

# Japan tax alert

Ersnt & Young Tax co.

## Consumption tax on cross-border digital services

Update of the relevant Consumption Tax Basic Circular and the release of a related Q&A

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As a result of the 2015 tax reform, new consumption tax rules (hereinafter, "new rules") will apply to cross-border digital services provided by overseas businesses to the Japanese market starting on 1 October 2015.

The Consumption Tax Basic Circular (i.e. interpretation by the Japanese Tax Authorities) was partially updated on 26 May 2015 and the National Tax Agency issued a Consumption Tax on Cross-border Services Q&A on 3 June 2015 (a pamphlet outlining the new rules was also released). This alert focuses on the effects of the new consumption tax rules on overseas businesses that provide cross-border digital services to the Japanese market and introduces the main points of the Basic Circular revisions and the newly released Q&A.

### I. Scope of services subject to the new rules

In the revised Basic Circular, the following services are presented as examples of digital services subject to the new rules. It should be noted that in addition to cloud services and the distribution of digital contents or online advertisements, the downloading of software and the provision of consulting services and IT support services via internet are also likely to be treated as digital services subject to the new rules. Businesses involved in cross-border e-commerce should review the revised Basic Circular and Q&A to confirm whether their services are subject to the new rules as digital services.

1. Distribution of e-books via the internet
2. Services allowing users to listen to music or watch videos via the internet
3. Services allowing the use of software via the internet
4. Services that provide other businesses with an online space to sell products
5. Services that post online advertisements
6. Continuous consulting services via phone or email

The Q&A also provides other examples of potential digital services such as services that allow customers to use cloud-based software or databases; services that provide a cloud-based space to store electronic data; and online English lessons.

The Q&A also provides the following examples of services which are not expected to be treated as digital services subject to the new rules.

- ▶ **Usage of telephone, fax, telegram, data transmission or internet to transmit information between parties (telecommunication services)**
- ▶ **Software development, etc.**  
There can be cases in which a request is made to an overseas business to develop a piece of copyrighted work for example software. The instructions are given via the internet and the deliverable is also received via the internet. If the use of the internet is incidental to the transaction (the development of copyrighted works), such services are not classified as provision of digital services.
- ▶ **Management or investment of assets located overseas (including internet banking)**  
The internet is used to give instructions, status reports, or results relating to the investment of assets or movement of funds. If the use of the internet is incidental to the transaction (the management or investment of assets), such services are not classified as provision of digital services. However, for example if the overall transaction generates separate usage fees for the use of cloud-based asset management software, such service portion would be classified as provision of digital services.

▶ **Data collection/analysis requested of a foreign business**

The internet is used to report the results of data collection or analysis based on the request of the recipient. If the use of internet is incidental to the transaction (the collection or analysis of data based on the request of the recipient), the services are not classified as provision of digital services. However, if a foreign business charges fees for the browsing or usage of data collected or analyzed by the foreign business itself (i.e. the data collection and analysis are not based on the request of another company), such transaction would be classified as provision of digital services.

▶ **Overseas litigation handled by overseas legal experts**

The internet is used to give instructions or status reports related to litigation. If the use of internet is incidental to the transaction (the handling of overseas litigation), such services are not classified as provision of digital services.

▶ **Transfer/licensing of copyrights**

The owner of a copyright transfers or licenses copyrights to a business which will duplicate, screen or broadcast such copyrighted material. If the transfer and receipt of such copyrighted works is done via the internet and the use of the internet is incidental to the transaction (the transfer or licensing of copyrights), such services are not classified as provision of digital services.

The new rules will apply if recipients of digital services have an address or their head office, main office in Japan. The new rules are therefore expected to apply when an overseas business provides digital services to the foreign branch of a Japanese corporation which has its address in Japan. It is also important that foreign corporations with a branch in Japan are also covered under the definition of overseas business. When the Japanese branch of a foreign corporation provides digital services to a Japanese corporation including its foreign branch, the new rules are expected to apply.

Even with the release of the latest Basic Circular and Q&A, there are still many types of services which may be difficult to judge in terms of whether they are to be treated as digital services. In such cases it is highly recommended that you consult with your local tax authority or your tax advisor far in advance of the effective date.

## II. Main points of the new rules

The following is an overview of the main points of the new rules including the contents of the new Basic Circular. For a general introduction of the new rules, please refer to our newsletter dated 27 January 2015 with the title "[2015 Tax reform package, Revision of the Japan Consumption Tax treatment of cross-border services.](#)"

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

The place-of-supply will be determined based on whether the address of the recipient of digital services is in or outside of Japan.

- ✓ For example, in the case of services that allow the downloading of e-books, music, games, etc. via the internet, it is necessary to make an objective and rational assessment for each transaction, such as by cross-checking the address that the customer stated at the time of purchase with the country of issue of the credit card used to make the purchase.

### 2. Introduction of the reverse charge mechanism

With respect to provision of B-to-B digital service, a reverse charge mechanism will be implemented which shifts the obligation of paying consumption tax to the business receiving the B-to-B digital service.

