that of the seller and of the borrower. Some participation agreements have a triggering event (such as poor financial performance by the original lender) which requires a change to the sub-participation arrangements to effectively transfer the loan to avoid the new lender assuming the original lender's risk.
- **Synthetic arrangements:**
Economic risks of debt can also be traded using derivatives and insurance policies.

9.2. Creating security

RESTRICTIONS ON FOREIGN LENDERS

For money lending into Japan, Japanese money lending business license requirement needs to be considered.

There are no restrictions on granting security over real estate to foreign lenders or on payments made to foreign lenders under a security document or loan

agreement, unless sanctioned persons or jurisdictions are involved. An ex-post-facto Bank of Japan filing is required for a non-Japanese resident taking security from a Japanese resident over real estate in Japan.

TAXES AND FEES

There is no stamp duty payable on mortgage agreements or pledge agreements. Depending on what is transferred, stamp duty is payable on security by way of transfer agreements, and stamp duty is payable on loan agreements, the amounts of which depend on the amount of the subject to be transferred or the amount of the loan, as applicable.

The tax rate for registration of mortgage over real estate is 0.4% of the secured amount (or the maximum secured amount for revolving mortgage).

Some notaries' fees are payable when preparing affidavits, and the like in the foreign lender's country, which will be used for registration of the mortgage for the benefit of the foreign lender.

CORPORATE GOVERNANCE

There are both financial assistance rules and corporate benefit rules.

FINANCIAL ASSISTANCE RULES

A company may not provide any benefit to its shareholders in relation to or in connection with the exercise of shareholder rights by a shareholder.

CORPORATE BENEFIT RULES

Directors must comply with the provisions of the Companies Act and other laws and regulations. A director must exercise independent judgment and reasonable skill, care and diligence and act in accordance with the company's constitution. Whether or not a director's decision or act is lawful is determined by (i) the process taken to make such decision or act and (ii) the content of the decision or act.

OTHER RULES

There are other corporate law issues which include rules relating to capital maintenance (prohibition of certain distributions to shareholders), restriction on transactions between a company and interested parties and provisions relating to transactions which take place within certain periods before the company entering into an insolvency process.



RESTRICTIONS ON PAYMENTS TO FOREIGN LENDERS

There are no restrictions on payments made to foreign lenders under a security document or loan agreement.

A borrower may be required to deduct withholding tax in respect of interest which is payable to a foreign lender depending on the jurisdiction of incorporation of the parties and the application of any relevant tax treaties. The allocation of any tax risk is dealt with on a transaction by transaction basis in the facility agreement.

PRIORITY OF SECURITY

A creditor can agree to subordinate its security interest to that of another creditor by a priority agreement. The change of priority with regard to mortgage over real estate may be registered.

9.3. Consequences of taking security

JURISDICTION

If a choice of law is a sensible choice made in good faith, the Japanese courts will generally give effect to it, subject to statutory mandatory provisions of Japanese law, e.g. with regard to perfection by registration of mortgage over real estate located in Japan. It would generally not be advisable to choose a law other than Japanese law to govern a security document under which a Japanese company creates security over assets situated in Japan.

IMPERFECT SECURITY

Without valid perfection, a security right may not be asserted against a third party which is considered to include, without limitation, the security grantor's trustee in bankruptcy.

ENVIRONMENTAL LIABILITY

A holder of security over land is not liable for environmental damage unless it owns, manages or takes possession of the land.

Great care must be taken if the security is enforced because as mentioned above, owners of land can be responsible, among others, for investigating potential environmental damage on that land or coming from it and for taking necessary measures to prevent health hazard, even if it did not cause such damage (owners has the right to claim the expenses for such investigations and measures against the person who actually caused such environmental damage). A mortgagee should not go into possession of land without careful consideration of the implications of potential environmental liability.

9.4. Borrower insolvency/enforcement

ENFORCEMENT OF SECURITY

A loan agreement and security agreement usually describe events of default which must have occurred before the lender can enforce its security. Typical events of default include non-payment of interest or principal, breach of representations or warranties, breach of covenant, material adverse change and insolvency.

Once the security has become enforceable, the lender can enforce its security immediately. Enforcement may be in a public auction (or execution against earnings from the collateral), private sale of the collateral or bulk sale (private sale of loan claims with security to another lender).

In the case of a private sale, the lender has certain duties to obtain a proper price for the assets.

NON-INSOLVENCY PROCEDURES

Civil rehabilitation under the Civil Rehabilitation Act and corporate reorganization under the Corporate Reorganization Act are available. In the case of corporate reorganization, creditors are, in general, prevented from enforcing their security.

Out-of-court workout and corporate reorganization ADR are also available, both of which often involve debt waiver only by financial institutions so that the debtor can continue its business smoothly. For such debt waiver, consent from all the persons waiving their debts is required.

EFFECT OF BORROWER'S INSOLVENCY

Generally, the onset of a borrower's insolvency does not affect security interests, although under corporate reorganization creditors are, in general, prevented from enforcing their security.

Security can be at risk of being set aside if they are:

- provided with little or no consideration within six months of or after the company's suspension of payment;
- provided after the company becomes unable to pay its debts generally and the creditor is aware of the suspension of payment or the company's inability to pay its debts generally; or
- provided after the application for commencement of bankruptcy proceedings and the creditor is aware of such application.

- Security may also be challenged on other grounds relating to insolvency.

ORDER OF PAYMENT

The order of priorities of security interests is largely based upon the date of (perfection of) creation of

the security, though such order of priorities can be exchanged by agreement.

In the case of a public auction, the orders of priorities of payment is, in general:

- expenses for common benefits (procedural costs);
- tax and public dues;
- secured claims; and
- unsecured claims.



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