Grant Thornton

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Lease transactions

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Many companies in Japan conduct lease transactions, such as office leases, copiers and vehicles, and these lease transactions are accounted for in accordance with IFRS, US GAAP or Japan GAAP and so on. Japan corporate tax law has particular treatments for lease transactions. This article provides an overview of leases from the lessee's perspective.

1. *How does Japan corporate tax law classify lease transactions?*

Corporate tax law classifies leases as either “leases under corporate tax law” or “other leases”. The corporate tax law requires 2 conditions to be treated a lease under corporate tax law.

1) The lease agreement cannot be terminated during the lease term, or be substantially equivalent to non-cancellable (Corporate Tax Law 64-2, para 3, item 1).
2) The lessee under the relevant lease is able to obtain the economic benefits derived from the asset substantially subject to the lease, and is required to cover substantially the costs arising from the use of such asset (Corporate Tax Law 64-2, para 3, item 2).

The first condition requires the lease to be non-cancellable during the lease term. An example of being substantially equivalent to non-cancellable would be if the lessee faced an early termination fee equal to almost all (approximately 90% or more) of the remaining lease payments (Corporate Tax Basic Circular 12-5-1-1).

The second condition requires full payout. Whether the lessee is required to cover substantially the costs arising from the use of the asset is determined based on whether the total amount of lease payments payable by the lessee during the lease term exceeds approximately 90% of the normal acquisition cost of the asset. This also includes the costs necessary to prepare the asset for business use (Enforcement Order of the Corporation Tax Law 131-2, para 2).

Additionally, certain conditions must be met for land lease transactions to be classified as leases under corporate tax law.

Ownership transfer is significant concept for leases under corporate tax law particularly when calculating depreciation, as they are classified as ownership transfer leases and non-ownership transfer leases. There are numerous rules and guidelines for determining whether a lease transfers ownership such as an option to purchase for free or at a nominal price etc.

2. *The treatment of leases under corporate tax law.*

When lease transactions are classified as leases under corporate tax law, they are generally regarded as sales and purchases transactions when calculating corporate income tax, although under some circumstances the sale or purchase is deemed not to have occurred and instead it is treated as a monetary loan transaction.

Leased assets can be depreciated in the same way as for owned fixed assets, and the depreciation amount is deductible subject to the applicable tax limitations. There are several rules and guidelines regarding the determination of the acquisition cost of leased assets, including those related to renewal lease fees and incidental costs.

In the case of a non-ownership transfer lease treated as a sales and purchase transaction, the lease term is regarded as the depreciation period, and the limit amount of depreciation is calculated for tax purposes using the straight-line method (Enforcement Order of the Corporation Tax Law 48-2).

Although lease payments are separated into principal and interest for accounting purposes, for tax purposes part of the interest is treated as depreciation, and deductions are limited to the depreciable amount.

3. *The tax treatment of other lease transactions.*

On the other hand, when lease transactions are not leases under corporate tax law, they are treated as other lease transactions and regarded as rental transactions for corporate income tax purposes.

For example, many companies applying IFRS recognize right-of-use assets and lease liabilities based on office rental agreements. However, since the approximately 90% criterion mentioned earlier is rarely met for office leases, such transactions are generally treated as other lease transactions, in other words, as rental transactions for corporate income tax purposes. Even if depreciation and interest expenses are recorded for accounting purposes, the monthly office rent is deductible when payable for tax purposes.

4. *Recent tax reforms relating to lease transactions*

Following recent amendments to align Japan accounting standards for leases with IFRS, corporate tax reforms regarding lease transactions were announced in December 2024.

1) In calculating depreciation for tax purposes, the residual value included in the acquisition cost will not be deducted, and the asset can be depreciated down to JPY 1 at the end of the lease term. This will be applied to leased assets under non-ownership transfer lease contracts concluded on or after April 1, 2027 and there will be transitional measures.

2) The specific rule for determining the fiscal year to which income and expenses from lease transfers belong (the deferred payment basis) will be abolished; however, this rule applies only to lessors in lease transactions.