



Japanese residential real estate investment structures overview

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Introduction

- The Japanese corporate tax rate (effective rate approximately 31-35%) is one of the highest in the developed world. This makes tax a very important consideration in undertaking Japanese real estate investments.
- Inward investment in Japanese real estate by large investors is predominantly conducted using one of two structures (or a combination of these) which each offer favourable tax treatment:
 - A Tokumei Mokuteki Kaisha (TMK) based structure; or
 - A Tokumei Kumiai (TK) based structure.
- This slide pack provides an overview of some of the key tax and related considerations associated with these structuring approaches.
- The information in this slide pack is for general information purposes only and does not represent a comprehensive or exhaustive analysis of the relevant Japanese tax treatments applicable to the indicated investment structures, nor to all potential variations on these structures. It is imperative that specific advice be sought on the tax position for particular investment transactions and structures.

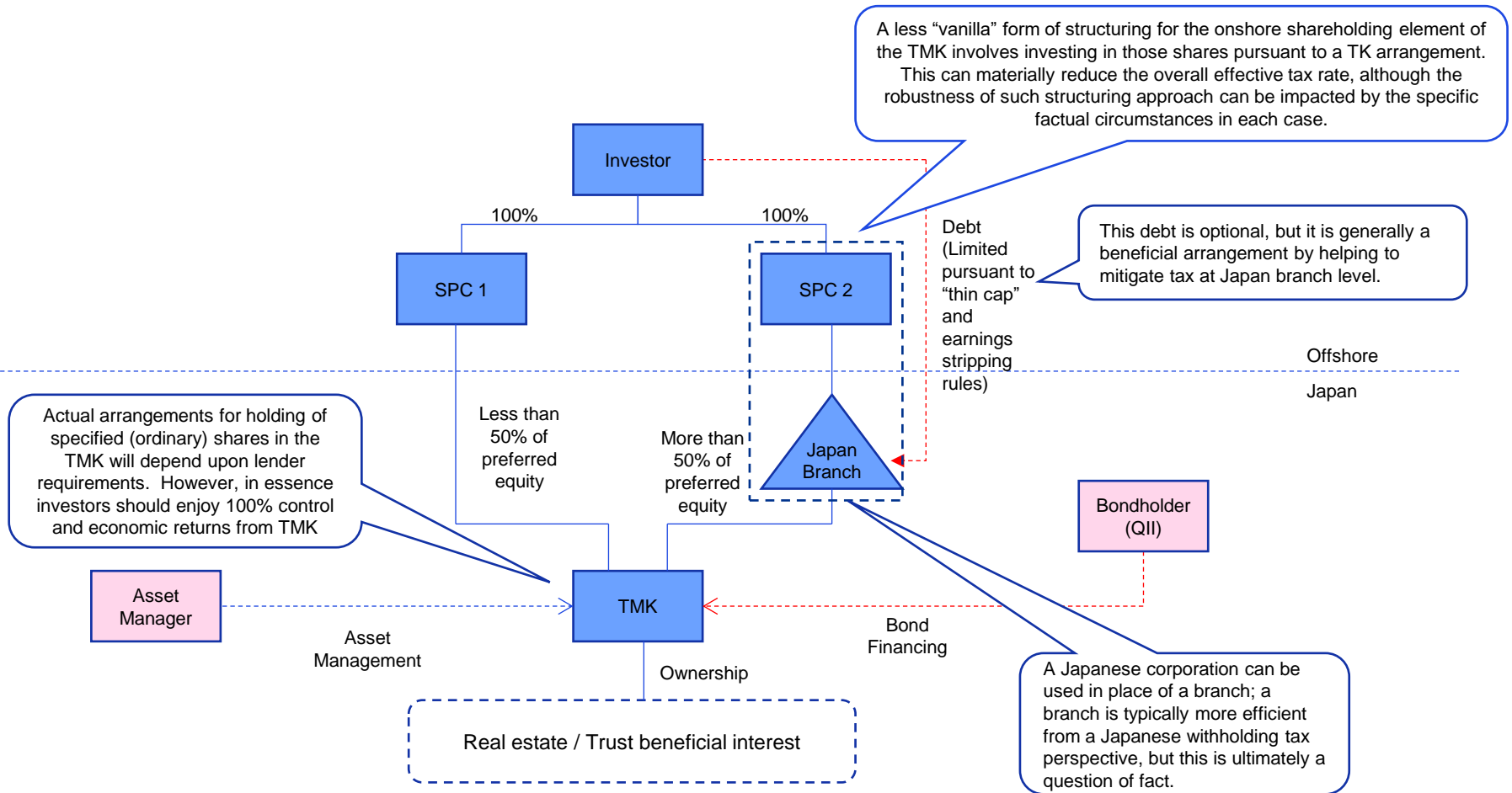
High Level Comparison at a Glance

	TMK	TK
Form of investment interest	Ownership of equity in property owning vehicle	Contractual with more limited rights. This means more limited legal control over the asset.
Ease and cost of set up	Somewhat complicated, but widely used and understood.	Somewhat complicated, but widely used and understood.
Timing for set up (lead time for closing an investment)	Around 2 months	Around 2 months
Tax Robustness	Generally robust, subject to tax treaty eligibility	Level of robustness will be very fact specific. Often some level of potential sensitivity
External Debt Financing	Required	Optional. Lender friendly structure
Cash Repatriation	Somewhat cumbersome	Easy
Tax outcome dependent on tax treaty benefit eligibility	Yes	(Generally) No
Feasible for development projects	Yes	Yes
Indicative Japanese Effective Tax Rate	Approximately 20% - 27.5% dependent on tax treaty (some potential further reduction through internal financing, whilst a TMK-TK hybrid approach could potentially reduce ETR to 12.5% - 20% or even lower if the investor into the TK is Korean)	20.42%



