THE LEASE-MORTGAGE: The better way to protect investors and promote Thailand's residential real estate market

Recent Thai court rulings which have held the so-called "collective leasehold" or "secured leasehold" ("**Collective Lease**") to be void, have created quite a stir among Thai real estate developers and investors. This is because many developers who sell to foreign investors have been marketing and selling the Collective Lease for several years now in Thailand. Thus, the implications of these rulings could affect a significant segment of the real estate market in Thailand.

A long-term lease is a common means for a foreigner to invest in Thai real estate. This is due largely to the fact that Thai law, with some limited exceptions, prohibits foreign freehold ownership of real estate. However, under current Thai law, the maximum lease term is a mere 30 years. Thus, it has become rather common for developers, who are marketing to foreigners, to offer a long-term lease of 30 years with two additional successive 30-year term renewals.

Under Thai law, however, any such additional term is not an "extension" of the lease; rather it is merely a "renewal" of the lease. This means that the new term is essentially a new contract. The result is that if the owner of the property changes during the first lease term, the new owner will *not* be obliged to honor the renewal of the lease, *even if* the lessee has already pre- paid the original owner for the renewal term.

In an effort to address this insecurity, many developers offer the Collective Lease. They promise not only a lease but also acquisition of shares in a Thai limited company that owns the land that will be leased to the investor. Other investors in that same development would then do the same–lease their land and also become one of the owners of the land owning and land leasing Thai limited company. The idea is that eventually all of the investors in the development would "collectively" control the land owning and land leasing Thai company. Purportedly, this would then in turn ensure that the Thai company would renew all of the investors' leases for the two successive 30-year terms—"guaranteeing" or "securing" the investors' full 90 years.

We have already detailed in previous articles here and here why the Collective Lease does *not*achieve the security for the foreign real estate investors in Thailand that it advertises. Now added to that, we have the holdings of two Thai Trial Court and three Thai Appellate Court judges who have held the Collective Lease legally "void", in other words, legally invalid. We have explained those rulings here. We wish to emphasize that this law firm does *not* agree with the legal holdings of these five judges. However, given that the Collective Lease fails to provide any real security and that Thai judges are not bound to agree with the legal opinions of this law firm, it is not surprising that real estate developers and investors in Thailand are looking for an alternative to truly secure real leasehold investments.

Any alternative must avoid the issues that might be created and which are not dealt with by the Collective Lease. It must address: (1) the risk that the lease may not be renewed for a second or third 30-year term, (2) the tax issues created by a lease renewal in light of the pre-payment for the commonly marketed 30+30+30 years lease; and (3) issues relating to the use of illegal Thai shareholding "nominees". The only alternative that does all of this is what I will refer to here as the "**Lease-Mortgage**". It is not only a simple structure; it reflects what is already actually happening in most of these common 30+30+30 year lease agreements in Thailand.

As alluded to above, these lease agreements are almost always "pre-paid" in full. However, the two additional 30-year renewal terms can only be granted and effected at the end of each prior 30-year term. Thus, the current landowner has merely promised he will give these additional terms to the lessee in the future, yet he has already received money for them. This is "money for nothing" in return or, legally speaking, a "loan". Until such money is paid for something that is actually provided, under the law it is merely a loan. Thus, in all of these common structures where a single lease payment covers all 90 years, two-thirds of the payment is, from a legal standpoint, merely a loan. And what is the simplest and best way to secure loaned money? Do exactly what banks do — subject the loan to interest and register a mortgage against the land to secure the loan and applicable interest.

The Lease-Mortgage does exactly this and thereby simply provides the accurate legal structure for what is already happening as a practical matter (the lease for the first 30 years plus a loan for the next two 30 year terms) by adding what should happen in such cases (interest on the loan and a mortgage securing the loan for the next two 30 year terms) through the combination of: (1) the 30+30+30 year lease agreement with, (2) a loan and mortgage agreement. Once the agreements are finalized, the first 30-year lease term is registered on the land and a mortgage securing the loan of the rent for the two additional 30-year renewal terms is also registered on the same land.

If the lease is renewed, for the second 30 years, that portion of the loan is, again in non- technical language, "forgiven" because the parties agree that it then becomes rent for the second 30-year term. In other words, since the second term is actually provided at that time, it is no longer a loan but a rent payment — and the mortgage covering that portion of the loan is also then automatically removed from the land. The same would then hold true for the loan of the rent for the third 30-year term and the mortgage securing it.

However, if at the end of the first or second 30 years the lease is not renewed for any reason, then the investor will be able to immediately foreclose on the property, have it sold, and recoup his investment.

