Japan Hotel Investments Guide

A joint publication between Baker & McKenzie and JLL's Hotels & Hospitality Group
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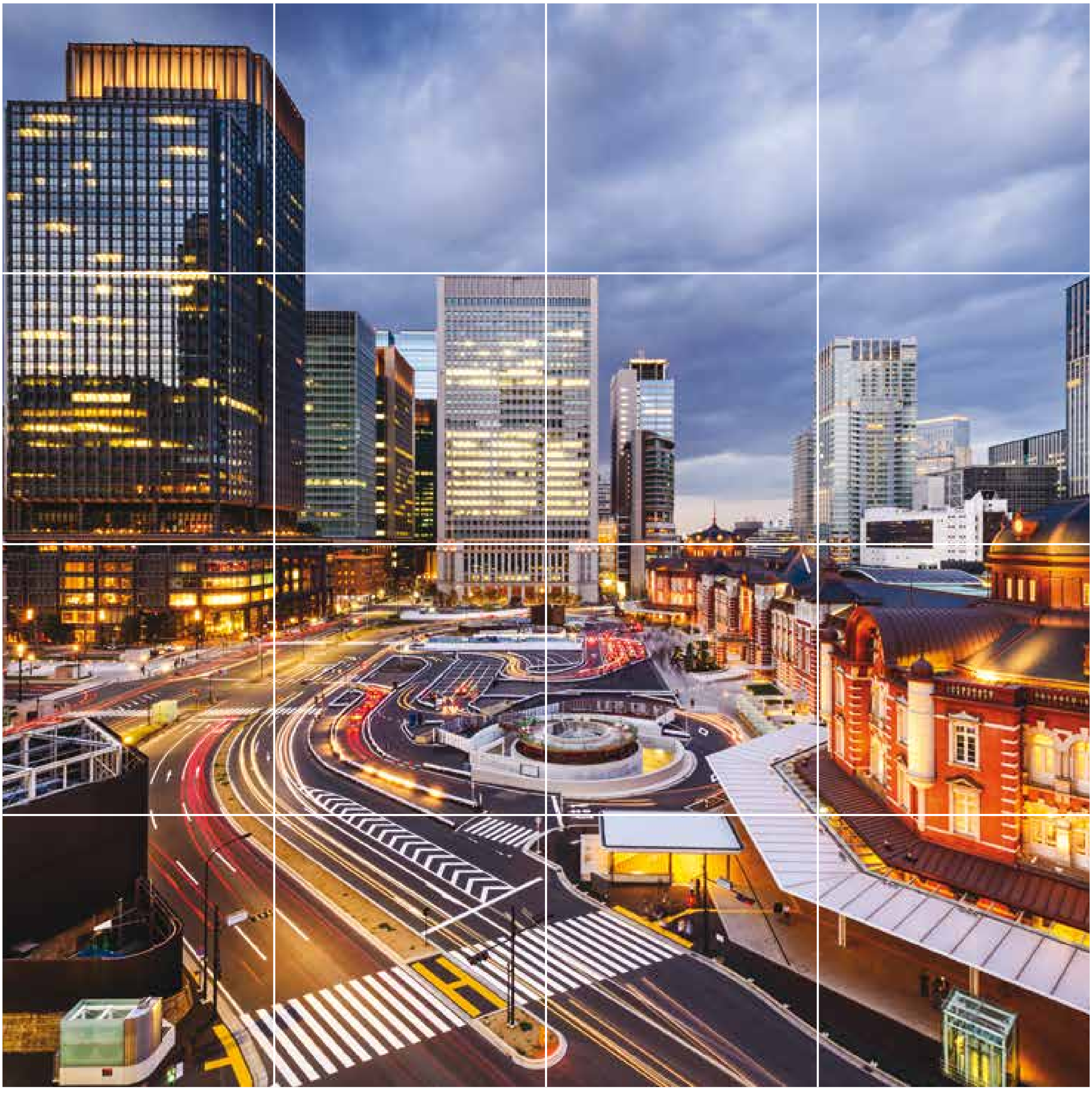

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INTRODUCTION

The Japanese government doubled its target for annual inbound visitors arrivals to 40 million by 2020 based on the surge in inbound visitor arrivals in response to the easing of visa restrictions and active marketing efforts by the Japanese government. Against a backdrop of heightened uncertainty in global markets across the Americas, Europe and Asia, Japan's strong domestic demand fundamentals and surging inbound arrivals have driven record-high hotel market trading performance over recent years.

As one of the best performing hotel markets in Asia, Japan has recorded excellent growth particularly in its visitor fundamentals. In 2015, Japan recorded a 47.1% year-on-year increase in international visitation thanks to the easing of visa policies for Chinese and other Asian nationals in addition to the depreciation of the Japanese yen. Additionally, despite the strengthening of the yen in 2016, indications are that international visitation growth remains strong. As such, the trend of strong inbound visitation is expected to continue for the foreseeable future with Japan offering a wide range of leisure and business opportunities, along with the benefit of unprecedented infrastructure investment in Tokyo ahead of the Summer Olympic Games in 2020. From an investment standpoint, Japan is expected to be one of the top hospitality investment destinations in the region given its strong currency outlook, growing tourism demand, measured supply pipeline and stable political environment.

Japan has long been a target market for foreign investors as it does not restrict foreign ownership or management of hotels. Foreign investors can explore a number of investment structures to best suit their investment profiles and goals. Selecting the appropriate investment structure is hence crucial to foreign investors of hospitality assets in Japan.

JLL's Hotels & Hospitality Group and Baker & McKenzie have extensive experience and knowledge of the Japan hospitality market and structures preferred by foreign investors. We hope that this Guide will serve to provide a basic understanding of the market and addresses some of the initial concerns for first-time investors in hospitality assets in Japan.

We would be pleased to offer the full spectrum of our services to you and to assist you with any hospitality investment opportunities you may be considering in Japan.

INVESTING IN HOTELS IN JAPAN

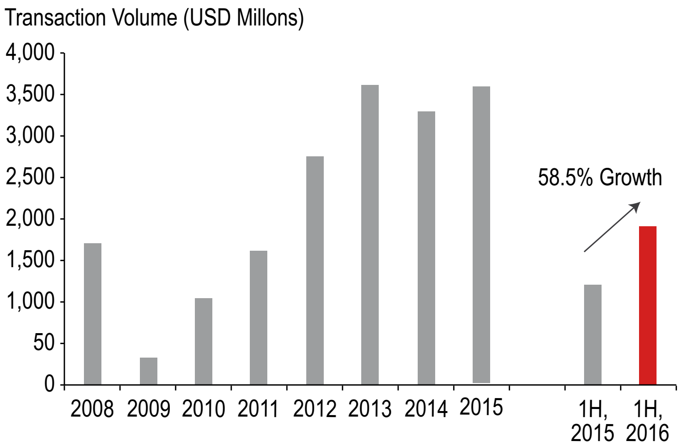
The hotel investment market in Japan continues to be one of the largest and more active markets in the Asia Pacific region.

In 2015, Japan recorded the second-highest number of hotel transactions on record. The market is expected to continue to see strong transaction volume as a result of interest from active domestic investors in addition to appetite for investment from U.S. private equity funds and alternative sources of capital. For example, there has been growing interest from Chinese investors evaluating purchases in the market, most recently highlighted by the sale of Tomamu Resort to an affiliate of the mainland Chinese group, Fosun.

