

Client Alert

April 2015

Japan to Impose Consumption Tax on Digital Services Provided by Foreign Service Providers to Japanese Purchasers (*Revised*)

This client alert, originally issued in April 2015, has been updated based on new (clarified) information provided by the government in the form of a JCT administrative circular and official Q&A ("guidance"), released in June 2015.

Updated sections of this alert are as follows:

- *Calculation of the JPY 10 million threshold (see pages 3 and 4) does not include B2B sales;*
- *The requirement that a foreign service provider register with the National Tax Agency in order for a Japan-based business customer purchasing B2C services be eligible for an input JCT credit is not a "temporary" requirement but rather a "perpetual" one (see footnote 12 in page 5).*

We will provide details of these and other JCT developments in the form of another client alert.

Japan's 2015 tax legislation was passed by Japan's Diet and promulgated on March 31, 2015. The legislation includes a new Japanese Consumption Tax ("JCT") regime that imposes JCT on digital services and content provided by foreign service providers to purchasers located in Japan.

This Client Alert discusses details of the new JCT regime.

1. Overview of New JCT Regime

JCT, Japan's tax similar to VAT in the European context, is imposed at a flat 8% on the payment for the transfer or lease of assets in Japan, or the provision of services in Japan. The tax rate is slated to increase from 8% to 10% on April 1, 2017. Currently, digital services provided by a service provider located outside of Japan are outside the scope of JCT. Such services would include, for example, the sale of e-books, the provision of music streaming services, or the provision of internet advertising services by a foreign service provider. Under the 2015 Tax Legislation, the above described services will be subject to JCT, beginning on **October 1, 2015**, if the recipient of the service is located in Japan.¹

¹ Under applicable transitional rules, where a foreign service provider provides digital services continuously during a period commencing before October 1, 2015 and continuing through and/or beyond October 1, 2015, based on a contract concluded

In the case of B2B transactions,² JCT is to be collected by way of a reverse charge system. The proceeds of a sale by a foreign service provider would thus be exclusive of JCT. In the case of a B2B transaction, the law requires the foreign service provider to provide notice to the Japanese business customer that the transaction is subject to a reverse charge, and the Japanese business customer is responsible for filing and paying the applicable JCT to the tax authorities.

In the case of B2C transactions, the foreign service provider will be required to file a JCT return and pay JCT through a tax administrator located in Japan. The sales proceeds collected by the offshore service provider would thus include the underlying price of the service in addition to applicable JCT.

2. Applicability of New JCT Regime

2.1. Definition of Key Terms and Concepts Under New Law

2.1.1. Digital Services

Digital services are defined under the new law as "(i) the provision of a copyrighted work, as defined under Article 2(1)(i) of Copyright Law, including a license to utilize such copyrighted work, via an electronic telecommunication network, or (ii) the provision of services via an electronic telecommunication network, excluding the provision of the service of mediating other people's telecommunications using telecommunications facilities, such as a telephone or telegraph. Further, excluded from the scope of both (i) and (ii) is (a) the notification of the results of another transfer of assets or provision of services, and (b) the provision of services that are ancillary to a separate transfer of assets or provision of services."³

2.1.2. Distinction Between "B2B" and "B2C" Services

The new law defines B2B digital services as "the provision of digital services by a foreign service provider to recipients normally limited to business enterprises, considering the nature of the service, the terms and conditions, and other factors relating to the provision of the services."⁴

before April 1, 2015, the new provisions of the amended Consumption Tax Law described above will not apply. Rather, the *situs* rules in effect prior to the effective date of the new provisions in the amended Consumption Tax Law will still apply, under which the location at which the services are rendered is determined based on the location of the service provider. Nonetheless, even in such a case, if the parties change the amount of consideration provided for such digital services on or after April 1, 2015, the rules described in the above amended Consumption Tax Law will apply (amended JCT Law Enforcement Order Supplementary Provisions with respect to the 2015 tax legislation 2(1) and (2)).

² "B2B services" are services provided by one business to another; "B2C services" are services provided by a business to a consumer.

³ Amended Japanese Consumption Tax Law ("JCT Law") 2(1)(viii-iii).

