

## Japan Tax & Legal Inbound Newsletter

Certain rental losses from buildings located outside of Japan may not be used to offset aggregate income

May 2021, No. 68

As from 1 January 2021, Japanese individuals who use the simplified method to calculate an overseas building's useful life may no longer use an amount of depreciation expense giving rise to a rental loss to offset their aggregate income (i.e., Japan-source and foreign-source, or worldwide, income). However, when they sell the building, any disregarded rental loss amount may be added to basis when calculating capital gains from the sale.

### Background

For a long time, Japanese high-net-worth individuals took advantage of a tax break based on the difference between the real estate market in Japan and the one overseas. In particular, since Japanese properties generally lose their value faster compared to properties outside of Japan, such individuals were able to use a legal and simplified method to determine the useful life of overseas rental properties with high acquisition costs to report substantial depreciation expenses. Where this reporting resulted in a rental income loss, the loss was used to offset other income (e.g., employment income). In doing so, taxable income subject to the highest individual income tax rate of 55.945% (including the local inhabitants tax) could be reduced. Additionally, provided that a property was held for at least five years, any capital gains resulting from its sale could be taxed at a reduced rate of 20.315% (including local tax), thus reducing overall tax costs. Moreover, capital gains incurred from a sale taking place after the seller's permanent departure from Japan were considered foreign-sourced, rendering the income non-taxable altogether.

The government of Japan changed these rules as part of its 2020 tax reform as it felt that the useful life of a property calculated in this manner may not closely match the property's actual useful life and as it considered that individuals were reporting excessive amounts of depreciation expenses.

### Overview of new rules

As from 1 January 2021, when calculating depreciation expenses for a used rental building located outside of Japan using the simplified method to determine useful life, any amount of depreciation expense giving rise to a rental loss is disregarded for Japanese tax purposes. As such, this amount may not be used to offset aggregate income (e.g., rental income from properties located in Japan, net employment income).

However, when a building is sold, losses that have been disregarded may be deducted from the accumulated depreciation expenses that should be excluded when calculating the property's basis for sale (i.e., the disregarded losses should be added to basis), resulting in a higher basis and thus lower capital gains (as illustrated below).

### Used buildings located outside of Japan

The new rules described above apply to used buildings located outside of Japan that have been acquired by an individual for rental purposes and for which the individual uses one of the following methods to determine the property's useful life:

- **Estimated useful life:** An estimation may be used if either the rules of the jurisdiction where the property is located or an appraiser cannot provide the property's useful life. However, if an official number can be obtained, proof must be attached to the taxpayer's tax return. Additionally, any fees incurred in obtaining an official certificate may be included in the overall acquisition cost of the building.
- **Simplified method:**
  - Useful life, for tax purposes, of used property that has exhausted its legal useful life = 20% of legal useful life
  - Useful life, for tax purposes, of used property that has exhausted a portion of its legal useful life = (legal useful life) - (number of years between original construction and acquisition) + (20% of years exhausted from legal useful life)

### Offsetting losses with income from other sources

Rental income losses incurred on a used building located outside of Japan may be used to offset rental income from other properties located overseas. However, any excess losses resulting from depreciation expenses calculated using the simplified method will be disregarded for Japanese tax purposes. Consequently, these disregarded losses may not be used to offset income from other sources, such as income from properties located in Japan and employment income.

#### Offsetting rental loss from foreign property with rental income from property located in Japan—Sample calculation:

|   | Foreign property |                | Japan property |
|---|------------------|----------------|----------------|
|   | Used building    | Other property |                |
| a) Depreciation expense                         | 60               | 20             |                |
| b-1) Rental income                              | -                | 30             |                |
| b-2) Rental loss                                | (100)            | -              |                |
| c) Net rental loss from foreign property        | (70)             |                |                |
| d) Disregarded loss (smaller of a, b-2, or c)   | (60)*            |                |                |
| e) Net rental income (loss) from all properties | (10)             |                | 80             |
| f) Offset rental income                         | 70               |                |                |

\* Of the total rental loss from foreign property, an amount equal to the depreciation expense is disregarded for tax purposes. Therefore, 60 cannot be used to offset rental income from Japan property.

### Property sale

When the above treatment has been applied to a used building, any loss disregarded for rental calculation purposes may be included as an additional acquisition cost (basis) when the building is sold.

#### Taxable capital gain from sale of used building located outside of Japan—Sample calculation:

|  | Foreign used building |
|--|-----------------------|
| A) Gross proceed from sale   | 600                   |
| B1) Acquisition cost (initial basis)   | 500                   |
| B2) Accumulated depreciation   | 120                   |
| B3) Accumulated losses that were disregarded for rental calculation purposes | 100                   |
| C) Adjusted basis (B1 – B2 + B3)   | 480                   |
| D) Taxable capital gain from sale (A – C)                                    | 120                   |



#### Deloitte's View

These new rules will increase the tax burden on any individual taxpayers who have traditionally been reporting large amounts of depreciation expenses for used properties located overseas so as to use large rental losses to offset other sources of income (e.g., employment income). By obtaining a certified estimate of a property's useful life in advance, taxpayers have a greater chance of being able to use all of their depreciation expenses such that losses should not be disregarded. This solution also means that taxpayers would not have to manage disallowed amounts until a property's sale, making this approach worth considering.

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