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Japan Tax Bulletin

Restriction on the offset of a loss from investments in overseas second-hand buildings, against other types of income

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The 2020 Tax reform closed a loophole for wealthy individual taxpayers who used investments in offshore second-hand buildings to reduce their income tax liability. Losses generated by these investments can be used to offset against other types of income and reduce a taxpayer's total tax liability. The loophole relied on the accelerated depreciation deductions that could be taken for a second-hand building that was either nearing, or had reached, the end of its statutory useful life.

1. *Useful life of a second-hand building*

The useful life of a second-hand tangible asset is the estimated number of years during which the asset can be used after put in use. The useful life of a second-hand tangible asset for its new owner can be also calculated with the simplified method under the regulations as follows:

- If the building has reached the end of its statutory useful life - 20% of the statutory useful life of a new building.
- If the building has not yet reached the end of its statutory useful life, the remaining life for the new owner is calculated as:
  - (The statutory useful life of a new building – the number of years of use) + 20% of the number of years of use.

The statutory useful life of a residential building made of concrete is 38 years and that of a wooden building is 20 years. As a result, the useful life of a wooden second-hand building that has been used for 20 years or more, is just 4 years for the new owner

If a residential property is purchased and rented out, the portion of the purchase price that relates to the building can be depreciated over this shorter useful life. Generally, the value of the building portion of a residential property is higher in foreign countries than it is in Japan, and deprecating this portion over a relatively short useful life usually gives rise to a net loss for the investment.

As a result, investments in foreign residential property have been utilized as a tax shelter, where the loss created by the investment is offset against other income such as employment income.

2. *Real property losses from an overseas second-hand building*

From the 2021 tax year onwards, if an individual taxpayer has real property income generated from an "overseas second-hand building", the "overseas real property loss amount" is disregarded.

2.1 Overseas second-hand building

An "overseas second-hand building" is a building that is used in generating an individual taxpayer's real property income, and whose deductible depreciation is calculated using the useful life regulations for second-hand buildings.

2.2 Overseas real property loss amount

The "overseas real property loss amount" is the portion of a loss generated from leasing an overseas second-hand building that arose from the depreciation of the building.

- If the depreciation exceeds the loss generated from leasing an overseas second-hand building, the amount corresponding to depreciation is deemed to equal the loss.
- If the depreciation does not exceed the loss generated from leasing an overseas second-hand building, the amount corresponding to depreciation is the actual depreciation amount.

An individual taxpayer may have real property income from leasing real property other than foreign second-hand buildings, such as real property, rights on real property, vessels or aircraft located in foreign countries. In this case, the loss generated from leasing overseas second-hand buildings is first offset against this other real property income as (1) – [(2)-(3)] where:

(1) Real property income from leasing real property other than overseas second-hand buildings such as real property, rights on real property, vessel or aircraft located in foreign countries.
(2) Total loss from leasing an overseas second-hand building.
(3) Total depreciation of the overseas second-hand building.

The overseas real property loss amount is then the amount of this loss that arose from the depreciation of the overseas second-hand building.

3. *Calculation of real property income where an individual taxpayer owns more than one overseas second-hand buildings*

If an individual taxpayer owns 2 or more overseas second-hand buildings, real property income for each building is calculated separately.

Additionally, if an individual taxpayer owns 2 or more types of real property that generate real property income, the income is separated into the following categories and calculated separately:

(1) Overseas second-hand real property;
(2) Overseas real property other than (1) above; and
(3) Real property other than (1) and (2).

Common expenses are allocated to each category based on revenue or a different basis as stipulated in the regulations.

4. *Sale of an overseas second-hand building*

If an individual taxpayer sells an overseas second-hand building, the taxable capital gain is calculated as:
Sales price – acquisition cost of the building – selling expenses.
The acquisition cost is reduced by accumulated depreciation but this does not include depreciation that was disregarded under this new rule.

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