

## Japan tax newsletter

Ernst & Young Tax Co.

# 2015 Tax reform package

## Revision of the Japan Consumption Tax treatment of cross-border services

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The Liberal Democratic Party and Komeito announced the 2015 tax reform package on 30 December 2014. The Government Tax Commission had been discussing the potential levy of Japan Consumption Tax on cross-border services to level the playing field between domestic and foreign businesses for some time, and this has been incorporated in the current tax reform package.

The tax reform affects businesses and private consumers engaged in cross-border e-commerce transactions including the online distribution of digital content such as e-books and music to the Japanese market from overseas. Companies would need to take appropriate measures before the expected implementation date of October 2015.



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## 1. Review of the place-of-supply criteria for the provision of digital services

The place-of-supply criteria for the provision of digital services (provision of services via telecommunication lines, such as the distribution of e-books, music and advertisements) will be changed from the location of the office, etc. providing the service, to the address, etc. of the person receiving the service.

As in European countries, Japanese consumption tax is imposed at the location where consumption actually takes place (destination), in line with the nature of consumption tax to impose a tax burden on consumption. However, for transactions in which the location where the service is rendered is unclear (such as the provision of services that takes place both domestically and internationally), consumption tax is currently imposed if the office, etc. of the business providing the service is located in Japan. While domestic businesses engaging in the distribution of e-books, music and advertisements to the Japanese market have been taxed, overseas businesses providing the same services have not been taxed. This has resulted in an unlevel playing field between domestic and overseas business providing the same services.

As a result of the review of the place-of-supply criteria, the criteria regarding provision of digital services will be changed and will be based on destination. As a result, the cross-border provision of digital services by overseas providers to the Japanese market will be considered a domestic transaction and will be subject to consumption tax.

## 2. Scope of affected transactions

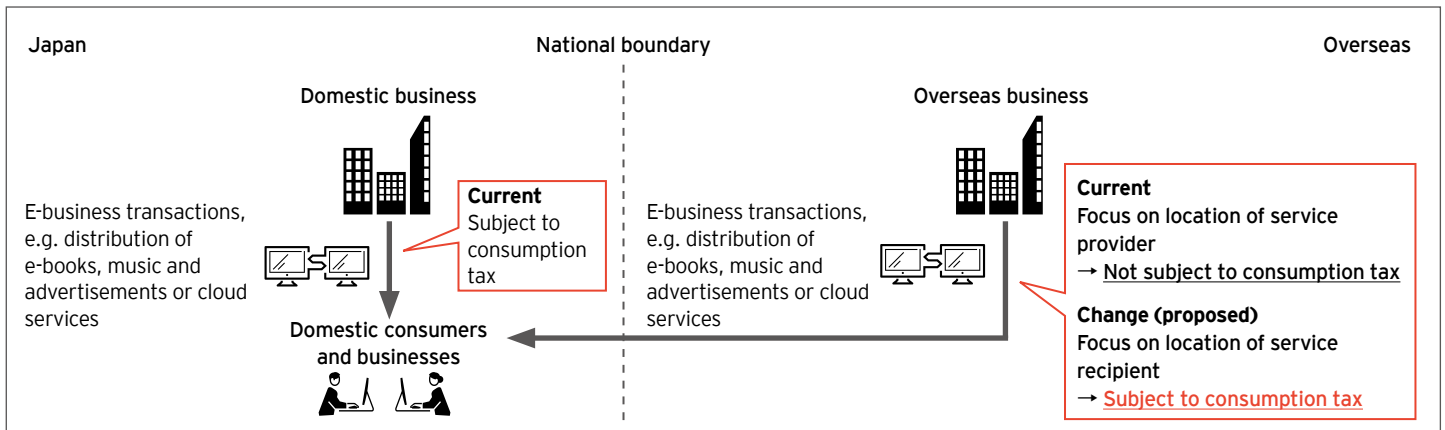
Digital services subject to review do not include the provision of services accompanying the transfer of assets (other than digital services) or simply allowing the use of telecommunication lines. However, transactions pertaining to “licensing of copyrighted work” are included.

