Recent developments in J-REIT structures

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Real estate funds and securitisation in Japan often take the form of real estate investment trusts (REITs). The J-REIT structure is particularly preferred for investment funds that adopt acquisition-growth strategies based on specified investment policies and criteria, and which require portfolio replacement from time to time. On the other hand, other structures are typically used for investments in real estate that are identified from the outset, and when asset replacement is not generally expected.

There have recently been several notable developments in the legal framework governing the structures of real estate funds and securitisation in Japan. This article provides an overview of these structures and summarises recent legal developments in this area.

J-REIT STRUCTURE

J-REITs take the form of "investment corporations" (toshi hōji), which are governed by the Act on Investment Trusts and Investment Corporations of Japan (ITA). An investment corporation's investment policies, which govern its investments in real property and real property-related assets (such as beneficiary interests in Japanese trusts that hold underlying real property), are set out in its articles of incorporation. Investment corporations typically derive investment funding through issuance of investment units (toshiguchi) and debt-financing arrangements (such as loans and issuance of corporate bonds). Most existing J-REITs are closed-end funds listed on the Tokyo Stock Exchange, where their investment units are publicly traded. As of 30 November 2015, there are 52 J-REITs listed on the Tokyo Stock Exchange.

Investment units in investment corporations are similar in nature to ordinary shares in Japanese joint stock companies (kabushiki kaisha). As such, many of the provisions in the Companies Act of Japan governing joint stock companies also apply to investment corporations and investment units. Due to the focus of J-REITs on acquisition growth, certain features of ordinary shares were not initially adopted for investment units. However, some such features have now been introduced to investment units.

The ITA requires investment corporations to outsource all asset management functions to licensed asset management companies (such as investment management business operators registered and licensed under the Financial Instruments and Exchange Act of Japan (FIEAJ)). In other words, J-REITs are purely investment vehicles with no capacity to manage or operate their asset portfolios, and outsource substantially all of their operations to asset management companies and other third parties.

Where certain statutory requirements (such as the requirement to make annual distributions in excess of 90% of distributable profits) are satisfied, J-REITs are exempt from corporate income tax in respect of the dividends they distribute. J-REITs enjoy such favourable tax treatment because they are considered investment vehicles that do not engage in any other business. To restrict the activities of J-REITs to asset investment, Japanese law generally prohibits J-REITs from holding majority voting rights in other entities. However, this rule has now been relaxed.

RECENT AMENDMENTS TO THE ITA

Amendments to the ITA (the Amendments) came into force on 1 December 2014. The Amendments include, among others:

- Removal of the prohibition against J-REITs acquiring their own investment units.
- Relaxation of the rules regarding rights offerings by J-REITs.
- A new exception to the prohibition against J-REITs holding majority voting rights in other entities.

The Amendments are discussed in further detail below.

Acquisition of investment units

The ITA previously prohibited J-REITs from acquiring their own investment units, except in certain limited circumstances. In the past, the market price of a J-REIT's investment units was expected, theoretically at least, to reflect the J-REIT's net asset value. In practice, however, the market price of a J-REIT's investment units was often influenced by movements in the financial and capital markets, and therefore differed from (and typically fell below) the aforementioned theoretical price. This gave rise to proposals to allow J-REITs to acquire their own investment units in order to mitigate the impact of financial and capital market conditions on market price. Such proposals have now been accepted.

According to the Amendments, J-REITs are now permitted to acquire their own investment units both through private solicitation extended to all unitholders as well as through on-market acquisitions. In either case, certain terms (including the number of investment units acquired, consideration (required to be in cash only) and the period permitted for acquisitions (restricted to a year or less)) must be determined by the board of directors of the J-REIT. J-REITs are required as soon as practicable to dispose of or cancel acquired investment units.

Rights offerings

Prior to the Amendments, the ITA allowed J-REITs to make public offerings of their investment units, but prohibited them from issuing options that entitled unitholders to subscribe for investment units at a fixed exercise price. This meant that unlike Japanese joint stock companies, J-REITs were not permitted to conduct fundraising through rights offerings.

Further, J-REITs were required under the ITA to issue their investment units at a "fair price" in public offerings. "Fair price" is generally considered to mean a price that is close to market price. However, the market price of a J-REIT's investment units, calculated on the basis of the J-REIT's net asset value, would often be lower than the theoretical value of such units. This was especially the case in times of economic downturn. As such, the "fair price" requirement often compelled the adoption of offering prices that were below net asset value-based theoretical values, which in turn diluted the value of investment units held by existing unitholders who failed to subscribe for their pro rata share in a J-REIT's new public offering.
Under the Amendments, J-REITs are now permitted to issue investment unit options. The Amendments seek to ensure fair treatment of existing unitholders and to mitigate potential dilutionary losses that may be incurred by existing unitholders.

The ability of J-REITs to issue investment unit options will be subject to certain restrictions, including the following:

- J-REITs are only permitted to issue investment unit options for no consideration by way of pro rata allotment to unitholders based on their current holding ratios, rather than through public offerings.
- J-REITs are prohibited from imposing transfer restrictions on investment unit options (or, for that matter, investment units) so as to enable holders to dispose of their allocated options on the market.
- Consideration for the exercise of investment unit options can only be paid in cash.
- The exercisable period of investment unit options must not exceed three months.

