Tax Updates in Japan

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Written by Yasuharu Aizawa, Vice-chairman,
Masami Kondo, Member,
Makoto Tamada, Member,
Yoshihiko Nakanishi, Member,
International Relations Dept.,
Japan Federation of Certified Public Tax Accountants' Associations

Consumption Tax System in Japan

1. Tax Credit for Consumption Tax on Purchase under Japanese Taxation

(1) Significance and Requirements of Tax Credit for Consumption Tax on Purchase

When the consumption tax was first introduced in Japan (April 1989), the "Retention of accounting books or invoices, etc." (accounting method) was stipulated as a requirement to claim a tax credit for consumption tax on purchase. After the 1997 revision, the Consumption Tax Act was further amended to stipulate the "Retention of accounting books and *qualified invoices*, *etc.*" (Qualified invoice-based method) as a new requirement for purchase tax credit from October 2023.

Furthermore, along with the implementation of the qualified invoice-based method, electronic invoices will be regarded as invoices, etc. specified in the Consumption Tax Act.

(2) Qualified Invoice-based Method

After the qualified invoice-based method, or the so-called Invoice System, is implemented on October 1, 2023, qualified invoices can be issued only by "Business Issuer of Qualified Invoice," (same as "Qualified invoice issuer"), accredited by the District Director of the relevant tax office.

Therefore, a business operator exempted from consumption tax obligation (tax-exempt business operator has taxable sales of 10 million yen or less during the base period) needs to apply to be registered as Business Issuer of Qualified Invoice, while also submitting the Report on the Selection of Taxable Proprietor Status for Consumption Tax to become a taxpayer of consumption tax, file return and pay for consumption tax for the taxable period excluding the transitional period.

Moreover, a taxable business operator (business operator with taxable sales exceeding 10 million yen during the base period) needs the confirmation, etc. of account books and items specified on rate-classified invoices. They need to perform complicated separate accounting such as classifying multiple tax rates according to the reduced tax rate system. The retention of qualified invoices, etc. also becomes mandatory to receive a tax credit for consumption tax on purchase. In principle, current tax-exempt business operators can be registered as Business Issuer of Qualified Invoice from October 1, 2023, if they complete the registration application by March 31, 2023. Whether to be registered and become a taxable business operator or remain to be a tax-exempt business operator is up to a voluntary decision of the business operator, so they need to consider how they respond to the new Invoice System.

In addition to the above, the simplified tax system needs to be considered in the case of the business operator with taxable sales of 50 million yen or less for the base period. The simplified tax system allows a business operator to file the consumption tax return with simplified calculation by submitting a notification in advance instead of using the general taxation rule.

Moreover, a transitional measure will be applied for taxable purchases from tax-exempt business operators, etc. as the qualified invoice-based method begins. Specifically, subject to the retention of relevant invoices, etc. stating the same items specified on the rate-classified invoice issued by a tax-exempt business operator, etc. and the retention of account book indicating that the transitional measure applies to the transaction (the transaction is a taxable purchase eligible for a special measure of 80% or 50% tax credit), a taxable business operator is eligible to claim tax credit even for the transaction with tax-exempt business operator for a certain percentage of the input tax amount (80% creditable for the first three years and 50% creditable for the remaining three years) for six years from the start date of the new Invoice System.

The Japanese taxation office is actively disseminating information on the registration application for business operators concerning the Invoice System. We, Certified Public Tax Accountants, will also need to cooperate with the taxation office to provide an overview of the Invoice System to the wider public.

(3) International Comparison of Purchase Tax Credits

European countries have histories of introducing the credit-method value-added tax (VAT) using the invoice to claim for input tax credits for the purpose of eliminating cascading turnover taxes.

Maintaining the invoice is mandatory for the recipient to claim for purchase tax credits, while at the same time, the invoice is said to have the mutual supervision effect for encouraging tax payment by the invoice issuer.

In Japan, the qualified invoice needs to specify items such as business operator's registration number, tax rate, and tax amount, which are similar to the requirements under the EU VAT system. Since tax-exempt business operators are not allowed to issue the qualified invoice, purchase from a tax-exempt business operator is not eligible for tax credits. This is also the same as the EU VAT system.