Let's return to our points above.

(1) Does the Lease-Mortgage address the risk that the lease may not be renewed for a second or third 30-year term?

YES.

As outlined above, the investor's prepaid investment and interest is secured by a registered mortgage on the land title deed. Thus, the investor's security, the mortgage, "remains with the title deed" regardless of whether or not the land is ever transferred to a new owner. If the lease is not renewed as required, the investor may have the land sold and receive the sale price to cover his original investment and interest. However, even if the land were transferred, the more likely scenario would be that the new owner would be willing to honor the renewal term and await its end, rather than lose the land by a forced sale.

(2) Does the Lease-Mortgage address the tax issues created by a lease renewal in light of the pre-payment for the commonly marketed 30+30+30 year lease?

YES.

As explained above, the Lease-Mortgage reflects what is actually agreed upon between the parties: a total pre-payment for 90 years of lease, which shall be payment for three successive 30-year terms.

Under the Collective Lease, this is a major problem for the land owning and leasing Thai company. The Thai tax regimen will interpret full payment only for something *actually provided*. And as we explained, only the first 30-year lease term can be actually provided. Absent any other legal explanation for the payment, all of it will be considered income for that Thai land owning and leasing company for the first 30 years and it will all be taxed accordingly in the first 30 years. Thus, the Thai company will unfortunately have all of its lease income taxed 30 to 60 years in advance of when it should have been.

Furthermore, the Thai land owning and leasing company will not be able to account for income from the lease in the second and third 30-year terms. The Revenue Department will expect income for those later terms and may assess factious rental income and tax it; if not paid, the land will be seized and sold to a new owner. In such case, any lease renewal terms will be unenforceable.

However, none of this horror story is the case with the Lease-Mortgage.

The land owning and leasing company, the developer's company, is not financially affected at all. It still receives the exact same amount as under the common pre-paid lease with two renewals. But under the Lease-Mortgage, the payment will be booked differently to accurately reflect the 1/3 rental income for the first 30-year term and the remaining 2/3 balance, as a loan. Loans are not taxed and, therefore, the Thai land owning and leasing company/developer thereby also benefits under the Lease-Mortgage structure by having (1) the rental income properly taxed over the correct 90-year period, as well as, (2) the liquidity of as yet untaxed loan cash available during the first and second 30-year terms.

(3) Does the Lease-Mortgage address the issues relating to the use of illegal Thai shareholding "nominees"?

YES.

A Thai company limited cannot own land and lease it if there are not at least two individual Thais who own shares directly or indirectly in that company. However, it is illegal for Thais to hold shares in a Thai company as "nominees" to benefit a foreigner. Thais cannot lawfully hold such shares "in name only" without actually having invested in that company. Unlike the Collective Lease, the Lease-Mortgage does not require an investor to risk using such Thai nominees because the Lease-Mortgage investor is not forced to become a part owner of any Thai company in order to purportedly secure his lease in Thailand. The Lease-Mortgage investor is, therefore, at no risk of losing his lease investment due to the use of any such Thai nominees.

Thus, the Lease-Mortgage is a much better alternative to the Collective Lease. Obviously, it is at best implemented in the beginning of a development before the first leases are entered into and that is the context in which we have discussed and detailed the Lease-Mortgage above.

However, it should be noted that existing developments and their investors may also benefit from the use of a mortgage as a security for the renewal of a lease. This is what we will refer to as a "**Penalty-Mortgage**".

A Penalty-Mortgage can be implemented in an existing development to provide its investors with an additional layer of security in relation to the renewal of their leases.

And it is quite easy to implement. The lessor and the lessee simply enter into a **Penalty Agreement**, which provides that lessor will be subject to a significant Thai Baht penalty in the event that the lease is not renewed as required under the lease agreement. That penalty is then secured with a registered mortgage on the leased land.

As with the Loan-Mortgage, the security provided to the investor by the Penalty-Mortgage also "travels with" the land title deed. Regardless of whether or not the land is ever transferred to a new owner, if the lease is not renewed as required, the investor may have the land sold. The investor is then entitled to receive the sales price to cover his original investment and interest as provided under the Penalty Agreement. However, even if the land were transferred, the more likely scenario would be that the new owner would be willing to honor the renewal term and await its end, rather than lose the land by a forced sale.

The simple elegance and accuracy of the Lease-Mortgage and Penalty-Mortgage provide uncomplicated security and enhanced resale value for investors, as well as, greater marketability and other financial benefits for developers.

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