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KPMG Japan tax newsletter

Consumption Tax Treatment of Cross-Border Supplies of Digital Services



1. Definition of 'Digital Services' and their Place of Taxation	2
2. Classification of 'Digital Services' Provided by Foreign Suppliers	3
3. Tax Treatment of 'B2B Digital Services'	4
4. Tax Treatment of 'B2C Digital Services'	5
5. Registration Regime for Foreign Suppliers	7
6. Rules to Determine Taxpayer Status	8
7. Timing of Application/Transitional Measures.....	9

In the past the place of taxation for cross-border supplies such as online provision of e-books/music or internet advertising has been determined broadly by the place of the supplier for Japanese consumption tax purposes. Thus, such supplies provided by foreign suppliers have not been subject to consumption tax, while such supplies provided by domestic suppliers have been subject to consumption tax. As a result, the difference in the consumption tax treatment has caused distortion in the competitive conditions between foreign and domestic suppliers.

By virtue of the 2015 tax reform, new rules have been introduced by categorizing such supplies into a new concept of 'digital services' for which the place of taxation will be determined by the place of the service recipients from 1 October 2015.

We have set out in this newsletter the main points of the new rules applied to cross-border supplies of digital services.

1. Definition of 'Digital Services' and their Place of Taxation

Under the 2015 tax reform, a new concept of 'digital services' was defined and the place of taxation for 'digital services' will be determined by the place of the service recipients. Therefore, 'digital services' provided from foreign suppliers to domestic business customers and domestic consumers will be categorized as domestic transactions subject to consumption tax, which is the same tax treatment as in EU countries.

(1) What are 'digital services'?

'Digital services' are 'services supplied through telecommunications lines such as supplies of copyrighted works through telecommunications lines (including transactions to give authorization to a person to exploit copyrighted works)' and include neither 'services that merely enable customers to use communication lines (e.g. telephone)' nor 'supplemental services incidental to non-digital services.'

Examples of 'digital services' indicated by the Ministry of Finance are as follows:

- online provision of e-books/e-newspapers/music/movies/software
- services that enable customers to utilize software/database in the cloud
- internet advertising services
- services that enable customers to utilize internet shopping sites/auction sites
- provision of market places on web sites to sell online games, etc.
- provision of online English lessons

There is still uncertainty on the scope of 'digital services,' especially what kinds of services are categorized in 'supplemental services incidental to non-digital services' being excluded from 'digital services.' Further guidance on that is expected to be released by the tax authorities.

(2) Place of taxation for 'digital services'

The place of taxation for 'digital services' will be determined by the place of the service recipient, which depends on whether the recipient is an individual or a company as follows:

An individual	domicile or residence (the place where the person lives for a year or more)
A company	the place where its head office or principal office is located

As shown above, as the place of taxation of 'digital services' received by a company will be determined by the the place where its head office or principal office is located, for example, 'digital services' received by a foreign branch of a Japanese company are treated as domestic transactions (subject to Japanese consumption tax), while 'digital services' received by a Japanese branch of a foreign company will be treated as foreign transactions (not subject to Japanese consumption tax).

2. Classification of 'Digital Services' Provided by Foreign Suppliers

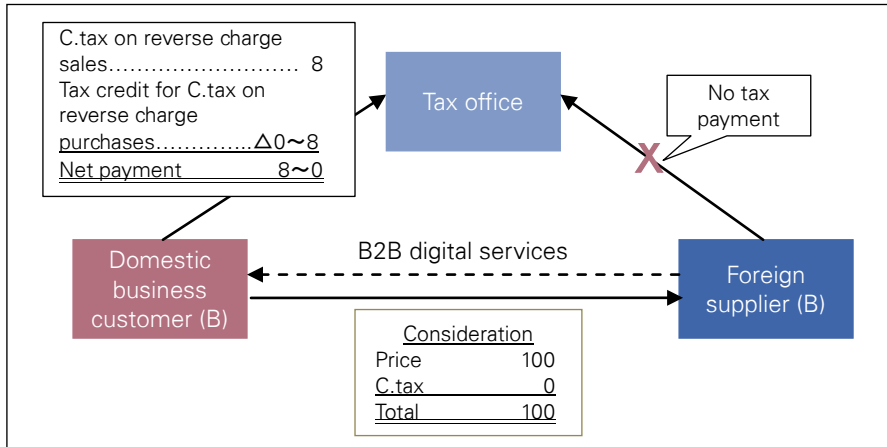
In EU countries, VAT identification numbers are used for the purpose of recognizing whether the customer is a consumer or a business customer. However, as Japan has not adopted a VAT identification number system, 'digital services' provided by foreign suppliers (non-resident individuals or foreign companies) will be classified as follows based on the characteristics of the services or the terms and conditions of the transactions:

