

1 Historical Background

Nowadays, consumption tax in the form of credit-method value added tax is one of the most important revenue sources for the Japanese government. Indeed, this general consumption tax has accounted for approximately 30% of the total amount of taxes and duties in Japan (including those levied by municipalities) in recent years. This general consumption tax has a relatively short history in Japan. It was first introduced in 1989, however, the Japanese tax authority started the feasibility study for the introduction of the general consumption tax in the 1960s. Until then, Japan had had a consumption tax called a “commodity tax” which was only applicable to certain limited items that were conceived to be luxurious. Because of this limited application, it was not a significant revenue source for the Japanese government. The commodity tax was abolished when the general consumption tax was introduced, but a special consumption tax is still applicable to petroleum, tobacco and liquor.

In Japan we have a number of opponents to the general consumption tax who tend to emphasize its regressive nature. The example below illustrates the “regressive” nature of a consumption tax:

Example 1

	Income	Consumption
Person A	1,000	800
Person B	5,000	2,000

If we apply a 20% consumption tax to Person A and Person B, the tax amount would be 160 and 400, respectively. 160 constitutes 16% of the total income of Person A, while 400 constitutes only 8% of the total income of Person B. This feature can be viewed as “regressive”. This result occurs because a person with a large income tends to spend a smaller percentage of his/her income.

Opposition to the general consumption tax was really strong, such that the first draft bill regarding the general consumption tax, which was brought to the Diet in 1987, was not even discussed in the Diet, but rather, became null. At that time, the fact that consumption tax was applicable to groceries rather than luxury items invited severe criticism.

Of course, a general consumption tax has quite a few advantages compared to income tax, which include a neutral economic impact, simplicity and administrability. While these merits have become broadly accepted since its introduction about 30 years ago, Japan still has many citizens who prefer income tax to consumption tax. That is the principal background to the uncertainty about increasing the consumption tax rate to 10% (which includes a 2.2% local consumption tax) as well as the introduction of a reduced tax rate for some groceries when the rate increases. Although, as a matter of law, the rate increase is scheduled to be effective as from October 2019, it is often reported that the Japanese government is considering a further delay.

## **2 Principal Features of the Japanese Consumption Tax**

### **(1) General**

As briefly noted above, among various kinds of general consumption tax Japan has adopted a credit-method value added tax, which is also the consumption tax method used in the EU countries. Consumption tax is imposed at each stage of a sale at the tax rate of 8% (including 1.7% local consumption tax), subject to input tax credits for the consumption tax amount paid by the same taxpayer.

#### **Column 1 Various Kinds of Consumption Tax**

Some of the states in the US have a different type of general consumption tax, which is a sales tax. Sales tax is a kind of consumption tax that is imposed at a single sales stage. If it is imposed at the wholesale stage, it is a wholesale sales tax. If it is imposed at the retail stage, it is a retail sales tax. Since the sales tax is applicable to a single sales stage, no input tax credit or subtraction of business purchases from its tax base is necessary.

Theoretically, a retail sales tax and a value added tax would end up yielding the same tax amount if the tax rate is the same. However, under a retail sales tax it is inevitable that some business purchases, rather than final consumption, will be taxed because it is impossible for retail sellers to distinguish real consumption from a purchase of retail goods for the purpose of further production (= non-consumption, but a business purchase).

If we do not allow input tax credits for the consumption tax imposed at every sales stage, it would be a turnover tax. Turnover tax was popular in Europe before World War II. If other conditions are the same, the revenue from turnover tax should be larger than from value added tax by the amount of the input tax credit. However, turnover tax is not tax-neutral. Under a turnover tax system, vertically-integrated enterprises would be subject to consumption tax only once, while if not integrated, enterprises would be subject to consumption tax at every sales stage. That was the reason why turnover tax has been replaced with value added tax.

While Japan as well as the EU countries permit taxpayers to credit the amount of consumption tax that the same taxpayers actually pay to their sellers, identical results can be achieved by deducting the amount of business purchases from the tax base (i.e., the amount of sales minus the amount of business purchases would be the tax base for the consumption tax). For tax administration purposes, this subtraction-method value added tax would be less favorable to tax authorities because the tax authority needs to verify the accuracy of the amount of the business purchases as well as the amount of sales. While it would be fair to classify the Japanese consumption tax as a credit-method value added tax, it involves some features of a subtraction-method consumption tax in the sense that it does not yet strictly require invoices issued by payees to allow input tax credits.

Consumption tax can be in forms other than sales tax and value added tax. For example, the self-assessment type of consumption tax can be structured by utilizing the following formula:

$$\text{Consumption} = \text{Income} - \text{Savings}$$

In addition, a flat tax, which was proposed by Mr. Steve Forbes in the 1996 US presidential campaign, is a kind of consumption tax.

### **(2) Specific features of the Japanese consumption tax**

The Japanese consumption tax can generally be seen as an import of the European value added tax. However, it has some unique features as well.

(i) Broad Tax Base/Single and Relatively Low Tax Rate

As discussed further in detail below, Japanese consumption tax is intended to cover the whole consumption of goods and services in Japan. Goods and services exempt from consumption tax are strictly restricted. In addition, Japanese consumption tax has maintained a single flat and relatively low tax rate since its introduction. A broad tax base has enabled this tax rate feature. This feature of the single flat rate will no longer be true when the tax rate increases to 10%. The reduced tax rate of 8% (including 1.76% local consumption tax) will be applied to (aa) foods and beverages (excluding liquor) other than those provided at restaurants or under catering services and (bb) daily newspapers meeting some specified criteria.

(ii) Small-size Business Treatments

Japanese consumption tax has historically permitted small-sized business to be exempt from consumption tax or to apply a simplified calculation. For example, an enterprise with an amount of taxable sales of 30 million yen or less was allowed to be exempt from Japanese consumption tax until 2004. This feature has been reduced in concert with an increase in the consumption tax rate. This special treatment aimed to support small-sized business for which administrative burdens could be very large compared to large-sized business. However, the tax rate increase has created a disparity between tax-exempt small business and fully-taxed large business. In addition to this small-size business exemption, we have some unique features favorable to small-business. We will discuss this topic in more detail below.

### **3. Outline of the Japanese Consumption Tax**

#### **(1) What is taxed? - Tax base**

##### **(a) General discussion**

First, let us focus on the tax base. The following constitutes the tax base for the Japanese consumption tax:

- (i) Transfers (or loans) of goods or provisions of services by business in Japan for which consideration is paid (“Domestic Transactions”); and
- (ii) Import of goods.

