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Japan Tax Bulletin

Taxation of leasing transactions in Japan

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1. Definition of a leasing transaction for tax purposes
A leasing transaction is defined as a rental transaction of assets, which satisfies all of the conditions below:

- Non-cancellable
  A leasing transaction which is non-cancelable for the lease term, or one where the lessee is required to pay the leasing fees for the remaining term (90% or more of the total leasing fees).

- Full pay out
  A leasing transaction where the lessee is able to derive substantially all of the economic benefits arising from the leased asset, and the lessee bears substantially all of the costs arising from using the assets.

Where the total leasing fees the lessee pays during the leasing term exceed 90% of the acquisition cost of the leased asset, the lessee is treated as bearing substantially all of the costs arising from using the assets.

However, a rental transaction of land does not qualify as a leasing transaction if either of the following conditions is satisfied:

- A portion of the book value of the land being leased, is treated as a deductible expense in accordance with the Corporation tax law enforcement ordinance, on the grounds that the value of the land has been diluted due to leasehold rights being granted on the land.

- Neither of the following occurs:

(i) The title to the land is transferred to the lessee for free or at a nominal price after or during the leasing term.
(ii) The lessee is granted an option to purchase the land at a significant discounted price.

2. Treatment of a leasing transaction for Corporation tax purposes.
A leasing transaction is treated as the sale of the leased assets from the lessor to the lessee for Corporation tax purposes.

If the overall facts and circumstances of the transactions surrounding the sale and lease back, including the type of asset involved, are deemed to result in a finance transaction, then the sale is disregarded and the transaction is treated as a loan from the lessor to the lessee

2.1 Tax treatments for the lessor
(1) A leasing transaction treated as a sale
The lessor recognizes revenue and costs in relation to the leased asset in the business year when the leased asset is sold (leased). As the sale of assets through a leasing transaction qualifies as a long-term installment sale, profits and costs in relation to the leased asset can be recognized on a deferred payment basis (i.e. over the lease period)

(2) A leasing transaction treated as a loan
If the sale and lease back is treated as a loan, the sales price of the asset is treated as a loan from the lessor to the lessee. A portion of the lease fees received by the lessor is treated as repayment of the loan.

2.2 Tax treatments for a lessee
(1) A leasing transaction treated as a sale
a. A leasing transaction with no transfer of the ownership of the leased asset
The leased asset is depreciated using the straight-line method over the leasing term.
A leasing transaction is treated as one with no transfer of the ownership of a leased asset if none of the following occurs:

- The leased asset is transferred to the lessee for free or a nominal price at the end or during the leasing term;
- Under the lease agreement, it is stipulated that the lease agreement is renewed for a nominal lease fee equivalent to free of charge when the lease terminates;
- The lessee is granted an option to purchase the leased asset at a significantly favorable price when the lease agreement terminates or during the lease agreement;
- The leased assets can be used only by the lessee during their economic lives as they are manufactured on a bespoke basis for the lessee, or they are unidentifiable like architectural scaffoldings;
- The leasing term is shorter than the legal useful lives of the leased assets (shorter than 70% of legal useful lives, or 60% for assets whose legal useful lives are 10 years or longer).

b. Leasing transactions other than the above
The leased asset is depreciated using the deprecation method chosen by the lessee.

c. Acquisition cost
The acquisition cost of leased assets for tax purposes is the total amount of leasing fees payable. Where the total leasing fee payable can be reasonably divided into a principal portion and an interest portion, the principal portion can be used as the acquisition cost.

(2) A leasing transaction treated as a loan
If the sale and lease back is treated as a loan, the sales price of the asset is treated as a loan from the lessor to the lessee. A portion of the lease fees paid by the lessee are treated as loan repayments.

3. Consumption tax

If the leasing transaction is treated as an asset sale for Corporation tax purposes, consumption tax should be recognized on the revenue and costs of the leased assets when they are delivered to the lessee.

If the revenue and costs of leased assets are recognized by the lessor on a deferred payment basis, a mismatch arises in the timing of recognition of consumption tax by the lessor and lessee. The lessee recognizes consumption tax when the assets are delivered but the lessor recognizes consumption tax on them on a deferred payment basis.

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