Based on the discussions within the Government Tax Commission, it is believed that transactions where the substance of the service is completed overseas, such as legal consulting or management of overseas financial assets, would unlikely be included in the transactions within the scope of these revisions, even if the deliverables or management reports are provided across borders in digital format. However, careful attention will be required as to whether software, systems, etc. provided from overseas are in scope. The taxpayer will need to take stock of their transactions and assess whether the transactions are in scope.

Further deliberation regarding the scope of applicable transactions are expected to take place, taking into consideration the status of implementation of the current tax reforms, discussions among international authorities, tax reforms in European countries to become destination-oriented, and the substance of various transactions. The scope may be further expanded in future tax reforms.

Furthermore, up to now, it had not been clear whether the distribution of e-books, music and advertisements should be considered “provision of services” or “transfer/loan of assets”, which are treated differently for consumption tax purposes. However, the current reforms will explicitly state that they are “provision of services”.

### Revision of the place-of-supply criteria for the provision of digital services (proposal)



### 3. Implementation of reverse charge mechanism for B-to-B transactions

#### i. Provision of B-to-B digital service

With the implementation of the reverse charge mechanism, the provision of digital services where it is clear from the nature of the services provided or relevant contractual provisions that the receiver of such services is a business, will be classified as “provision of B-to-B digital service”.

The administration of the reverse charge mechanism in European countries is based on the value added tax identification number (VAT-ID) system. In such countries, a service is considered to be provided to a business where the service recipient is assigned a VAT-ID. Since a similar system does not exist in Japan, whether or not a service is provided to a business will be determined based on the nature of the service provided or relevant contractual provisions. Overseas businesses will likely be required to review their transactions and relevant contractual provisions.

Moreover, it should be noted that even if an overseas business provides digital services to both businesses and individual consumers, services that are deemed to be clearly provided to businesses based on the nature of the service or contractual provisions will be classified as provision of B-to-B digital service.

#### ii. Implementation of the reverse charge mechanism

With respect to provision of B-to-B digital services, a “reverse charge mechanism” will be implemented, which places the obligation of paying consumption tax for the transaction on the business receiving the service. Accordingly, the domestic business receiving the services will be the taxpayer.

##### a. Overseas businesses (provider)

Overseas businesses providing B-to-B digital services will provide digital services to domestic businesses without charging consumption tax.

Accordingly, overseas businesses providing B-to-B digital services to domestic businesses will be required to indicate to the domestic businesses in advance that the domestic business will be responsible for paying consumption tax.

##### b. Domestic businesses (customer)

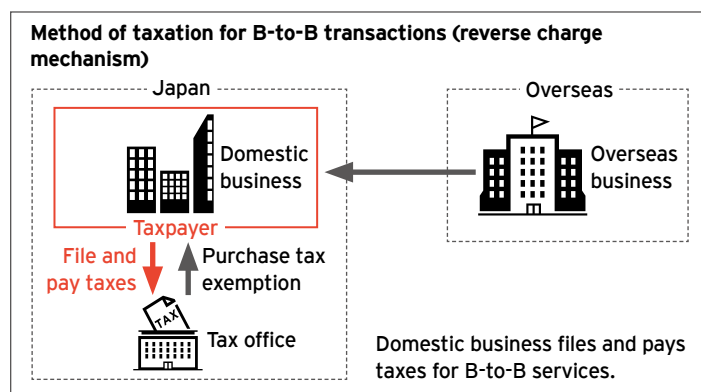
Domestic businesses will receive B-to-B digital services without being charged consumption tax. With the implementation of the reverse charge mechanism, instead of overseas service providers, domestic businesses will become responsible for paying consumption tax related to the reverse charge. The domestic businesses will be able to claim an input tax credit for the amount of the reverse-charged consumption tax.

If a tax-exempt business receives B-to-B digital services, the business will not be obligated to pay consumption tax.

In consideration of the administrative burden, if the taxable sales ratio for the taxable period that a domestic business receives B-to-B digital services is 95% or greater, for the time being, the service provision performed during this taxable period is deemed null and excluded from the entity's consumption tax returns.