- ✓ It is necessary to determine whether the service is classified as a B-to-B digital service based on the nature of the service (e.g., distribution of advertisements, provision of an online space to sell games and software).
- ✓ When it is difficult to determine the classification based on the nature of the service, it is necessary to determine whether the contractual provisions (confirmed via contract, correspondence during the contract process, etc.) could classify the service as a B-to-B digital service (e.g., cloud service).
- ✓ The overseas business that provides B-to-B digital services has an obligation to inform, in advance, the domestic business which is the customer in the transaction that the reverse charge mechanism is applied to the B-to-B digital services.

- ✓ When the reverse charge mechanism is applied, the amount billed by the overseas business will not include consumption tax.
- ✓ When a business receiving digital services has a taxable sales ratio of 95% or greater for the taxable period under regular consumption taxation, or when a business adopts the simplified consumption taxation for the taxable period, there is no requirement to report reverse charge consumption tax in the tax returns for the time being. Reverse charge will only apply for businesses which have a taxable sales ratio of less than 95% for the taxable period under regular consumption taxation.

### 3. Limitations on input tax credits for B-to-C digital services performed by overseas businesses

As a provisional measure, input tax credits will not be available for businesses receiving B-to-C digital services for the time being. However, input tax credits may be available for businesses receiving B-to-C digital services which are provided by a "registered overseas business" (see 4. below).

- ✓ Digital services that are not classified as B-to-B digital services will be classified as B-to-C digital services. B-to-C digital services for example include the distribution of e-books, music and movies to consumers. If for example digital services are shown on the website of the overseas business as targeted only for businesses but the overseas business cannot restrict individual consumers from buying such services, such services are also treated as B-to-C services.
- ✓ Based on the request of the customer, the registered overseas businesses have an obligation to issue invoices which state their overseas business registration number and notify the fact that they have an obligation to pay consumption tax on taxable sales of B-to-C digital services.
- ✓ Input tax credits may only be applied when the business receiving B-to-C digital services keeps the invoices that include the registration number of the registered overseas business.

#### 4. The establishment of the overseas business registration system

Overseas businesses that fulfill the following requirements can become registered overseas businesses by applying at the Commissioner of the National Tax Agency via the District Director of the Tax Office with jurisdiction. Information regarding such businesses, such as name, address or head office location, and registration number will be published on the National Tax Agency website.

- a. The overseas business is subject to consumption tax
- b. The overseas business provides or plans to provide B-to-C digital services
- c. The overseas business has an office in Japan that provides B-to-C digital services
- d. If the overseas business has no office in Japan which provides B-to-C digital services described in c., the overseas business has designated a tax agent for consumption tax
- e. If the overseas business has no office in Japan, the overseas business has designated a tax representative
- f. The overseas business is not delinquent in the payment of national taxes

Applications for registration will be accepted beginning 1 July 2015.

### III. Actions and considerations

The new rules will apply to transactions conducted on or after 1 October 2015. The new rules can have an impact on service provisions therefore it is necessary to promptly assess the current situation, the potential future consequences and to consider the necessary steps to prepare for the change.

1. Confirming whether a transaction is affected by the new rules
  - a. Is the transaction considered a provision of digital services?
  - b. Is the digital service being provided to Japanese customers?

- c. If a. and b. apply, is the transaction based on an agreement concluded on or before 31 March 2015, and will it be considered a continuous provision of digital services both before and on or after 1 October 2015? (A provisional measure applies in this case and the current (i.e. pre-revision) consumption tax law will apply to such service provisions until the end of the service contract term. Agreements that are for example renewed each month will be considered as if a new agreement is concluded each month and will not be eligible for this provisional measure.)

#### 2. Confirming the classification of a transaction

- a. Based on the nature of the service, can the recipients of the digital service normally be restricted to businesses?
- b. Based on the transaction terms, can the recipients of the digital service normally be restricted to businesses? (For example, if the contents of the digital service provision are separately negotiated and are part of an agreement concluded between the parties to such transaction, and it is clear that the recipient of the digital service will use the provided service as a business, the digital service will be considered B-to-B.)
- c. Can the online registration for the digital services by non-business entities (consumers) realistically be restricted? (If not, the digital service will be considered B-to-C.)
- d. Regarding b., if negotiations are necessary, identify potential issues and negotiate and conclude/revise the agreements.

#### 3. Overseas businesses that provide B-to-B digital services

- a. Obligation to state that a transaction is subject to reverse charge  

(For example when introducing the details of a transaction online or in documents presented at the time of negotiations regarding the transaction details, it is necessary to notify that the transaction is subject to reverse charge in a manner that makes it easy for the other party (service recipients) to understand that reverse charge applies.)

- b. Revise contents or forms of agreements (if necessary; refer to 2. b. and d.)

#### 4. Overseas businesses that provide B-to-C digital services

- a. Confirm whether there is a filing obligation by confirming past taxable sales amount and whether tax exemption for small businesses applies (It should be noted that the provision of B-to-B digital services is excluded from taxable sales when considering the eligibility of the overseas business for the tax exemption for small businesses.)
- b. Registration as a registered overseas business (In order for the overseas businesses to provide B-to-C digital services that are eligible for input tax credits at the level of domestic businesses, they must be registered as overseas businesses.)

- c. Selection of a tax representative

- d. Preparation of tax returns and cash management of tax payments

#### 5. Other points

- a. Impact analysis of the new rules on the business
- b. Considering a price setting policy for transactions subject to the new rules
- c. Considering IT system compatibility with new processes necessary under the new rules

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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