One of the differences between the Japanese consumption tax and the EU VAT is the calculation method for the amount of tax to be paid. The EU VAT is calculated by adding up taxes. On the other hand, the Japanese consumption tax system allows both adding up taxes and calculating deductible taxes for sales or purchases, although some limits are placed on the combination of calculations. The second difference is that the Japanese consumption tax system requires maintaining both account books and qualified invoices, etc. under the qualified invoice-based method, although the EU VAT system requires only the invoices to claim for purchase tax credits. Since EU nations require only the retention of invoices to claim purchase tax credits, it may be a possibility that the retention of accounting books will be unnecessary in the future of Japanese taxation.

When the consumption tax was first introduced in Japan, our system adopted a unique accounting method that is unparalleled in the world. It is believed that the retention of accounting books stating certain items was set as a requirement to claim for purchase tax credits as a way to improve the reliability. At the time of the consumption tax rise in April 1997, "retention of account books or invoices, etc." was revised to "retention of account books *and* invoices, etc." (invoice method). In Japan's consumption tax system, the amount of tax is calculated based on the total transaction amount by calculating the deductible tax. Therefore, it is considered necessary to retain account books that fulfill certain description requirements.

It should also be noted that the account book stipulated as a requirement for purchase tax credits specified in the Consumption Tax Act is not necessarily the same as that specified in the Income Tax Act and Corporation Tax Act.

2. Consumption tax pertaining to "*Fixed assets subject to adjustment*" and "*Specific high-value assets*"

(1) Introduction

It is common for companies and investors in Japan and abroad to obtain capital gains by purchasing and selling a building, etc. In Japan, the Consumption Tax Act was enacted in April 1989, which demanded a fair tax burden from a wide public. As a specific concern, there were some issues arising from the application of consumption tax on purchase or sales of buildings, etc. Currently, Japanese Consumption Tax Act sets the provisions pertaining to "*fixed assets subject to adjustment*", "*specific high-value assets*" and "*self-constructed specific high-value assets*." The Consumption Tax Act has been amended from time to time since its enactment to achieve appropriate and fair consumption taxation meeting the needs of the times.

(2) "*Fixed assets subject to adjustment*" and "*Specific high-value assets*"

If a certain taxable business operator purchases fixed assets subject to adjustment or specific high-value assets during the taxable period, the business operator is restricted from using the Business Operator Tax Exemption Threshold System and simplified tax system until three years have elapsed from the first date of the taxable period to which the date of purchase of such assets belongs. In other words, the business operator must stay taxable and calculate the consumption tax as a taxable business operator until three years have elapsed, in principle.

① Fixed assets subject to adjustment

Fixed assets subject to adjustment exclude inventory and include assets such as buildings, attached facilities, machinery and equipment, marine vessels, aircraft, vehicles and conveyance equipment, tools, furniture and fixtures, and mining right as well as other assets that are purchased at a price of JPY1,000,000 or more (consumption tax excluded) for each item. Inventory is excluded from such assets.

② Specific high-value assets

i Specific high-value assets mean inventory or fixed assets subject to adjustment of which amount of payment consideration is 10 million yen or more for one transaction unit.

ii Self-constructed specific high-value assets mean such inventory that construction, etc. have been performed by a business operator based on the contract with another person or as the business operator's inventory or fixed assets subject to adjustment.

(3) Calculation method of consumption tax

Consumption tax is calculated by deducting the consumption tax amount on taxable purchase etc. from the consumption tax amount on taxable sales.

① General taxation

Consumption tax on taxable sales deducted by Consumption tax on taxable purchase, etc. = Amount of consumption tax (the positive value means tax payment and the negative value means tax return)

② Simplified tax system

Consumption tax on taxable sales deducted by the deemed purchase tax credit（Multiply the consumption tax on taxable sales by the deemed purchase rate）

= Amount of consumption tax

Consumption tax is calculated based on the amount of taxable sales and paid as long as taxable sales are performed.

(4) Approaches and Challenges

The consumption tax has been in place for 34 years since its introduction in 1988. Over these years, we, Certified Public Tax Accountants have discussed various agendas with the tax authorities for making repeated revisions.

Under the Consumption Tax Act before revisions, a business operator who acquired specific high-value assets during the period of being a tax-exempt business operator was able to claim purchase tax credits by applying the adjustment measure for inventory during the period after becoming a taxable business operator. Moreover, if the business operator sold such specified assets during the period after returning to the tax-exempt business operator status, such sales was exempted from the consumption tax obligation while being eligible for the purchase tax credit. This had been a problem in the Japanese consumption tax system but it was corrected with the 2016 revision.

The 2020 revision further stipulated that, in principle, purchase tax credits are not granted for the consumption tax on taxable purchase, etc. of specific high-value assets (i.e. residential rental buildings) acquired for the purpose of housing lease which is deemed as nontaxable sales.