In addition to these basic items, specific kinds of business purchases called Specified Purchases or “*tokutei-shiire*” in Japanese are also subject to consumption tax. The concept of Specified Purchases has been introduced principally for the purpose of capturing cross-border internet services. We will discuss this matter in more detail later.

##### **(b) Specific discussion on each item**

###### **(i) Domestic Transactions**

Japanese consumption tax first applies to any transfers (or loan) of goods or provision of services by business in Japan for which consideration is paid. This notion virtually covers all the commercial transactions in Japan for which consideration is paid. To be more precise, this concept can be divided into four components: (aa) consideration; (bb) by business; (cc) transfers (or loans) of goods or provisions of services; and (dd) in Japan.

First, the requirement of “consideration” means that consumption tax only applies to transactions with some charges. Thus, a pure gift or estate is out of the scope of consumption tax in general. The exclusion of a gift or estate from the tax base for consumption tax may be justified by arguing that a

gift should not be viewed as consumption. However, there is a question about whether excluding all free-of-charge transactions, such as self-consumption by business, can be justified for the same reason. Reflecting this discussion, this “consideration requirement” has certain exceptions. Those exceptions include gifts by a company to its directors and self-consumption by business of its purchased inventories.

Second, the requirement of “by business” means that Japanese consumption tax does not apply to non-business transactions, such sales of goods between friends.

The reasons for this non-business exclusion are believed to be:

- ① Difficulty in administration  
→ Imagine a case where you must calculate the amount of consumption tax by applying the complicated tax credits system. In addition, it is not practical for the tax authority to chase these non-business transactions.
- ② No big potential for tax

The guidelines and court precedents have given a relatively broad definition to the term “business”, which should mean sales of goods, etc., that are made continuously, repeatedly, and independently. Therefore, Japanese consumption tax generally applies irrespective of the scale of business or method of business. This broad definition of “business” shows some contrast with a relatively high threshold for exemptions, as discussed below.

The above-described reasons for the non-business exclusion did make sense, at least at the time of its introduction in 1989. However, the recent and rapid expansion of c-to-c transactions and the sharing economy have raised serious concerns about the potential effects of tax base erosion. It is worthwhile to note that because of the general and broad nature of the said definition of “business”, even typical c-to-c sales may be viewed as business sales for the purpose of Japanese consumption tax if the seller of such c-to-c sales repeatedly sells similar kinds of goods.

The third requirement, which is “transfers (or loans) of goods or provisions of services”, is intended to cover any transaction for every item or matter that can be sold or loaned, and thus, has no special effects limiting the scope of taxable events or the tax base of Japanese consumption tax.

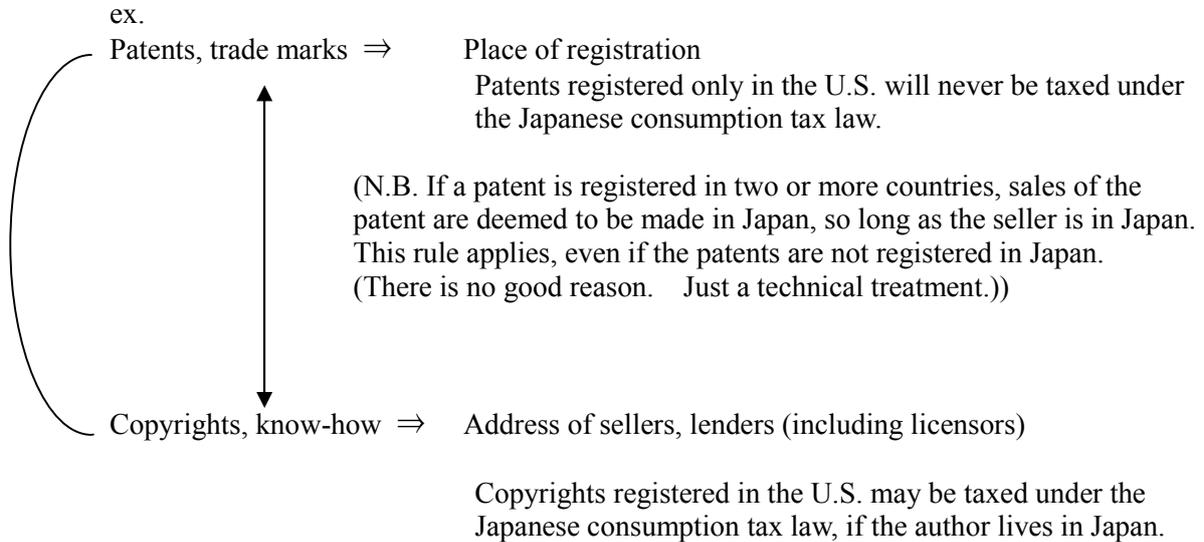
Then, the fourth and final component of taxable sales or loans is “in Japan”. Although we would not encounter any difficulty in determining whether or not a certain sale is made in Japan in most cases, this requirement may be an issue in a marginal case. The Japanese consumption tax law has detailed rules regarding this “in Japan” requirement, which is quite distinctive between “goods” and “services”.

#### “In Japan” requirement for sales (or loans) of goods

As for sales (or loans) of goods rather than services, the general rule is that whether or not sales are made in Japan should be determined based on the location of the said goods. Thus, if the sold (or loaned) goods are located in Japan when sold, the related sales (or loans) are deemed to be made in Japan and are subject to Japanese consumption tax. Please note that imports of goods are also subject to Japanese consumption tax. Thus, sales (or loans) of goods to Japanese residents generally constitute the tax base for Japanese consumption tax.

These location rules have several special rules for intangibles as illustrated below:

- ① How about intellectual property?  
→ We have very detailed rules.



- ② Monetary claims ⇒ Address of creditors

The consumption tax law also provides special rules for sales of other specific kinds of property such as airplanes, ships, and good-will.

#### “In Japan” requirement for services

Different from the sales of goods, the location of services is determined based on the place where the service is provided. This is almost the same as the rule where, if a person provides services in Japan, such service is deemed to constitute a taxable transaction in Japan. For example, if a Japanese boxer earns fight money outside Japan, no Japanese consumption tax will be payable. The logical conclusion of this rule is that if a US musician holds a recital in Japan, she/he is obligated to pay Japanese consumption tax in respect of her/his performance fees for the recital. As you can imagine, this conclusion is somewhat unrealistic, and thus, we have a special rule for these situations. For details, please see the discussion regarding “Specified Purchases” below.