⁴ Amended JCT Law 2(1)(viii-iv). In a case where it is unclear by looking at the nature of services whether a transaction is B2B or B2C, it is necessary for the parties to make the determination based on the transaction terms and conditions. In such a case, the foreign service provider may not unilaterally make such a determination by merely asking the customer to "self-declare" the nature of the transaction on the service provider's website; rather, the foreign service provider and the customer must enter into a customized contract with respect to the transaction (as opposed to a general contract that the service provider would use with an unspecified number of customers), that shows the foreign service provider and customer both agree that the customer is a business enterprise. The degree of "customization" that would be necessary in practice in this case is unclear at this point.

B2C digital services are defined as services other than B2B digital services.

2.1.3. Determining Whether or Not a Recipient of Digital Services is Located in Japan

The recipient of a digital service will be considered to be located in Japan, and thus subject to JCT, if the following are in Japan at the time the digital services are received.⁵

- the address or domicile⁶ of the recipient of the digital services; or
- the location of the headquarters or the main office of the recipient of the digital services.⁷

2.2. Thresholds for JCT Filing Obligations

A foreign service provider will only be required to file JCT returns and pay JCT to the government under the new rules where the volume of taxable sales to Japan-based customers exceeds certain thresholds, as described below.

2.2.1. General Rules - "Mandatory Taxpayer Status"

2.2.1.1. JCT Taxable Sales (B2B and B2C) in the "Base Period"

A foreign service provider will be considered a "mandatory consumption taxpayer", and thereby required to file JCT returns and pay JCT in Japan for the current period, where its B2C sales subject to JCT in the "base period" (as described below) exceed in the aggregate **JPY 10 million** (approximately USD 84,000).⁸ The "base period" is the fiscal year two years before the current fiscal year. Applying this rule, if a calendar-year foreign service provider had JCT taxable B2C sales exceeding JPY 10 million in Japan in 2013, the service provider would be considered a mandatory consumption taxpayer for 2015 with respect to sales on or after October 1, 2015. Although the new JCT regime comes into effect from October 1, 2015, for purposes of determining whether JCT taxable B2C sales in the base period exceeded JPY 10 million or not, the new JCT regime is deemed to have been in effect in the base period.

2.2.1.2. JCT taxable B2C Sales in the "Specified Period"

Even if JCT taxable B2C sales in the base period (*i.e.* 2013) did not exceed in the aggregate JPY 10 million, the corporation will still be considered a mandatory consumption taxpayer for the current fiscal year (*i.e.* 2015) if JCT taxable B2C sales in the first half of the preceding fiscal year (the "specified period"; in the case of 2015, the period of January to June in 2014) exceeded JPY 10 million.⁹

⁵ Amended JCT Law 4(3)(iii).

⁶ "Domicile" is defined as the place one has resided up until the present time, for one year or longer.

⁷ The point of supply will be determined by the location of the headquarters. Therefore, where a foreign service provider provides digital services to the foreign branch of a Japanese company it will be subject to JCT, but where the foreign service provider provides digital services to the Japan branch of a foreign company it will be outside the scope of JCT.

⁸ A small foreign service provider whose JCT taxable B2C sales were JPY 10 million or less in its base period would still be able to charge the 8% JCT, as long as the digital services were subject to JCT because the JCT paid between the parties would not be characterized as genuine JCT but rather as JCT "equivalent", which is of the nature of a part of the consideration for the purchase price or services (see Tokyo District Court Judgment dated March 26, 1990).

⁹ JCT Law Supplementary Provisions with respect to the 2015 tax legislation 36(1).

2.2.2. Special Transitional Measures for Foreign Service Providers

There are two special transitional measures under the new regime that apply where a foreign service provider is unable to easily determine what its previous JCT taxable B2C sales would have been, for purposes of determining whether JCT taxable B2C sales exceeded relevant thresholds in the "base period", the "specified period", or in both periods. We describe the two sets of rules in more detail below.

