

## Client Alert

April 2014

### Japan to Impose Consumption Tax on Payments for Digital Products or Services Provided by Overseas Suppliers

On April 1, 2014, Japan's Consumption Tax ("JCT") rate increased from a flat 5% to a flat 8%. The rate is slated to increase again, to 10%, effective October 1, 2015, assuming Japan's economic conditions continue to improve. The government has announced that it will make the final decision on whether to increase the rate from 8% to 10% by the end of December 2014. In connection with this increase, the government has also been discussing new legislation under which JCT would be imposed on payments for cross-border digital goods and services.

On April 4, 2014, the Tax Commission of Japan's Cabinet Office (the *zeisei chosakai*) announced its intention to impose JCT on payments for digital products purchased from overseas suppliers, beginning in 2015 at the earliest. The new consumption tax regime applying to digital products is expected to be formally proposed in Japan's 2015 tax reform legislation.<sup>1</sup>

If the proposed changes to Japan's Consumption Tax Law ("CTL") are passed, due to a change of the *situs* rules for cross-border digital product transactions for JCT purposes, there will be significant additional compliance requirements imposed on companies providing digital goods or services to Japan-based customers. As described in more detail below, offshore digital content providers that provide digital products to consumers in Japan will be required to register with the Japanese tax authorities, appoint tax administrators, file JCT returns and pay JCT. Offshore content providers that provide digital products to businesses in Japan will be required to notify business customers of the requirement to pay JCT via a reverse charge mechanism, by means of which such business customers must file returns and pay JCT.

#### 1. Issues Under Current Law

Under current law, JCT is imposed on payments for:

- (i) assets transferred or leased in Japan,
- (ii) services provided in Japan, and
- (iii) foreign goods withdrawn from a bonded area.

To determine whether the place of supply in a transaction was Japan, the following provisions apply:

<sup>1</sup> This alert draws on Japanese language materials from a Tax Commission meeting that took place April 4, 2014, as disclosed on the Cabinet Office's website: [www.cao.go.jp/zei-cho/gijiroku/discussion1/2014/26dis13kai.html](http://www.cao.go.jp/zei-cho/gijiroku/discussion1/2014/26dis13kai.html).

- Transfer or lease of assets: The location of an asset at the time it is transferred or leased.<sup>2</sup>
- Provision of services: The location of the provision of the service.<sup>3</sup>

Special rules regarding "place of supply" apply in the case of special transactions, such as transactions involving intangibles, or the provision of cross-border services.<sup>4</sup> Types of transactions that would be affected by the change to the CTL are described below.

### 1.1. Purchase of Digital Products or Services, such as e-Books or Music, from Foreign Suppliers

Under current JCT law, it is not clear whether the purchase of e-books or the use of music streaming services should be characterized for JCT purposes as the "lease of an asset" or the "provision of a service".

Where e-books and music streaming services are categorized as the "lease of an asset", they are further subcategorized as the "lease of a copyright". The place of supply in the case of the lease of a copyright is the address of the lessor of such copyright.<sup>5</sup> If the lessor of a copyright is located outside of Japan, the consumption of e-books or music streaming services by a person in Japan is treated as supplied outside of Japan, and thus outside the scope of JCT.

Where e-books and music streaming services are categorized as the "provision of a service", the relevant Cabinet Order does not include specific provisions governing the place of supply of such services.<sup>6</sup> The services are thus categorized as the provision of "other" cross-border services.<sup>7</sup> The place of supply of "other" services is the location of the office of the service provider associated with the provision of such services.<sup>8</sup> If the office of the service provider is located outside of Japan, the provision of such services are treated as provided outside of Japan, and thus outside the scope of JCT.

As described above, the supply of digital materials is currently outside the scope of JCT when obtained from overseas providers, regardless of whether the transaction is characterized as the lease of goods or provision of services. The fact that digital products fall outside the scope of JCT when obtained from overseas providers, while the same materials are subject to JCT if obtained by providers located within Japan, has been a source of significant discontent among Japanese publishers and music providers, who have been pushing the government to revise the JCT law so as to (in their view) level the playing field.

<sup>2</sup> CTL Art. 4(3)(i).

<sup>3</sup> CTL Art. 4(3)(ii).

<sup>4</sup> See CTL Enforcement Order ("CTLEO") Arts. 6(1) and (2).

<sup>5</sup> CTLEO Art. 6(1)(vii).

<sup>6</sup> See CTLEO Art. 6(2)(i) through (vi), which sets out rules governing the place of supply of provision of services in specific cases.

<sup>7</sup> CTLEO Art. 6(2)(vii).

<sup>8</sup> *Id.*

## 1.2. Software Downloaded from the Server of a Foreign Supplier

The same rules that apply to e-books or music streaming services apply with respect to the download of software. Regardless of whether the transaction is categorized as the “lease of an asset” or the “provision of a service”, when downloaded from an overseas provider, the transaction falls outside the scope of JCT under current rules.

## 1.3. Internet Advertising Services

The provision of internet advertising services should be considered the “provision of services” for JCT purposes, to the extent there is no “asset” provided to a third party.

Generally, as discussed in 1 above, the place of supply of provision of services is the place where the service is provided.<sup>9</sup> In the case of an internet advertisement service, there is a view that the location of the server is the place of supply.<sup>10</sup> Therefore, if the server of the company providing the advertising services is located outside of Japan, the provision of the internet advertising services is outside the scope of JCT.

