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This article examines the business consequences of Japan’s new consumption tax rules for digital services.

One of the main pillars of Japan’s tax system is the consumption tax, which in many ways is similar to a value added tax. The consumption tax has undergone significant changes that affect suppliers of digital services.

The changes, which affect services supplied on or after 1 October 2015, address the growing debate in Japan about how to tax foreign suppliers of cross-border services such as digital content. Under the previous government, these services were not subject to the consumption tax – even though they were consumed in Japan – because the suppliers’ foreign headquarters were considered to be the place of supply.

Given the importance of international e-commerce, the current Japanese government found that the previous system put Japanese-based suppliers of the same services at a disadvantage because foreign businesses did not have to pay the 8 percent consumption tax. The government also feared that Japan would lose out on significant tax revenues as demand for these services grew.
This led to indirect tax reforms, which introduced a new set of rules concerning cross-border digital services. The new rules are similar to those regarding cross-border digital services in other VAT jurisdictions. To determine their consumption tax liability, foreign suppliers should now focus on whether their services qualify as digital services and who their customers are.

The revised law includes a Q&A document published on the Japanese Tax Authorities (JTA) and Basic Circulars' website (https://www.nta.go.jp/shiraberu/ippanjoho/pamph/shohi/cross/01.htm), offering official JTA interpretations. Digital services include the distribution of e-books, newspapers, music, movies, and games; online shopping, booking, and advertising; and also services that allow for the use of cloud databases. The new rules do not apply when the use of digital services is incidental to the provision of the main service (examples include telecommunication services and online banking services).

The foreign supplier, therefore, must consider whether the services it provides to Japanese customers can be deemed digital. And – as is typical for new laws, especially in a rapidly developing field such as this one – the lines of demarcation for digital services are not abundantly clear. If the foreign supplier can prove that it is not providing digital services (for consumption tax purposes), the new place-of-supply tax rules will not apply. However, if the foreign supplier concludes that it is providing digital services, the rules must be adhered to.

Under the revised consumption tax law, the place of supply of digital services is now considered to be the address of the recipient of those services, meaning that suppliers that have Japanese customers must consider consumption tax implications.

While the provisions apply in both business-to-business (B2B) and business-to-consumer (B2C) contexts, the consequences vary based on the nature of the recipient. Digital services provided to a Japanese business will be treated as B2B services. In such cases, the foreign supplier must inform its business customer that digital services are being consumed, and the business customer must account for the consumption tax on B2B services under a reverse-charge mechanism. In those circumstances, the foreign provider will not incur a consumption tax liability and does not have to file a tax return in Japan, and the business recipient has full responsibility for consumption tax compliance: If the recipient can prove that the services are not digital services, it can decide not to apply a reverse charge even if it has received a B2B notice from the foreign supplier.

Currently, a B2B business customer with a high taxable sales ratio (95 percent or greater) is not subject to a reverse-charge mechanism. However, Japanese businesses such as financial institutions that have a relatively low taxable sales ratio (less than 95 percent), and are subject to a reverse-charge mechanism, will be subject to an increased tax burden under the new rules. This is because Japanese businesses with a low taxable sales ratio can credit only a portion of the consumption tax liability, which arises under reverse charge for B2B services.

Conversely, if the customers are consumers, or if the foreign supplier cannot differentiate between business customers and consumers, the services must be treated as B2C services. In this case, the foreign supplier must determine whether it is required to pay consumption tax for the given year and, if so, it will have to charge 8 percent consumption tax to its consumers and business customers, file a consumption tax return, and pay the tax authorities. Japanese consumption tax law includes complex provisions and tests for determining when a business – foreign or otherwise – becomes a consumption tax payer in a financial year. In other words, there may be financial years during which the foreign supplier has to charge consumption tax at 8 percent to its customers on B2C services, and there can be financial years when the foreign supplier does not have to charge consumption tax.

The potential business consequences of the new law can be quite significant. Foreign suppliers subject to the new consumption tax rules might have to increase prices for recipients of their digital B2C services. This could cause a shift in buying behaviors for services that must remain competitively priced. The foreign supplier also has to monitor whether it has to charge consumption tax to its B2C customers for the given financial year.
The business recipient of B2C services – where the provider is not aware of the business nature of its customer – will also see an increase in prices, and, in principle, the business recipient is unable to credit input consumption tax on B2C services. However, if the foreign supplier registers itself as an overseas business with Japan's tax authorities and receives a registration number, which it provides on the invoice to the business recipient of the services, the services recipient could claim input consumption tax credit on B2C services under general rules.

Although the application of the new rules commenced on 1 October 2015, there are specific temporary measures for digital services that were purchased that apply before October 1 but will continue to be provided on or after that date.

This legislation is new, and with it comes uncertainty about the exact scope of digital services, the level of comfort regarding the separation of B2B and B2C service recipients, among other potential issues that could arise. There also may be complex cases that were not contemplated when the legislation was first drafted. For example, if a foreign supplier provides digital services to Japanese buyers through a Japanese commissionaire, the structure itself could be difficult to interpret under the digital services-related rules. In any case, it is necessary for a foreign supplier to decide whether it is providing digital services to Japanese clients; if so, the supplier must assess its client base and determine whether it should be subject to consumption tax payments for B2C services during a given financial year. The issues related to digital services can have far-reaching consequences and must be addressed with care.

It is generally possible to open a dialogue with the tax authorities in advance, to take their views on a prospective transaction. We also expect that tax authorities will continue to issue guidance about their interpretation and approach to the application of the new consumption tax rules, and it is contemplated that the consumption tax laws will be revised in the next few years.

It is, therefore, essential for service providers to keep themselves updated on the latest developments in Japanese consumption tax legislation.

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