<p>'B2B (business to business) digital services'</p>	<p>'Digital services' supplied by foreign suppliers where the recipients of the services are normally limited to business customers based on the characteristics of the services or the terms and conditions of the transactions</p>
<p>'B2C (business to consumer) digital services'</p>	<p>'Digital services' supplied by foreign suppliers not falling under the above ('B2B digital services')</p>

For example, internet advertizing services provided by foreign suppliers (those for which recipients are normally limited to business customers based on the characteristics of the services) and cloud services provided from foreign suppliers to business customers under an individual contract between them (those for which recipients can be specified as business customers based on the terms and conditions, although it is not clear from the characteristics of the services) will be treated as 'B2B digital services.'

3. Tax Treatment of 'B2B Digital Services'

Where a foreign supplier provides 'B2B digital services' to a domestic business customer, the obligation to declare/pay consumption tax on the services will be imposed on the domestic business customer under the reverse charge mechanism as illustrated below:



Domestic business customers

- Consideration for the 'B2B digital services' paid from a domestic business customer to a foreign supplier does not include consumption tax. The domestic business customer has the obligation to declare/pay consumption tax on the reverse charge sales (the 'B2B digital services' provided by the foreign supplier) on behalf of the foreign supplier.
- The consumption tax on the reverse charge purchases (the 'B2B digital services' received from the foreign supplier) will be subject to consumption tax credit.
- Although it is generally required to preserve accounting records and invoices including certain items in order to take a tax credit for consumption tax paid on ordinary taxable purchases, the preservation of invoices is not required for consumption tax on reverse charge purchases. However, it will be necessary to state that they are subject to the reverse charge mechanism in the accounting records in addition to the items to be indicated in them for ordinary taxable purchases.
- When part/all of the consumption tax on assets acquired through reverse charge purchases is not creditable, such amount will be deductible for corporate tax purposes in the fiscal year of the purchases provided that it is recorded as an expense in the accounting books.
- If the taxable revenue ratio (the ratio of taxable sales over the sum of taxable and non-taxable sales) for a taxable period is greater than or equal to 95 percent or if the simplified calculation method is elected for a taxable period, 'B2B digital services' will be ignored for the taxable period for the time being. This is a measure to take into account of administrative burden for domestic business customers of the new law.

Foreign suppliers

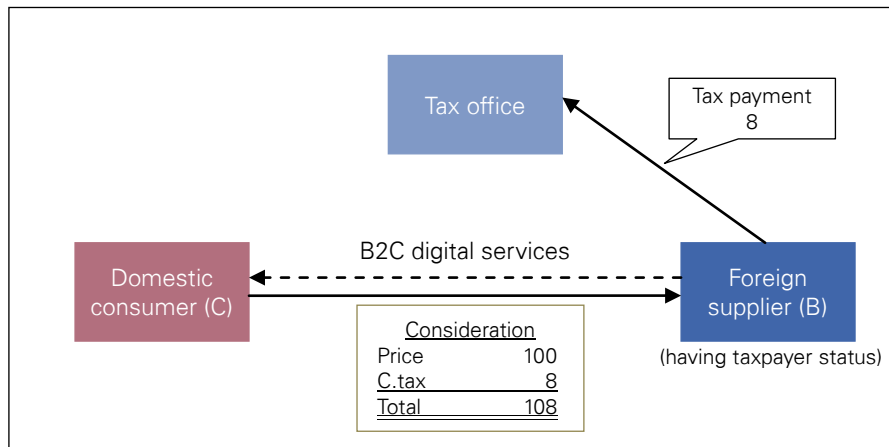
- A foreign supplier providing 'B2B digital services' will have an obligation to notify domestic business customers in advance that these supplies are subject to the reverse charge mechanism.