Further, as to services provided through the internet or other IT systems (ex. online books and music, “IT Used Services”), the location of such services is not very clear. In this respect, the 2015 tax reforms introduced a new provision specifying that IT Used Services are deemed to be provided at the location of recipients. Thus, IT Used Services, which include various online services, are subject to Japanese consumption tax as long as their clients are Japanese residents, irrespective of the location of the relevant service provider. Japan understands that this rule is difficult to enforce if service providers are located outside Japan. Therefore, as a part of the 2015 tax reform, a few special provisions were introduced for IT Used Services. We will explain those special rules in the discussion regarding “Specified Purchases” below.

- (ii) Imports of goods

As to cross-border transactions, Japan adopted the destination principle for the purpose of consumption tax. Thus, Japanese consumption tax is imposed on imports of goods rather than exports of goods. To be more precise, imports of goods by anyone who receives delivery of foreign goods from bonded areas are taxed. For the purpose of enforcing tariffs on imported goods, bonded

areas are well administered. Well-administered bonded areas help the efficient enforcement of consumption tax on imported goods.

We will discuss the destination principle in more detail in (d) Exempt (Zero-Rated) Export Transactions below.

(iii) “Specified Purchases” (*tokutei-shiire*) - Internet services (& entertainment services)

As discussed above, in respect of certain kinds of services, without special rules non-Japanese service providers would be obligated to pay Japanese consumption tax by filing tax returns. The concept of “Specified Purchases” is intended to solve or reduce this issue.

Specified Purchases consist of (aa) receipt by businesses of entertainment services from entertainers and/or sportspersons and (bb) receipt by business of business-addressed IT Used Services (for the definition of this term, please see the discussion in the “In Japan” requirement for services above). For Specified Purchases service recipients, rather than service providers, must pay consumption tax.

#### Personal entertainment services

As discussed above, if a person provides services in Japan, that service is deemed to constitute a taxable transaction in Japan. Therefore, according to this general rule, if a US musician holds a recital in Japan, she/he is obligated to pay Japanese consumption tax in respect of her/his performance fees for the recital by filing a tax return in Japan. This result is harsh for a non-Japanese individual. It is impractical to enforce this rule as well. In this regard, the 2015 tax reform has shifted the obligations to pay consumption tax from entertainers to recipients of these entertainment services if the recipients are business persons or business entities. Since almost all material entertainment activities are managed by businesses, individual entertainers or sportspersons are virtually released from obligations relating to Japanese consumption tax. In turn, business recipients of these entertainment services must pay consumption tax to the tax authority, but need not pay the tax amount to service providers. Please note that this special rule is only applicable to cases where direct recipients of entertainment services (= counterparties of entertainers) are businesses. So, if a non-Japanese musician is directly paid by individual audiences, the entertainer must file a tax return and pay consumption tax on the entertainment fees.

#### IT Used Services

IT Used Services are deemed to be provided at the location of service recipients. Thus, IT Used Services which include various online services are subject to Japanese consumption tax as long as their clients are Japanese residents, irrespective of the location of the relevant service provider. Again, it is difficult to enforce this rule on non-Japanese service providers residing outside Japan. In order to reduce the magnitude of this issue, the 2015 tax reform shifted the payment obligations relating to consumption tax from service providers to recipients to some extent. Under the current rule, if certain IT Used Services are addressed only to business persons or business entities, the recipients rather than service providers are obligated to file tax returns and pay consumption tax on the relevant IT Used Services, which are one of the constituents of Specified Purchases. Please note that this exceptional treatment is available only if, as a matter of the nature of the IT Used Services, such IT Used Services are only addressed to businesses. This exception is not available if recipients may possibly involve final consumers.

In this regard, the scope of the application of this exceptional rule for IT Used Services is quite limited. With respect to non-business or business-non-business mixture services, service providers are obligated to pay consumption tax. In order to increase the efficiency of enforcing this rule, the Japanese consumption tax law generally disallows input tax credits related to IT Used Services other than those constituting Specified Purchases. Further, the Japanese consumption tax law provides a registration system for non-Japanese providers of IT Used Services. Such registered providers

represent that they will file tax returns for and pay consumption tax on IT Used Services to Japanese residents. For IT Used Services provided by registered providers, input tax credits are allowed on the service recipients. The tax authority has a list of registered non-Japanese service providers available to the public.

## **Column 2 Background of Specified Purchases**

As you can gather, the tax system regarding IT Used Services and Specified Purchases is complicated. This complicated feature is a product of the 2015 tax reforms that tried to combat unjustifiable tax disadvantages for Japanese service providers as opposed to non-Japanese service providers in respect of IT Used Services. Before the 2015 tax reforms, in relation to the "in Japan" requirement for taxable Domestic Transactions the location of IT Used Services was determined by referring to the location of each service provider. Therefore, a non-Japanese company that provided novels on an on-line basis or E-books was not subject to Japanese consumption tax in respect of its services even if its customers were Japanese residents. After all, such services are not Domestic Transactions, as long as the service provider resides outside of Japan. However, when the same kinds of services were provided by a Japanese company, they were taxed as Domestic Transactions. Of course, Japanese providers complained about this disparity between non-Japanese providers and Japanese providers. The 2015 tax reforms have changed the rule regarding the "in Japan" requirement, and now the location of IT Used Services is determined based on the location of service recipients (i.e., clients). Even after the 2015 tax reforms, non-Japanese service providers have more advantageous conditions in respect of IT Used Services that do not constitute Specified Purchases. They must pay Japanese consumption tax as a matter of law, but practically the Japanese tax authority has no means of enforcing it unless the service providers are eminent. Still, a number of non-Japanese service providers that are broadly engaged in IT Used Services addressed to Japanese clients have voluntarily registered them with the tax authority according to the said registration system. As a result, we can say that the discrepancy between Japanese service providers and non-Japanese service providers has been dramatically reduced.

### **(c) Exempt transactions**

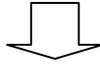
Japanese consumption tax exempts the following kinds of transactions from taxable transactions:

- ① Sales and leases of real property excluding buildings and houses
- ② Sales and loans of securities or notes and drafts or other cash equivalent
- ③ Various financial/insurance transactions
- ④ Sales of pre-paid cards, etc.
- ⑤ Sales of stamps by the government
- ⑥ Fees charged for public services such as company registration fees
- ⑦ Other items excluded from the consumption tax base for policy reasons

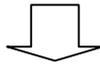
Sales or other transactions of virtual currencies including bitcoins are also exempt. We may argue that some of the above-mentioned items are exempt because they do not constitute consumption, while exemption of some other items cannot be fully explained for that reason.