When the taxable sales ratio is less than 95%, the domestic business will be required to report the tax amount related to the reverse charge and the input tax credit amount in its consumption tax returns. Therefore businesses will need to consider the implementation of necessary internal controls and processes, such as the tracking and compilation of tax amounts, etc.

It should be noted that for businesses with a low taxable sales ratio (e.g. financial, real estate and healthcare-related industries), the reverse-charged tax amount is likely to exceed the reverse-charged input tax credit amount, which may result in an increase to the business's consumption tax burden (cost increase).



### 4. Method of taxation for B-to-C transactions and measures to secure appropriate taxation

#### i. Provision of B-to-C digital service

All digital services provided by overseas businesses other than B-to-B digital services will be classified as “provision of B-to-C digital service”.

With respect to overseas businesses which provide digital services to both businesses and individual consumers, the provision of all services other than that which may be deemed to be clearly provided to businesses based on the nature of the service or contractual provisions, will be classified as “provision of B-to-C digital service”.

## ii. Method of taxation

As a result of the change to the place-of-supply criteria, the provision of B-to-C digital services by overseas businesses to Japanese market will be subject to consumption tax, and overseas businesses will be obligated to pay the tax. During discussions within the Government Tax Commission, the issue was raised that there may be limitations in encouraging overseas businesses to conduct appropriate tax filing through administrative orders, due to the fact that overseas businesses are located outside of Japan and are not under Japan's executive jurisdiction. In order to prevent input tax credit being claimed by a domestic business absent payment of tax by an overseas business, an overseas business registration system outlined in section iii below will be established, and domestic businesses will only be allowed to claim input tax credit under certain conditions.

### a. Overseas businesses (provider)

As outlined above, overseas businesses providing B-to-C digital services to the Japanese market will be obligated to pay consumption tax.

### b. Domestic businesses (customer)

As stated in i. above, where it is unclear whether or not the recipient of the digital service is a business, the transaction is classified as provision of B-to-C digital service. Therefore, there is a possibility that the provision of service to a domestic business is classified as provision of B-to-C digital service. According to these reforms, in principle, domestic businesses receiving services classified as B-to-C digital service will not be allowed to claim input tax credit for the time being.

However, with the implementation of the overseas business registration system described in iii. below, domestic businesses receiving services classified as B-to-C digital service will be allowed to claim input tax credit if the services are provided by a registered overseas business and the domestic business obtains and stores invoices listing the overseas business's registration number.

## iii. Establishment of overseas business registration system

With the establishment of this system, provided that certain requirements are met, domestic businesses which receive B-to-C digital services from overseas businesses will be able to claim input tax credit.

As the overseas service provider's registration status will determine whether or not a domestic businesses receiving B-to-C digital service will be able to obtain input tax credit, domestic businesses should implement necessary procedures, such as checking the overseas service provider's registration status, prior to any

transaction. Meanwhile, it is expected that overseas service providers would in effect be pressured to register in order to ensure that its prices remain competitive.

In situations where an overseas service provider finds it challenging to fulfill its obligations as taxpayer, it may be necessary to take steps to clarify that the services rendered are B-to-B, for example by changing the relevant contractual provisions. If the provision of service is classified as B-to-B, reverse charge will be applicable and the overseas service provider will not be required to file consumption tax return and pay consumption tax.

### a. Registered overseas business

Certain overseas service providers (other than businesses which are subject to the tax exemption for small businesses) satisfying the following criteria may become registered overseas businesses by submitting an application to the Commissioner of the National Tax Agency via the district director of the tax office with jurisdiction over the place of tax payment and becoming registered.

- ▶ The overseas service provider has a business office, facility or establishment of a similar nature in Japan related to the provision of digital services for the Japanese market, or a tax agent for consumption tax purposes.
- ▶ For businesses that do not have an office in Japan, etc. and is required to have a tax representative, that a tax representative has been appointed.
- ▶ There is no delinquency in payment and at least one year has passed since the cancellation of a previous overseas business registration.

### b. Application and cancellation

The application outlined above in a. may be made on and after 1 July 2015.

Information including the registered overseas business's name, address or location of its headquarters or principal office and registration number will be immediately disclosed online after registration is complete.

