

Taxation of Real Property Investment in Japan

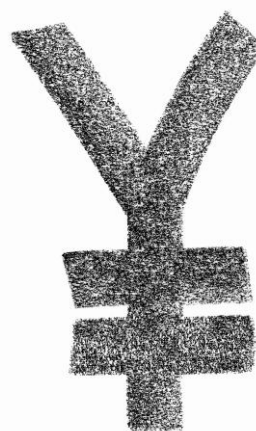
(As of May 14, 2010)



Introduction

In the so called “Bubble Economy” period (from late ‘80 through early ‘90), the price of real property had been soaring and speculative transactions involving real property were frequently made. In order to discourage such speculative transactions, the taxation system was designed so that capital gains from disposition of real property are heavily taxed.

After the collapse of Bubble Economy, the price of real property has significantly come down. In order to stimulate demand for land, a variety of methods have been introduced. Following the sub-prime loan crisis and Lehman shock, more aggressive and immediate provisions have been enacted in order to accelerate the demand for land and promote its effective use. This article outlines various taxes imposed on real property investments in Japan.



1. Taxes on real property investment in Japan

	Type of tax	Tax base	Tax rate
(1) Acquisition	Real estate acquisition tax	Market value	4% or 3%
	Special land holding tax**	Acquisition cost	3%
	Consumption tax	Acquisition cost	5%
(2) Holding	Fixed assets tax	Assessed value	1.4%
	Special land holding tax**	Acquisition cost	1.4%
	City planning tax	Assessed value	0.3%
	Land value tax*	Assessed value	0.3%
(3) Rental Income			
(a) Corporate taxpayer	Corporation tax	Rental income is included in gross income.	30%(standard rate)
	Enterprise tax		2.7 - 9.6%
	Inhabitant tax	Corporation tax amount	17.3 - 20.7%
(b) Individual taxpayer	Income tax	Rental income is included in gross income	5 - 40%
	Inhabitant tax		10%
(4) Disposal			
(a) Corporate taxpayer	Corporation tax	Capital gains (loss) are included in gross income.	30%(standard rate)
	Enterprise tax		2.7 - 9.6%
	Inhabitant tax	Corporation tax amount	17.3 - 20.7%
(b) Individual taxpayer	Income tax	Capital gains are separately taxed from other income	30 or 15%
	Inhabitant tax		9 or 5%
(5) Other	Stamp tax		200 Yen - 540,000 Yen
	Registration and license tax		0.2-2%

* Land value tax has been suspended since 1998.

**Special landholding tax has been suspended since 2003.

(1) Acquisition

i. Real estate acquisition tax

Real estate acquisition tax is levied by a prefecture on the acquisition of land or buildings in the prefecture by a taxpayer. Individuals or corporations who have acquired land or buildings through purchase, gift, exchange, or construction (including enlargement and remodeling) regardless of whether the acquisition was paid for, or registered or not are required to notify the prefecture within 30 days of the acquisition. An acquisition through inheritance is not assessed.

The tax base is the assessed value of real property as determined by the standard valuation code of fixed assets of the Ministry of Public Management, Home Affairs, Post and Telecommunication. The tax rate is 4% but is reduced to 3% in the case of an acquisition of residential property.

ii. Special landholding tax

Special land holding tax was introduced in 1973 in order to discourage speculative transactions of land and accelerate the supply of dormant land. However, following the collapse of the economic bubble, the imposition of this tax was suspended in 2003.

This tax is imposed on those who have acquired or own land over a certain size and is based on the acquisition cost of the land at a rate of 1.4% and 3% of the tax base for holding and acquisition respectively. An acquisition by inheritance, gift, corporate merger, division etc. is exempt from the tax. The tax is a municipal tax but is collected on an exceptional basis as metropolitan tax in the 23 wards of Tokyo. Land under the thresholds below is exempt from the tax.

Municipality	Threshold
Designated cities under Art 252-19 of Local Autonomy Law	2,000 m ²
Designated municipalities where a city planning area under Art 5 of City Planning Law is located	5,000 m ²
Others	10,000 m ²

iii. Consumption tax

Consumption tax is VAT and levied by the national government and prefecture on the transfer of goods or services in Japan. The tax base is the consideration of the transfer of goods or services. The rate is 5% (4% national and 1% prefecture).

The transfer or lease of land, or rights to land is exempt from consumption tax as well as the lease of residential buildings.

(2) Holding

i. Fixed assets tax

Fixed assets tax is levied by a municipality on land, buildings and other depreciable property located in the municipality. In the 23 wards of Tokyo the tax is imposed by metropolitan.