In 2016, buyers' appetite for hotel assets in Japan remains high but there have been fewer hotel assets available for sale in the market. Notwithstanding the fact that fewer transactions took place in 1H 2016, Japan registered significant growth in total transaction volume of 58.5%, mainly driven by large scale transactions, notably the sale of the Grand Pacific Le Daiba in May 2016 for circa USD 605 million.

Meanwhile, transactions involving hotel development sites in major cities have become increasingly active in 2016. Reflecting the scarcity of existing hotel assets for sale in the market, hotel investment capital is moving towards hotel development opportunities.

J-REITs and other domestic investors remain the most active players in the hotel investment market in Japan during the year. Though Japan has witnessed a surge in interest from offshore investors in recent years, only a number of those investors have been able to successfully acquire in Japan due in part to unfamiliarity with the local market and lack of understanding of the relevant commercial and legal realities in Japan. Nevertheless, many private equity groups based in the U.S. are still flush with cash and have a need to deploy capital. It is expected that many of these groups will be motivated to acquire assets. Secondary markets in Japan are expected to be one of this group's biggest targets.

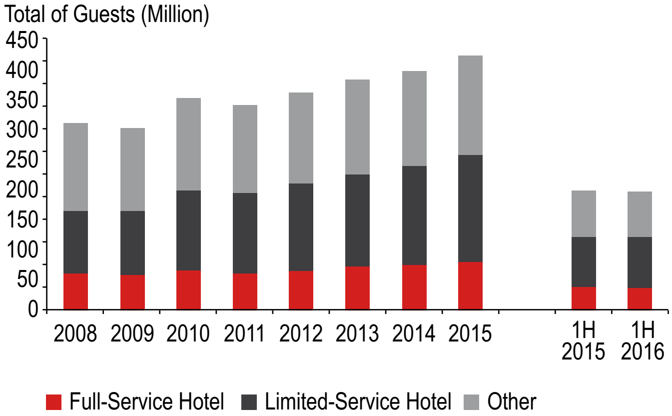


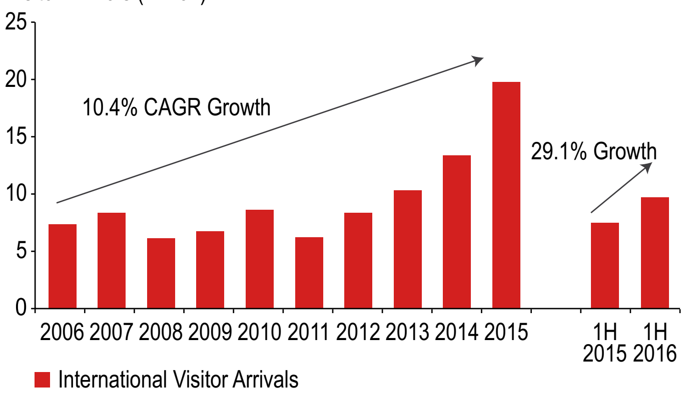
Source: Real Capital Analytics

TOURISM MARKET

Despite the surge in international visitation to Japan over the recent years, domestic guests remain the largest source of room night demand in Japan, representing approximately 85.4% of the total accommodation demand in 2015. This further strengthens the position of Japan's hotel market as the strong domestic demand fundamentals provide a natural hedge against the relatively more volatile international demand, which is susceptible to changes in economic, political and natural environment.

The ongoing liberalization of visa policies for foreign visitors to Japan has driven significant growth in visitor arrivals in recent years. In response to the growth in visitation, the Japanese government has revised their international visitor targets from 20 million to 40 million by 2020 and from 30 million to 60 million by 2030. Strong growth in visitation from China is expected to continue into the future while emerging markets such as Indonesia and India are expected to drive growth over the longer term.





FREQUENTLY ASKED QUESTIONS

A. Investment Market Environment in General

01. Are there any purchasing restrictions for foreign investors?
    - No. There are currently no restrictions on foreign investment in hotel or other kinds of commercial real estate with the possible exception of agricultural land.

02. What is the typical operating structure of a full-service / limited-service / traditional inn (ryokan) in Japan?
    - Many local full-service hotels are independently self-operated by the owner or leased by the owner to local operators while international chain hotels are typically under management or franchise agreements with the owner.
    - Most limited-service hotels are under a long-term lease contract with a local operator.
    - Most Japanese style hotels (ryokan) are self-operated.

03. What kinds of licenses are required to own and operate a hotel?
    - A hotel permit is required in order to operate a hotel business. Refer to page 17 of this Guide for more detailed information regarding the requirements for a hotel permit.
    - If an owner is not operating the hotel, the owner does not require a hotel permit.
    - If the owner is leasing the hotel to a third party operator, the owner is not required to obtain any hotel license or permit but the operator will need to obtain the hotel permit.
    - Restaurant, liquor and other licenses may be required depending on the kinds of services to be provided on site. Obtaining a liquor license in Japan is a relatively straightforward process.

04. What are the typical cap rate / yields in the market? Do the J-REITs disclose yields?
    - Generally, cap rates are confidential and hence not disclosed to the public.
    - J-REITs disclose net operating income/net cash flow and cap rates of their acquired hotel assets, but such net operating income refers to stabilized net operating income, not going-in net operating income.
    - J-REITs disclose a summary of the relevant appraisal report and often the income on which the cap rate is applied is not NOI, but NCF, which takes into account capital expenditure.
    - Based on information disclosed cap rates by J-REITs, the target stabilized cap rates range from 4%-5% in key markets such as Tokyo, Osaka, and Nagoya, and from 5%-6% in secondary markets such as Fukuoka and Sapporo.

B. Acquisition/Process

01. What are the key areas of focus during due diligence? Are there any local vendors providing bilingual due diligence services?
    - In addition to a basic due diligence review of real estate properties including a review of registered title and encumbrances, boundary confirmations and ownership structure, a potential buyer obtains the following reports from third-party advisors:
      (i) an "Engineering Report" which covers the physical aspects of the building conditions and compliance with relevant codes and regulations, (ii) an environmental report, and (iii) an appraisal report. A typical Engineering Report in Japanese costs one to two million yen per property. Some engineers provide English translation with additional cost.

- Seismic risk assessment is another important area for due diligence in Japan. The engineering report usually covers such analysis including the "Probable Maximum Loss" (PML). Based on the results of the assessment, the potential buyer considers whether or not to purchase earthquake insurance but also note that potential lenders may require insurance if the PML is over a certain level. See also following Q&As of this section.
- If the buyer acquires the operating company in addition to the hotel real estate, the buyer often retains an accounting/ tax advisor and a law firm to conduct corporate due diligence. Human resources and market studies are also key parts of operational due diligence.
- Major global consultants/advisors and accounting firms have local offices in Japan and provide bilingual services for off-shore investors.

02. How are future capital expenditures valued / estimated?

- Typically, the Engineering Report addresses the estimated deferred maintenance and capital expenditure amounts for the next 10 years in addition to reporting on building code compliance, hazardous material existence and PML as explained above.
- The FF&E reserve amount required by an operator is typically set at 2.0% to 3.0% of gross revenue.