If a notification requesting a cancellation of the registration is submitted to the Commissioner of the National Tax Agency via the district director of the tax office with jurisdiction over the place of tax payment, the registration will lose its validity as of the day following the final day of the taxation period in which the notification was submitted (if the notification is submitted after a certain date, of the following taxation period).

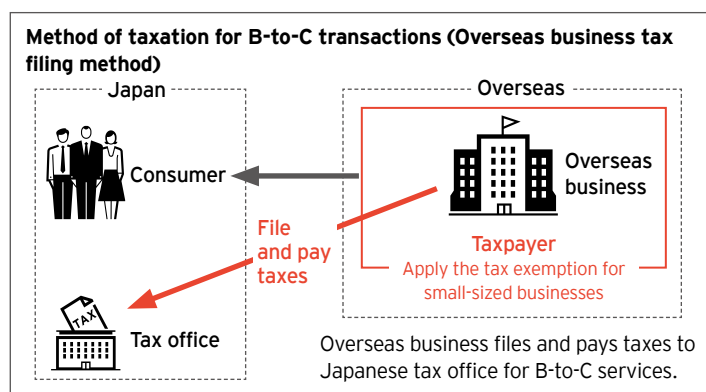
It should be noted that the tax exemption for small businesses will not apply for taxation periods following the taxation period in which it was registered unless a notification to request the cancellation of the registration is submitted.

#### iv. Tax exemption for small businesses

The Japanese consumption tax law provides an exception which exempts enterprises from consumption tax obligation under certain circumstances, such as where the taxable sales during the base period does not exceed JPY10M.

The tax reform provides the following exceptions in determining the tax obligations of overseas service providers.

- ▶ For the tax exemption for small businesses, if the first day of the base period for the taxable period is before 1 October 2015, the tax reforms are deemed to have been effective from the first day of the base period.
- ▶ However, if there are circumstances which makes it challenging to calculate the taxable sales with the tax reforms deemed to be effective from the first day of the base period, it is acceptable to use the amount of taxable sales calculated by deeming the tax reforms to be effective from 1 April 2015 to 30 June of the same year and multiplying it by 4.



#### 5. Applicable period

With the exception of reforms regarding applications for registration as registered overseas business described in 4. iii. b. above, these reforms will apply to transfer of assets, etc. in Japan, taxable purchases, and withdrawal of taxable goods from a bonded area occurring on and after 1 October 2015.

#### 6. Recommended actions

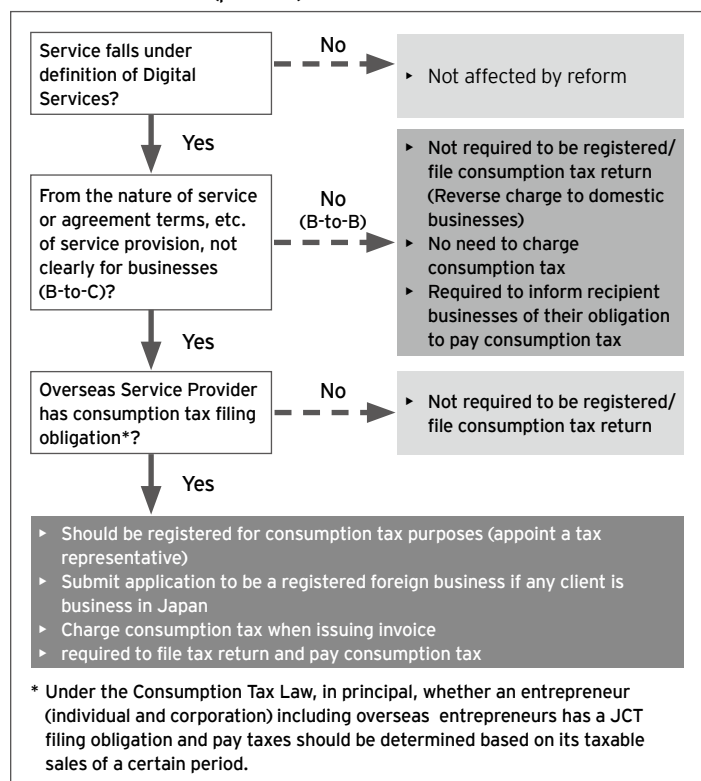
The reforms will become effective as of October 2015. As the reforms may affect consumption tax returns for taxable periods which include the period after 1 October, businesses should promptly review their current transactions and consider necessary measures.