Q. With respect to item ③, should fees for intermediation services provided by financial institutions be subject to consumption tax?

The logical answer to this Q. must be yes. A core function of financial institutions is to provide financial intermediation services and we do not have a reason to exclude the fees for such intermediation services from the tax base for consumption tax.



However, as to banks or other lending institutions, the fees for such intermediation services are partly included in the difference in interest rates between bank deposits and loans.



Theoretically, these fees should be taxed, but Japan (and European countries) exempts these fees from consumption tax, because of the difficulty in calculating the amount of such fees. It is administratively impossible for the tax authority to extract the fee-portion of bank loan interest and tax that portion.

Item ⑦ includes the following:

- (aa) certain services for the handicapped;
- (bb) certain education related services;
- (cc) social welfare services; and
- (dd) burial and cremation services.

As you can easily imagine, these items are exempt from consumption tax with due consideration for the psychological state of people paying for these services.

#### (d) “Zero-Rated” Export Transactions

Distinct from import transactions, export transactions are exempt from Japanese consumption tax. In addition to the mere exclusion from the tax base of export transactions, exporters are entitled to tax refunds for the amount of consumption tax paid to suppliers (input tax credit).

The above-mentioned feature of combining the exemption and tax refund is called “zero-rated.” This feature is a logical conclusion of the destination principle, where no tax burden shall be imposed in respect of export transactions. Without allowing input tax credits or related tax refunds, exporters would economically bear the consumption tax applied to their business purchases under the value-added tax system.

European countries have also adopted the destination principle, and Japan has followed the European practice. The following illustrates the rationale for the destination principle.

A fundamental question is “Should exported goods (and services) be taxed in

the exporting country or in the importing country?”

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Origin principle

Destination principle

If the tax systems are internationally harmonized, no difference will arise. Assume that every country has a value-added tax with the same tax rate, every commercial transaction including a cross-border transaction would be subject to consumption tax at the same rate. However, if the tax rates are different among countries, under the origin principle products from countries with a low-rated consumption tax would be in a favorable position. That is the reason why the destination principle is more popular than the origin principle.

The said “zero-rated” treatment is applicable to:

- (i) exports of goods;
- (ii) international transportation services; and
- (iii) international communication services.

As discussed above, the “zero-rated” treatment of export transactions and the underlying concept of the destination principle are reasonable by themselves. However, in order for the “zero-rated” treatment to be practically viable we need to distinguish export transactions from other transactions such as domestic transactions. In this connection, taxpayers must prove that a transaction falls within the category of an “export transaction” by specified documents such as export permissions.

### Simple Case Studies

? Purchases at tax-free shops by non-Japanese?

Exempt (zero-rated).

? What is the difference between “zero rated” and “exempt”?

For simply exempt transactions as discussed in (3) above, taxpayers are not entitled to an input tax credit.



Exporters are entitled to an input tax credit.

ex. Hospitals

→ If you have a receipt from a hospital for its medical services, you would notice that no consumption tax is payable in relation to such services. This means medical services are exempt from consumption tax.

→ However, the hospital must bear the economic burden of consumption tax applicable to its purchases of medical equipment from suppliers. No tax refunds are available.

→ Fees for medical services should be determined after considering that consumption tax burden.

## **(2) Taxpayer - Who is taxed?**

### **(a) Introduction**

Imagine a situation where you purchase a shirt with a price tag of ¥2,000 (excluding consumption tax) at a supermarket.

The amount of consumption tax including the local consumption tax would be ¥160.

Who is the taxpayer for that ¥160, you or the supermarket?

The correct answer is the supermarket.

→ Although, economically, you as the consumer bear the economic burden of consumption tax, the supermarket is obligated to pay consumption tax to the relevant tax authority.

**(b) Taxpayer**

Please remember that (i) Japan has adopted a value-added tax not sales tax and that (ii) Japanese consumption tax does not apply to non-business transactions

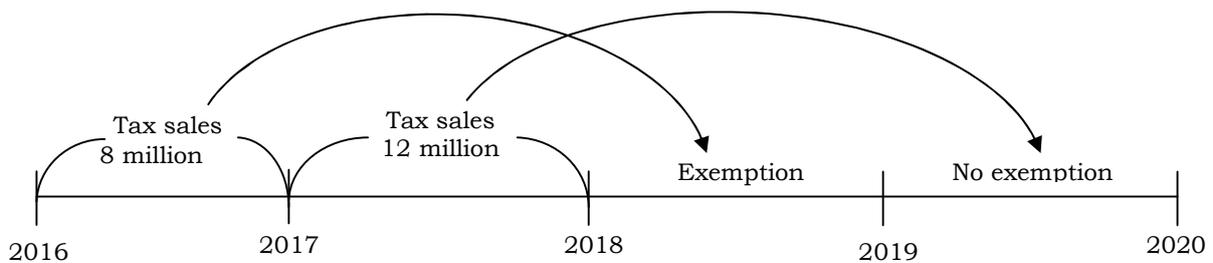
Therefore, the taxpayers paying Japanese consumption tax consist of every person and entity conducting business who engage in taxable transactions including imports of goods. This means that manufacturers, wholesalers and retailers are all obligated to pay consumption tax.

cf: Under a retail sales tax system (ex. some states in the USA.), only retailers are the taxpayers paying consumption tax

**(c) Small Business Exemption**

Currently, a business with taxable sales (excluding the amount of consumption tax) of 10 million yen or less is exempt from paying consumption tax. This exemption is called the “small business exemption.”

This 10 million yen threshold requirement must be met in the tax year two years preceding the current tax year.



**Column 3 - Why is small business exempt from consumption tax?**

Although it is not unique, Japan has both income tax and consumption tax.



There is a considerable administrative burden on taxpayers, especially small-business taxpayers who do not have sufficient human resources. Taking into account the relatively small impact on the tax amounts together with this administrative burden on small business, “small business” should be exempt from the obligation to pay consumption tax.

