

Japan Tax Bulletin

Effect of the reverse-charge mechanism on foreign enterprises

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The Consumption Tax Act and other relevant laws and regulations were partially amended in 2015 introducing a new taxation mechanism for consumption tax, called the “Reverse Charge Mechanism”

1. *Services which are subject to the reverse charge mechanism*

The reverse charge mechanism moves the consumption tax payment obligation for B to B cross-border telecommunicated services and for the provision of specific services (collectively the “Services”), from the providers of the service to the recipients.

Cross-border telecommunicated services are cross-border service transactions established through telecommunication lines such as internet or telephone lines where the recipients of the services are identified as enterprises with reference to the nature of service or trading terms etc.

Under the consumption tax law reform, books, music, advertising etc. distributed through telecommunication lines are deemed to be provided in the location of the recipient of the service (previously the supply was deemed to be provided in the location of the supplier). Cross-border telecommunicated services provided by foreign enterprises fall into two categories, “B to B” transactions and “B to C” transactions. “B to B” transactions are cross-border service transactions established through telecommunication lines such as internet or telephone lines where the recipients of the services are identified as enterprises with reference to the nature of service or trading terms etc. “B to C” transactions are cross-border service transactions which do not fall under the definition of “B to B” transactions.

The provision of specific services is mainly intended to cover to the provision of the services of motion picture or theatre artistes, musicians and any other entertainers or professional athletes, which are provided by an overseas company to another company (the provision of services to unspecified large number of peoples is excluded).

2. *Taxation mechanism of reverse charge*

Under the reverse charge mechanism, the recipients in Japan are required to withhold consumption tax and pay tax for the Services by filing tax return on behalf of the foreign enterprises. Foreign enterprises which provide the services need to issue an invoice with consumption tax added to the invoice amount. If consumption tax is not included in the invoice the payer has to deem the invoice amount to be consumption tax inclusive and withhold consumption tax from the payment, thus reducing the net receipt of the service provider. Foreign enterprises also need to make it clear to the recipients that they are responsible for paying the consumption tax to the tax authority.

3. *"Proportional method" and "Itemized method"*

Under consumption tax law, consumption tax on taxable purchases can be deducted from consumption tax on sales. If the consumption tax amount on taxable purchases is bigger than consumption tax amount on sales, a company can claim consumption tax refund by filing a consumption tax return. However, the full amount of consumption tax on taxable purchases can be deducted only if taxable sales are more than JPY 500 million and the taxable sales ratio¹ is 95%

or more.

Generally speaking the deductible consumption tax amount on taxable purchases is calculated using either the proportional method or the itemized method. Under the proportional method, consumption tax on taxable purchases is calculated by multiplying the taxable sales ratio by the total amount of consumption tax on taxable purchases.

The itemized method requires a clear distinction on each accounting ledger as to whether each tax credit for purchases is related to i) sales other than non-taxable only, ii) non-taxable sales only, or iii) sales which are a mixture of (i) and (ii). This is called the "Recording requirement for the itemized method". Also, under the itemized method, consumption tax on taxable purchases is calculated as the full amount of consumption tax on the purchases related to i) plus the consumption tax purchases related to iii) multiplied by the taxable sales ratio.

¹ Taxable sales ratio = Taxable sales + exempt sales / Taxable sales + exempt sales + non-taxable sales



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Due to the tax reform, the Services become out of scope under Consumption tax law (before the tax reform, the services provided in Japan were taxable transaction). So foreign enterprises do not have an obligation to file a tax return and pay consumption tax for the services. However in order to obtain a refund of consumption tax on purchases related to providing these services a foreign enterprises need to elect to be a taxable enterprise by filing a notification to the tax office, because only taxable enterprises can file a consumption tax return. Even if the foreign enterprise elects to be a taxable enterprise, as the Services are categorized as out of scope under consumption tax law, there is a

high possibility that their taxable sales ratio becomes minimal or even zero thus reducing the creditable consumption tax on taxable purchases potentially to zero. In order to fix this, the National Tax Agency circular 11-2-13-3 allows that under the itemized method, taxable purchases relating to the Services are categorized as “purchases related to sales other than non-taxable only”. Therefore if foreign companies elect to use the itemized method and meet the "Recording requirement for the itemized method", they will be able to take a credit for the full amount of consumption tax on taxable purchases related to the Services. Without adopting this method, foreign companies might potentially be unable to obtain a refund for consumption tax paid, thus increasing the costs of doing business with Japanese companies.

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