03. What steps are involved in a transfer of a real estate title in Japan?

- Real estate title or ownership rights (*shoyuuken*) is registered in the title register (*tokibo*) maintained at the local Legal Affairs Bureau. The seller and buyer need to submit title transfer related documents with the local Legal Affairs Bureau at the closing of the sale and purchase transaction. The seller and buyer often coordinate the preparation and delivery of the required title transfer documents as well as the filing of the application to transfer the registered title with the local Legal Affairs Bureau through a licensed judicial scrivener.
- Alternatively, if the real estate is entrusted and a trust bank is the legal owner, the seller will normally transfer its trust beneficiary interest ("TBI") subject to the approval of the trust bank with the trust bank continuing as the legal owner of the underlying real estate. The name of the holder of the TBI is reflected in the title register so the seller and buyer - like in a transfer of the registered owner of the property explained above - need to submit the TBI transfer related documents with the local Legal Affairs Bureau to transfer of name of the registered holder of the TBI at the closing of the sale and purchase of the TBI. The seller and buyer often coordinate the preparation and delivery of the required TBI transfer documents as well as the filing of the application to transfer the registered holder of the TBI with the local Legal Affairs Bureau through a licensed judicial scrivener.

04. What steps are involved in a transfer of non-real estate assets (i.e. FF&E, employees, licenses, contracts, etc)?

- If the real estate is entrusted to a trust bank, the non-real estate assets will normally be held by a separate operating company. The transfer of non-real estate assets can therefore be structured as an asset or "business transfer" or as a share transfer.
- A business transfer (*jigyou joto*) is frequently used to transfer the ownership of all of the FF&E, employees, licenses and contracts of a particular business segment together with the associated liabilities. Depending on the nature of the licenses and contracts, third party consents may be required. Please see page 11 of this Guide for further information.
- As an alternative to a business transfer, a share transfer of a company which owns non-real estate assets is also frequently used. Please see page 11 of this Guide for further information.

05. Does the sale and purchase agreement have to be drafted in Japanese?

- A seller and a purchaser can agree on and enter into a purchase agreement drafted in any language. Japanese is the most commonly used language especially for the sale and purchase of the hotel real property (land and building) but an English version is sometimes used in transactions involving foreign parties provided the parties agree to it.

06. What is the "Important Matters Disclosure Report" (Jyuyou Jikou Setsumeisho) and who issues this report for what purpose?

- The Important Matters Disclosure Report is designed to highlight the material terms of the purchase and sale agreement and material issues relating to the real estate involved.
- A licensed real estate broker in charge of the transaction is required to prepare this report under the Japanese Real Estate Brokerage Act. If there is no intermediate licensed broker involved, the Important Matters Disclosure Report will not be produced unless specifically agreed to by the parties involved.
- The Important Matters Disclosure Report is prepared in Japanese occasionally with English translation and the licensed broker in charge of preparing the report is required to present the report to the buyer in written form and also verbally explain the contents of the report to prior to the buyer signing the purchase and sale agreement.

07. Does a seller require a deposit upon signing a purchase and sale agreement?

- Although there is no statutory requirement for a buyer to make a deposit in order to sign a purchase and sale agreement, a non-refundable deposit of 10% of the purchase price is commonly accepted for real estate transactions in Japan. Note that the amount of the deposit is often agreed as the amount of the liquidated damages payable by the buyer or the seller in the event the purchase and sale agreement is terminated due to the fault of the buyer or seller.
- The deposit is usually paid to a Seller's account upon signing of the sale and purchase agreement, and the remaining amount of the purchase price will be settled upon completion of the transaction.

08. Are escrow services available in Japan?

- Yes, there are several agents in Japan providing escrow services for real estate transactions but these services are not often used in Japan.

09. What is the typical closing process?

- Upon execution of the purchase and sale agreement, the seller and buyer will prepare to hand over the subject assets in a smooth and timely manner. The closing process usually takes one to two months after signing, but in some transactions, the purchase and sale agreement is simultaneously executed and the transaction is closed on the same day.
- At the closing, the seller and buyer settle the payment and hand over the subject assets including related documents and keys. A judicial scrivener engaged by the seller usually prepares and files the necessary document to apply for registration of the title transfer for the transaction on behalf of both parties.

10. Does a buyer have to pay a transaction fee to a real estate broker?

- This varies depending on the deal. A real estate broker is allowed to charge a transaction fee to a buyer up to the statutorily mandated maximum fee of approximately 3% but payment of a fee is not mandatory and subject to negotiation. Investors should discuss brokerage fees with their real estate broker and the seller at the outset to determine what the required fees are which sometimes are charged to both the seller and buyer.

C. Investment Structure

01. What is the typical structure of a hotel acquisition in Japan by foreign investors?

- The structures or vehicles most widely used by foreign investors to acquire hotel real estate in Japan are the TMK and the TK or GK-TK structures, as described in greater detail on pages 11-13 of this Guide.

02. Do prospective foreign investors need to set up an office in Japan in order to set up a TMK, TK, GK or KK?

- No, they do not need to set up an office, although at least one company representative, e.g. director, manager or member residing in Japan will be required for a TMK in Japan. Depending on the structure, offshore investors may either need to file a tax return in Japan for income earned in Japan or file on the basis of the permanent establishment status of the foreign company through which the investment is made. Prospective investors should consult their legal and tax advisors for detailed advice.

03. What asset management services are required under the regulatory framework in Japan?

- If the hotel real estate is entrusted to a trust bank, the minimum asset management services required on behalf of the company owning the TBI under the Financial Instruments Exhange Act (FIEA) is the giving of instructions to the trust bank on behalf of the company owning the TBI for the administration of the real estate. See pages 13-14 of this Guide for more information.

04. Why is real estate title is frequently entrusted?

- One key benefit of entrusting real estate is to save transfer tax. While acquisition of bare real estate is subject to real estate acquisition tax, a transfer of a trust beneficially interest (TBI) is not subject to real estate acquisition tax. Stamp duty levied on TBI transfers is also lower than that levied on transfers of bare real estate. Although entrustment involves additional cost such as trust service fees for the buyer, it is still considered a more cost-efficient approach particularly in large transactions depending on the anticipated holding period.
- Another benefit of entrusting real estate is that trust banks tend to conduct their own due diligence regarding the assets prior to agreeing to accept the real estate, thus giving investors some level of comfort as to compliance matters. This is particularly helpful for institutional investors such as J-REITs. Due diligence conducted by trust banks is normally conducted independent of the buyer's due diligence.

05. Can foreign investors replace the trust bank upon the completion of the acquisition of the TBI?

- Yes they can, subject to consent from both current and incoming trust banks.

06. What are the typical trust fees and asset management fees?

- There is no official guideline or regulation regarding trust fees, as these are typically negotiated between the beneficiary and the trustee. Depending on the trust bank, the annual trust fee may be structured as a percentage of the asset value, for example, less than 1.0%, or as a fixed amount.
- Likewise, there is no commonly recognized asset management fee structure in the market. The fee level depends entirely on the scope of services provided which, in turn, vary from contract to contract. In addition, depending on the asset manager, the asset management fee might be structured as a percentage of net operating income, for example, 5.0%, or alternatively be pegged at a certain percentage of the asset value, for example 1.0%. In addition, it is not uncommon for an asset manager to charge a percentage of the assets acquired or disposed if the scope of the asset manager includes assistance with the acquisition or disposition of assets.

D. Accounting/Tax

01. Do Japanese hotel owners / operators use a standard format for managerial accounting (i.e. USALI)?

- While some Japanese hotel operators use USALI, the majority do not use any standard format for managerial accounting.