The municipality sends an assessment notice every year to the owner of the fixed assets and collects the tax in four installments.

The tax rate is 1.4% of the assessed value of fixed assets, which is determined and revised every three years.

ii. City planning tax

City planning tax is levied by a municipality on land or houses which are located in an area where a city planning project under the City Planning Law or the Land Re-adjustment Law is in effect. It is levied by the metropolitan government in the 23 wards of Tokyo.

The taxpayer and the tax base are the same as those for fixed assets tax but the rate is 0.3%. It is collected in conjunction with fixed assets tax.

iii. Land value tax

Land value tax was introduced in 1991 in order to discourage speculative transactions of land by imposing a heavy tax on such transactions. However, after the collapse of economic bubble, there was no need to prevent sharp rises in land prices and so the tax was suspended in 1998 and is unlikely to be reintroduced.

(3) Rental income

i. Depreciation

When computing rental income a deduction is available for the depreciation of buildings. The acquisition cost of buildings is depreciated over their useful life as stipulated by government regulations. These useful lives can range from 7 to 50 years depending on the structure.

ii. Corporate taxpayer

Rental income is subject to corporation tax in the same manner as ordinary business income. The effective tax rate after aggregating of corporation tax, enterprise tax and inhabitant taxes is 40.69%.

iii. Individual

Rental income is classified as real estate income. If a lessor has 10 or more rooms or 5 or more houses, his or her real estate income is basically treated in the same manner as business income. If the scale is smaller than the above, a casualty loss on assets can only be subtracted within the real estate income.

Related expenses such as depreciation and interest on loans are deductible from real estate income. When a loss arises in computing real estate income, it can be offset against other income except for a loss on assets made by small scale landlords. However the portion of the loss relating to interest expense on a loan obtained for purchasing the land cannot be offset against other income.

iv. Non-resident

A non-resident or a foreign corporation is taxed in the same manner as a resident or a domestic corporation except for the following points:

Withholding tax

Rental income earned by a non-resident or a foreign corporation is subject to withholding tax at 20%. The taxpayer can claim a credit against the final tax liability in its tax return for the withholding tax paid. When the withholding tax amount is larger than the final tax liability amount the excess can be refunded.

Local tax

When a non-resident or a foreign corporation does not have domicile or PE in Japan, local taxes (Inhabitant taxes and Enterprise tax) are not levied on its income.

(4) Disposal

Corporate taxpayer

A capital gain arising from the disposal of land, rights to land or shares in a land holding company is included in gross income and taxed at regular tax rates regardless of the holding period.

(a) Surcharge on capital gains from sale or transfer of land or rights to land

This surcharge is currently suspended on disposals made between January 1, 1998 and December 31, 2013.

Previously, capital gains arising from the disposal of land were subject to a surcharge. The amount of the surcharge was determined based on the holding period of the land computed as of January 1 of the year of disposal. as follows:

Holding period	Surcharge
5 years or less	10%
Longer than 5 years	5%

(b) Shares in a land holding company

The disposal of shares in a land holding company is taxed in the same way as the disposal of land if the following conditions are met:

- i) 70% or more of the gross assets of a holding company consist of land or rights to land at any time during three years preceding the end of the disposal year.
- ii) The shareholder making the disposal and its related persons own 30% or more of the outstanding shares in a land holding company.
- iii) The shareholder sells at least 15% of the shares over a period of three years with at least 5% disposed of in the current year.

(c) Rollover relief

Rollover relief for exchanged real property

Tax free rollover treatment is allowed in the cases where similar types of property are exchanged. A capital gain on the old property can be deferred and rolled over into the cost of the new one. Property qualifying for this treatment includes land, buildings, machinery, ships and mining rights. In order to qualify for the tax free treatment, both the transferred property and the acquired property must have been held for one year or more by the respective parties, and be used for the same purpose before and after the exchange. Please note that there are many other requirements to satisfy.

Other main types of rollover relief

- Government subsidies for acquisition or renovation of real property
- Insurance payments for the acquisition or replacement of damaged property
- Appropriation and allocation of land

(d) Additional measures

In addition to the above, special measures have been introduced for land acquired in 2009 and 2010. Both of the following two new measures will not be applied, if the 2009/2010 land is acquired from an affiliated individual or company.

Rollover relief for previously acquired land

A company can apply for part of the capital gain on the sale of land not held as inventory, to be rolled over into the cost of land acquired in Japan in 2009 and 2010 thus deferring the gain until 2009/2010 land is sold. The gain on disposal must take place within ten years of the end of the fiscal year in which the 2009/2010 land was acquired and the company must submit a form stating it intends to roll over gains into the acquired land by the due date of its tax return for the acquisition year (2009 or 2010).

