GENERAL LEGAL AND PROCEDURAL CONSIDERATIONS FOR REAL ESTATE PURCHASE AND SALES TRANSACTIONS IN THE UNITED STATES

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I. INTRODUCTION

All real estate purchase and sales transactions should be planned very carefully. There are some important points which the Japan buyer or seller must know and consider about any real estate purchase and sale in the United States. This article will present an overview of the practical considerations of such real estate purchase and sales transactions, including purchase procedures, business and tax planning, due diligence, escrow and title insurance, and closing.

II. MARKET ANALYSIS

As with any acquisition, there are general legal and procedural considerations, particulary for Japanese buyers. Regardless of the method of acquisition, the buyer should obtain certain information regarding the property prior to making an acquisition of U.S. property.

The buyer should obtain a market study prepared by a licensed real estate broker. The broker will present an analysis of sales within the past year with comparable properties. These sales prices, known as "comps," will give a potential buyer a fair comparison of what the market price is for the property. Such market studies are generally provided for free by brokers or real estate agents.

III. CHOICE OF ENTITY

Different types of entities can be combined in an ownership chain to produce the best tax and business results for an investor. The following is a brief analysis of the advantages and disadvantages of various types of ownership structures.

A. Ownership Through a United States Corporation.

By establishing a United States corporation to own the property, the investor creates a liability shield. A creditor

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of the corporation can only use the corporation's assets to satisfy his debts. While it is possible to "pierce the corporate veil" and seize the assets of the shareholders of the corporation, courts are not likely to allow creditors to pierce the corporate veil provided that the corporation is adequately capitalized and proper corporate formalities are followed. In general, so long as the corporation's debt to an equity ratio does not exceed 3:1, that is $3.00 of debt to every $1.00 of equity, the corporation is not likely to be challenged as being inadequately capitalized. Similarly, so long as the corporation has been properly formed and the shareholders and directors meet regularly and keep minutes of such meetings, and so long as the shareholders do not commingle the corporation's property with their own personal property, the corporation is not likely to be challenged for not following corporate formalities.

Secondly, by using a corporation to own the property, only the corporation will be required to file a United States tax return. The individual investor can now maintain some anonymity since he does not have to file annual tax returns.

There are disadvantages to ownership through a single United States corporation. The value of the corporate stock will still be subject to United States estate tax, since stock of a United States corporation held by a non-resident alien individual is included in that individual's gross taxable estate. Additionally, the corporate stock will be subject probate since it is owned by an individual.

Additionally, any sale of the corporation's stock by the Japanese individual will be subject to United States capital gains tax. Since the corporation's primary asset is real property, the stock of the corporation is treated as a real property interest and subject to the same taxation scheme as an actual interest in real property.

B. Direct Ownership Through a Japan Corporation.

Another option involves establishing a Japan corporation which purchases the property. This option avoids U.S. estate tax liability and avoids the probate process. Under Japan law, a corporation provides a liability shield, so creditors could

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only reach assets of the Japan corporation and not the assets of its shareholders.

One disadvantage to direct ownership by a Japan corporation is that the Japan corporation is subject to United States income tax and must file a federal tax return each year. The Japan corporation may also be subject to state income tax and may be required to file an annual state income tax return depending on the state. Although the U.S.-Japan Tax Treaty prohibits the branch level tax, distributions of profit from the U.S. branch to the Japan corporation can result in U.S. withholding taxes being assessed on distributions from the parent Japan corporation to its shareholders.

If a single Japan corporation owns multiple properties in the United States, income from one property can be used to subsidize loss in another without adverse tax consequences. The disadvantage to such multiple ownership is that all of the properties owned by the Japan corporation are available to satisfy a claim by a creditor of any one property. In other words, the corporate liability shield is lost because all the assets are in the same corporation.

On the other hand, if each property is owned by a separate Japan corporation, when income from one property is used to subsidize the loss of another property, significant withholding taxes can be imposed because the income will be deemed to be a dividend to the Japan parent corporation and then transferred to the second company. Thus, if multiple properties are contemplated, ownership through a Japan corporation would not be a recommended structure.

C. Ownership Through a Japan Parent Corporation And a U.S. Subsidiary Corporation.

This is the preferred investment structure. The investor establishes a Japan parent corporation which, in turn, establishes a U.S. subsidiary corporation to purchase the property. The liability shield is maintained through the U.S. corporation. There is no branch tax or second level withholding tax, since the Japan corporation is not operating in the United States, and, the individual is not subject to estate tax or the

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probate process because of the existence of the Japan parent corporation.

In the event of multiple properties, the U.S. corporation can form several subsidiaries, one for each such property owned. All of the U.S. corporations can file a consolidated tax return so that income form one property can be used to subsidize another property, yet the corporate liability shield for each property is maintained.