02. What kind of real estate transfer taxes do the buyer / seller bear?

- Normally the buyer is responsible for the real estate acquisition tax, the stamp duty incurred in registering the transfer of title, and the consumption taxes applicable to the value of the building being sold.
- Real estate acquisition tax is typically 1.5% to 4.0% of the land and building value assessed by the municipal government.
- Typical registration tax incurred in registering the transfer of title is 1.5% to 2.0% of the transaction value (usually the purchase price).
- Stamp duty of up to JPY480,000 depending on the value of the transaction stated in the purchase and sale agreement.
- Consumption taxes are currently 8.0% and are applicable to the value of the building (usually the purchase price allocated to the building).
- Due to frequent changes in the applicable rates and different treatments for different asset types, potential investors should consult their real estate and tax advisors for further information.

03. What is the corporate tax rate in Japan and what measures can be put in place to reduce corporate tax rate?

- In general, the effective corporate tax rate is 33% to 35%. There are several ways to reduce the effective tax rate and these are outlined in page 11 of this Guide.

04. How is property tax assessed?

- An assessed property value is determined by the municipal government, which issues the tax bill and the assessed value to the owner as of January 1 which is payable usually in two instalments as determined by the applicable municipal government.
- Property tax comprises fixed asset tax and urban planning tax.
- The property tax rate set by the municipal government is typically 1.4%.
- The urban planning tax rate is typically less than 0.3%.

05. How is the value of the building portion of the real estate determined for the purpose of calculating the consumption tax?

- The allocation of the purchase price between land and building is typically stipulated in a purchase and sale agreement. However, as there are several approaches to determining the allocation, potential investors should consult their tax and accounting advisors for further information.

E. Others

01. Are hotel owners required to purchase earthquake insurance in Japan?

- Earthquake insurance is typically not required, but may be required by the non-recourse lender if the PML exceeds a certain level based on the lender's underwriting criteria. .

02. What is PML? How PML is calculated and what is its relevance?

- Probable Maximum Loss indicates how much economic value would be lost due to a strong earthquake, estimated to occur once every 475 years. An Engineering Report prepared by a licensed engineering firm usually estimates the PML. A PML less than 15% is generally expected by buyers and lenders.

03. What is a structural calculation document (*Kouzou Keisansho*)?

- A structural calculation document is a summary of structural calculations for the building's architect. The report is normally prepared as part of the detailed property plans. The report shows the tolerance of the structure for weight and other forces including seismic impact. The report normally consists of 100 to 500 pages of calculations and underlying assumptions.
- Structural calculation document is normally reviewed by engineers in order to prepare an engineering report.

04. Are foreign investors allowed to secure non-recourse financing for acquisitions of hotels in Japan?

- Yes they are, but often lenders will request certain bankruptcy remote ownership structures and a sponsor guarantee for "bad boy carve-outs" and environmental liabilities.

05. Is it possible to acquire hotel management platform companies or brands in Japan?

- Yes, however, such opportunities are rather rare as many of the domestic hotel management companies are owned by large domestic companies such as publicly traded real estate developers or railway companies.
- A hotel license is required for owner-operators or third-party operators of hotels. Refer to page 17 of this Guide for more detailed information.

06. Is there any hotel-specific labour union in Japan?

- There is no industry-wide labor union focusing on the hospitality industry in Japan. If hotel staff do unionize, it will usually be at the operating company or group-wide level.

07. How are alternative accommodation platforms such as Airbnb regulated in Japan?

- Comprehensive regulations for alternative accommodation platforms such as Airbnb are currently being considered at the national and local levels in Japan. Some regulations have been adopted in certain localities with limited participation (see below). Note that as a general rule, subject to certain exceptions under applicable local regulations, offering short term accommodation for payment would be deemed conducting hotel business and not having the required hotel permit would be in breach of the Hotel Business Act (Ryokan Gyo Hou) depending on the length of stay and other factors.
- The Japanese government has designated certain National Strategic Special Zones in which local governments can pass special ordinances allowing private owners under certain conditions to offer such accommodation without obtaining a hotel permit. To date, only two local governments have passed such ordinances: Osaka City and Ota-ku in Tokyo, but very few facilities have registered under these ordinances due to very strict conditions such as minimum length of stays, etc.

08. Is gaming legalized in Japan?

- Various types of gambling such as horse racing, motor boat racing, bicycle racing and lotteries have been legal in Japan for many years under special laws. As to casino gaming, there has been much discussion - especially during the past five years - of Japan adopting legislation to legalize casino type gaming. As recently as in January 2016, the ruling Liberal Democratic Party (LDP) declared that the Integrated Resorts Promotion bill would not be introduced during the current session of the Diet. However, with the current focus by the LDP and its coalition parties to pass more legislation to boost the economy, the Integrated Resorts Promotion bill may be introduced as early as during the September 26 to November 30, 2016 extraordinary session of the Diet, but the likelihood of passage is reported as not being high.

09. Does the Japanese government have any incentive plans for developers to encourage them to build hotels?

- In June 2016, the Ministry of Land, Infrastructure, Transport and Tourism requested local governments to award a bonus FAR (floor-to-area ratio) of 1:5, or up to an additional 300%, depending on the conditions of the hotel development.
- Construction works for hotels are subject to the new system, which will start as early as the end of 2016 fiscal year (ending March 2017). The new standards are expected to substantially increase hotel room stock before the 2020 Tokyo Olympic and Paralympic Games.

JAPANESE STRUCTURES FOR HOTEL INVESTMENTS

A threshold question to consider in planning any hotel investment in Japan is what structure or vehicle the investor ought to use in order to acquire or develop hotel assets.

A number of different structures are available for the acquisition or development of hotel assets in Japan. The more common entities and structures seen in Japan are the *Kabushiki Kaisha*, commonly referred to as the KK, the *Godo Kaisha*, commonly referred to as the GK, the *Tokutei Mokuteki Kaisha*, commonly referred to as the TMK, and the *Tokumei Kumiai*, commonly referred to as the TK or GK-TK structure.

The structures or vehicles most widely used by foreign investors to acquire hotel real estate in Japan are the TMK, and the TK or GK-TK structures. TMKs and GK-TKs are used in a variety of real estate finance transactions in Japan, including bankruptcy remote acquisitions, limited-recourse lending and securitization transactions.

Both structures offer tax benefits that are not available to investors using ordinary business vehicles such as the KK or GK. However, the tax advantages of these structures must be carefully weighed against other considerations such as the cost of establishment and administration, as well as licensing and filing requirements.

The following pages of this Guide provide an outline of the TMK and GK-TK structures.

KK

A KK, sometimes referred to as a "joint stock corporation" is most often used by larger, more established companies for carrying on business in Japan including hotel business.

While the TMK or the TK structure may be more tax efficient vehicles for foreign investors, in some cases it may be advantageous to acquire the shares or take over the business of the existing KK which owns and operates the hotel assets instead of acquiring the hotel assets in a TMK or TK-GK structure. The analysis is similar to shares vs. assets in a mergers and acquisitions transaction. Potential advantages of a share transaction include not having to obtain the transfer related consents from third parties in some instances or the transfer of licenses (unless change of control requires such consents), no real estate transfer tax and the possibility of acquiring tax-deductible loss carry-forward. Potential disadvantages include the assumption of the liabilities of the KK.

A KK is incorporated under the Companies Act and must have at least one shareholder to whom at least one share must be issued, and at least one director. The Japan residency requirement for at least one director was abolished but lenders, etc. for practical reasons may still require a KK to have at least one resident director. A shareholder of a KK is generally not liable for the debts and other obligations of the company. The business affairs of a KK are overseen by one or more directors (individually or collectively as a board if the KK decides to have a board).

