

Challenges: First Islamic financing for real estate investments in Japan

MIKIHISA HIRAI highlights the challenges faced by private practitioners in developing Shariah compliant structuring and product offerings that are also compatible with the Japanese tax and legal regime.

Japan is a non-Muslim country. With only 50 mosques in Japan in 2009, the country's Muslim community (estimated to represent far less than 1% of the population) is very small. It is therefore unsurprising that the Japanese legal and tax system has only a faint notion of how to accommodate transactions that comply with Shariah principles.

Importance of accommodating Islamic finance

Despite the relatively minuscule Islamic footprint within Japan's borders, Japan's economic relationship with Islamic countries is surprisingly substantial. For example, Japan imports almost all of its oil needs, which make up approximately 15% of all Japanese imports, and roughly 90% of which is supplied by the Gulf nations.

Further, Japan's socio-economic ties with Indonesia, a predominantly Muslim country, are growing, as evidenced by increases in both Indonesian students and in skilled nurses in Japan.

Moreover, in today's financial world, capital travels across country borders at volumes and speeds unimagined even a decade ago. The characteristics of investment capital exporters have also diversified. It is little wonder then that Islamic financing has attracted attention from a variety of parties and that its techniques have evolved, becoming more sophisticated.

Therefore, it is essential for any non-Muslim country wanting to capitalize on these developments to improve its financial infrastructure to accommodate Shariah compliant products and financial techniques.

First Islamic financing for real estate

I run a Japan-based real estate fund and asset management firm, which is unique in that it has been managing investment capital from institutional investors from the Middle East into Japanese real estate

for over seven years. Naturally, we have developed our own significant interest in Islamic financing and devoted much attention towards executing Shariah compliant real estate transactions.

Our extensive discussions with a number of Islamic financial institutions and our relentless efforts to find a way to develop and implement Shariah compliant financing in Japan for real estate culminated in 2007 when we successfully delivered (and continue to manage) a Japanese commercial real estate investment involving three office properties in Tokyo for a Gulf-based Islamic global real estate fund.

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Strategies as a pioneer

In the past, I was instrumental in pioneering a number of 'first time' financial transactions. Beginning with (1) a debt assumption transaction I executed for a Japanese corporation in the 1980s, I have also initiated and delivered (2) US real estate investment funds for Japanese life insurers and corporate investors in the 1980s and (3) in 1990, bulk sales of Japanese non-performing loans.

When faced with a new type of transaction, my philosophy is to get it done with the least number of parties involved in the most simplistic way, although this novel transaction may

eventually be deemed too primitive and small in size in subsequent years.

For any 'first' kind of deal, you do not want to have parties whose petty concerns, grievances, and other considerations could potentially stall the process and possibly risk the closing of the deal. Often, the significance of the completion of the deal itself can work to nullify and negate any minor concerns some parties might have expressed.

Based on this principle, I eliminated the option of using a trust beneficial interest, which is used extensively for Japanese real estate investments in conventional space.

The biggest challenges and solutions implemented

Paying or receiving interest is prohibited as riba under Islamic principles. Therein lies a central challenge: in a country where Islamic principles are not recognized, it is a formidable task to create an 'interest-free debt financing' transaction. However, because of their sheer size and various other reasons, real estate transactions require substantial amounts of debt funding.

In addressing these challenges, we first studied the use of installment sales techniques.

However, we quickly realized that unless certain components of such installment sales payment amounts are explicitly stated as representing interest in the relevant agreement, such payment amounts would be subject to Japan's consumption tax at a rate of 5%.

In a real estate transaction for which a substantial portion of the acquisition is financed by debt, such a tax burden would erode the value of the transaction substantially. Setting aside how the transaction is documented, it has raised a fundamental question of how to differentiate between the summation

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of installment sales payments and the acquisition price of the real estate assets. If it were recognized as an 'interest', it would have created a problem from the Shariah perspective.

On the other hand, if it were recognized as commission, then we would have faced the additional cost of consumption taxes. We have abandoned this approach because this conundrum is essentially irreconcilable.

Second, we studied a finance lease transaction as an acceptable analogue to Ijarah financing. Simply stated, the lessor leases the relevant real estate asset (provides a debt financing, under conventional concepts) to the lessee, which here would be an equity investor.

Under the relevant lease agreement, the lessee makes a series of lease payments, beginning with a lump sum payment of, say, 30% of the acquisition value of assets. This would be followed by a series of equal payments at a rate commensurate with what a debt provider under conventional terms would request as interest, until the remainder, say 70% of the acquisition value, is finally paid.

Naturally, in our case, the lessee is willing to accept a balance sheet treatment that recognizes that the economic substance of the relevant real estate assets resides with the lessee. Structuring the lease agreement to this effect was relatively easy. It is important to understand that in this case the legal ownership of the assets resides with the lessor.

As is customary in today's structured financing, both the lessor and the lessee vehicles were placed under bankruptcy-remote structures.

Despite its inherent advantages, this bankruptcy-remote structuring also created a tax problem from the viewpoint of Japanese corporation tax. Under the tax rule, the above-mentioned finance lease transaction is treated in almost the same way as a sales transaction, for which payments are made on an installment basis.

(The difference between 'installment sales' and 'finance leasing' is that the ownership of the asset is transferred

to the buyer for the former, whereas it remains with the lessor (seller) for the latter. In terms of tax treatment, real estate holding tax, certain transaction-related tax items and consumption taxes are treated differently for 'installment sales' and 'finance leasing'.)

This means that the lessor ends up recording revenue recognition of close to 30% initially. Assuming that it incurs its financing cost on a level basis, the lessor would end up recording a disproportionate taxable income at the outset. This further means that it would have substantial tax payment obligations, for which it would then have to find appropriate funding. This creates both funding and deal-economics problems.

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For a while, we were at a loss for a solution to these problems, but we eventually found an answer in a section of the Japanese tax code connected with a sale and leaseback transaction.

By implementing a combination of a sale of assets and a leaseback on a finance lease basis, which is deemed as a loan from the lessor to the lessee under Japanese tax perspectives, the subject asset is not deemed to have changed hands.

Therefore, the lessor vehicle is relieved from the potential of substantial income recognition, with its attendant difficulties, at the outset.

Conclusion

The experience outlined above was very instructive, in that we found that the Japanese tax regime presented the biggest challenge. We were somehow able to find valid solutions to circumvent the tax regime's restrictions.

However, I am not sure whether the Japanese tax regime can be amended to provide easier solutions. As private practitioners, we need to continue to develop better Shariah compliant structuring and product offerings that are also compatible with the Japanese tax and legal regime.

We are encouraged because the Japanese government is making conscious efforts to promote capital inflows from the Islamic world by introducing a favorable withholding tax treatment on fixed-dividend payments made by a specific purpose trust, which is akin to Sukuk.

In accordance with the Asset Liquidation Law, the Special Tax Measurement Law and related regulations amended in May 2011, profit distribution and profit from redemption in connection with certain bond-type-trust beneficiary interest becomes exempted from taxation.

Detailed treatments will be published by the related enforcement orders in accordance with the enforcement of the amendments of the laws.

Under the principle that a favorable treatment may be made available to bond-akin investments, this new tax break route may be strategically well-utilized for real estate equity investments.

I do hope that these preliminary efforts, by both private sector practitioners and government officials, will pave the way towards a Japanese investment environment more accommodating for Islamic capital providers and their users.

It is also important to note that Islamic financing is not solely for Muslims. It can be made available to whoever recognizes and wishes to leverage its advantages.⁽²⁾

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