Moreover, since the introduction of consumption tax, the invoices, etc. issued by tax-exempt business operators had been accepted as valid for purchase tax credits. This caused many cases where the consumption tax on sales is not paid (by a tax-exempt business operator) while the tax credit is granted for the purchase (from a tax-exempt business operator). With the qualified invoice-based method (Invoice System) taking effect on October 1, 2023, this issue is expected to be solved as well.

Since Japanese taxation under the Consumption Tax Act is increasing complexities year by year from its enactment to the present, we believe that the system needs to be changed to become easier for anyone to understand in the future.

(5) Major revisions concerning fixed assets subject to adjustment and specific high-value assets, etc. in the Consumption Tax Act

1988	Establishment of the Consumption Tax Act
1989	Enactment of the Consumption Tax Act
2010	・In the case of acquisition, etc. of fixed assets subject to adjustment, in principle, tax-exempt business operators, taxable business operators, and the application of the simplified tax system are subject to restrictions until three years have elapsed from such acquisition
2016	・Revision of special exempt rules applied for small and medium-sized business operators when they acquire specific high-value assets
2020	・Amendment of the tax credit system for consumption tax on acquisition, etc. of residential rental buildings

	・Adjustment of the amount of consumption tax on acquisition, etc. of residential rental buildings
2023	・ Introduction of the qualified invoice-based method (Invoice System)

3. Electronic Invoicing (E-invoicing)

(1) Overview of E-invoicing

The Japanese tax system will introduce the qualified invoice-based method from October 1, 2023, requiring the invoices to specify such items as applicable tax rate and consumption tax amount.

While at the same time, electromagnetic records providing the items specified on a qualified invoice are called the electronic invoice, which is used for the digital exchange of data with partners, etc. via e-mail or websites.

Following the introduction of reduced tax rate along with consumption tax rise in October 2019, E-invoicing aims to increase the transparency of transactions, prevent errors and frauds, and ultimately leads to establish the precise accounting process.

(2) Background of E-invoicing

Eyeing at the introduction of the Invoice System in October 2023, E-Invoice Promotion Association: EIPA was established in Japan by 10 private companies engaged in accounting information systems. In December 2020, the Association announced that it will develop the standard specifications for e-invoicing in Japan to be in compliance with the Peppol international invoicing model. Over 30 countries in Europe, Asia, and Australia implement this international invoicing model, which sets common rules for documentation and specifications of e-invoices transmitted via the Internet. Unlike the conventional method of issuing and receiving paper-based data, e-invoicing is said to be a promising measure for improving the operational efficiency among business operators and reducing transaction costs amid the advancement of digitalization and paperless operation.

Japan Federation of Certified Public Tax Accountants' Associations has been participating in EIPA as a special member since October 2021.

(3) Challenges surrounding E-invoicing

The Invoice System is applicable to taxable business operators with sales exceeding JPY10,000,000, while the so-called tax-exempt business operators are excluded. The tax credits for consumption tax on purchase from a tax-exempt business operator will be abolished completely in October 2029. Since tax credits will not be granted for consumption tax on purchase of the product from an exempt business operator, a taxable business operator who is a purchaser of the product will also need to bear a bigger burden of tax. For the issuance of e-invoice, the issuer needs to secure the framework to ensure accuracy and reliability as well as the safety of data. Japanese Ministry of Internal Affairs and Communications cited the mandatory introduction of electronic seal (e-seal) as a point of discussion, to prove that the electronic document, etc. is issued by a corporation. The Ministry also mentioned that the e-seal is expected to be used for e-invoicing. At any rate, various reforms will take place until the introduction of qualified invoice-based method in October 2023, and corporations introducing e-invoicing will need to respond to complicated changes in regulations and schemes.

(4) International trends in E-invoicing (Significance of E-invoicing in EU)

E-invoicing in the EU value-added tax (VAT) system has started when the matters concerning electronic signature were regulated by the 1999 Directive. Since then, several revisions were made and the 2010 EU VAT Directive stipulated that the electronic invoice will be treated in the same way as the conventional paper-based invoice. At the same time, the invoice in PDF format was also accepted as the form of ensuring the authenticity of the invoice.

In South Korea, e-invoices are also used to claim for purchase tax credits for value-added tax, which is similar to the EU VAT system. E-invoicing was introduced in South Korea in 1997, and it now supports fundamental taxes which account for 29% of the total tax revenue.