TMK investment

Illustrative TMK Structure Diagram

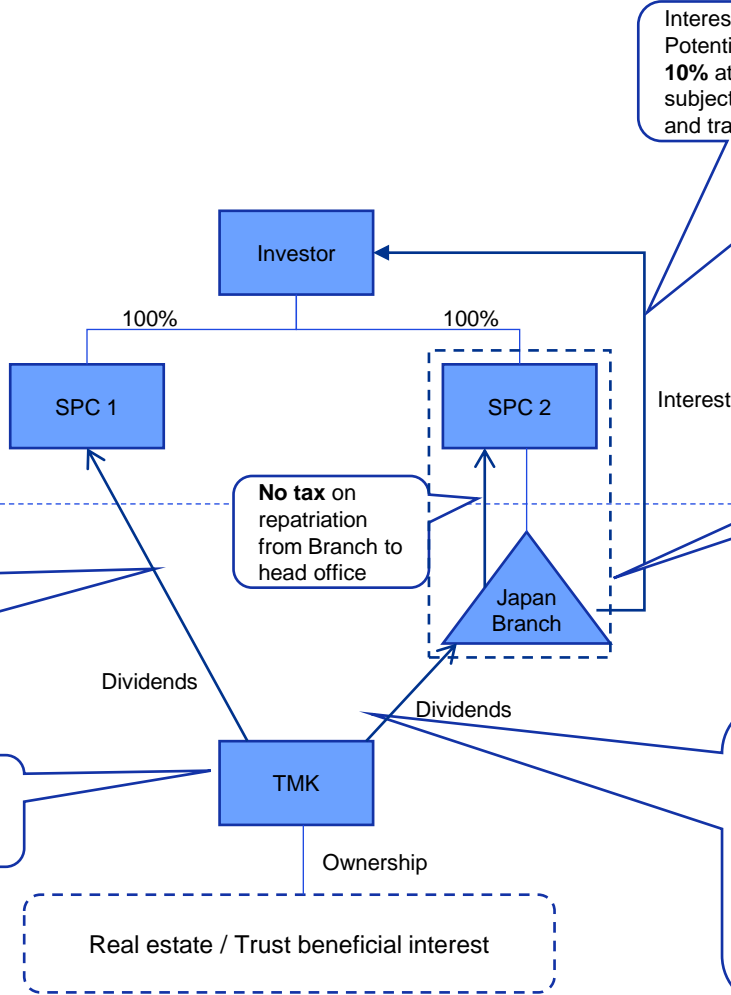


Illustrative TMK Cashflow/Tax Leakage Diagram

Indicative Effective Japanese Tax Rate

$49.9\% \times (\text{say}) 10\% + 50.1\% \times 35\% = 22.5\%$ (for example)

This can be reduced by leverage at the onshore holder of the preferred shares (i.e. at the Japan Branch level) and can be impacted – up or down – by the extent of tax treaty relief available and the branch taxation position. With a TMK-TK hybrid approach, ETR potentially reducible to **12.5% to 20%**.



Interest is subject to **20.42%** withholding tax. Potentially reducible under tax treaty, typically to **10%** at best. Deductible amount of interest subject to "thin capitalization", earning stripping and transfer pricing rules.

Branch is subject to tax at approx. **31-35%** depending on circumstances. Additional non-profit based taxation may also apply. As noted with a TK this can potentially be reduced to **low 20%**. Potentially **0%** for genuine Korean resident investors, for a genuine TK arrangement.

No tax on repatriation from Branch to head office

Offshore
Japan

Payment of **pre-tax dividends** subject to **20.42% withholding tax**. Potentially reducible under tax treaty, for example to **5% (Singapore)** or **10% (PRC)** or **15% (Australia)**.

TMK level taxation should be minimal if managed correctly. Maximum around **JPY2m per year**.

Payment of pre-tax dividends subject to 20.42% withholding tax. This is fully creditable against tax liability of the branch (and refundable if in excess of tax liability). Pursuant to the 2022 Japan tax reforms, the WHT obligation on dividends payable on or after 1 October 2023 to domestic corporate shareholders that directly own more than one third of the total shares in a dividend paying entity is expected to be abolished.

TMK Structure – Some Key Features

What is a TMK?

- A TMK is a special purpose corporate vehicle introduced to encourage securitisation of certain assets. A TMK can only acquire limited types of assets (essentially, real estate related) and undertake limited activities.
- Investors in a TMK will hold equity as shareholders, and will receive returns in the form of dividends before corporate tax provided the TMK meets the tax qualifying requirements. Since the investor is the owner of the TMK, the investor has ultimate control over the management and operation of the investment made through the TMK.