Income earned by a KK is subject to corporate tax (national and local) currently at a marginal rate of 33% to 35%. A KK is also not eligible for any preferential tax treatment on real estate investments, along the lines which a TMK or TK may enjoy as explained below.

The KK has become less commonly used for real estate investment purposes since the introduction of the GK several years ago as explained below.

GK

A GK, sometimes referred to as a "limited liability company", is modelled on the limited liability company provided for under US law.

A GK is also incorporated under the Companies Act and must have at least one member or equity holder (*shain*) but does not appoint directors. However, if the member or executive member (*shikkou shain*), if there is more than one member, is a company, they must appoint a manager (*shokumu shikkousha*). The members of a GK are responsible for the management of its business but are generally not liable for its debts and other obligations. The GK does not require any Japan resident member, executive member or manager but lenders, etc. for practical reasons may still require a GK to have at least one resident member, executive member or manager.

The GK has become more commonly used in real estate investment transactions by foreign investors in part because of its simpler governance structure. In addition, a lender will usually prefer a GK over a KK because a GK cannot be made subject to corporate reorganization proceedings to which a lender's security interest may be subject.

Income earned by a GK, whether from real estate investments or otherwise, is subject to corporate tax (national and local) currently at a marginal rate of 33% to 35%. As with a KK, the GK is not eligible for any preferential tax treatment on real estate investments along the lines which a TMK or TK may enjoy.

TMK

A TMK is a special purpose limited liability company that can only be established and used in connection with the securitization or "monetization" of certain prescribed assets, including real estate and trust beneficiary interests in real estate.

A TMK is authorized under the Act on Securitization of Assets (*Shisan Ryuudouka Hou*), commonly referred to as the Asset Liquidation Law, to purchase prescribed assets, and to fund the purchase of such assets through the issue of prescribed classes of equity to investors, or by the issuance of specified bonds to or specified purpose borrowings from one or more qualified institutional investors (QII). The securities which a TMK can issue for funding the purchase of assets generally are limited to "preferred equity" (*yuusen shusshi*), "specified bonds" (*tokutei shasai*), and specified purpose borrowings (*tokutei mokuteki kariire*).

A TMK must comply with various regulatory requirements including the filing of a "notification of commencement of business" (*gyoumu kaishi todokedesho*) and an "asset liquidation plan" (*shisan ryuudouka keikaku*) or ALP, with the competent Local Finance Bureau of the Ministry of Finance. This needs to be completed before it acquires any assets, issues any preferred equity or specified bond securities, or undertakes any borrowings.

If local nonrecourse financing (bond or loan) is contemplated, the lender may require that the TMK's voting capital is owned by a "general incorporated association" (*ippan shadan houjin*), a Japan bankruptcy remote vehicle, or alternatively an offshore bankruptcy remote vehicle such as a Cayman Island charitable trust.

In addition, as preferred equity and specified bonds issued by a TMK are regarded as types of "security" (*yuuka shouken*) under the FIEA, it must appoint a "solicitation" or private placement agent, who is usually a licensed securities company or real estate asset management company, in order to issue preferred equity or specified bonds.

A key advantage of the TMK is that it is permitted to deduct distributions made to its equity holders as an expense, i.e. distributions are not subject to double taxation, provided certain requirements prescribed by the Act on Special Measures Concerning Taxation (*Sozei Tokubetsu Sochi Hou*) are met. The key requirements include:

- a majority of the specified or common equity, preferred equity and specified bonds issued by a TMK must be held by Japan taxpayers, e.g. entities organized under Japanese law or registered Japan branches of foreign incorporated entities;
- specified bonds in the amount of at least 100 million Japanese yen must be issued to and be held by one or more qualified institutional investors (QII), and if the TMK borrows monies, the loans must be made by one or more qualified institutional investors (QII); and
- the TMK distributes more than 90% of its profits as calculated under the Act on Special Measures Concerning Taxation (*Sozei Tokubetsu Sochi Hou*) to its equity holders for each applicable fiscal year.

A TMK is also entitled to reduced rates of real estate acquisition tax (*fudosan shutokuzei*) and registration and license tax (*toroku menkyozei*) in the event it should acquire the underlying or "bare" real estate (as opposed to the beneficiary interest in real estate held in trust). Dividend distributions by a TMK to non-resident equity holders are subject to the Japanese withholding tax at the rate of 20%. The reduced rate is reviewed every two years or so; historically it has been reduced to between one-third to one half of the regular rate.

A reduced treaty rate may apply depending on the residency of the non-resident equity holder and other conditions. For example, one advantage of using a Singapore-based holding or investment structure is currently the reduced tax treaty withholding rate of 5% applicable to distributions made by Japanese companies to Singapore equity holders.

TK

A TK is a type of limited partnership, often referred to as a "silent partnership". A TK is formed when a TK investor or "silent partner" enters into a bilateral agreement, commonly referred to as a TK agreement, with another party called a "TK operator" under which the TK investor provides funds to the TK operator in exchange for the TK operator's promise to distribute to the TK investor a specified share of the profits and losses arising from the TK business. A TK operator is

often a GK, and hence the term “TK-GK” structure is used to describe a TK structure in which the TK operator is a GK.

The TK operator is the only party entitled to participate in the management or administration of the TK business similar to the general partner in a limited partnership in some common law jurisdictions. It owns all of the assets of the partnership business and is responsible for making all business decisions unlike a partnership in some common law jurisdictions where the partnership owns the assets and not the general partner. The TK investor merely has contractual rights and obligations under the TK agreement and is generally not liable for the debts or other obligations of the TK business.

A key advantage of a TK is that the distribution of profit by the TK operator to the TK investor can be treated as a deductible expense at the TK operator level, i.e. distributions are not subject to double taxation. However, the TK operator’s ability to make such deductions depends on the contractual relationship between the TK investor and the TK operator qualifying as a passive “silent partner” investment arrangement. This usually means that the TK investor has no contractual right to veto decisions of the TK operator or otherwise participate in the management of the TK business. On the other hand, the management of the TMK business can be directed by the specified equity holders or the TMK’s asset manager which may be an affiliate of the TMK or an equity holder. TK distributions are subject to the Japanese withholding tax rate of 20.42%. Note that most tax treaties, especially tax treaties that were recently renewed, contain a special provision by which the Japanese tax authorities have the right to tax the TK distributions pursuant to Japanese domestic tax legislation (i.e. TK distributions are generally not subject to tax treaty benefits).

Unlike a TMK, a TK operator must be licensed under the Real Estate Syndication Act (*Fudousan Tokutei Kyoudou Jigyou Hou*) in order to acquire and manage “bare” real estate using funds contributed by a TK investor. They must also be licensed under the Real Estate Brokerage Act (*Takuchi Tatemono Torihiki Gyou Hou*) in order to conduct real estate business. These licensing requirements do not apply if the TK operator acquires a trust beneficiary interest in real estate instead of “bare” real estate since trust beneficiary interest are deemed securities rather than real estate for these purposes.

As noted above in relation to the TMK, if a local non-recourse financing is contemplated, the lender may require that the TK operator is owned by a Japanese or offshore bankruptcy remote vehicle.

TBI

In many hotel purchase and sale transactions, the hotel real estate assets offered for sale will be in the form of a trust beneficiary interest (*shintaku juekiken*), commonly referred to as a “TBI”, rather than the actual hotel land and/or building, especially if the owner is a foreign investor intending to sell the hotel in several years.