The maximum portion of the gain that can be rolled over is 80% against land that is acquired in 2009 and 60% against land acquired in 2010.

Long term capital gains deduction

If a company disposes of land acquired in 2009 or 2010 which it has held for at least five years as of 1 January of the year of disposal, it can take a deduction from the gain equal to the lower of either the gain itself or 10 million Yen.

Individual taxpayers

Capital gains arising from disposition of real property (land, rights to land or buildings) are taxed separately from other income at a special rate. Capital gains from real property are classified as either short term or long term capital gains depending on the holding period of the disposed property. From January 1, 2004, capital losses from real estate cannot be offset against other types of income and cannot be carried forward. If the acquisition cost of a property is not clear it is deemed to be 5% of the sales price.

(a) Long term capital gains

Capital gains from real property are classified as long term capital gains when the holding period of the real property as of January 1 of the disposal year is more than 5 years. Capital gains are computed and taxed as follows:

$$(\text{sales price} - \text{acquisition cost} - \text{other incidental expenses}) * 20\%$$

The rate of 20% comprises of National tax (15%) and Inhabitant tax (5%). A non-resident only needs to pay national tax element.

(b) Short term capital gain

Capital gains from real property are classified as short term capital gains when the holding period of the real property as of January 1 of the disposal year is 5 years or less. The gain is computed in the same ways as for Long term capital gains but tax at 39%, comprising 30% national tax and 9% inhabitant tax. A non-resident needs only pay the national tax element. .

Short term capital gains include capital gains arising from the disposal of shares in land holding companies providing the conditions given at (b) of Corporate taxpayer above are met.

(c) Rollover relief

Rollover relief for exchanged real property

As with corporations tax free rollover treatment is allowed in the cases where similar types of property are exchanged. Please see the corporation section above for further details.

There are many other rollover reliefs such as those applying to the replacement of residence or replacement of business property, etc.

(d) Special tax deduction

There are also many kinds of special deductions, for example a ¥30 million deduction (maximum) from the sale of an individual's main residence.

(e) Special measures

Rollover relief for previously acquired land

As with a company, an individual can apply for part of the capital gain on the sale of land not held as inventory, to be rolled over into the cost of land acquired in Japan in 2009 and 2010 thus deferring the gain until 2009/2010 land is sold. The gain on disposal must take place within ten years of the end of the fiscal year in which the 2009/2010 land was acquired and the individual must submit a form stating it intends to roll over gains into the acquired land by the due date of its tax return for the acquisition year (2009 or 2010).

The maximum portion of the gain that can be rolled over is 80% against land that is acquired in 2009 and 60% against land acquired in 2010.

Long term capital gains deduction

If an individual disposes of land acquired in 2009 or 2010 which it has held for at least five years as of 1 January of the year of disposal, it can take a deduction from the gain equal to the lower of either the gain itself or 10 million Yen.

Non-residents

A non-resident or a foreign corporation is taxed in the same manner as a resident or a domestic corporation except the following points.

Withholding tax

When a non-resident or a foreign corporation disposes of real property, the consideration is subject to withholding tax at 10%. A taxpayer can claim a credit against its final tax liability when the filing a tax return. If the withholding tax amount is larger than the final tax liability the excess can be refunded.

Local tax

Inhabitant taxes are not levied on capital gains from the disposal of real property by a non-resident or a foreign corporation .

5) Others

i. Stamp tax

Stamp tax is levied by the national government on taxable commercial documents (agreements regarding transfer of real property) under the Stamp Tax law. The taxpayer is the person who prepares the taxable document. The tax is paid by attaching revenue stamps to the taxable document.

The tax amount is based on the contracted amount, up to a maximum of \540,000 for the contracted amount is more than \5 billion. The minimum amount is \200 based on a contracted amount of \100,000 or less or where no amount is described.

ii. Registration and License tax (National Tax)

Registration and License Tax is assessed upon the registration of the right of ownership on land or real estate. The tax is usually based on the value of the real estate as shown in the fixed asset tax register of the area in which the land or real estate is located. The tax rates are as follows:

Type of registration		Amount paid
Ownership transfer registration	Succession, merger of corporations	Real estate value x 0.4%
	Gift	Real estate value x 2.0%
	Sale & purchase	Real estate value x 2.0%
Right of ownership retention registration		Real estate value x 0.4%
Registering the mortgage deed		Claimable asset amount x 0.4%
Preliminary registration	For retaining transfer or ownership transfer claim	Real estate value x 1.0%
	Other preliminary registrations	1/2 the tax rate of the definitive registration

Reduced rates apply to transfer of ownership of land through sale or trust as follows:

Period	Rate applicable to sale of land	Rate applicable to trust of land
Until 31 March 2011	1%	0.2%
1 April 2011 to 31 March 2012	1.3%	0.25%
1 April 2012 to 31 March 2013	1.5%	0.3%

2. Typical investment structures

Godo Kaisha

Concept

A Godo Kaisha (“GK”) is a corporate entity loosely based on the U.S. LLC in that the liability of the investors in the GK is limited to their capital contribution. However, unlike the U.S. LLC for US tax purposes, it is not a pass through entity for Japanese tax purposes.