Why is a TMK tax efficient?

- In principle, a TMK is subject to normal corporate tax rates of approximately 35% on its taxable profit. However, where the TMK meets the conditions to be a “tax qualifying” TMK, it is allowed to take a deduction against taxable income in respect of any dividend distributions which it makes to shareholders. Given this treatment, the TMK itself will typically only suffer very limited tax itself. This is the same for both rental income and capital gains.
- In essence therefore the burden of Japanese taxation on returns from investments the TMK makes is levied on the distributions to shareholders. Given a shareholder directly holding TMK shares from offshore should only be subject to withholding tax on such distributions, the overall tax burden can be considerably reduced relative to the normal 30-35% rate in Japan.

Some Key Limitations

- In order to obtain a deduction for its dividends the TMK must meet a number of conditions. Although these conditions can typically be achieved without undue burden, it does have to be noted that there are limitations on the actions and attributes of the TMK which must be observed to preserve its beneficial tax status. The relevant conditions for “tax qualifying” status are set out in the following slides.
- One such key condition is the requirement for the TMK to obtain bond financing – i.e. a debt free approach is not possible with a TMK structure.
- Returning of cash from the TMK to shareholders can only be achieved through a dividend (which requires distributable earnings) or a redemption of preferred equity (which requires a legal process to be completed, and also naturally requires outstanding preferred equity which can be returned). Thus, there is typically less flexibility for returning of cash under a TMK structure relative to TK or Direct offshore ownership structures.

Some key merits and demerits of the TMK

Merits

- No requirement for passive investment, so investors can maintain control and ultimate ownership.
- Competitive tax rate where a beneficial tax treaty dividend withholding tax rate can be accessed.
- Potential for greatest certainty on tax treatment.
- Potential reduction in property acquisition taxes, which is especially beneficial where target real estate is unentrusted.

Demerits

- Sources of funding are restricted by the TMK related laws (practically, bonds will have to be issued to Tax QII) with attendant additional costs and administration associated with the preparation of the relevant documentation etc.
- Less flexibility regarding repatriation of cash. Pre-liquidation this requires a dividend or a redemption of preferred equity.
- Relatively burdensome regulatory requirements on set up and maintenance.
- Typically higher set up and running costs as more entities are required.
- Tax rate achievable very dependent on availability of tax treaty benefits. Access to and robustness of tax treaty positions may be more challenging under the BEPS / Multilateral Instrument regime, particularly for collective investment arrangements.

TMK “tax qualifying” conditions

Conditions to be a “tax qualifying” TMK

1. The TMK is duly registered under Article 8 of the current TMK law;
2. At least one of the following conditions is satisfied:
 - a. The TMK has issued corporate bonds which are offered to the public, as provided in Article 2-3-1 of the Financial Instruments and Exchange Law, and the issuance amount is JPY 100 million or more;
 - b. The TMK has issued corporate bonds which are fully subscribed by and are expected to be continued to be held by Tax QII;
 - c. The TMK has issued preferred equity units which are subscribed by 50 or more investors; or
 - d. The TMK has issued preferred equity units which are subscribed to only by Tax QIIs.
3. More than 50% of the total issuance price of any preferred equity issued, and more than 50% of the total issuance price of any specified equity issued, must be for, respectively, preferred equity and specified equity issued in Japan.
4. The TMK’s fiscal year does not exceed one year.

Although there are four “securitisation” events available to the TMK, the practical reality is that the Tax QII bond issuance is the option which is adopted in practice. Note that there is no minimum issuance amount prescribed for this and the necessary amount should be considered on both absolute and relative terms based on the specific investment.

This is an important requirement because it effectively requires that the majority of the TMK’s equity must be issued domestically. Since a domestic shareholder will be subject to a higher level of taxation than an offshore shareholder this has the effect of increasing the overall Japanese tax rate on an investment ultimately held 100% from offshore.

TMK “tax qualifying” conditions

Conditions to be a “tax qualifying” TMK continued

Dividends deductible as an expense for tax purposes under the TMK law are those declared for the fiscal year in which the TMK meets all of the following conditions:

5. The TMK conducts its asset securitisation business and other business relating thereto in accordance with its Asset Liquidation Plan.
6. The TMK only engages in business prescribed under its Asset Liquidation Plan.
7. The TMK contracts out the management of the specified assets to a third party prescribed under the TMK Law, or enters into a trust agreement with a third party trustee for management of the specified assets.
8. The TMK is not a closely held company within the meaning of the Japanese Corporate Tax Law and the Ordinance for Enforcement of the STML, except in cases where condition 2(a) or (b) above is satisfied.
9. More than 90% of the TMK’s “distributable profit” in respect of the fiscal year is declared and paid as a dividend to the equity holders.

Strictly these further conditions are fiscal period conditions. That is, a TMK could fail such a condition and not be a “tax qualifying” TMK in relation to that period, but could then attain or regain such “tax qualifying” status in a subsequent period.

Distributable profit is a defined amount (refer to NOTE on following slide) which is an adjusted accounting profit figure. Because one of the adjustments is 5% of the outstanding bond amount, this can mean that “distributable profit” is relatively low (or possibly zero) and this hurdle easy to meet. However, it should be noted that this is the minimum distribution requirement for “tax qualifying” status only. In order to minimise taxable income the TMK should always be looking to distribute an amount as close as possible to its taxable profit for the relevant period.