A TBI in real estate is created when the owner of the real estate entrusts the real estate to a trustee, usually a licensed trust bank. On entrustment of the real estate pursuant to a trust agreement between the owner and trustee, the trustee acquires the legal title to the real estate and the former owner acquires a trust beneficiary interest in the real estate.

Under the trust agreement, the trustee administers the real estate (but not the hotel business) for the benefit of the TBI holder in consideration for a fee and the TBI holder receives periodic distributions of trust income, after deduction of the costs of managing the real estate (including taxes and insurance).

A couple of key points for foreign investors to note here include:

- very few licensed trust banks will agree to negotiate or document the terms of the trust agreement other than in the Japanese language;
- the TBI holder will need to appoint an asset manager with the requisite license under the FIEA in order to instruct the trustee in relation to administration of the real estate as the TBI is deemed to be a security under the FIEA;
- for regulatory and other reasons, trust banks normally do not acquire and are not involved in administering or operating the hotel FF&E, employees and other business assets of the hotel – these will be held by a separate operating company, usually in the form of a KK or GK; and
- in a GK-TK structure, the TK operator (i.e. the GK) does not require a license under the Real Estate Syndication Act

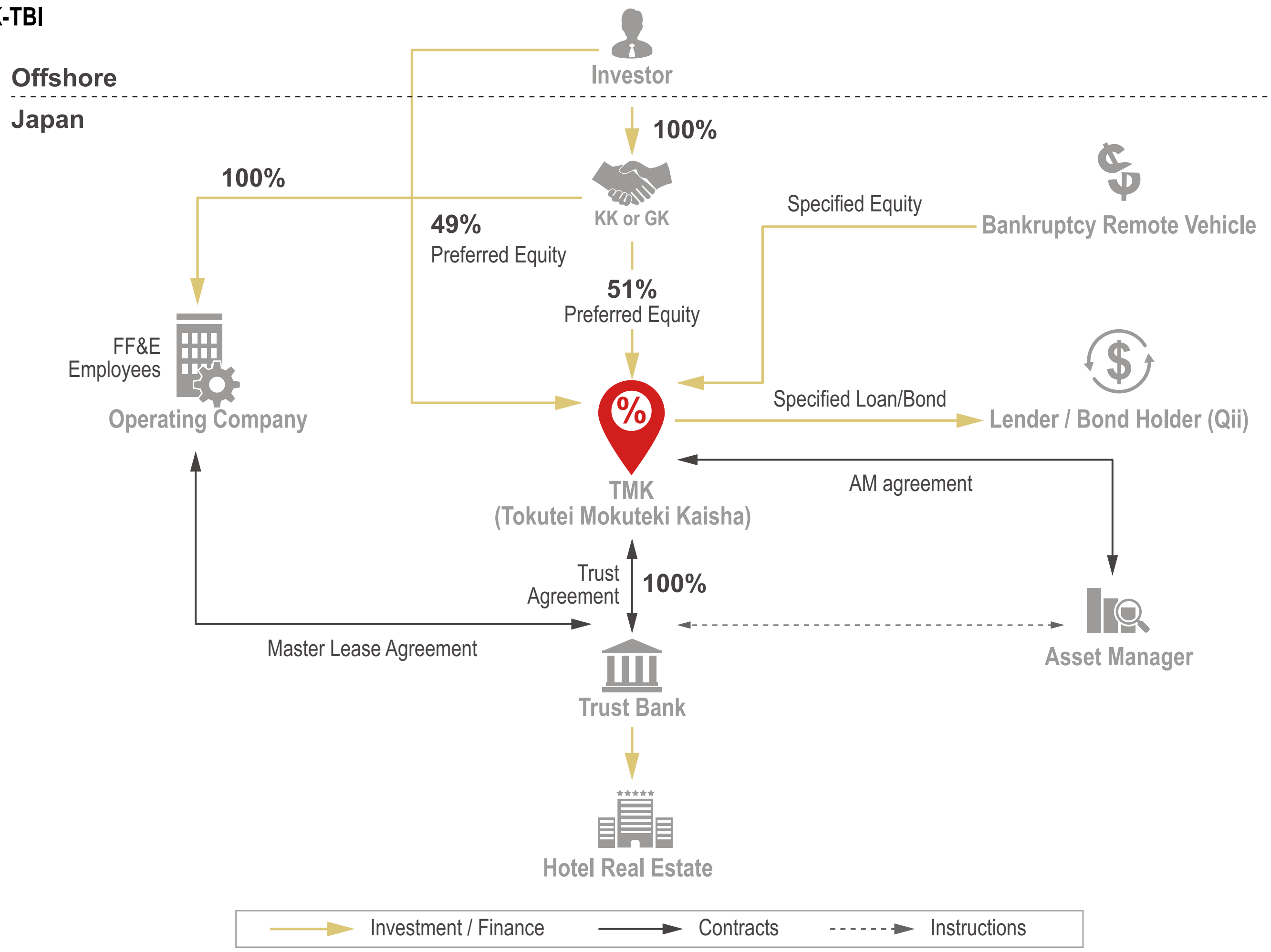
Why do developers and owners of hotel real estate often place the real estate in trust? There are several advantages to the trust structure including:

- the transfer of a TBI is not subject to real estate acquisition tax and thus, depending on the intended holding period and the trust related fees, it may be advantageous from a tax savings standpoint to entrust the real estate;
- trust banks normally undertake its own due diligence review of the real estate before accepting entrustment and will alert the buyer to any material risks identified as a result of the review and thus the lender and the market often perceives entrusted property to be in good condition at least from a building code compliance standpoint; and
- in a GK-TK structure, the TK operator does not have a license under the Real Estate Syndication Act.