**Restriction on J-REIT shareholding in other entities**

Real estate investment in foreign jurisdictions where direct ownership of real estate is legally prohibited or restricted may, as a practical matter, be inconvenient or economically inefficient. To circumvent such difficulties, investors often establish local subsidiaries to acquire real estate. However, J-REITs were previously not permitted to hold majority voting rights in other entities, and were therefore prohibited from holding subsidiaries. This prohibition precluded J-REITs from investing in real estate through vehicles established in foreign jurisdictions.

Under the Amendments, J-REITs are now permitted to hold majority voting rights in other entities subject to the satisfaction of certain requirements, including the following:

- The target asset must be real estate located in a foreign jurisdiction.
- The J-REIT must be prevented from directly acquiring such real estate due to local regulations, local practices or for other unavoidable reasons.
- The J-REIT’s majority voting rights must be in a vehicle incorporated in the foreign jurisdiction solely for the purpose of acquiring such real estate.
- Such vehicle must distribute all cash that it is entitled to distribute under local regulations and practices, within six months from the end of each business year.

Some of these requirements require closer consideration from the regulatory and practical perspectives.

For example, certain guidelines were published on 27 June 2014, by the Financial Services Agency of Japan in respect of the second bullet point above. The guidelines designated the US, India, Indonesia, China, Vietnam and Malaysia as foreign jurisdictions where J-REITs are prevented from directly acquiring real estate due to local regulations, local practices or other unavoidable reasons. These jurisdictions are, however, only listed as typical examples. As such, it is possible that other countries may also be categorised as eligible foreign jurisdictions where J-REITs can acquire ownership in real estate through investment vehicles.

Additionally, the cash distribution requirement under the fourth bullet point above will be difficult to satisfy as a practical matter. Specifically, it is necessary to audit an investment vehicle’s financial statements in order to determine the maximum amount of cash it is able to distribute under local regulations. However, such audit process, being subject to local accounting standards, will likely take considerable time to complete. Accordingly, the six-month period within which an investment vehicle is required to distribute all its distributable cash may be too short.

It is uncertain how many J-REITs will be interested in acquiring real estate abroad in view of the need to satisfy the above requirements. Although some J-REITs such as Aeon REIT Investment Corporation have acquired real estate in foreign jurisdictions, such instances are still very rare.

**ESTABLISHMENT OF INFRASTRUCTURE FUND MARKET**

The Tokyo Stock Exchange established on 30 April 2015 an infrastructure fund market on which certain J-REIT investment units can be listed. The infrastructure fund market is mainly targeted at J-REITs that invest in infrastructure assets (including renewable energy facilities such as solar power systems), although the listing of investment trust beneficiary securities on the infrastructure fund market is also technically permissible.

Under the rules of the Tokyo Stock Exchange (TSE Rules), certain requirements must be satisfied before a J-REIT is permitted to list its investment units on the infrastructure fund market. One such requirement is that at least 70% of the J-REIT’s total asset portfolio must comprise infrastructure facilities and assets related thereto (such as securities issued by vehicles that own mainly infrastructure facilities).

The TSE Rules also require disclosure of information in respect of those entities that operate and manage the infrastructure asset portfolio of a J-REIT. In addition, the policies and strategies adopted by a J-REIT that invests in infrastructure assets in selecting and appointing infrastructure facilities operators must be expressly set out in the J-REIT’s articles of incorporation. These rules are based on the general view that infrastructure facility operators, in addition to asset management companies, are key players in the J-REIT industry.

J-REITs are exempt from corporate income tax in respect of the dividends they distribute if certain statutory requirements are satisfied. These requirements include, in the case of J-REITs that invest in infrastructure assets, compliance with the prohibition against direct operation of infrastructure facilities. Such J-REITs are instead required to lease their infrastructure facilities to third parties in order to generate rental income. An infrastructure facility rental scheme typically involves the following arrangement:

- A J-REIT gains ownership of infrastructure facilities (such as solar power generation facilities).
- The J-REIT leases the infrastructure facilities to third parties (which then become infrastructure facilities operators).
- The infrastructure facilities operators (that is, the lessors) enter into agreements with other third parties (such as agreements with energy suppliers to sell energy generated by the relevant solar power generation facilities) for purposes of generating profits.
- The infrastructure facilities operators then use the profits they have generated from the sale of solar energy to pay rental to the J-REIT (that is, the lessor).
- The J-REIT in turn pays dividends to its investors from distributable profits generated through rental income.

As of the date of this article, no J-REIT is listed on the infrastructure facilities market. According to some media reports, however, some J-REITs are now targeting listing on the infrastructure facilities market.

**CONCLUSIONS**

Although the J-REIT structure has been in common use in Japanese real estate funds and securitisations, it has been subject to certain practical difficulties. The Amendments outlined above offer hope for some mitigation of these obstacles. Specifically, it is hoped that the Amendments will offer more flexibility to market participants and encourage an increase in transactional volume, not only in the number of investment vehicles established in Japan, but also in the number of outbound transactions by, and foreign investments into, J-REITs.
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