#### Overseas businesses (provider)

- ▶ Review of applicable transactions (are they digital services?)
- ▶ Review of the classification of the services provided (“B-to-B” or “B-to-C”)
- ▶ Calculating historical taxable sales and confirming whether or not the tax exemption for small businesses will apply (\*1)
- ▶ Decide whether or not to register (\*1)
- ▶ Appointment of tax representative, etc. (\*1)
- ▶ Preparation for tax return and tax-related tasks (\*1)
- ▶ Inform service recipients of their obligation to file consumption tax (\*2)
- ▶ Assess the impact of the reforms
- ▶ Assess the implications of the reforms on future business and consideration of pricing policy
- ▶ As needed, review whether the classification of the services provided can be changed; e.g., by changing contractual provisions
- ▶ Consideration of technological requirements for new processes

(\*1) B-to-C only (\*2) B-to-B only

#### Overseas businesses (provider)

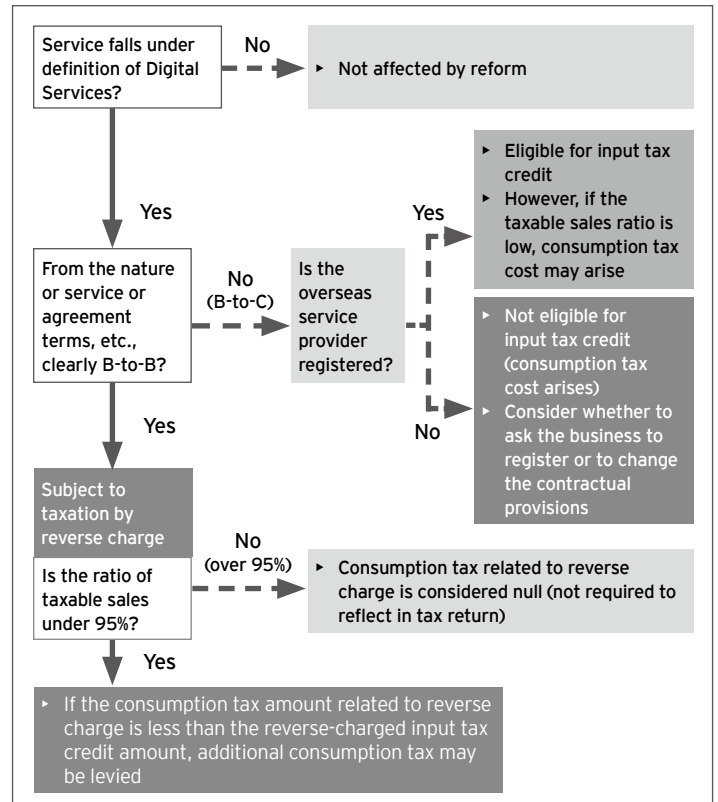


## Domestic businesses (customer)

- ▶ Review of applicable transactions (are they digital services?)
- ▶ Review of the classification of the services received ("B-to-B" or "B-to-C")
- ▶ Verification of tax obligation from reverse charge method
- ▶ Consideration of methods to calculate and manage tax amount related to reverse charge and input tax credit amount (\*3)
- ▶ Verification of whether or not the business can claim input tax credit (registration status of the overseas service provider) (\*4)
- ▶ If taxable sales ratio is low, confirm the increase of consumption tax cost and consider potential measures to mitigate the additional cost
- ▶ Assess the impact of the reforms
- ▶ As needed, review whether the classification of the services received can be changed; e.g., by changing the contractual provisions
- ▶ Consideration of technological requirements for new processes

(\*3) B-to-B only (\*4) B-to-C only

## Domestic businesses (customer)



Comments or general inquiries regarding this tax newsletter may be directed to our Corporate Communications team at [tax.marketing@jp.ey.com](mailto:tax.marketing@jp.ey.com)

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