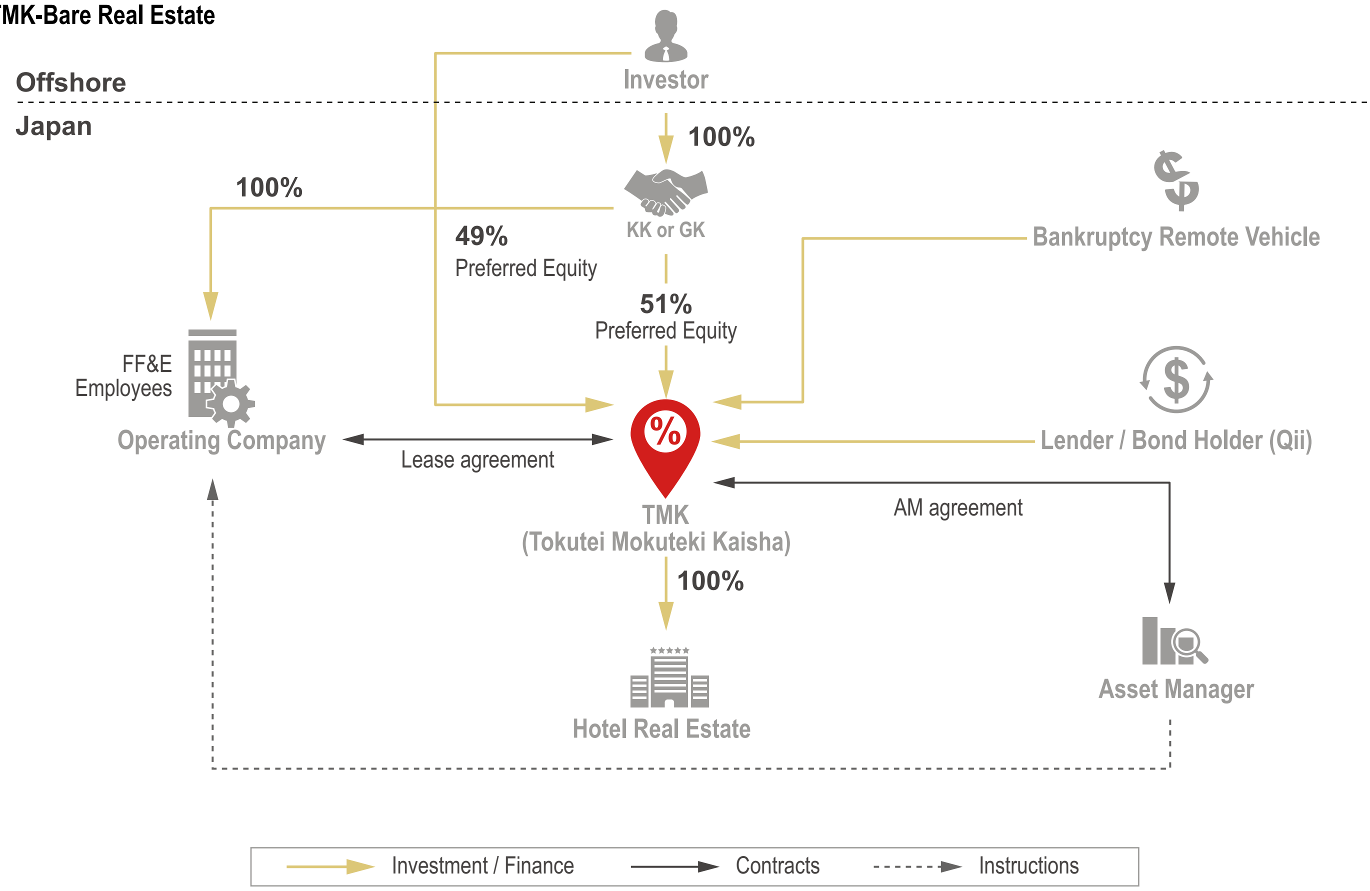
The following pages of this Guide provide structure charts illustrating how each of the TMK, GK-TK and KK structures might be used by an offshore investor to acquire a hotel in Japan. The TMK structure diagrams appearing on pages 15-16 of this Guide also highlight the key structural differences depending on whether or not the TMK acquires a TBI or bare real estate.

For ease of reference, each structure chart includes a brief summary of the key tax, regulatory and other considerations applicable to each structure.

TMK-TBI



TMK-Bare Real Estate



Key Considerations

Tax

- A TMK is permitted to deduct distributions to equity holders as an expense if it meets certain tax requirements, including:
  - issuing a majority of common equity and preferred equity to Japan taxpayers;
  - issuing specified bonds in the amount of at least 100 million Japanese yen to one or more QIIs; and
  - distributing more than 90% of profits to its equity holders for each applicable fiscal year.
- Distributions made by a TMK are currently subject to withholding tax at a 20.42% rate which may be reduced under the applicable income tax treaty (generally, to 5% under the current Japan-Singapore Tax Treaty).
- Reduced tax rates apply with respect to real estate acquisition tax / registration and license tax, should the TMK acquire the underlying real estate (as opposed to a TBI).

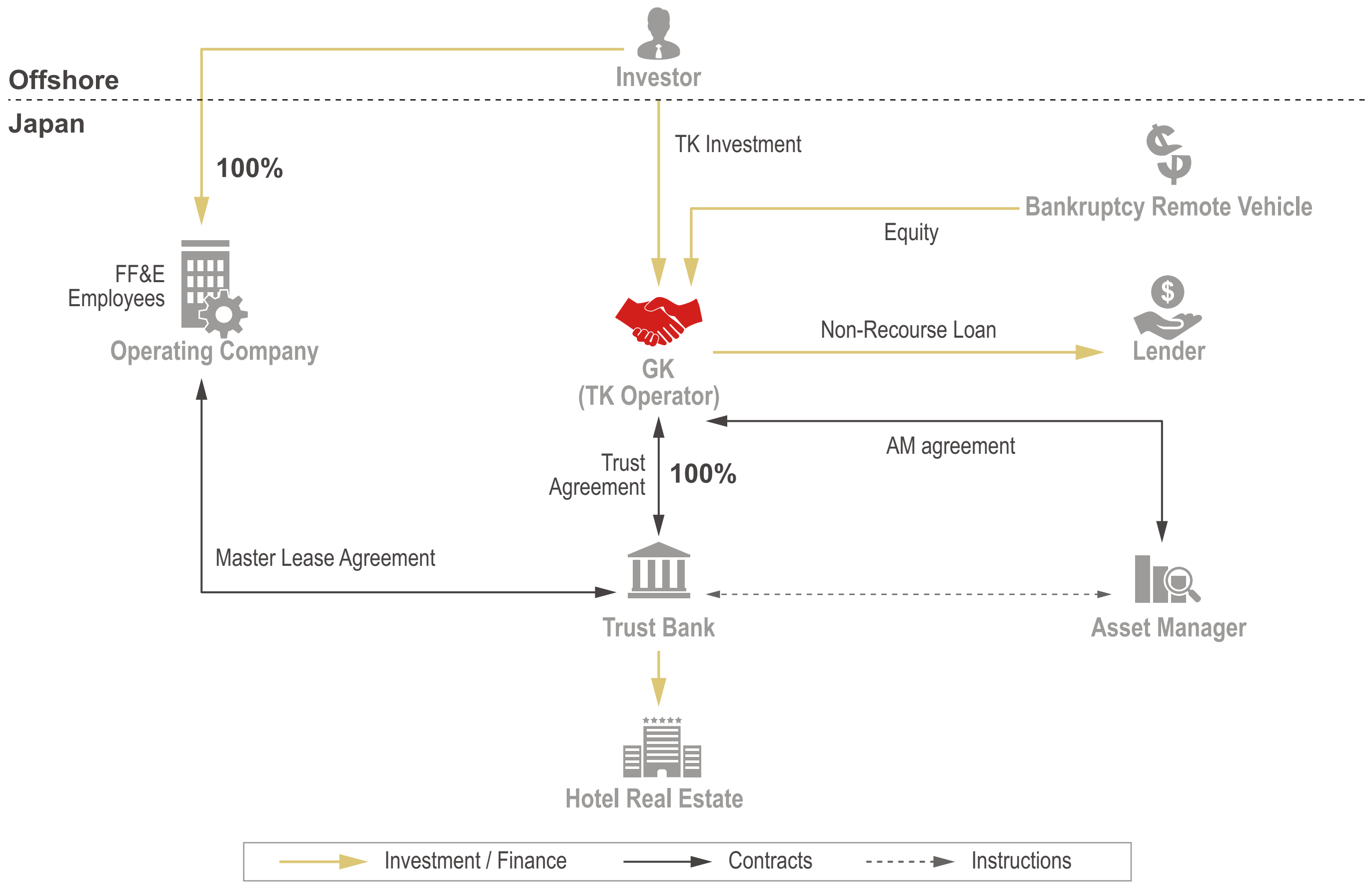
Regulation

- A TMK must file a Notification of Commencement of Business and an Asset Liquidation Plan (ALP) together to the Local Finance Bureau, before it acquires any assets or issues any preferred equity or undertakes any borrowing.
- A TMK must appoint a “solicitation” or private placement agent, in order to issue preferred equity or specified bonds.