TMK “tax qualifying” conditions

Conditions to be a “tax qualifying” TMK continued

10. The TMK does not have any assets other than the properties or other specified assets disclosed in its Asset Liquidation Plan.

11. Where the TMK obtains a loan, this should only be from Tax QII and should not be from specified equity holders.

Note that the “tax qualifying” TMK can also obtain loan financing in addition to debt financing, but this must again come from a Tax QII.

NOTE:

$$\begin{array}{rcl}
 \text{Distributable profit} & = & \text{Distributable profit calculated based on accounting principles (Note c)} \\
 & & \text{less } \left\{ \begin{array}{l} 5\% \text{ of outstanding bonds value (Note a)} \\ \text{less Retained earnings carried forward from prior years} \end{array} \right. \\
 & & \text{plus } [X] \text{ (Note b)}
 \end{array}$$

Note (a): The outstanding bond value means the balance of the bond at the end of the financial year.

Note (b): $[X] = \{\text{Redemption amount of bonds during the financial year (if any) less: Depreciation amounts that are deductible for corporate tax purposes}\} \times 2$

If $[X]$ is a negative amount, $[X]$ is treated as zero. That is to say, if the total amount of bonds redeemed during the financial year does not exceed the depreciation expense recognised by the TMK during the financial year, this adjustment is not required.

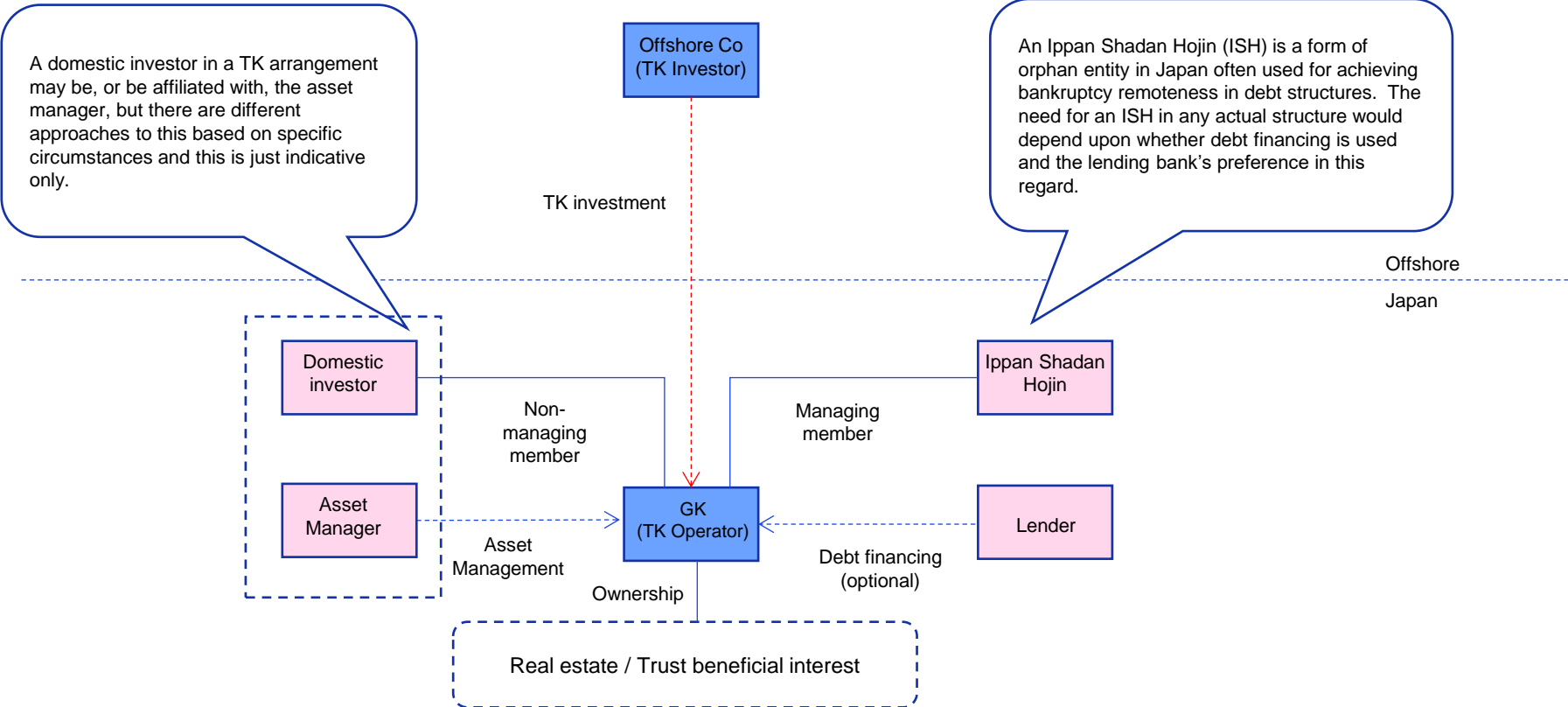
Also, if the Specified Assets (being those assets identified in the Asset Liquidation Plan) are disposed of, or the TMK issues bonds or promissory notes (including loans) during the financial year, amounts acquired from the disposition or issuance and applied to the bond redemption are deducted from the above redemption amounts of the bonds.