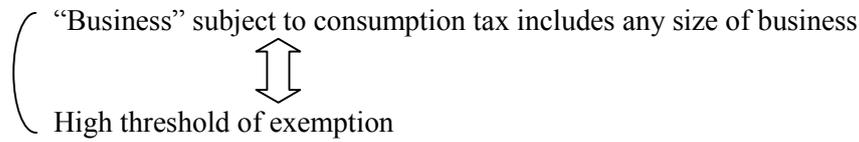
The small business exemption is not unique in Japan, but what was notable was its high threshold. In introducing the general consumption tax in 1989, this burden on small business was seriously criticized. As a result, under the original rule the exemption threshold was 30 million yen rather than 10 million yen. Surprisingly, as of 1989 more than 60% of businesses were said to be exempt from consumption tax because of this high threshold.

As you can easily imagine, the effect of consumption tax dramatically changes when the amount of taxable sales reaches the 30 million threshold.

( cf. Until 1997, Japanese consumption tax had a marginal deduction system that softened this drastic change.

This high threshold caused various issues. The following is an example of tax planning utilizing this high threshold:

Example:



Mr. A plans to buy a building, and rent it to third parties.

- Year 1 Buy a building at 300 million yen. Receive rent 20 million yen a year.
- pay to the seller of the building 24 million yen (8% of 300 million) as consumption tax
  - elect to be a taxpayer
  - then
- A will receive a tax refund of 21.6 million yen.
- $\therefore 24 \text{ million} - 20 \text{ million} \times 8\%$
- $= 21.6 \text{ million yen}$

Year 2 and thereafter

- Receive rent 20 million yen
- elect to be exempt from consumption tax
- no payment of consumption tax

A few case studies

Case 1 Even if a taxpayer meets this exemption requirement, he/she may elect to pay consumption tax.

Who makes such an election? Crazy people?

No. → Exporters have strong incentives to be taxpayers.

$\therefore$  They can get tax refunds.



Please refer to the discussion regarding zero-rated export transactions.

Case 2 How about new business that did not have any taxable sales two years ago?

- Individuals and corporate entities with paid-in capital of less than 10 million yen. → Tax exempt
- Corporate entities with paid-in capital of 10 million yen or more. → Tax

Case 3 Is the following argument correct?

Because an exempt small business need not pay any consumption tax to the Japanese government, he/she need not add any amount to the price for the goods which he/she sells.

Ans. No.

Why?

Because a tax-exempt small business may not claim credits for the input tax.

Japan has adopted a value-added tax rather than a sales tax.

Thus, a tax exempt small business has paid consumption tax on its business purchases (input tax).

⇒ He/She requires his/her customers to pay, at least, an amount equal to the input tax.

Of course, if he/she adds 8% to sale prices, he/she will retain a portion of the consumption tax.

ex.

	Value	Value with Tax	Tax
Sewing Shirts	500	540	40
Wholesale	700	756	16 $700 \times 8\% - 40 = 16$
Retail	1000	1080?	?

If the retailer qualifies as a tax-exempt small business, he/she need not pay consumption tax (i.e. 80) to the government. What he/she needs is to have his/her customers pay an amount equal to the input tax (i.e., 56). Thus, if he/she sells a shirt at ¥1,080, he/she has ¥24 tax benefit. To the contrary, if he/she sells a shirt at ¥1,000, he/she bears the ¥56 tax.

#### Case 4 Partnership

→ The rule is that the tax burden should be divided in proportion to the share of the respective partner.

		A 60%	B 30%	C 10%
Taxable Sales	1500	$1500 \times 8\% \times 60\%$ =72	$1500 \times 8\% \times 30\%$ =36	$1500 \times 8\% \times 10\%$ =12
Business Purchase	1000	(credit) $1000 \times 8\% \times 60\%$ =48	$1000 \times 8\% \times 30\%$ =24	$1000 \times 8\% \times 10\%$ =8
Consumption Tax		24	12	4

### (3) How to calculate the tax amount?

As we have already discussed the tax base and the obligors of consumption tax, it is time that we discuss how consumption tax is calculated. First, we focus on national tax. The amount of national consumption tax that must be paid by each taxpayer is calculated in accordance with the following formula:

Taxable amount × Tax rate - Input tax credit (& other credits)

Let us discuss each item of this formula.

**(a) Taxable amount**

**(i) General**

The first item, which is the “taxable amount,” means the amount of all the consideration received in relation to taxable transactions. This rule is also applicable to Specified Purchases. As to the scope of taxable transactions, please refer to the discussion regarding the tax base in (1) above. Under the Japanese consumption tax law, the tax rate is provided as a tax-exclusive rate. Therefore, the taxable amount does not include the amount of consumption tax including local consumption tax.

Q1 Does it include payments in-kind? (other than cash)

Yes. All the consideration irrespective of its form must be included. We have detailed and technical rules in respect of payments in-kind.

Q2 In calculating the taxable amount, which one should be used, the actual sale price or the market value?

Subject to limited exceptions such as sales to directors of the company in question, the taxable amount is calculated based on the actual sale price rather than the fair market value of the sold goods.

- ∴ ( ① Administrative reason  
= Difficulty in ascertaining market values  
② Consumption = Income - Savings

→ If the price of a consumption transaction is cheap, the amount saved in such transaction will be used for other consumption transactions or savings. In the latter case, he/she will eventually use those savings and the consumption tax law can capture the amount saved in a previous transaction at that moment.



This second rationale may be criticized from a possible tax deferral viewpoint.

(ii) Taxable period

The taxable amount of Domestic Transactions is calculated based on each taxable period, which is generally one year.

- 1) Imports of goods  
Taxpayers must pay consumption tax on each import. → No concept of the taxable period
- 2) Domestic Transactions including Specified Purchases

- Individual tax payer: → Calendar year = taxable period for individual income tax
- Corporate tax payer: → Fiscal year = taxable period for corporate income tax

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Taxpayers may elect to adopt the three-month or the one-month taxable period. (This election is usually made by exporters, who want to receive tax refunds sooner.)

This one-year taxable period is intended to reduce the burden of calculating the tax amount. Therefore, the taxable period for consumption tax is the same as that for income tax.

Q1 Can you find any problem with this long taxable period?

A1 Yes

- Who bears consumption tax? → Consumers
- Who are taxpayers? → Retailers, etc.  
(∵ VAT)

If taxpayers may retain the amount of consumption tax for a period, they may earn interest on that amount (= time value of money).



In order to reduce this issue Japan has introduced an interim payment system.

= Taxpayers with a taxable period of longer than three months must pay the estimated amount of consumption tax for a shorter period calculated on the basis of the amount of consumption tax actually paid for the immediately preceding taxable period.