The only significant disadvantage to this system is the cost associated in establishing and maintaining the multiple corporations.

D. Tax Considerations

As investment in U.S. real property by foreigners began to increase, the United States paid particular attention to taxation of such investments. In 1980, the federal government enacted the Foreign Investment in Real Property Tax Act ("FIRPTA") which was designed to ensure that any gain on the sale of real property by a foreigner would be subject to United States income tax. In 1985, a comprehensive withholding system was added to ensure that the tax was paid.

Currently, corporations are taxed at the rates which vary from 15% to 38% depending on the corporation’s income. In addition to the corporate income tax, there is, in effect, a double tax on all distributions of income made by corporations. The corporation first pays a tax on its own income, and when the corporation distributes that income in the form of dividends to its shareholders, the shareholders must pay a second income tax on the dividends at the shareholder’s tax rates. The combined federal tax rate on income actually distributed to shareholders can exceed 50% for corporations. If the distribution is made to a foreign person, such as a Japanese corporation, the distribution is subject to a flat tax of 15%.

Certain corporations are allowed to avoid this double taxation by making what is known as an "S" election. When the corporation makes such an election, the shareholders pay tax based only on their respective share of the corporation's income.

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An "S" Corporation is taxed more like a partnership than a corporation. However, in order to make an "S" Corporation, the corporation cannot have any non-U.S. resident shareholders. Thus, a Japanese investor or a Japan corporation could not be a shareholder in an "S" Corporation unless the Japanese individual investor resides in the United States for more than 183 days per year.

Another alternative is to form a Limited Liability Company ("LLC") which has the limited liability characteristic of a corporation but is taxed like a partnership. Most states have adopted statutes which permit the establishment of an LLC. Unlike "S" corporations, foreign individuals and corporations can be members of an LLC. LLC's do not pay a corporate income tax, instead, each member must pay tax on that member's share of the LLC's income for that year. There are certain other taxes that may apply to LLC's depending on where they are doing business, for instance California imposes a tax on the gross receipts of the LLC. The LLC will also be required to withhold tax on each foreign partner's share of income. Nevertheless, the LLC can be an attractive alternative for real estate ownership when some of the owners are non-residents of the United States.

IV. A. Due Diligence

Due Diligence is the process in which the buyer examines all of the details regarding a piece of real estate before the buyer is committed to purchase the real estate. After the buyer and seller sign a purchase contract, the buyer is usually given a period of time to conduct due diligence. The length of time is negotiated between the buyer and the seller and will vary depending on the complexity of the property that is being purchased.

During this time, which is often referred to as the "due diligence period" or the "contingency period" the buyer can usually cancel the transaction if he is not satisfied. The purchase agreement can be written so that the buyer can cancel for any reason, or in the alternative, the buyer can only cancel if certain contingencies are not satisfied. The seller, however, does not have a right to cancel during this period, and remains

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obligated to sell the real property unless the buyer exercises its right to cancel. If the buyer does exercise its right to cancel, the buyer is usually entitled to a full refund of any deposit, although the parties can agree that the seller will be reimbursed for any expenses incurred during the due diligence period.

The buyer should make sure that the Purchase Contract requires that seller provide the following documents at the beginning of the due diligence period:

1. A current Commitment for Title Insurance, also known as Preliminary Title Report, issued by the Title Company, along with copies of all exceptions (such as include any mortgages, easements, recorded leases or liens;
2. Copies of all tenant leases and contracts, including a current rent roll;
3. All reports, engineering studies, architectural drawings, plans and specifications that are in the Seller's possession regarding the real property;
4. A certified as-built survey of the real property prepared by a registered surveyor or engineer which will show whether the improvements encroach on any other property (in many cases the title insurance company will require a current survey before it issues the title insurance policy);
5. Copies of current financial statements and budgets for the real property if the buyer is considering the property as an investment;
6. Copies of all existing warranties and guaranties that relate to any of the improvements on the real property;
7. A schedule of all of the personal property that may be sold along with the real property.

In addition, the purchase contract should give the buyer the right to conduct its own inspections at the buyer's expense. The buyer should consider having the following inspections performed during the due diligence period:

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1. An environmental study to determine if any hazardous wastes, including asbestos, exist on the real property. (Discussed below)
2. A soil and geological survey and report.
3. An inspection of any buildings or other structures by a licensed engineer. As part of this inspection, the buyer should be sure that all improvements meet the applicable building codes and all necessary building permits have been obtained.

If the buyer finds anything about the real property that is not satisfactory during the due diligence period, the buyer should notify the seller in writing. Many purchase contracts provide that unless the buyer notifies the seller in writing, the buyer will be deemed to have accepted the real property. The seller is often given a short period of time to attempt to cure the deficiency.

