

Japanese Consumption Tax

**Sawamura & Co
Japan**

JAPANESE CONSUMPTION TAX

Japanese Consumption Tax is comparable to European VAT as the basic system is similar to that of VAT. Consumption tax is a pass-through tax for a business and the final consumers should owe the tax. Consumption tax should be recognized on each transaction and identified on accounting books. In this brief note, it is explained how the Japanese VAT works in practice. Please consult with your tax advisers for details as this provides just a general guideline with regard to the Consumption tax system.

Basic system

Taxable transaction

Consumption tax is imposed on certain transactions at the flat rate of 5% (4% for national and 1% for local tax). We should identify which transaction is taxable, non-taxable, exemption or out of scope, for all transactions.

Types	Explanations	Examples (more rules)
Taxable	all domestic transactions unless mentioned below, and import goods; rated at 5%	transfer or rent of goods or providing services as normal course of business with consideration
Exemption	taxable with zero-rated	exports; services to non-resident; international mails
Non-taxable	exemption without credit; non-consuming goods; by political decisions for the social purposes; limited to certain items	transfer of land or stock security, bank interest, insurance, stamp, pre-paid card; school tuition, (private) house rent for residential portion, textbook
Out of scope	transactions outside Japanese territory, no consideration even if domestic supply; non-consuming items	Out-to-out transaction; free domestic services; salaries, depreciation, dividend, loans

Consumption tax should be **identified separately for purchases** (import of goods, purchase of goods, expenses and fixed assets in Japan) and sales (transfer of goods and providing services, and other income in Japan).

For example, if a company imports the goods from the U.S., the transaction is subject to Import Consumption tax at 5% (and perhaps customs duty. If so, CIF price plus customs duty is subject to Consumption tax). The company is asked to pay for it. When the company buys the goods or is provided services in Japan, they should also pay the Consumption tax of 5%. This is a major difference to Sales tax in the U.S. as Consumption tax is levied in each party relating to the business processes.

When the company exports the goods to the U.S., it is exemption. No Consumption tax should be added. However, if the company sells the goods or provides services in Japan, it is subject to Consumption tax and the company should add 5% Consumption tax and collect the tax as part of the transaction.

Consumption tax is an indirect pass-through tax for the business. The company charges the Consumption tax on taxable sales or income and collects the tax on behalf of the tax office, while they pay the Consumption tax on taxable purchases (including purchase of fixed assets) or expenses but are entitled to reclaim the tax from the tax office. The former is called “output tax” and the latter is “input tax” as compared to European VAT system. The company is required to prepare the Consumption tax returns in which all the Consumption tax (by related account) in the fiscal year should be summarized and the net tax is calculated. If the net is negative (input tax exceeds output tax), the company can take a refund. If not, they should pay the net.

This is a very basic process as to how the Japanese Consumption tax works. For the accounting entries, see #2 Accounting in detail.

Taxable entity

Not all businesses are subject to Consumption tax. Only registered company under the Consumption tax should charge Consumption tax (“output tax”) and reclaim the input tax. However, a non-registered company should also pay the Consumption tax although the input tax cannot be reclaimed. There is a mandatory registration according to taxable sales and income amount, or a voluntary registration if the company elects to tax. In principle, any company can make a choice.

It depends on the taxable sales and income amount in the two previous fiscal year (“basic year”) whether the company is obliged to be registered with the Consumption tax. The threshold is ¥10 million. For example, a company had the taxable sales of ¥8 million in 2005, they are not required to become the taxable entity in 2007 although they are still entitled to be registered on a voluntary basis. Therefore, a tax planning shall be required to make the choice **before** the next fiscal year starts. If the company decides to be registered voluntarily, it cannot be changed for 2 years.

There is another rule for a new company. When a company is incorporated and its paid-in share capital is ¥10 million or more, they must be registered under the Consumption tax from the beginning. It is the same if the share capital increases to ¥10 million or more in the second year of the incorporation (there is no basic year for the first 2 years after the incorporation). Usually we suggest the new company or foreign affiliate (subsidiary company or branch of a foreign entity) be registered with Consumption tax in the initial stage in order to be consistent with the Consumption tax system unless the operation is very small.