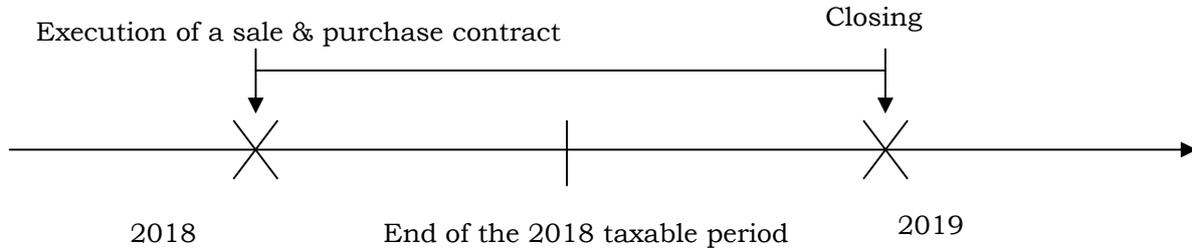
Ex. X: Corporate taxpayer  
 Fiscal year    • •    Calendar year  
 The amount of consumption tax paid for 2017  
                   • •    600 million yen  
 The amount of consumption tax that must be paid for 2018  
                   • •    500 million yen

In this case, for every month X must pay one-twelfth of the tax amount of the preceding fiscal year (i.e., 50 million yen), and then, at the end of the fiscal year the tax amount would be finally adjusted. In this case, X should have paid 550 million yen (50 million per month x 11 months) prior to the fiscal year end. So, at the end of the

fiscal year X would receive a tax refund of 50 million yen, which is equal to the excess of the said 550 million yen over the 500-million tax obligation.

Q2 If a taxable transaction is closed in year after the signing, for which fiscal year would such taxable transaction be accounted?

For example:

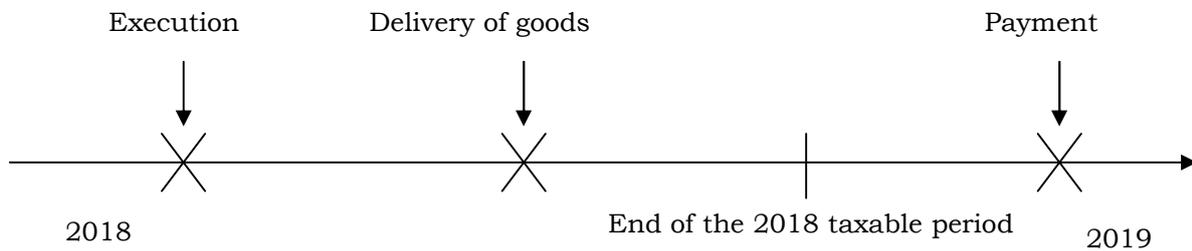


In this case, will the sale belong to 2018 or 2019?

Ans. 2019



How about the following case?



In this case, will the sale belong to 2018 or 2019?

Ans. 2018

→ Taxable transactions are accounted for on an accrual (delivery) basis not on a cash basis.

How about installment sales, etc.?

We have very detailed and technical rules for various transactions.

**(b) Tax rate**

The current tax rate of Japanese consumption tax is functionally 8%, which is a combination of the 6.3% national tax and the 1.7% local tax. However, when you see a receipt for a purchase at a supermarket or other retailers, you will notice that the receipt does not distinguish between national consumption tax and local consumption tax. We will discuss the underlying reasons in the next chapter.

The 2012 tax reforms, which have increased the tax rate from 5% to 8% as from April 2014, originally scheduled a further increase to 10% from October 2015. However, this second-stage rate increase has been postponed twice, and according to the current schedule the increase will be effective as from October 2019. Although Japan has maintained a single tax rate, at the same time as the rate increases to 10% the reduced tax rate of 8% (including 1.76% local consumption tax) will be applied to some selected items. The items eligible for the reduced tax consist of (i) foods and beverages and (ii) daily newspapers meeting some specified criteria. Nonetheless, liquor and any other alcoholic drinks are not eligible for the reduced tax rate but are subject to the 10% tax. Any foods or beverages that are served at restaurants or provided under catering services are excluded from the items eligible for the reduced tax rate, while simple food delivery services are generally eligible for it. This reduced tax rate is a product of the discussions aimed at, at least partially, combating the regressive nature of consumption tax. Of course, there are various policy arguments regarding the appropriateness of this two-tier tax rate system and the selection of eligible items for the reduced rate.

**(c) Input tax credits**

**(i) General**

As discussed above Japan has adopted a credit-method value-added tax. It means that in calculating consumption tax the amount paid by the business is credited. These tax credits, which are called input tax credits, are the product of the tax rate and the amount of business purchases. Therefore, the tax amount will be calculated in accordance with the following formula:

$$\begin{aligned} \text{Tax Amount} &= \text{Tax Rate} \times \text{Taxable Transactions} \\ &\quad - \frac{\text{Tax Rate} \times \text{Business Purchase}}{\text{(Input Tax)}} \end{aligned}$$

While the input tax credits are essential to the value-added tax system (without the input tax credits it would be a turnover tax rather than a value-added tax), if taxpayers can easily exaggerate the amount of input tax credits, the value-added tax system would not work. Until recently, Japan did not require invoices as mandatory evidence for input tax credits, but taxpayers were permitted to rely on their accounting records. This reflects the relatively short history of value-added tax in Japan. Everyone understands that an invoice-based credit system, which requires invoices to be eligible for input tax credits, would help to accurately calculate input tax credits and prevent undue exaggeration of input tax credits. However, when consumption tax was introduced in 1989 the Japanese government thought highly of simplicity rather than accuracy. It has been said that it is difficult for persons who are not familiar with the value-added tax system to receive and preserve invoices solely for the purposes of calculating consumption tax.

Of course, as time goes on, taxpayers have become more sophisticated with regard to value-added tax. This sophistication resulted in tax reforms which require taxpayers to maintain accounting records and invoices, bills, etc. from 1997 (until then, taxpayers had to maintain accounting records or invoices). Even under this new system the Japanese consumption tax does not require that the invoices specifically state the amount of the input tax. The invoice requirement is scheduled to become more stringent. From October 2023 invoices will generally need to specify the consumption tax amount to be eligible for input tax credits.<sup>1</sup> It has been explained that upon the introduction of the two-tier tax rate system stringent invoice requirements will be essential for feasible and efficient tax administration.

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<sup>1</sup> From October 2029, only invoices issued by businesses registered with the Japanese tax authority will be eligible as evidence for input tax credits. From October 2023 through September 2029, business purchases from non-registered businesses are still eligible for input tax credits but only the specified portion will be taken into account.