Taxation

A GK is considered as a corporation and subject to Corporation tax as the same manner as a Kabushiki Kaisha.

Tokumei Kumiai

Concept

A Tokumei Kumiai (“TK”) is provided for under Japan’s Commercial Code. It consists of a TK operator and one or more “silent” TK investors. A TK is not a legal entity for Japanese tax purposes, but rather an agreement between the TK investor and the TK operator under which the TK operator agrees to operate the business on behalf of itself and the investor. The TK investor makes a contribution to the TK operator in exchange for a percentage of the TK operator’s profits or losses. Critically, the TK investor must not have any control in the management of the TK operator.

Taxation of the TK operator

The TK operator is subject to normal Japanese corporate/income tax as a taxable entity doing business in Japan, however the TK operator is able to claim any income distributions made to the TK investor as a deductible expense. The TK operator will report net income in the case net losses are distributed.

Taxation of TK investors

The Japanese tax implications of a TK investor may vary, depending on whether the TK investor is a resident of Japan, and in the case where the TK investor is a non-resident of Japan (i) whether it has a PE in Japan, or (ii) the jurisdiction in which the TK investor is a resident.

Japan resident partners

The Tokumei Kumiai profit/loss allocation is treated as normal taxable income/loss of the TK investor for the particular period in which the income/loss is received. While no withholding tax was levied on TK profit distributions to Japanese resident partners where there are less than 10 TK investors, from January 2008, 20% withholding tax will be levied on such distributions, regardless of the number of partners. Profit/loss distributions received by the investor will be aggregated with the taxpayer's other income and taxed at the applicable marginal rate. With respect to a TK arrangement in which the investment is real estate, an active individual TK investor may be able to offset losses against other income, however a passive TK investor is prohibited from doing so. An active TK investor is one who plays an active role in the business decisions of the Japan TK operator.

Foreign partners having a permanent establishment in Japan

The profit/loss allocation from the TK to a TK investor deemed to have a PE in Japan is treated as normal taxable income/loss of the TK investor for the period in which the accounting period end date of the TK operator falls. The TK investor is required to file a tax return and pay income tax at the applicable marginal rate. The distributions from a TK to foreign partners are subject to 20% withholding tax, which is creditable for the TK investors when declaring such income in their Japanese tax returns.

Foreign partners not having a permanent establishment in Japan

A TK investor who doesn't have a PE in Japan is taxed 20% withholding on the actual distributions of the TK's profit allocations. There are no further Japanese tax obligations in respect of the TK allocations and no requirements to file a tax return in Japan. It should be noted that non-resident TK partners residing in certain jurisdictions may be able to claim a tax exemption by virtue of that jurisdiction's Double Tax Agreement ("DTA") with Japan containing an "Other income" article which provides such income is only taxable in the country in which the investor resides, meaning such TK distributions are not taxed in Japan. One example is the Netherlands-Japan DTA, although a new tax treaty is currently being agreed. While Japan's DTAs with other jurisdictions such as the US and the UK also contain an "Other income" provision, protocols to these agreements give Japan the right to impose Japan domestic withholding tax rates on such income, resulting in the 20% rate being levied.

Tokutei Mokuteki Kaisha

Concept

A Tokutei Mokuteki Kaisha ("TMK") is a special purpose company which allows a flow through tax treatment, similar in certain respects to a US Regulated Investment Company. A TMK is only permitted to engage in certain securitization and liquidation activities that are specified in the approved TMK rules and government approvals are required to establish one.

Taxation

Provided that 90% or more of annual income is distributed (and other requirements are met,) a TMK is entitled to a tax deduction for qualifying dividend distributions to its shareholders and so most of the earnings are taxed at the shareholder level.

Dividends paid to foreign shareholders are subject to a 20% withholding tax, unless reduced by a treaty. Capital gains are taxable in principle unless a foreign shareholder is resident in a treaty jurisdiction with a full capital gains exemption. However some treaties (such as the US-Japan Tax Treaty) contain an exception to this exemption for TMKs that are treated as real estate holding companies.