Note (c) : If there is any loss carried forward from prior years and/or any current year impairment loss, the total amount of the loss carried forward from prior years and 70% of the current year impairment loss is deducted from the accounting income before tax.



TK investment

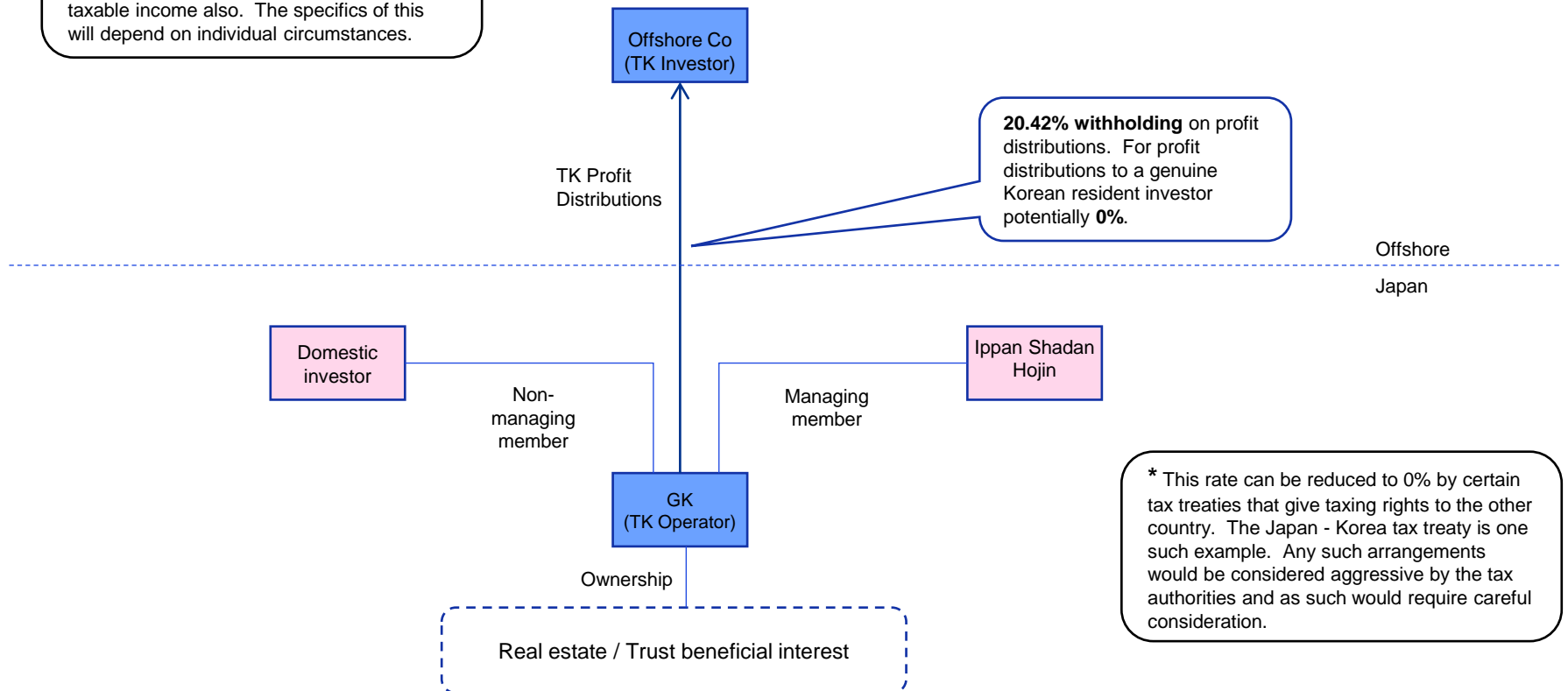
Illustrative TK Structure Diagram



Illustrative TK Cashflow/Tax Leakage Diagram

Effective Japanese Tax Rate 20.42%*

The TK Operator will typically need to receive some return. Hence, the GK and/or domestic investor will ordinarily have some taxable income also. The specifics of this will depend on individual circumstances.



* This rate can be reduced to 0% by certain tax treaties that give taxing rights to the other country. The Japan - Korea tax treaty is one such example. Any such arrangements would be considered aggressive by the tax authorities and as such would require careful consideration.

TK Structure – Some Key Features

What is a TK?

- A TK is a contractual arrangement under which one or more silent investors (the “TK investor” or *kumiai-in*) makes a contribution to a Japanese operating company (the “TK operator” or *eigyosha*) in return for a share in the profit/loss of a specified business conducted by the TK operator (the “TK business”).
- The investment by the TK investor does not represent equity in the TK operator, nor does the TK investor gain any ownership interest in the underlying assets of the TK operator. Furthermore, the TK investor is not permitted to participate in the management or operation of the TK business, but is intended to take a passive investment role (“Tokumei Kumiai” translates as “anonymous partnership”, and is often referred to as a silent partnership).
- Typically, special purpose TK operators (i.e. TK operators established to undertake a specific investment, or to achieve bankruptcy remoteness) take the form of a *godo kaisha* (“GK”). A GK is a form of Japanese limited liability company.

