

The future direction of Japan Consumption Tax treatment on cross-border services

1. Introduction

Japan's Government Tax Commission ("Tax Commission") has held a series of International Taxation Discussion Group ("ITDG") meetings in recent months to discuss the future of Japan Consumption Tax ("JCT") treatment on cross-border services. On 4 April 2014, the Tax Commission provided its current direction regarding the place-of-supply criteria and applicable JCT taxation methodology for cross-border services, while on 26 June 2014, further specifications were provided to address concerns raised by the public.

This newsletter summarizes the outcomes of these meetings and the current general direction regarding the JCT treatment on cross-border services likely to be introduced in the anticipated 2015 JCT legislation.

2. Challenges under the current JCT regime

Under the current Japan Consumption Tax Law, JCT 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, JCT taxability 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 JCT treatment can be applied to overseas service providers despite distributing the same digital contents (e.g., e-books and music).



3. Direction of the JCT reform

In view of the above challenges that the current JCT regime poses in terms of tax neutrality in the provision of cross-border services, the Tax Commission has indicated in the recent ITDG meeting to amend the place-of-supply criteria and the taxation methodology for cross-border services.

(1) Changes to the place-of-supply criteria

The Tax Commission is currently considering the following changes:

For the service provisions listed in (4) and (5) in the table below, the place of supply may change from the location of the service provider to the location of the service recipient. Henceforth, regardless of whether the service provider is located in Japan or not, JCT 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).

(Table 1) Proposed changes

Type of service provision	Criteria	
	Current regime	New proposal
When the place of supply of service is clear	Place where the service is provided	No change
When the place of supply of service is unclear		
1) International logistics/ telecommunication/ post	Place of dispatch/ destination	No change
2) Insurance	Location of the office that issued the insurance agreement	No change
3) Information service for plant constructions	Location where majority of materials are procured	No change
4) Provision of information or design	Location of the service provider's office	Location of the service recipient's address or main office
5) Other than 1) - 4) above		

Source: Documents submitted to Ministry of Finance of Japan prepared by the International Taxation Discussion Group of the Government Tax Commission

The Tax Commission provided further clarification in response to the public's specific comments and concerns. Such included (a) information gathering and analysis services conducted abroad and (b) asset acquisition, management and divestiture services conducted abroad that may be defined as services where the place-of-supply is unclear and thus subject to JCT under the new proposal when the deliverable of the services are made from abroad but received in Japan. The Tax Commission clarified that such services should be treated as out-of-scope

since the services themselves are wholly conducted abroad. However, it also highlighted that, if the 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.

(Table 2) Tax Commission's response to public comments on the newly proposed place-of-supply criteria.

Comments received	View to the comments
<p>1. Regarding services conducted by non-resident entities such as legal consulting, brokering, intelligence gathering and analysis, even if it is evident that services are conducted wholly abroad, if the deliverables of such services are provided cross-border through the internet or other telecommunication channels, would they be treated as services where the place-of-supply is unclear?</p> <p>(Examples of similar transactions: system development, R&D and design consigned to and conducted overseas)</p> <p>2. Regarding financial asset management services conducted wholly abroad by non-resident entities, even if it is evident that services are conducted wholly abroad, if the reports of such services are provided cross-border through the internet or other telecommunication channels, would they be treated as services where the place-of-supply is unclear?</p>	<p>Regarding 1 and 2. It should be clarified in the JCT legislation that the following services conducted wholly abroad be out-of-scope of JCT.</p> <p>(a) Gathering, organizing and analyzing of overseas information that is conducted abroad (including the provision of the deliverable). (b) Acquiring, managing and transferring of overseas assets that are conducted abroad (including the provision of the deliverable).</p> <p>However, if the services under (a) above is conducted as part of services conducted in Japan (e.g., services to implement IT system developed abroad in Japan, or to reflect the outcome of R&D conducted abroad in manufacturing activities in Japan)</p> <p><i>Note: Regarding offshore services conducted as part of domestic services, if the transaction is to be split between services conducted abroad and in Japan, given that the non-resident entity may not register to file JCT, a reverse charge mechanism may be considered.</i></p>
<p>3. Given that there are various intercompany service transactions between group companies domestically and globally, shouldn't such transactions be out-of-scope?</p>	<p>JCT regime does not exempt taxation simply because the transactions are inter-company in nature. Even if JCT is levied, input credit should be available in principle (i.e., no impact on P/L)</p> <p>Examples of likely taxable transactions</p> <ul style="list-style-type: none"> ▶ Parent company providing group-wide standardized training to its subsidiaries ▶ Parent company procuring and providing group-wide IT system to its subsidiaries (e.g., email, intranet system, etc.)

Source: Excerpts from documents submitted to Ministry of Finance of Japan prepared by the 5th International Taxation Discussion Group of the Government Tax Commission

(2) Possible taxation methodology for cross-border service transactions

If 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 JCT. Therefore, in order to cater for such newly taxable transactions, the following taxation methodologies are being considered for B-to-B and B-to-C transactions respectively.

