



## Towards J-REITs' Acquisition of Overseas Real Property

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On December 7, 2012, a working group under the Financial Services Agency of Japan (the "FSA") issued its final report (the "Working Group Final Report") on the proposed amendments to the legal regime of investment trusts and investment corporations, which are primarily governed by the Investment Trust and Investment Corporation Law (the "ITICL"). The Working Group Final Report, among other things, proposed making an exception to the current regulation prohibiting investment corporations from acquiring a majority of the voting rights in the stock (*kabushiki*) of other corporations. In response to this proposal, on April 16, 2013, a bill (the "ITICL Amendment Bill") to amend the ITICL was submitted to Japan's Diet.

Recently, Japanese corporations are becoming more active in acquiring overseas real properties, and as a reflection of this market trend, there is a growing demand for Japanese real estate investment corporations ("J-REITs") to acquire real properties outside Japan. In that context, if the ITICL Amendment Bill is passed by the Diet, it would be a significant step towards J-REITs' acquisition of overseas real properties. But even with the amendment, J-REITs still face a host of challenges.

This note identifies the issues addressed in the Working Group Final Report and the ITICL Amendment Bill, as well as the other rules and guidelines currently in effect, in connection with this topic.

### A. The Working Group Final Report and the ITICL Amendment Bill

#### 1. The Working Group Final Report and the ITICL Amendment Bill

Since May 2008, when the Tokyo Stock Exchange (the "TSE") revised its Securities Listing Regulations, J-REITs are no longer prohibited from acquiring overseas real properties. Many J-REITs have already removed restrictions on such acquisition from their articles of incorporation (*kiyaku*).

On the other hand, the current ITICL prohibits J-REITs from acquiring a majority of the voting rights in the stock of other corporations (Article 194 of the ITICL and Article 221 of the current ordinance under the ITICL). Further, to be eligible for a favorable tax treatment specially designed for J-REITs, they cannot hold a majority of stock or other shares (*shusshi*) issued by other corporations (Article 67-15.1(2) of the current Act on Special Measures concerning Taxation). These regulations make it practically difficult for J-REITs to acquire overseas real properties, because the acquisition tends to be made through a special purpose vehicle established in the country where the property is located or a third country. The use of overseas vehicles is due to tax advantages and the foreign country's foreign investment regulations and other considerations.

In response to these circumstances, the Working Group Final Report and the ITICL Amendment Bill propose the following:

**Working Group Final Report:**

“It would be appropriate to permit J-REITs to hold a majority of the voting rights in the stock of a vehicle (SPC) to acquire an overseas real property, if such acquisition of stock can be substantively deemed to be an acquisition of that real property, but only to the extent that the reliability of the J-REIT system is secured, and bearing in mind the character of a J-REIT and the rationale for restricting J-REIT's control over another company's business.”

**ITICL Amendment Bill - Article 194.2:**

“The preceding paragraph (author's note: Article 194 of the current ITICL, which prohibits J-REITs from acquiring a majority of the voting rights in the stock of other corporations) do not apply to a registered investment corporation's acquisition of stock issued by a corporation the sole purpose of which is to carry out transactions set forth in Article 193.1(3) to 193.1(5) (author's note: these transactions are acquiring, transferring or leasing real property or subcontracting the management of real property), if the registered investment corporation is not able to carry out, as set forth in the Cabinet Order (author's note: the draft Cabinet Order is not yet available), those transactions in respect of an overseas specified asset due to the laws and regulations of the country where that asset is located or other restrictions.

2. Relevant tax reform

A bill to amend the relevant tax laws (the “**Tax Law Amendment Bill**”) relating to the ITICL Amendment Bill was passed by the Diet ahead of the ITICL Amendment Bill itself. The Tax Law Amendment Bill was promulgated on March 30, 2013, and will take effect simultaneously with the ITICL Amendment Bill (if passed). By virtue of this Tax Law Amendment Bill, J-REITs can be eligible for a favorable tax treatment even where they hold a majority of the stock or other shares issued by other corporations, as long as such holding is in accordance with Article 194.2 of the ITICL Amendment Bill.

### 3. Detailed requirements to be defined in the Cabinet Order

The Working Group Final Report does not elaborate the situations where an acquisition of stock is substantively deemed to be an acquisition of real property. Besides, the ITICL Amendment Bill per se does not lay down the detailed requirements for exclusion from the prohibition of acquiring stock with majority voting rights, and those requirements will be determined in the Cabinet Order, the draft of which is not yet available to the public. Considering the restrictive languages of the ITICL Amendment Bill, there remains a good chance that those requirements may be restrictive.

In particular, it should be noted that the Working Group Final Report expressed certain alarm at multi-tiered SPC structures and retaining overseas profits at the offshore SPC level. Such alarm may possibly lead to restrictive requirements under the Cabinet Order.

Thus, we should keep an eye on the draft Cabinet Order, which we expect to be made available at a later stage, and other developments in the proposed amendments.

## **B. Systems required for investments in overseas real property**

The TSE requires (i) listed J-REITs investing in overseas real properties to properly disclose their investment policy regarding overseas real properties and the risks associated with those investments, and (ii) the J-REITs' asset managers to establish systems to handle those risks (the TSE "Listing Guide for REIT (Investment Securities)").