**(ii) Business with taxable transactions and tax-exempt transactions.**

If all of transactions concluded by a taxpayer were taxable transactions, the calculation of consumption tax and the input tax credit would be simple. However, in reality many taxpayers enter into both taxable transactions and tax-exempt transactions. If we permit a taxpayer with such mixed transactions to fully credit the amount of input tax, the taxpayer would get windfalls because the taxpayer should be viewed as a final consumer in respect of the business purchases used for tax-exempt transactions.

To deal with this matter Japan has taken the following approach:

- (aa) If the amount of taxable transactions accounts for 95% or more of the total amount of revenue and the amount of taxable transactions is 500 million yen or less, the taxpayer may claim the input tax credit on all its business purchases.
- (bb) If not (= less than 95% or the amount of taxable transactions exceed 500 million yen), the taxpayer must calculate the amount of the input tax attributable to the taxable transactions.

└─▶ Two methods of calculation

- ( i) Itemized method
- ( ii) Proportional method

i) Itemized method

First Step: Divide its business purchases into three categories;

- ① purchases attributable only to taxable sales
- ② purchases attributable to both taxable sales and tax-exempt sales
- ③ purchases attributable exclusively to tax-exempt sales

Amount of the input tax credits

$$= ( \textcircled{1} + \textcircled{2} \times \frac{\text{taxable sales}}{\text{total sales}} ) \times \text{tax rate}$$

ii) Proportional method

This method is a simplified one.

Amount of the input tax credits

= total amount of taxable purchases

$$\times \frac{\text{taxable sales}}{\text{total sales}} \times \text{tax rate}$$

Example

A: Percentage of taxable transactions: 80%

Business purchases 1,000	}	①	600
		②	300
		③	100

Under the itemized method

$$(600+300 \times 80\%) \times \text{tax rate} = 840 \times \text{tax rate} \quad \Rightarrow \quad \text{tax credit}$$

Under the proportional method

$$1,000 \times 80\% \times \text{tax rate} = 800 \times \text{tax rate} \quad \Rightarrow \quad \text{tax credit}$$

→ A will use the itemized method.

B: Percentage of taxable transactions: 80%

Business purchases 1000	}	①	500
		②	300
		③	200

Under the itemized method,

$$(500+300 \times 80\%) \times \text{tax rate} = 740 \times \text{tax rate} \quad \Rightarrow \quad \text{tax credit}$$

Under the proportional method,

$$1,000 \times 80\% \times \text{tax rate} = 800 \times \text{tax rate} \quad \Rightarrow \quad \text{tax credit}$$

→ B will use the proportional method.

||

Possible tax arbitrage because of permission to use the simplified method (= proportional method)

Q: Can we justify this 95% rule?

It is often said that this 95% rule can simplify the calculation of input tax credits by small business.



Really?

A taxpayer must prove that the amount of taxable transactions account for 95% or more of the total amount of revenue.

= In any event, any taxpayer needs to calculate the amount of taxable transactions and the amount of tax-exempt transactions.

**(iii) Simplified calculation ··· Unique Japanese system**

Taxpayers with taxable transactions of 50 million yen or less may elect to calculate the amount of taxable business purchases by multiplying the amount of taxable transactions by the percentage specified below:

	Percentage
Wholesalers	90%
Retailers	80%
Farming, fishing, construction, mining, manufacturing, etc.	70%
Transportation, other services	50%
Real estate	40%
Other business	60%

This means that a relatively small business need not calculate the amount of business purchases or the amount of input tax. While this system is also intended to reduce the administrative burden on small businesses, opponents of this system criticized this simplified calculation by stating that if the actual percentage of the business purchases exceeds the specified percentage, the relevant taxpayers would not elect to apply this simplified calculation, but calculate the tax amount in accordance with default rules.

- \* We also have detailed rules regarding taxpayers who are engaged in two or more kinds of business.
- \* Taxpayers must file a notice with the relevant tax office if they intend to use this simplified calculation.

**(d) Other tax credits**

- (i) Discounts and rebates
- (ii) Distressed debts

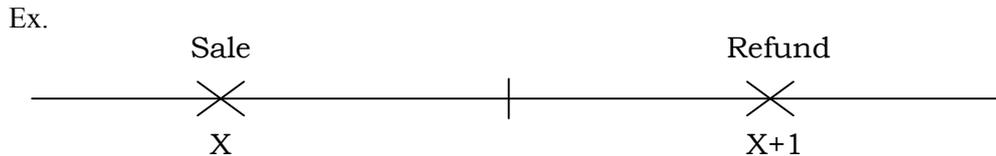
**(i) Discounts & Rebates**

In the case of post-sale discounts, refunds, or cancellation of taxable transactions, tax credits for the amount of attributable consumption tax are available to taxpayers instead of deducting the amount of taxable transactions. The amount of tax credits is calculated according to the following formula:

$$\frac{\text{The amount refunded, etc.}}{\text{Tax inclusive amount}} \times 6.3/106.3 = \text{The amount of tax credit}$$

Because the refunded amount is tax inclusive (including 1.7% local tax), we must multiply 6.3/108 rather than 6.3/106.3 6.3/100. 6.3% is the rate of the national consumption tax.

The tax credits are available for the fiscal year in which the post-sale discount, refund, or cancellation of the taxable transaction was actually made.



Therefore, for the above example the tax credit is available in X+1.

(ii) Distressed debts

As discussed above, taxable transactions are accounted for on an accrual (delivery) basis, not on a cash basis. Therefore, certain adjustments are necessary in the event that customers of taxpayers fail to pay purchase prices, although they have received goods or services.

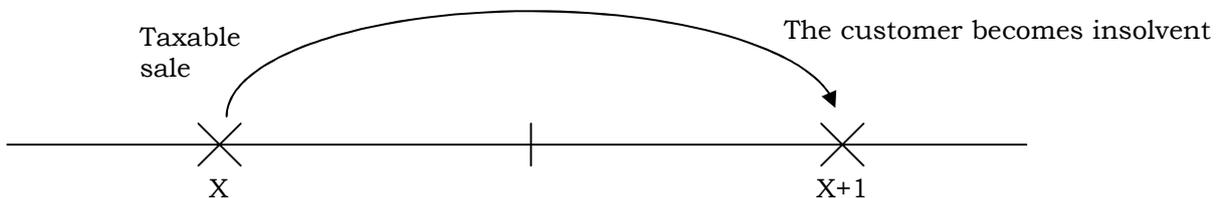
Both deductions from the taxable transactions and tax credits can be useful measures to handle this non-payment by customers. As with refunds, etc. discussed above, Japanese consumption tax has adopted the concept of “tax credits”.

