

Japan Tax Bulletin

Tax treatment of real estate owned by a foreign corporation and leased in Japan

December 2021

1. Overview

Due to the prolonged Covid-19 pandemic, more and more Japanese companies are selling off their headquarter buildings and other real estate holdings in order to secure cash reserves and drastically downsize their office space. Among the buyers are foreign funds, foreign corporations, and wealthy foreign individuals. In this bulletin, we will review the tax treatment of a foreign corporation and a non-resident individual that leases office space in Japan to a Japanese company or a Japanese resident.

2. Obligation of the lessee (Japanese corporation) to withhold tax

Office rentals fall under the category of "consideration for the rental of real estate located in Japan" within Japanese domestic source income, and Japanese companies paying such rent are obliged to withhold tax at 20.42%.

In general, tax treaties grant taxation rights for real estate rental income to the country where the real estate is located (e.g., Japan-U.S. tax treaty, Article 6), so the treatment under the Japanese income tax law is applied as it is.

The withholding obligation of the lessee may be waived if the foreign corporation has a permanent establishment in Japan for the part of the rental income attributable to that permanent establishment.

3. Obligation of the lessor (foreign corporation) to file a tax return

The lessor is subject to income tax withholding from the rental income at a rate of 20.42% and also has the obligation to file a corporate tax return in Japan. If the lessor is a foreign corporation, the income tax withheld on the rental income is deducted from the amount of corporate tax. The corporate tax imposed on foreign corporations is levied at a rate of 23.2%, based on taxable domestic source income after deducting appropriate expenses. Therefore, if a foreign corporation files a corporate tax return, the amount of withholding income tax at 20.42% is generally larger than the calculated corporate tax liability, and the corporation is entitled to a refund of the withholding tax in excess over the income tax liability.

A foreign corporation that earns domestic rental real estate income without establishing permanent in Japan is not subject to business tax and inhabitant tax as long as the foreign corporation does not have a permanent establishment in Japan, but is subject to local corporate tax. The local corporate tax is a surcharge to the national

corporate tax collected with it and the revenues are delivered to local governments entirely. The local corporate tax rate has been increased from 4.4% to 10.3% for taxable years beginning on or after October 1, 2019. For Japanese corporations, the local corporate tax rate was raised instead of the inhabitant tax rate being lowered, so there was no change in the total tax burden. However, for foreign corporations that are only required to file corporate tax and local corporate tax returns, the increase in the local corporate tax rate has an impact on their tax payments.

If a foreign corporation has a permanent establishment in Japan, it is obliged to file business tax and inhabitant tax returns in addition to the corporation tax and local corporate tax.

4. Obligation of the lessor (not-resident individual) to file tax return

For non-residents, the lessee is required to withhold income tax at the rate of 20.42% from the rental fee and the lessor is also required to file an individual income tax return in Japan.

In the case of non-residents, the amount of real estate income is to be reported and taxed with other categories of income at progressive tax rates. The method of calculating the amount of real estate income for non-residents is the same as that for residents, as the regulations on calculating taxable income for residents are applied to non-residents as well.

5. Consumption Tax Return Obligation

Office rentals are "taxable transactions" under the consumption tax law because the location of the office is in Japan. If the transaction falls under the category of rental of residential accommodation, it is a "non-taxable transaction"^{*1}.

In principle, the consumption tax liability is the same regardless of the lessor's place of residence or corporate status. A foreign corporation that does not have a permanent establishment in Japan may still be a consumption taxable enterprise if its taxable sales exceed the threshold. An enterprise is exempt from filing a consumption tax return and making consumption tax payments if its taxable sales in the base period do not exceed JPY10 million as a general rule (there are other requirements). The base period generally means the fiscal year 2 years prior to the current fiscal year.

*1 non-taxable transaction

Transfers of certain designated types of assets and services are non-taxable either because the asset is not of the type contemplated for Consumption Tax or for reasons based on social policy concerns.

- Sales and leases of land and rights to land
- Transfers of securities
- Financial transactions
- Sales of postage stamps and document stamps
- Merchandise and service cards
- Government fees
- International money orders and foreign exchange
- Medical services
- Nursing care services
- Social welfare services
- Rental fee for lease of residential accommodation