4. Tax Treatment of 'B2C Digital Services'

An obligation to file a consumption tax return and pay consumption tax to the Japanese government with respect to 'B2C digital services' provided from a foreign supplier to a domestic consumer or a domestic business customer will be imposed on the foreign supplier.

(1) Where foreign suppliers provide 'B2C digital services' to domestic consumers

The tax treatment of 'B2C digital services' provided from a foreign supplier to a domestic consumer is illustrated below:

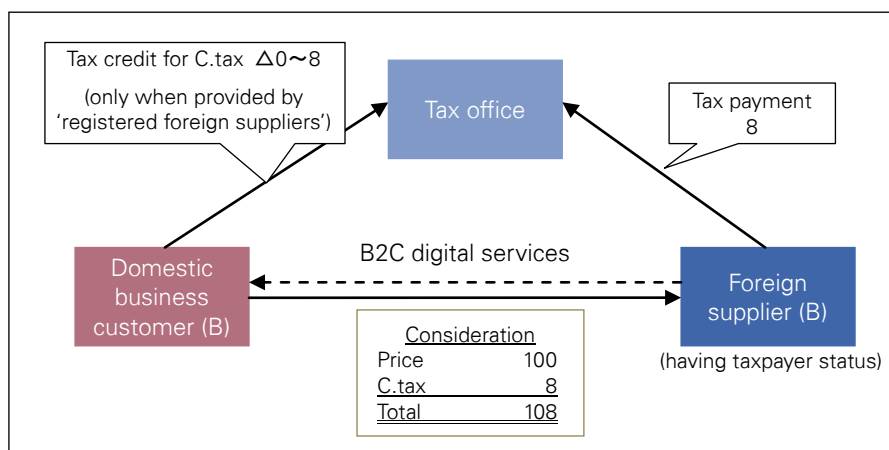


Foreign suppliers

- When the foreign supplier has taxpayer status for Japanese consumption tax purposes, it is required to file a consumption tax return and pay consumption tax on 'B2C digital services' to the Japanese government.

(2) Where foreign suppliers provide 'B2C digital services' to domestic business customers

As discussed in 2, 'digital services' supplied by a foreign supplier are categorized as 'B2B digital services' only where the recipients of the services are normally limited to business customers based on the characteristics of the services or the terms and conditions of the transactions. Thus, there will be cases where a domestic business customer receives 'B2C digital services' from a foreign supplier. The tax treatment of 'B2C digital services' provided from a foreign supplier to a domestic business customer is illustrated below:



Domestic business customers

['B2C digital services' provided by a non-registered foreign supplier]

- The domestic business customer will not be allowed to take a credit for the consumption tax on the 'B2C digital services' provided by a non-registered foreign supplier for the time being.

['B2C digital services' provided by a 'registered foreign supplier']

- The domestic business customer will be able to take a credit for the consumption tax on the 'B2C digital services' provided from a 'registered foreign supplier.'
- It is generally required to preserve accounting records and invoices including certain items in order to take a tax credit for consumption tax paid on ordinary taxable purchases. For consumption tax paid on 'B2C digital services' provided by a 'registered foreign supplier,' the 'registration number of the registered foreign supplier' (both for accounting records and invoices) and 'a statement that the registered foreign supplier has an obligation to declare and pay consumption tax on the supply' (for invoices) are additional items to be indicated in accounting records and invoices. Note that invoices can be preserved by electronic records. (The preservation requirement for invoices is not applied to certain cases including where the amount of a transaction is less than JPY30,000. This exception will be applied to a tax credit for consumption tax paid on 'B2C digital services' provided by a 'registered foreign supplier' as well.)

Foreign suppliers

- When the foreign supplier has taxpayer status for Japanese consumption tax purposes, it is required to file a consumption tax return and pay consumption tax on 'B2C digital services' to the Japanese government. (Please see 5(3) for things to be noted if the foreign supplier is a 'registered foreign supplier'.)

5. Registration Regime for Foreign Suppliers

(1) Procedures to become a 'registered foreign supplier'

In connection with the above amendments discussed in 4(2), a new regime to register foreign suppliers has been introduced. A foreign supplier having consumption taxpayer status will be able to become a 'registered foreign supplier' by submitting an application form together with certain documents to the National Tax Agency (NTA) through the competent tax office. Foreign suppliers will be able to submit an application for registration on or after 1 July 2015.