### 1. Disclosure of the investment policy and the associated risks

To meet the above-mentioned disclosure requirements, if a J-REIT plans to acquire overseas real properties, it would likely need, in advance, to:

- (i) cause its asset manager's investment guidelines to be amended to provide for the investment policy regarding overseas real properties; and
- (ii) collect various information on real estate investments in the country where the target real properties are located and understand and evaluate the risks associated with such investments.

Not only the risks but also generic information on such investments (*e.g.*, legal system, tax system and real estate market) must be properly disclosed, as a basis of understanding the risks. Further, if a

complicated investment structure is used to acquire the overseas real property, the structure and all particular risks associated with it must be adequately disclosed.

## 2. Establishment of adequate management system

Most importantly, the TSE requires the asset managers to establish systems for adequate and proper asset management and disclosure relating the risks associated with the investments in overseas real properties, such as those due to the relevant country's legal system, tax system, real estate market, natural disasters or exchange rate fluctuations. To this end, they would need human resources knowledgeable about and experienced in dealing with the conditions of the country where the real property is located, and perhaps need to engage a local property manager or asset manager in that country and establish a working and timely communication system with that manager.

In practice, the requirement of establishing such systems would likely be a significant challenge (or could pose an impediment) that a J-REIT must overcome in its plan to acquire overseas real properties.

## C. Real estate appraisal

In January 2008, the Ministry of Land, Infrastructure, Transport and Tourism published the "Guideline for Appraising Overseas Investment Real Estate" (the "**Appraisal Guideline**") indicating standard appraisal methods for Japanese real estate appraisers to assess overseas real property for investment purposes. The TSE generally requires listed J-REITs to obtain appraisal reports that comply with the Appraisal Guideline.

### 1. Two methods for appraisal

The Appraisal Guideline proposes the following two appraisal methods, in either of which a Japanese appraiser is expected to conduct an on-site property inspection:

- (i) Overseas Appraisal Support Method: A Japanese appraiser hires a local appraiser to collect basic information and provide other support necessary to complete the appraisal, but the Japanese appraiser itself performs the appraisal; and
- (ii) Overseas Report Review Method: A Japanese appraiser hires a local appraiser to prepare the appraisal report, and reviews and verifies that appraisal report. The Japanese appraiser must translate the appraisal report into Japanese.

Thus, the appraisal of overseas real property would be significantly more costly and time-consuming than that of real property in Japan.

## 2. Qualification for appraisers

The Appraisal Guideline requires a Japanese appraiser to understand the local real estate market trends, real estate legal and tax systems, appraisal standards and appraiser qualification systems, and other basic information relating to the overseas real property, so that it can review and verify the local appraiser's work results.

In principle, the Appraisal Guideline also requires a local appraiser to be certified or qualified as a specialist in the relevant country. Further, as a general rule, the local appraiser's qualification system must be administered by a countrywide organization, which grants qualifications or titles according to each appraiser's knowledge and experience and has the power to take disciplinary actions in cases of fraudulent or improper appraisals. If a real property is located in a country that has no such qualification system, investing in that real property would be difficult.

## 3. Contents of appraisal report

Under the Appraisal Guideline, an appraisal report must have all the necessary matters under the Japanese Real Estate Appraisal Standards to the extent possible. In addition, the report should state (i) the respective roles of the Japanese appraiser and the local appraiser, (ii) the real estate market trends and the legal and tax systems of the country where the target real properties are located, (iii) the differences in real estate practices, and (iv) the results of verifying the appraisal report prepared by the local appraiser (if the Overseas Report Review Method is adopted).

### **D. Requirements for the country where an overseas real property is located**

The Investment Trust Association also requires the J-REIT asset managers to make sure that the target real property is in a country that satisfies the following requirements (Article 24-2 of the Rules of the Investment Trust Association):

- (i) the country has established a legal system or other systems to properly protect the rights of use, profit or disposition of real property;
- (ii) the country has established a registration system or other similar systems to perfect the rights to real property against third parties;

- (iii) the country has established a legal system or other systems for the proper execution or performance of contracts relating to real property;
- (iv) the exchange rate of the currencies used in the relevant transactions are properly published and can be exchanged for Japanese yen without delay as needed;
- (v) the infrastructure for proper fund transfers and settlements have been established; and
- (vi) dispute resolution systems such as a court system have been established.

If these requirements are applied strictly, the countries into which J-REITs may make real estate investments may be limited to a small number of developed countries.

## E. Looking forward

There remain challenging hurdles to J-REITs' acquisition of overseas real property. However, the passage of the ITICL Amendment Bill and the Tax Law Amendment Bill will certainly be a significant positive step to the future global development of J-REITs, and will stimulate further discussions on this development.

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## News

### ➤ Firm engaged in deals recognized at Thomson Reuters' 'DEALWATCH AWARDS' 2012

- The global offerings of shares of Japan Tobacco Inc. held by the Japanese government and the repurchase of the shares by Japan Tobacco Inc., in which Mori Hamada & Matsumoto was engaged as legal counsel to the issuer and the seller, was awarded Equity Deal of the Year in Thomson Reuters' 'DEALWATCH AWARDS' 2012.
- The global offering of investment units by Industrial & Infrastructure Fund Investment Corporation (total value: approximately JPY 11 billion), in which Mori Hamada & Matsumoto was engaged as issuer's agent, was awarded J-REIT of the Year in Thomson Reuters' 'DEALWATCH AWARDS' 2012.