(i) B-to-B transactions

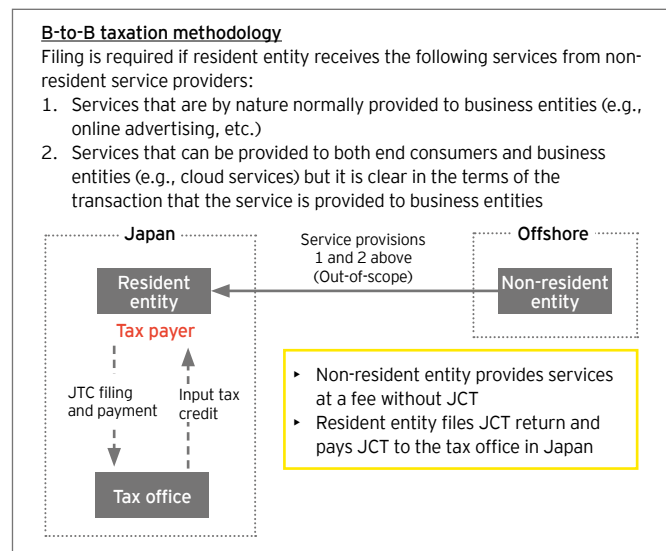
Among the newly taxable service transactions, services that are obviously provided to business entities by nature or by transaction terms are treated as B-to-B transactions.

According to the envisaged criteria, services provided by nonresident entities that are clearly for business entities by nature of the services and transactions, would be categorized as B-to-B transactions. Such services would include online distribution of advertisement and provision of online cloud services provided to domestic business entities.

The Tax Commission is proposing to introduce reverse charge mechanism to such B-to-B transactions as the taxation methodology. In this scenario, the recipient of the services becomes the tax payer and recognizes both the consumption tax liabilities and the input tax credit, while the non-resident entity that provides B-to-B 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 JCT filing workload involving the reverse charge mechanism for tax payers with a high taxable sales ratio (e.g., 95%), the Tax Commission is currently considering to introduce a provision that permits exemption of the reverse-charged JCT amount in the JCT filing calculation by taking the position that the JCT amount equates the reverse-charged input JCT amount. This implies that the JCT liability may increase for entities with a low taxable sales ratio as a result of reverse-charged input credit amount being smaller than the actual reverse-charged JCT amount.

(Diagram-1) Reverse charge mechanism



Source: Documents submitted to Ministry of Finance of Japan prepared by the International Taxation Discussion Group of the Government Tax Commission

(ii) B-to-C transactions

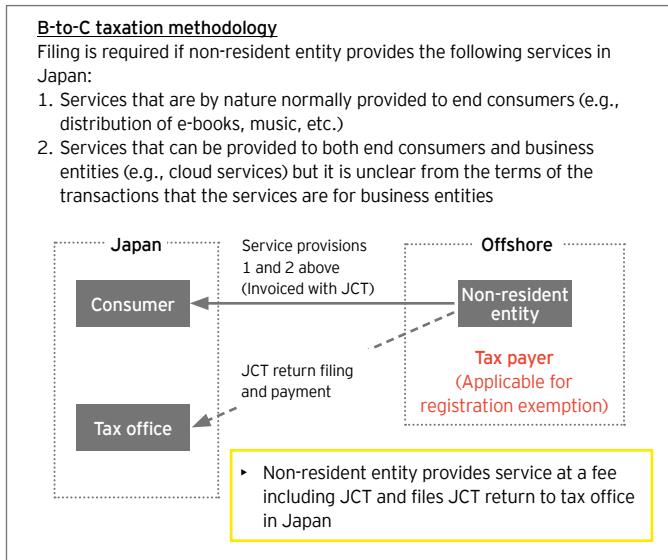
When it is not clear that services provided by non-resident entities are for business entities based on its nature or transaction terms, such services would be categorized as B-to-C transactions under the envisaged criteria. This implies that, even if the non-resident entity provides services to both end consumers and business entities, such transactions would still be treated as B-to-C 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 JCT filing methodology for B-to-C transactions is expected to be JCT registration by non-resident entity through an appointment of a fiscal agent. The Tax Commission is also considering extending the existing JCT registration exemption program to non-resident entities whose domestic taxable sales amount is JPY10m or less.

Under this tax filing methodology, the recipient of the services should normally be able to credit the input JCT paid. However, the Tax Commission has raised concerns over the possible difficulty in collecting JCT from non-resident entities located in countries outside of their tax jurisdiction and this has prompted the Tax Commission to look into the possibility of not allowing input JCT credit for services purchased from abroad. If such decision is made, the JCT burden may increase for some domestic recipients of such services.

Furthermore, the Tax Commission is considering to permit application of the reverse charge mechanism if services provided to business entities but categorized as B-to-C transactions can be re-characterized as B-to-B transactions by altering the terms of transaction to demonstrate that the services are clearly for business entities.

(Diagram-2) JCT registration by non-resident entities



Source: Documents submitted to Ministry of Finance of Japan prepared by the International Taxation Discussion Group of the Government Tax Commission

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