Why is a TK tax efficient?

- The TK operator is a standard taxable company in Japan, subject to the full Japanese effective corporate tax rate (at approximately 31-35%), but where the TK is bona fide, the TK operator is permitted a tax deduction for profits allocated to the TK investor. Accordingly, TK operator level taxable income will ordinarily be significantly reduced.
- For a non-resident TK investor with no permanent establishment (PE) in Japan, withholding tax of 20.42% arises at the time of *distribution* of allocated profits. This should be the final Japanese tax on such profits.
- A very limited number of Japan’s tax treaties provide for complete exemption from this withholding tax. The Japan-Korea tax treaty is one such example that does.
- If the TK is not viewed as bona fide, this could result in the TK investor being deemed to have a general partnership with the TK operator in Japan, resulting in taxation on the TK investor’s profits at the full Japanese effective corporate tax rate. Where for example, the Japan – Korea tax treaty is sought to be applied this would need to be considered very carefully as would of course the residency of the Korean investor and the commercial rationale for the use of Korea to invest into Japan.

Some key merits and demerits of the TK

Merits

- Debt funding and form of borrowing are optional. Further, where debt is obtained this is typically easier to arrange, less documentation intensive and more flexible.
- Relatively low, flat tax rate which may, depending on investor circumstances, provide a more favourable effective rate than under a TMK.
- Other than in the limited cases of exemption granting tax treaties, the Japanese tax result is not dependent on tax treaty eligibility.
- Can be more flexible for multiple property acquisitions.
- Faster turnaround of cash with administrative flexibility in distributing cash.
- No need to file amendments with financial regulators when plans change.
- Typically slightly lower establishment costs.

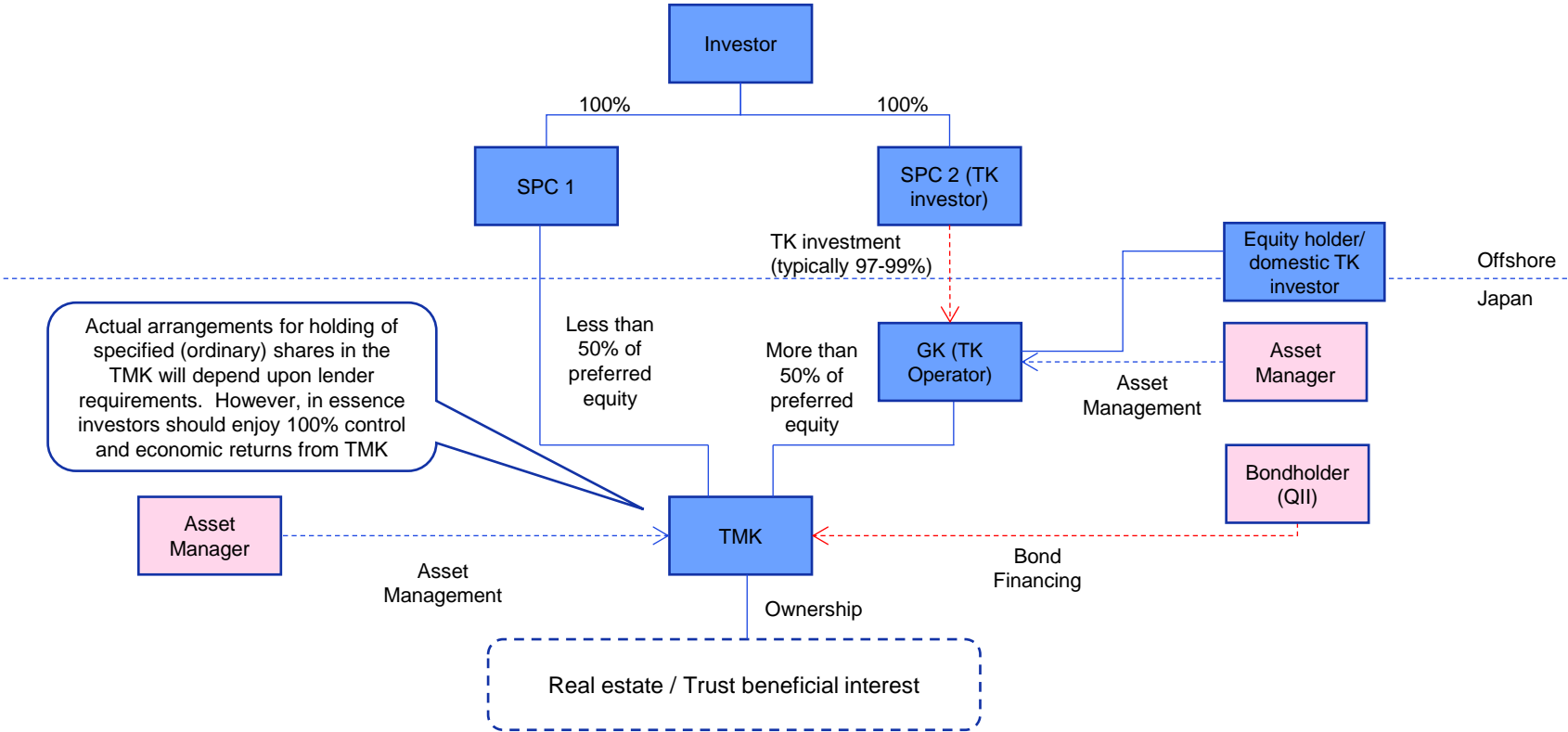
Demerits

- TK investor cannot participate in the control or management of the TK business. If this is not respected, returns can become subject to full Japanese tax rates.
- Contractual interest only for investor; no equity or ownership of underlying assets.
- Potentially less certainty as to tax outcome relative to a TMK.
- Potentially cumbersome Financial Instruments and Exchange Law and/or Real Estate Syndication Law requirements.