In some cases, the buyer will be purchasing the real property "as is." In such a case, there may not be a due diligence period, or the due diligence period will be limited to title issues only, such as mortgages, liens, encumbrances and the like. The buyer may not have any right to conduct due diligence as to the physical issues such as environmental, soils or building inspections. Buyers should be very careful when purchasing real property "as is" since there may not be any due diligence period.

IV. B. Environmental Due Diligence

Hazardous waste and environmental contamination have become an area of tremendous concern because the owner can be liable for contamination clean-up costs, regardless of fault. The value of real estate can be adversely affected since the clean-up costs and other liability can be astronomical. Moreover environmental clean-up costs may not be deducted as repairs, but instead must be capitalized.

Hazardous waste and environmental contamination can include asbestos, petroleum products, chemicals and other substances. In order to avoid liability for the clean-up costs, or at least plan for such expenses, environmental due diligence in the form

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of preliminary site assessment tests and reports are becoming a common practice.

Environmental consultants and specialized engineers can provide assistance during the due diligence period by performing tests and providing preliminary site assessments and other reports for potential buyers. The cost for consultant's reports can also be somewhat expensive; however, these expenses may be nominal when compared to the potential exposure for the liability costs since environmental liability can encompass the entire chain of ownership and operation for a particular parcel of real property.

In addition to hiring consultants and obtaining reports and preliminary site assessments, there are certain representations and warranties, as well as indemnity agreements, which may provide some protection from environmental clean-up liability for real estate investors or developers.

Due diligence can include site assessments by an environmental consultant. Detailed representations and warranties should also be obtained regarding current and past site uses and operations; use, storage, disposal and transportation of hazardous substances; presence of underground or above-ground tanks and past contamination. The risks can be allocated through indemnity agreements or cost-sharing agreements.

V. PURCHASE PROCEDURE

The actual purchase procedure will, of course, vary depending on how the property is purchased. This section will address the general purchase procedure for real property in the United States.

A. Confidentiality Agreement

A buyer may be asked to sign a Confidentiality Agreement before any specific information is disclosed to him about a property by the seller. The seller may require this agreement in order to assure that the buyer does not use such information distributed by the seller in order to compete with the seller on another property. These agreements generally provide that the

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buyer will not disclose information provided to and by the seller to any third parties other than when necessary in the case of lawyers, accountants, inspectors or similar people involved in the transaction. If you are asked to sign such an agreement, it is recommended that you have it reviewed by a lawyer prior to signing it.

B. Offers and Counter-Offers

Once a buyer is determined that he wishes to purchase a property, generally an offer is made to the seller. The offer must be made in writing and delivered to the seller. The offer should specify a certain limited period of time for which it is valid. If it is not accepted by the seller prior to the expiration of such time, the offer has expired and is no longer valid.

Once the seller receives the offer, the seller can either accept the offer, or respond with a counter-offer to the buyer. Generally, principals, the submission of a counter-offer automatically revokes the buyer's original offer. Certain counter-offers can include language that the original offer remains in force.

The buyer then has the opportunity to either accept the counter-offer or submit his own counter-offer. This process goes back and forth between the buyer and seller until the parties agree on the terms of the sale or decide that they are unable to agree and no longer pursue the sale.

C. Contingencies

The offer must address a number of terms other than just the purchase price. There are a number of potential contingencies which should be addressed in the offer. These include whether the sale is contingent upon the buyer obtaining financing, whether the sale is contingent upon the buyer selling an existing property, which is common in the case of residents, and whether the sale is contingent upon any inspections or surveys. In order to adequately protect the buyer, such contingencies should be clearly identified in the offer. Additionally, the offer should specify who is responsible for

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various closing costs, including escrow, title insurance, recording fees and other similar fees. Once the buyer and seller have agreed on the terms of the sale, the escrow process begins.

D. Letter of Intent

The letter of intent is typically a relatively short document which is signed after the seller and the buyer have reached an agreement in principle. Although a letter of intent is a preliminary agreement of terms of the transaction and typically does not bind the parties to complete the transaction, it is extremely important because it recites the most important elements of the transaction (what is being bought and sold, by whom, for how much, on what payment terms). Some of the terms are often specifically made binding, such as agreements not to negotiate a sale with third parties for an agreed upon period, agreements not to reveal trade secrets or other confidential information learned in negotiations, etc. The letter of intent should be taken as seriously as the final purchase contract and be prepared very carefully.

As mentioned before, the letter of intent includes the most important elements of the transaction. Especially in the real estate transactions, it is critical to refer to how to deals with the deposit. The letter of intent should provide clearly on what conditions the deposit will be reimbursed to the buyer or seized as the compensation for damages by the seller. In case of failing to conclude the contract, this provision will protect the buyer to some extent because the compensation for damages is limited to the agreed amount of money (usually, the amount of the deposit).