Note that if a foreign supplier falls under one of the following cases, an application to register should be rejected:

- Where the foreign supplier does not have an office involved with 'digital services' in Japan or the foreign supplier has not appointed a tax representative (Zeimu Dairi-nin, limited to certified tax accountants and certain lawyers) for consumption tax purposes.
- Where the foreign supplier who is required to appoint a tax agent (Nouzei Kanri-nin) (e.g. as the foreign supplier does not have an office in Japan) has not appointed a tax agent for consumption tax purposes.
- Where the foreign supplier has a delinquent tax liability in Japan and it is extremely difficult for the Japanese tax authorities to collect such liability.
- Where it is an application to re-register within one year from the cancelation of the previous registration of the foreign supplier for certain reasons.

(As a result of the first two bullet points, a foreign supplier without an office in Japan should appoint a tax representative and a tax agent.)

(2) Public announcement of registration

The NTA will make the following information of a 'registered foreign supplier' public on its website immediately after the registration:

- name
- address
- address of the office involved with 'digital services' in Japan, if it has such an office
- registration number
- date of the registration

The public announcement will enable domestic business customers to confirm whether foreign suppliers are registered or not in advance of 'B2C digital services.'

(3) Things to be noted by 'registered foreign suppliers'

- A 'registered foreign supplier' needs to issue invoices including the 'registration number' and 'a statement that the supplier has an obligation to declare and pay consumption tax on the supply' to domestic business customers upon their request and preserve such invoices for 7 years.
- A 'registered foreign supplier' will not be able to have tax exempt status after obtaining approval for the registration unless its registration is canceled.

6. Rules to Determine Taxpayer Status

(1) Principle rules to determine taxpayer status

Where one of the following conditions for a business operator is met, the business operator will have taxpayer status for consumption tax purposes:

- Taxable sales in the base period (generally, the fiscal year 2 years prior to the current fiscal year) exceed JPY10 million.
- Taxable sales in the specified period (generally, the first 6 months of the previous fiscal year) exceed JPY10 million. (Instead of taxable sales, total compensation such as salaries paid to resident individuals in Japan may be used.)
- It is a newly established company (a company which does not have base periods (generally, for the first 2 fiscal years)) whose stated-capital at the beginning of the fiscal year is JPY10 million or more.
- It is a newly established company (a company which does not have base periods (generally, for the first 2 fiscal years)) controlled by a person whose taxable sales exceed JPY500 million.
- Taxpayer status was voluntarily elected.

'Taxable sales' in the above means those subject to Japanese consumption tax, including export sales taxed at a zero rate but not including sales derived from 'B2B digital services.'

(2) Special rules to determine taxpayer status

The following special rules to determine taxpayer status have been set up in connection with the change of the place of taxation for 'digital services.'

Taxable period including 1 October 2015 (for a supplier having consumption tax exempt status under the pre-amendment rules)	If taxable sales in the base period or the specified period calculated on the assumption that the amendments discussed above were applied from the first day of the base period or the specified period exceed JPY10 million, the person will be treated as a taxpayer from 1 October 2015 to the end of the taxable period.
Taxable periods beginning after 1 October 2015 (where the first day of the base period or the specified period is prior to 1 October 2015)	Taxable sales in the base period or the specified period should be calculated on the assumption that the amendments discussed above were applied from the first day of the base period or the specified period.

If it is difficult for a business operator who conducted 'digital services' for the base period or the specified period to calculate taxable sales using the above methods, the business operator is allowed to calculate the taxable sales as follows:

Taxable sales in the base period	4 times the taxable sales for the period from 1 April to 30 June 2015 on the assumption that the amendments discussed above were applied for that period
Taxable sales in the specified period	Twice the taxable sales for the period from 1 April to 30 June 2015 on the assumption that the amendments discussed above were applied for that period

7. Timing of Application/Transitional Measures

(1) Timing of application

The amendments discussed above will be applied to transactions on or after 1 October 2015. However, foreign suppliers will be able to submit an application for registration from 1 July 2015.

(2) Transitional measures

The tax treatment before the amendments will be applied for 'digital services' supplied continuously before and after 1 October 2015 by foreign suppliers under contracts concluded before 1 April 2015. However, when the service fees are revised on or after 1 April 2015, the transitional measure will not be applied.

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