TMK-TK structure

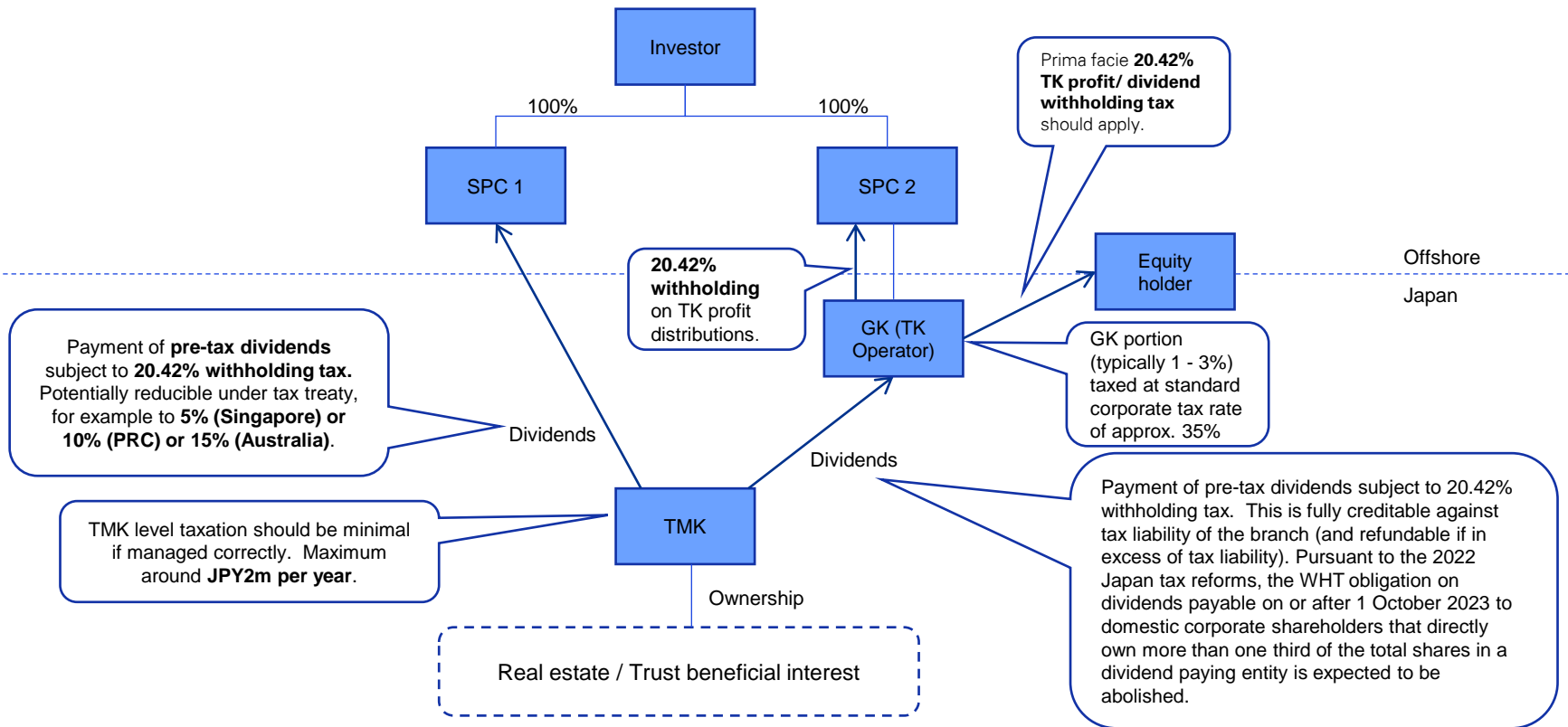
Illustrative TMK-TK Structure Diagram



Illustrative TMK-TK Cashflow/Tax Leakage Diagram

Indicative Effective Japanese Tax Rate

Potentially around 13% to 20%.





Structures for residential assets

Consumption Tax

Consumption taxable sales

- Japanese tax law requires that sellers and service providers charge consumption tax (at a rate of 10%) on sales to end users consumption taxable transactions (“**taxable sales**”).