If internet advertising is provided via a cross-border telecommunications line, it may also be characterized as the provision of a cross-border service for purposes of JCT law.<sup>11</sup> In the case of cross-border services, the place of supply is considered the location of the office of the service provider associated with providing the service.<sup>12</sup> Therefore, if the office of the service provider is located outside of Japan, the provision of internet advertising services is treated as outside the scope of JCT, regardless of whether it is considered the provision of a service or the provision of a cross-border service.

## 2. New JCT Proposal

According to the materials from the meeting of the Tax Commission that took place on April 4, 2014, the following changes were proposed. Please note that the changes described below are not final, but are the Tax Commission's current proposal. The proposal as described has, however, been mentioned in the press.

### 2.1. Digital Products to be Categorized as the “Provision of Services”

As discussed above, the appropriate category of digital content for JCT purposes is currently unclear: such content may be treated as either the “lease of assets” or the “provision of services”. Under the JCT proposal, provision of digital content would be categorized uniformly as the “provision of services”.

### 2.2. Change of the Place of Supply of Services

Currently, the place of supply of (i) information or design or (ii) other services is the location of the office of the service provider associated with **providing** such services. Under the revised JCT law, the place of supply of the above

<sup>9</sup> CTL Art. 4(3)(ii).

<sup>10</sup> Hidefumi Uesugi, "Q&A on Consumption Tax on International Transactions (4th edition)" (*Zeimu Kenkyukai*, 2013).

<sup>11</sup> *See id.*

<sup>12</sup> CTLEO Art. 6(2)(vii).

services will be the address, domicile, headquarters or main office of the person who **receives** the service.

## 2.3. New Method of Taxation

Taxation of the provision of cross-border digital services into Japan would take place as follows, depending on whether the Japan-based customer is a business ("B to B transaction") or a consumer ("B to C transaction").

### 2.3.1. B to B Transactions: JCT to be Imposed via a Reverse Charge Method

JCT will be imposed with respect to the following types of services via a reverse charge mechanism.

- (1) Services in the nature of those usually provided for business use (e.g. internet advertising services, legal services, etc.).
- (2) Services that would typically be provided to either business enterprises or individual customers (e.g. cloud services) which, in the particular case at hand, are obviously for business use, considering, for example, the terms and conditions of the relevant contract.

A foreign enterprise providing services to a Japanese enterprise would be required to do so at a price exclusive of JCT. The foreign enterprise would be required to notify the Japanese enterprise that the transaction is subject, however, to a reverse charge. The Japanese enterprise would be the party required to file and pay JCT with the relevant tax office in Japan. It is proposed that there would be certain exemptions from the filing requirement for Japanese enterprises, to the extent that such exemptions do not cause significant impact on Japanese tax revenue.

### 2.3.2. B to C Transactions: Japanese Registration Requirement

The following services will be subject to JCT via the registration method.

- (1) Services in the nature of those usually provided for private use (e.g. e-books and music streaming services).
- (2) Services that would typically be provided to either business enterprises or individual customers (e.g. cloud services) which, in the particular case at hand, are not obviously for business use, considering, for example, the terms and conditions of the relevant contract.

A foreign service provider that provides digital services to a consumer in Japan would be required to do so at a price inclusive of JCT. The foreign service provider would be required to register with a tax office in Japan, file JCT returns, and pay JCT to the relevant tax office. In order to comply with this requirement, the foreign service provider would be required to designate a tax administrator (*nouzei kanrinin*) to act as the foreign service provider's agent with respect to the tax return filing and tax payment responsibilities of the foreign entity. No particular license is needed in order to act as a tax administrator and either a natural person (as long as he or she is a resident in Japan) or a corporation may act as a tax administrator.

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### 3. Observations

In summary, if implemented, the proposed changes would:

- (1) uniformly characterize the purchase of digital products as the provision of services,
- (2) change the *situs* rule for the provision of services for JCT purposes as the place where the recipient of the services is located,
- (3) a. introduce a "reverse charge" mechanism with respect to cross-border B to B transactions, and  
b. introduce a tax filing obligation for offshore service providers with respect to cross-border "B to C" transactions.

Among other things, the proposed change to the *situs* rule ((2), above) is of great importance, because transactions that had previously been "outside the scope" of JCT would, going forward, be considered taxable (domestic) transactions. As a result, foreign suppliers selling digital products and consulting services would be required to notify their business customers in Japan that their transactions are subject to a "reverse charge" JCT payment, and foreign suppliers selling digital products such as e-books from offshore to individual customers in Japan would be required to register with the tax office in Japan, appoint a tax administrator, file JCT returns and pay JCT.

In terms of the background of this change, the Japanese government has been extremely concerned about economists' reports indicating that the leakage of consumption tax revenue with respect to e-commerce transactions is estimated at JPY 25 billion for 2012, and that the e-book market is expected to expand to JPY 240 billion in 2017, which is about three times the market volume in 2012.<sup>13</sup> Thus, it appears that the government believes immediate action is needed to address the issues with respect to JCT on e-commerce transactions before the significant expected expansion of the market.

This is certainly a development that enterprises involved in e-businesses targeting Japanese consumers should monitor and prepare for going forward.

<sup>13</sup> "Preventing Loopholes and Hollowing out of Industry – Imposing Consumption Tax on Digital Products Delivered via the Internet from Overseas": Nihon Keizai Shimbun, January 14, 2014.