Where it is difficult for a foreign service provider to calculate its JCT taxable B2C sales over the full year "base period", as defined above, the service provider may refer to the amount of JCT taxable B2C sales it had over the three-month period from April 1, 2015 to June 30, 2015.¹⁰ The "base period" for the three month period is calculated by analogy to the (regular) full year base period, such that the foreign service provider will only be considered a mandatory consumption taxpayer for 2015 if its JCT taxable sales exceeded JPY 2.5 million (*i.e.*, 25% of JPY 10 million) from April 1, 2015 to June 30, 2015.

A similarly accelerated "specified period" applies where a foreign service provider cannot easily calculate its JCT taxable sales for the regular six-month "specified period"; *i.e.*, the first half of the preceding year. Where the foreign service provider cannot calculate its regular six-month specified period, it may consider instead the three-month period from April 1, 2015 to June 30, 2015, and multiply the taxable sales volume over this three month period by two.¹¹ In such a case, the service provider will only be considered a mandatory JCT payer in 2015 if JCT taxable sales exceeded JPY 5 million from April 1, 2015 to June 30, 2015.

If the service provider is unable to easily calculate *either* its one-year "base period" or its six-month "specified period", essentially it will be considered a mandatory consumption taxpayer for the period commencing October 1, 2015 if its JCT taxable sales over the three-month period from April 1, 2015 to June 30, 2015 exceeded JPY 2.5 million, as the special rules for both the "specified period" and the "base period" both refer to the same three month period.

2.2.3. Exceptions for Newly Incorporated Companies

A newly established corporation that does not have a base period or a preceding fiscal year would generally not be considered a mandatory consumption taxpayer as long as its paid-in capital is less than **JPY 10 million**. If, however, another corporation with a direct or indirect greater than 50% interest in the new corporation (*i.e.* the new corporation's parent) recorded JCT taxable sales in its base period exceeding **JPY 500 million**, the new corporation *would* be considered a mandatory JCT payer in the current year, regardless of the new corporation's paid-in capital amount.

2.3. Eligibility of Japanese Business Customers to Take an Input Credit for JCT they Pay to Foreign Service Providers

Where a Japanese business enterprise receives B2C services from a foreign service provider, the Japanese business enterprise will not be allowed to credit input JCT against its output JCT liability, or get a refund of input JCT, unless the foreign service provider is a "registered foreign business operator" (a *Toroku Kokugai Jigyosha*) with the Japanese tax authorities. Additionally, to be eligible

¹⁰ JCT Law Supplementary Provisions with respect to the 2015 tax legislation Supplementary Provisions 36(3).

¹¹ JCT Law Supplementary Provisions with respect to the 2015 tax legislation Supplementary Provisions 36(4).

for the input tax credit / refund, the Japanese business enterprise must maintain an applicable invoice, which states that the foreign service provider will file and pay JCT, and includes the registration number of the registered foreign business operator and other basic information related to the transaction.¹²

2.4. Voluntarily Registering as a "Registered Foreign Business Operator"

A foreign service provider may voluntarily register with the National Tax Agency ("NTA") as a registered foreign business operator. Registering in this manner will enable the foreign service provider's Japanese business customers to take an input credit with respect to any B2C purchases they make, as described above in 2.3.

Once registered, the Commissioner of the NTA will publicly announce, via the internet, the name, registration number, and certain other information regarding the registered foreign business operator.¹³

The Commissioner of the NTA may refuse the registration of a foreign service provider if any of the following circumstances apply.¹⁴

- (i) the foreign service provider does not have an office or the like located in Japan in relation to the digital services to be provided in Japan OR does not have a tax agent with regard to JCT;¹⁵
- (ii) the foreign service provider has not designated a tax administrator;
- (iii) the foreign service provider has outstanding Japanese tax liabilities which it is having difficulty paying; or
- (iv) the Commissioner of the NTA has rescinded the registration of the foreign service provider within the past year for certain reasons (e.g. the foreign service provider failed to file JCT returns by the applicable deadline without a good reason for failing to do so).

