

TAX PLANNING INTERNATIONAL ASIA-PACIFIC FOCUS

International Information for International Business



VOLUME 14, NUMBER 12 >>> **December 2014**

www.bnai.com

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International Asia-Pacific Focus, 14 TPAF 9, 12/31/2014.
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Japan Consumption Tax Reform: 2015 and Beyond

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With the election over, Japan's Consumption Tax regime could now see major changes in the next couple of years. This article summarizes the expected general direction of reform in 2015 and beyond.

I. Introduction

Prime Minister Shinzo Abe and the Liberal Democratic party won in the snap general election held on December 14, 2014, where together with the Komeito party as coalition partner, they secured two-thirds of the lower house. The win has effectively given Abe control for up to four more years to institute his economic and tax policies.

Abe had called for this snap election in November after declaring the postponement in the rise of consumption tax to 10% that had been planned for October 1, 2015. The revised Consumption Tax law enacted on August 22, 2012 prescribes that consumption tax would increase in two stages—to 8% on April 1, 2014, and to 10% on October 1, 2015. However, because it includes an “economic resiliency” clause which makes the increase conditional on economic conditions improving, Abe made the decision to postpone the increase after Japan's GDP contracted for two consecutive quarters.

II. Timing of Further Rate Increase?

When Prime Minister Abe dissolved parliament in November, he announced that the consumption tax increase to 10% will be postponed by 18 months until April 1, 2017 and that this time the postponement would not come with an “economic resiliency” clause, meaning that the rate increase would definitely be implemented.

In order to proceed with this change, the law must be amended during next year's ordinary Diet session. With the coalition now firmly in control, it is expected

that the bill will be passed when the ordinary Diet session convenes in January, confirming the consumption tax increase to 10% in April 2017.

III. Introduction of Reduced Tax Rates?

Discussion surrounding an introduction of reduced consumption tax rates on certain daily necessities such as foodstuffs had been continuing prior to the recent election. In a new development, the Liberal Democratic and Komeito parties reached a coalition agreement on December 15, in which they confirmed that they will aim to introduce the reduced rates at the same time as when the consumption rate will increase to 10% (in April 2017).

While it is yet unclear how broad the reduced rates will be in terms of scope, introduction of such a concept could have far reaching impact on the current consumption tax regime. Namely, it could necessitate Japan to transform its consumption tax regime from the current subtraction method to an invoice method similar to VAT regimes in other jurisdictions such as the EU as the invoice method provides greater flexibility in implementing government's tax policy goals. However, there remains strong opposition from business on the introduction of the invoice method as it would be more complex and costly in terms of compliance.

IV. Changes to Taxation on Cross-Border Services

While the discussions surrounding reduced rates and invoice method are still preliminary, one change that is most certain to be implemented in the 2015 tax

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reform is change to the taxation rules on cross-border services by non-residents.

Under the current Japan Consumption Tax law, consumption tax is levied on services when a supply of taxable services takes place within Japan. The law requires that when it is unclear where the supply of certain services has taken place, then the location of the service provider is deemed to be the place of supply. In other words, consumption tax liability differs depending on whether the service provider is located in Japan or not. This disparity in tax treatment has been said to have negatively impacted the domestic digital content distribution industry since a different consumption tax treatment can be applied to overseas service providers despite distributing the same digital contents (e.g., e-books and music).

In view of the above challenges that the current consumption tax regime poses in terms of tax neutrality in the provision of cross-border services, the government is expected to amend the place-of-supply criteria and the taxation methodology for cross-border services.

A. New Place of Supply Criteria for Certain Cross-Border Services

For service provisions other than international logistics/telecommunications/post, insurance, and information services for plant constructions, the place of supply is expected to change from the location of the service provider to the location of the service recipient. Therefore, regardless of whether the service provider is located in Japan or not, consumption tax would be levied if the recipient is located in Japan. This new criteria is expected to be applied to distribution of digital contents (e.g., e-books, music, etc.).

Services conducted abroad for Japan residents such as information gathering and analysis services and asset acquisition, management and divestiture services should continue to be treated as out-of-scope services since the services themselves would be viewed as being wholly conducted abroad. However, it should be noted that if such services wholly conducted abroad are conducted as part of the services conducted in Japan, they may be treated as services where the place-of-supply is unclear, and hence be subject to the new changes on the place of supply criteria.

B. New Taxation Methodology

Once the proposed changes in the place-of-supply criteria are to be implemented, certain provision of services by non-resident entities would be subject to consumption tax. Therefore, in order to cater for such newly taxable transactions, the following taxation methodologies are expected to be implemented for B2B and B2C transactions respectively.

1. B2B Transactions

Among the newly taxable service transactions, services that are obviously provided to business entities by nature or by transaction terms are treated as B2B transactions.

According to the envisaged criteria, services provided by nonresident entities that are clearly for busi-

ness entities by nature of the services and transactions, would be categorized as B2B transactions. Such services would include online distribution of advertisement and provision of online cloud services provided to domestic business entities.

The reverse charge mechanism is expected to be introduced to such B2B transactions as the taxation methodology. In this scenario, the recipient of the services becomes the taxpayer and recognizes both consumption tax liabilities and input tax credit, while the nonresident entity that provides B2B services is required to notify the service recipient of the applicability of the reverse charge mechanism for its supply of services.

In order to minimize the consumption tax filing workload involving the reverse charge mechanism for taxpayers with a high taxable sales ratio (e.g., 95%), it is expected that by taking the position that the consumption tax amount equates the reverse-charged input consumption tax amount, a provision is to be introduced to permit exemption of the reverse-charged tax amount in the consumption tax filing calculation. While this would be welcome news for some, it implies that the consumption tax liability may increase for entities with a low taxable sales ratio.

2. B2C Transactions

When it is not clear that the services provided by non-resident entities are for business entities based on its nature or transaction terms, such services would be categorized as B2C transactions under the envisaged criteria. This implies that, even if the non-resident entity provides services to both end consumers and business entities, such transactions would still be treated as B2C transactions even when they are made to business entities. This includes electronic distribution and licensing of digital contents (e.g., e-books, music, etc.).

The consumption tax filing methodology for B2C transactions is expected to be consumption tax registration by non-resident entity through an appointment of a fiscal agent. Under this system, the recipient of the services should normally be able to credit the input consumption tax paid. However, because there are concerns over the possible difficulty in collecting consumption tax from non-resident entities located in countries outside of Japan's tax jurisdiction, it may be decided that input consumption tax credit for B2C services purchased from abroad would not be allowed. This may increase the consumption tax burden for some domestic recipients of such services.

Upon implementation of the new Japan Consumption Tax law encompassing the above changes, compliance obligations by applicable non-resident service providers will be enforced through various international information exchange agreements and tax treaties. Those who do not appropriately meet the compliance obligations may face scrutiny and questions upon financial audits as well as tax audits, and noncompliance will result in additional penalties and reputational risk.

V. Comments

As can be observed from the above, Japan's consumption tax regime could see major changes in the next couple of years. Companies operating in Japan and non-resident companies who supply to customers in Japan should monitor the upcoming developments carefully. Depending on the extent of the changes implemented, companies may need to start preparing

to invest in updating ERP systems, revise existing internal protocols and recruit staff to keep up with the changes. As for the 2015 tax reform, the coalition's FY2015 tax revision package is expected to be released on December 30.

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