The amount of tax credits in this case will be the amount of the distressed debts multiplied by 6.3/108.

Q: What are distressed debts?

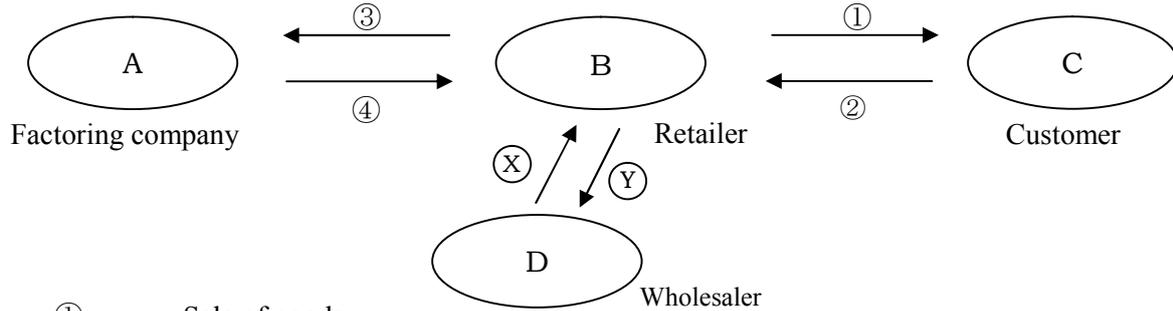
If taxpayers could claim tax credits on the basis of their own evaluation of the possibility that customers will fail to pay, the risk of tax evasion would be substantial. Reflecting this concern by the tax authority, we have relatively strict rules for recognizing distressed debts. Distressed-debts tax credits are only available when a customer of the taxpayer is under a judicial insolvency proceeding such as bankruptcy proceedings or other similar financial conditions.

Q1: When does a taxpayer claim the tax credit?



→ The taxpayer is entitled to the tax credit in X+1

Q2: Case Study



- ①: Sale of goods
- ②: Obligation to pay the purchase price
- ③: Assignment of the monetary claim against C
- ④: Payment of consideration for the assignment ③
- ⊗: Sale of goods (wholesale)
- ∅: Payment of the purchase price (wholesale price)

After these transactions, C must pay the purchase price for the goods to A.

What will happen if C becomes insolvent?

= Can A claim a distressed-debt tax credit?

→ No.

∵ The assignment of the monetary claim between A and B is an exempt transaction, not a taxable transaction.

Then, who can claim the tax credit?

→ B?

No.

∵ Because B received the whole amount from A.

↓ → Double taxation

What if the assignment between A and B is cancelled?

Theoretically, B may claim the tax credit, but the tax authority may object to such treatment.

#### (4) Local Consumption Tax

##### (a) Introduction

When you purchase a tax text-book for 5,000 yen at a bookstore in Japan, you must pay 5,400 yen including 8% consumption tax. However, the national consumption tax rate is 6.3% rather than 8%. This means that the remaining 1.7% is local consumption tax. This allocation is scheduled to change when the tax rate increases in 2019. When the rate increases, the national tax rate and the local tax rate will be 7.8% and 2.2%, respectively. For items eligible for the reduced tax rate, the national tax rate will be 6.24% and the local tax rate will be 1.76%.

When you have a receipt for the text-book, what you can see is ¥400 consumption tax. No breakdown between the national consumption tax (i.e., ¥315) and the local consumption tax (i.e., ¥85) is shown on the receipt.

**(b) Tax amount, taxpayers, etc.**

The amount of local consumption tax could be calculated in the same way as that for national consumption tax, except for the tax rate. However, technically the tax bases and the tax calculation formula are different from those for national consumption tax. With respect to local consumption tax, while the scope of taxable transactions is the same, the tax base is the amount of national consumption tax rather than the amount of taxable transactions, and the tax rate is technically  $22/78$ . In short, local consumption tax is  $22/78$  of the national consumption tax, and, as a result, is equivalent to 1.7% consumption tax.

The historical background is as follows:

At first, the Japanese consumption tax was the national tax.



Importance of consumption tax increased.



Local consumption tax was introduced.



If the system of local consumption tax is different from that of national consumption tax, the administrative burden on taxpayers would be substantial.

∴ Apply the same system.

**(c) Collection**

If taxpayers must pay local consumption tax separately from national consumption tax, they would have to prepare totally separate tax returns. In addition, the local tax authority may have different interpretations of the calculation, etc., of consumption tax. In order to prevent any unnecessary confusion, under the Japanese consumption tax system, local consumption tax is collected by the national tax authority and is allocated by the national government among municipalities. So, the next question is, how is the local consumption tax allocated?

**(d) Allocation**

As the financial impact of consumption tax has become significant for municipalities, proper allocation of local consumption tax among them is a critical issue. Japanese consumption tax is a kind of VAT. Therefore, but for the unified collection by the national agency, each municipality might collect VAT attributable to the business engaged in within the municipality rather than consumption within the municipality.

ex.

	Place	Price	Tax
Manufacturing	A	500	$500 \times 1.7\% = 8.5$
Wholesale	B	700	$700 \times 1.7\% - 8.5 = 3.4$
Retail	C	1000	$1000 \times 1.7\% - 11.9 = 5.1$

Therefore, A, the place of manufacturing, would get 8.5.

B, the place of wholesale, would get 3.4.

C, the place of retail, would get 5.1.

However, it is a convincing argument that consumption tax should be collected according to the volume of consumption.

If we follow this argument, C should get all (i.e., 17) in this example.

Japan has adopted the latter method.

The rationale for this method are (i) the latter method is consistent with the concept of consumption tax and (ii) allocation by the national agency in accordance with the former method (= allocation referring to each function) is impracticable.

Since it is impracticable for the national agency to fully identify the places of consumption, it is inevitable that local consumption tax be allocated among municipalities according to the indices that are believed to best reflect the volume of consumption. Japan has technical rules regarding these indices.

As a matter of a tax policy, the current system of allocation (i.e., the allocation of local consumption tax according to the volume of consumption) may have opponents. Under this system, a prefecture with a lot of manufacturers would have a relatively small amount of local consumption tax, while a prefecture of a lot of consumers would have a large amount of local consumption tax.