Once registered, the registered foreign business operator is not eligible for the JCT exemption in the fiscal years subsequent to the year in which it was registered, even if the company's JCT taxable sales in the base period for such years is JPY 10 million or less.¹⁶

¹² JCT Law Supplementary Provisions with respect to the 2015 tax legislation Supplementary Provisions 38. The law sets out that "for some period of time", a foreign service provider will be required to be registered in Japan in order for a Japanese business enterprise purchasing B2C services from such service provider to be eligible for a JCT input credit or refund. As a practical matter, however, "for some period time" in the context of a Japanese tax law effectively means "until such time as a change in the law is introduced". This requirement is thus not expected to be abolished at some point in the future, but rather to remain in effect perpetually.

¹³ JCT Law Supplementary Provisions with respect to the 2015 tax legislation Supplementary Provisions 39(1) and (4) and JCT Law Enforcement Cabinet Order Supplementary Provisions 7(3).

¹⁴ JCT Law Supplementary Provisions with respect to the 2015 tax legislation Supplementary Provisions Article 39(5).

¹⁵ A tax agent (*Zeimu Dairi-nin*) is different from a tax administrator (*Nouzei Kanri-nin*). A tax administrator is not required to have any particular license, but a tax agent must be a licensed tax attorney ("*Zeirishi*") or tax corporation ("*Zeirishi Houjin*"). In Japan, where a licensed tax attorney or tax corporation signs tax returns, the tax attorney / tax corporation would usually act as tax agent for the taxpayer.

¹⁶ Amended JCT Law Supplementary Provisions with respect to the 2015 tax legislation Supplementary Provisions 39(10).

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A registered foreign business operator may cancel its registration. After submitting an application for cancellation of registered status to the Commissioner of the NTA, the registration becomes invalid from the day following the end of the fiscal year in which the application was submitted.¹⁷

Foreign business operators may voluntarily register as "registered foreign business operators" on or after July 1, 2015.

2.5. Taxability of Online Consulting Services and English Lessons

As discussed herein, the provision of services by means of an electric telecommunication network to a customer located in Japan will be subject to JCT. There is an exception, however, with respect to notifying a party in Japan of the results of another transfer of assets or provision of services, or for providing services that are ancillary to a separate transfer of assets or provision of services. Not only will the provision of digital services, such as e-books or internet advertising services, be taxable under the new provisions, but also the provision of other types of online services, such as the provision of online English lesson via telephone or Skype, or the provision of other online consulting or educational services by a foreign service provider to a customer in Japan.

Where a consultant provides consulting services from outside of Japan to a customer in Japan via telephone or videoconference, the service would be subject to JCT. It should be kept in mind, however, that merely sending a report setting out the results of legal or other research performed outside of Japan via email to a customer in Japan should not be subject to JCT. This is because sending such a report by e-mail should be considered ancillary to the separate provision of services (e.g., research and analysis), that was rendered outside of Japan.

3. Comments and Observations

Japan's new JCT regime may be seen as generally consistent with global trends in light of BEPS for countries to seek to impose extraterritorial taxes on digital service providers providing inbound services. Having said that, the new JCT rules may impose significant compliance burdens on offshore companies that provide services to Japanese companies. With little time remaining before the October 1, 2015 effective date, many companies are continuing to consider fundamental questions raised by the new legislation, including whether their transactions are "digital services" that will be covered by the new JCT regime, whether registration in Japan as a registered business operator is advisable, and what such companies should consider "best practices" in terms of compliance with the new JCT regime.