Scope of Japanese Consumption Tax		
	Revenue items (input tax)	Expense items (output tax)
Taxable transactions	<ul style="list-style-type: none"> Commercial rents received Parking rents received Cleaning/ restoration fees received from tenants Sale proceeds from disposition of Building Utilities recoveries received from tenants (if any) Vending machine sales 	<ul style="list-style-type: none"> PM fees AM fees Utilities expenses Maintenance expenses
Non-taxable transactions	<ul style="list-style-type: none"> Residential rents Sale proceeds from disposition of Land Sale of equity Sale of debt Sale of TK instrument 	<ul style="list-style-type: none"> Insurance premiums paid Interest expense

Consumption taxpayer status

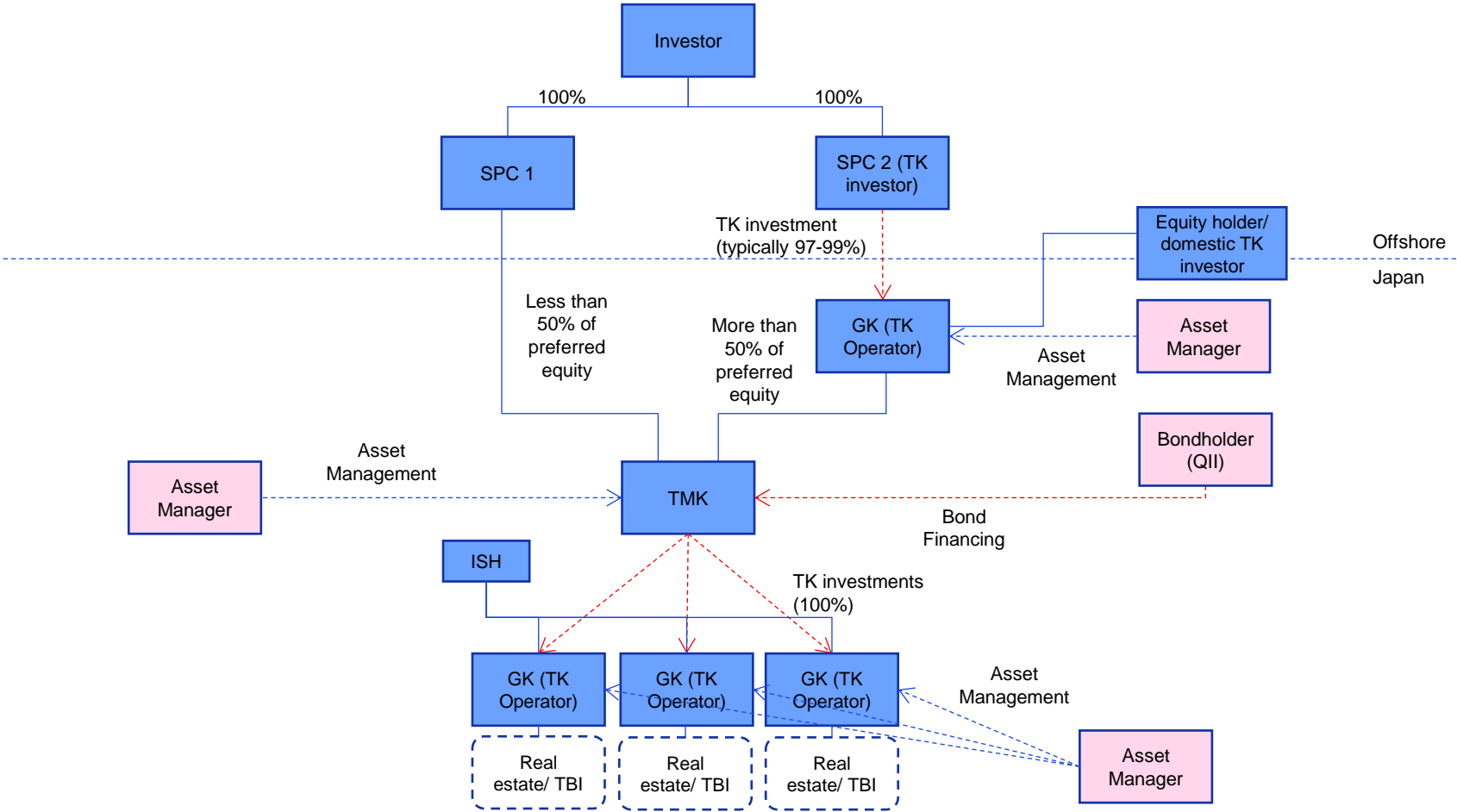
- However, whether or not the receiving entity is required to remit a portion or all of this consumption tax collected to the government will depend on the individual entity’s consumption taxpayer status.
- There are also a number of triggers for becoming a consumption taxpayer which should be considered, but most commonly, whether an entity will become a consumption taxpayer in a given fiscal period is determined based on the amount of revenue from taxable sales in the “**base period**”. Base period is broadly two fiscal years prior to the consumption taxable fiscal year of interest.

Consumption taxpayer status	
Base period annual taxable sales	Consumption taxpayer status
Not more than JPY 10M	Non-taxpayer
More than JPY 10M but not more than JPY 50M	Consumption taxpayer (can elect to be a simplified taxpayer; details on the right side)
More than JPY 50M	Consumption taxpayer

Consumption tax in the context of residential assets

- Where an asset holding entity is able to maintain non-consumption taxpayer status, they should charge consumption tax on the building sale, but are not required to remit such consumption tax to the tax authorities.
- Accordingly it is common to hold residential assets in separate asset holding GKs below a TMK in order to maintain each asset holding GK as a non-consumption taxpayer. However, this needs to be carefully managed.

Illustrative TMK-TK Structure Diagram for residential



Thank you

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