Incorporation

- The incorporation of a TMK usually takes about one month and the preparation and filing of an ALP about one week – after most of the material terms of purchase and sale agreements, the financing and other applicable documents have been finalized. It is also permissible to amend the ALP after the initial filing at the time issuance of equity, acquisition of assets and/or financing, as necessary.

GK-TK Structure



Key Considerations

Tax

- Distributions of profit by the TK operator to the TK investor at the TK operator level are treated as a deductible expense, i.e. are not subject to double taxation.
- Profit allocable to a non-resident TK investor is subject to withholding tax at an effective rate of 20.42%, subject to a lower tax treaty rate, as applicable.
- There are no reduced rates with respect to real estate acquisition tax / registration and license tax, should the TK operator purchase the underlying property.

Regulation

- The TK is a passive “silent partner” investment arrangement, under which investor has no right to control or manage the TK business (real estate investment).
- If direct real estate is acquired as opposed to a TBI, the TK operator must be licensed under the Real Estate Syndication Act and Real Estate Brokerage Act in order to acquire “bare” real estate and to conduct real estate business.

Incorporation

- A TK operator in the form of a GK can usually be established in two to three weeks. The TK agreement with the silent partner/investor can also be prepared and executed within this timeframe.

HOTEL BUSINESS PERMIT

In order to operate a hotel as a business in Japan (i.e. to receive payment for accommodations, etc.), the hotel will need to meet certain requirements under the Hotel Business Act (*Ryokan Gyo Hou*) ("Act") and obtain a hotel business permit.

Under the Act, the hotel will need to have a minimum number of guest rooms, minimum guest room size, reception area, lobby, bathrooms, restaurant, air conditioning and heating equipment, safety features and other amenities depending on the type of hotel (i.e. regular hotel consisting of 10 or more rooms, etc., Japanese style hotel (*ryokan*) consisting of 5 or more rooms, and budget hotel with no minimum room requirements). The hotel operator, whether the owner or a third party operator, may be an individual or a company, will be the applicant to obtain a hotel business permit for the particular hotel.

The relevant public health division of the local government is in charge of reviewing and issuing hotel business permits under the Act so the requirements can vary to some extent based on the interpretation and application of the Act in different jurisdictions.

The operator will need to submit a number of different documents and satisfy a number of different steps in order to obtain the hotel business permit to operate a particular hotel. Submissions include (i) a completed application, (ii) a copy of the articles of incorporation and the certified copy of the company registry, if the operator is a company, (iii) floor plan, (iv) the construction permit application (*kenchiku kakunin*) under the Building Standards Act (*Kenchiku Kijun Hou*); and (v) an application for confirmation of fire protection compliance (*shoubo horei tekigo tsuuchi sho*) under the Fire Services Act (*Shoubo Hou*).

The opening of a hotel may require also a public hearing under the Act especially if the hotel is located near a school, library or public health center. Based on the result of the public hearing, the approval of the hotel business permit and may be conditioned on the hotel owner and/or operator accommodate certain building or operational adjustments such as the hotel not having guest room windows overlooking a school playground. These hearings are conducted by the local public health center which is the agency in charge of the general health and welfare of the community.

At a Glance Comparison

Structure	Pass-through Tax Treatment	Reduced Real Estate Transfer Taxes[1]	Solicitation/ Placement Agent	Asset Manager/ Investment Advisory/ Mangement License	Timeframe from Formation to Closing
TMK	Yes, effectively (distributions deductible)	Yes (n/a if TBI)	Must retain private placement agent to issue preferred equity and specified bonds.	Must outsource management and retain asset manager, property manager, etc. If direct real estate is involved, must have license under Real Estate Brokerage Act. If TBI is involved, the asset manager must have the requisite FIEL license.	2-3 months
GK-TK	Yes, effectively (distributions deductible)	No (n/a if TBI)	Must retain private placement agent to enter into TK agreements with TK investors unless QII exemption available.	If TBI is involved, must retain asset manager with the requisite FIEL license. If direct real estate is involved, must have licenses under the Real Estate Synidcation Act and Real Estate Brokerage Act.	1-2 months

CONCLUSIONS

- The TMK and GK-TK structures are potentially more tax-efficient structures for hotel investment but attract a range of regulatory requirements.
- The GK-TK structure allows distributions to TK investors to be “tax deductible” to the TK operator and distributions are generally subject to the 20.42% withholding tax rate (or less, depending on the applicable tax treaty) to offshore TK investors.
- However, TK investors are not permitted to manage or control the TK business.
- The TMK structure is potentially the more attractive vehicle from a tax perspective because distributions to TMK equity holders may qualify to be “tax deductible” and a withholding tax rate to offshore TMK shareholders of less than 20.42% may apply depending on the applicable tax treaty (currently reduced to 5% under the Japan-Singapore Tax Treaty).
- The TMK structure is also potentially the more attractive vehicle from a regulatory perspective because, in contrast to a TK structure, the TMK itself does not need to obtain certain licenses (can be outsourced) for management purposes or to conduct real estate business.
- However, a TMK must file an asset liquidation plan (similar to a placement memorandum) and conduct its activities in accordance with the plan. In order to qualify for the tax benefits outlined above, they must issue a specified bond to a QII in the amount of at least 100 million Japanese yen and distribute at least 90% of its profits, as calculated under the Special Measures Concerning Taxation (*Sozei Tokubetsu Sochi Hou*).

GLOSSARY

Key terms - abbreviations

ALP

Asset Liquidation Plan (*shisan ryuudouka keikaku*), a document analogous to a placement memorandum which a TMK must file before it issues any preferred equity and specified bonds, undertakes any specified borrowing or purchases any real estate.

FIEA

Financial Instruments and Exchange Act (*Kin'yu Shouhin Torihiki Hou*), Law No. 25 of 1948, as amended.

GK

Godo Kaisha, a type of limited liability company modelled on the US LLC. See page 12 for details.

KK

Kabushiki Kaisha, sometimes referred to as "joint stock corporation", a type of limited liability company widely used to carry on business in Japan. See page 11 for details.

QII

Qualified Institutional Investor (*Tekikaku Kikan Toushika*), a buyer of securities deemed sophisticated by Cabinet Order under the FIEA, such as banks and insurance companies licensed in Japan.

TBI

Trust Beneficiary Interest (*Shintaku Juekiken*), the interest that a trust beneficiary holds in property entrusted to and administered by a trustee under a trust agreement. A TBI is treated as a security under the FIEA. See pages 13-14 for details.

TK

Tokumei Kumiai, a type of limited partnership commonly used for purposes of real estate investment. See pages 12-13 for details.

TMK

Tokutei Mokuteki Kaisha, a special purpose company commonly used for purposes of real estate investment. See page 12 for details.

Key players

Asset Manager	A TMK must outsource management and retain Asset Manager, Property Manager, etc. A TBI holder that is not licensed as an investment advisor or asset manager in Japan will need to appoint a third party asset manager with the requisite FIEA license in order to instruct the trustee in relation to administration of the real estate as the TBI is deemed to be a security under the FIEA. See also pages 13-14.
Solicitation / Private Placement Agent	A TMK will need to appoint a licensed securities broker as a placement agent in order to issue preferred equity or specified bonds as those are deemed securities under the FIEA. See also page 12.
Trust Bank	A special financial institution licensed to undertake trust business under the Law Concerning Concurrent Undertaking of Trust Business by Financial Institutions (Law No. 43 of 1943). The underlying real estate of a TBI is usually owned and administered by a Trust Bank. See also pages 13-14.

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