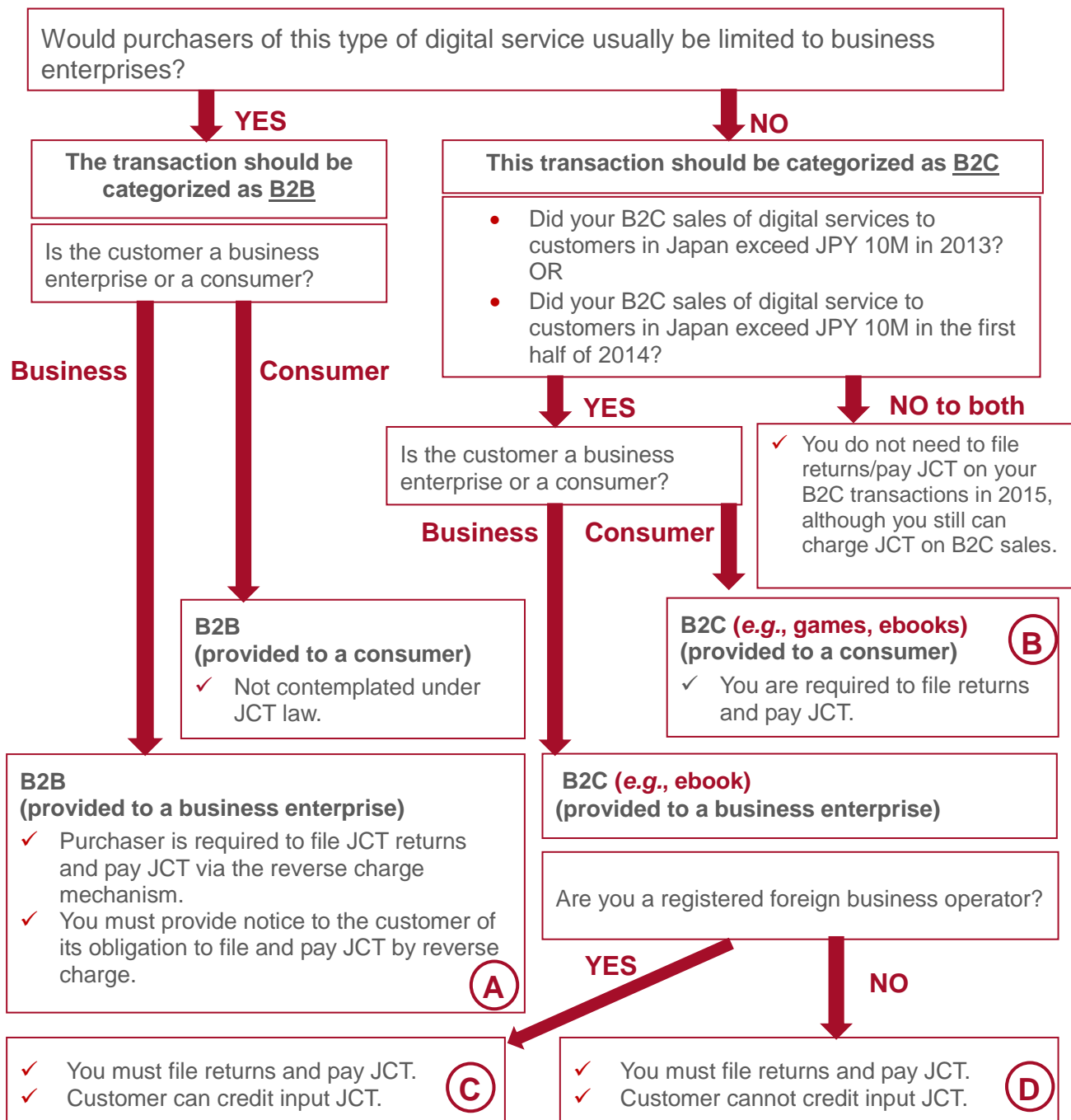
The Japanese government issued the JCT Administrative Circulars and the Q&A on the new JCT regime in June 2015. Even after such guidance has been issued, however, practical questions still remain. The most prudent advice may be for concerned corporations to contact their Japanese tax advisors to obtain tailored advice relating to their specific business operations, so as to determine the best course of action in light of the new law and its requirements.

¹⁷ Amended JCT Law Supplementary Provisions with respect to the 2015 tax legislation Supplementary Provisions 39(11).

Appendix

Assumptions:

- You are a provider of digital services located outside of Japan.
- Your financial period starts on Jan. 1, and the transaction takes place in or after Oct. 2015.
- Your customer in this case (*i.e.*, the purchaser) is located in Japan.



Assumptions:

- Price of service is 100 (exclusive of JCT)
- JCT is 8 (= 100 x 8%)
- Seller is an offshore provider of JCT taxable services to a Japan resident customer.