E. The Purchase and Sale Contract

The purchase and sale contract is very important because it is the definitive document that sets forth all of the terms of the transaction. The contract must include a description of the real property, including the legal description, the purchase price and terms and specify the parties to the transaction.

The purchase and sale contract should explicitly provide whether the buyer is buying free and clear of all liens, or

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assuming the existing mortgage or giving a new mortgage to the seller. If the buyer is obtaining its own financing, the purchase and sale contract should provide whether the sale is contingent upon the buyer obtaining necessary financing.

The purchase and sale contract should set the time and place where the sale is to close. Often the time is defined as a certain number of days after the purchase contract is signed, or a certain number of days after the close of the due diligence period. The purchase and sale contract should also clearly establish what items the parties are required to deliver at closing. The purchaser will be required to deliver the purchase price, either cash or a mortgage acceptable to seller. The seller will be required to deliver a grant deed and title insurance policy, as well as other documents depending on the type of property. Those other documents could include tenant leases and assignments, assignments of contracts and warranties, a bill of sale if personal property is being sold or a certificate of occupancy.

As discussed earlier in the due diligence section, the purchase and sale contract should establish the due diligence period and the documents and reports that the seller will provide to the buyer. The buyer will be given a limited period of time to review the documents and to conduct any inspections on the real property.

The purchase and sale contract may also require each party to make certain representations and warranties regarding the transaction. Each party should represent and warrant that it has been duly organized (as a corporation, partnership, limited partnership etc.) and that it is duly authorized to enter into the transaction. In addition, the buyer should ask that the seller represent and warrant that the seller has no knowledge or notice of any litigation involving the property, any pending liens or assessments against the property, any structural defects or environment violations, or unpaid bills for work done on the property.

The purchase and sale contract should obligate the seller to deliver a written affidavit that the seller is not a foreign person, if this is the case. In the United States the Foreign

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Investment in Real Property Tax Act (FIRPTA) imposed certain withholding tax requirements on the buyer when the seller is a foreign person or corporation. The buyer must withhold ten percent (10%) of the purchase price and pay it to the federal government. There are also state withholding requirements in some states. Therefore, the buyer should obtain a written affidavit from the seller that the seller is not a foreign person, in order to assure the buyer that it is not obligated to withhold any tax.

The purchase and sale contract should also set forth each party's remedies in the event that the other party defaults. The buyer should insist on the remedy of specific performance if the seller defaults. This remedy requires the seller to sell the property to the buyer according to the terms of the contract. If the buyer does not have this remedy, the seller could cancel the transaction at any time if it receives a better offer, and the buyer may not be able to purchase the property. The buyer should also limit the seller's remedies to the right to keep the deposit. Otherwise, in the event of a breach by the buyer, the seller could sue the buyer for damages if the seller is not able to resell the real property for at least the same price.

VI. Escrow, Title Insurance and Closing

Escrow is a solution to the concerns of both buyer and seller since the seller does not want to deliver the deed to the property until he is certain of receiving his money. On the other hand, the buyer does not want to pay money until the buyer is assured of receiving title to the property. Both of them are concerned whether the other party actually fulfills the contractual obligations. Once the parties have reached an agreement, the escrow is then opened with an escrow company. The purpose of the escrow is to use a third party to hold both the buyer's purchase money and the seller's legal title to property until all contingencies have been cleared. In the escrow, the parties submit written instructions to the neutral third party (the escrow agent) along with the consideration (money from the buyer, a deed from the seller). In accordance with only the instructions, the escrow agent must use the

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consideration. Escrow instructions must be in writing, clear, comprehensive, unequivocal, and non-conflicting.

During escrow, a title insurance policy should be obtained. A title insurance covers damages incurred by the insured arising out of the defects of titles of the real estate.

The title insurance policies contain two distinct types of coverage. The policies cover "loss and damage" incurred by reason of a defect, lien, encumbrance and other reasons stipulated in the policies. They also cover costs, attorneys' fee and expenses incurred in defense of the title as insured. Although the coverage for loss and damage is limited by the amount in the insurance policies, but the defense cost is not limited.

Closing is the term used for the completion of the purchase and sale transaction. Escrow will record the deed to transfer ownership to the buyer, and pay the purchase money to the Seller and/or Lenders. Other documents may be recorded, such as mortgages or deeds of trust, and UCC-1s if personal property is also transferred.

VII. CONCLUSION

Proper planning and preparation can assure the success of Japanese real estate purchase and sale transactions. United States lawyers can assist the investor by providing a clear understanding of the various legal entities and structures which are available. Lawyers take an active role in negotiations, preparation of agreements, and closing of real estate purchase and sales transactions.

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