Once it is registered, proper bookkeeping is required. Accounting books and vouchers (invoices, etc.) should be kept for 7 years, in principle.

Case study 1

- A U.S. company (A) purchases the goods from a Japanese supplier (X). There is no place of business of the U.S. company (A) in Japan, and there is no Consumption tax registration by the U.S. company (A). (X) is asked by (A) to send the goods directly to (A)’s customer (Y), another Japanese company.

The Japanese supplier company (X) issues an invoice to the U.S. company (A), and then (A) issues their invoice to the customer, Japanese company (Y). This is a bit tricky one.

Answer: Since the goods are transferred in Japan, the transaction from (X) to (A) is treated as domestic and taxable. So, depending on the tax status of (X) (See above), the

Japanese company (X) should add the Consumption tax on the invoice to (A) [this is not an export].

The transaction from U.S. company (A) to the Japanese customer (Y) is also subject to tax, as the supply is made in Japan [this is not an import]. So, depending on the tax status of (A), if registered, (A) should add the Consumption tax on the invoice to (Y) and reclaim the Consumption tax levied by (X). Regardless of whether (A) has a permanent establishment in Japan, (A) will be required to register it for the Consumption tax purpose if certain conditions are met (See above).

The Japanese customer (Y) can reclaim the Consumption tax charged by (A) through the tax returns, depending on the tax status of (Y). Even if there is no Consumption tax paid to (A), (Y) can do so as far as (Y) is registered with Consumption tax. So, it is crucial to see if the entity is obliged to register under the Consumption tax or voluntarily register with the Consumption tax.

Case study

- A non-registered company (B) sells the goods to a registered company (C) at ¥10,000 in Japan. How will the Consumption tax work ?

Answer: (B) shall not add the Consumption tax, while company (C) which registers with Consumption tax is still entitled to reclaim ¥476 (=10,000 *5/105) as input tax. It does not matter if (B) has paid the Consumption tax to their Tax Office, although (C) can give up the right to reclaim it. (C) should identify and account for the Consumption tax in their accounting books; purchase of the goods at 9,524 and input tax at 476.

Tax credit (reclaim of input tax)

In the year-end, the company should calculate the net tax. However, not all the input tax can be reclaimed indeed. This system is called tax credit and relies on the “taxable ratio” in the fiscal year. The issue is how to allocate the input tax as a tax credit. Care should be taken if the company’s business is related to property, finance, etc.

$$\text{Taxable ratio} = (\text{taxable} + \text{exemption}) / \text{all sales and income}$$

- * Note that the amounts are exclusive of Consumption tax and out-of-scope items. This calculation should be disclosed in the tax returns.

If the ratio is 95% or more, the input tax can apply for the tax credit in full. If not, there is a choice to allocate the input tax to taxable income by individual item, or on a pro-rata basis. Once the pro-rata method is chosen, it must be kept for 2 years. If the ratio is fluctuated dramatically, there may be required to adjust the tax credit in the following years with the long-term items such as fixed assets.

Simplified method

When the taxable sales and income in the basic year is no more than ¥50 million, the simplified method is available upon application. This is to calculate the net tax amount based on the taxable sale and income rather than summing up from the input tax.

The net tax is calculated by: (output tax) minus (output tax multiplying fixed credit rate)*

- * Fixed credit rates; wholesale 90%, retail 80%, manufacturing 70%, services 50% and others 60% (there are some rules for mixed operations)

This also gives a tax planning opportunity although it applies to small companies which are registered with Consumption tax and they cannot take a refund. Please make sure if this can apply and bring a benefit before the next fiscal year starts. Once it is chosen, it cannot be terminated for 2 years.

Accounting

Principle approach

For example, if a company buys a pencil for the business purpose at 105, the company should identify the consumption tax at 5 ($=105 * 5/105$) as an “input tax”. Or they can pick up the consumption tax in the invoice, if it is properly quoted. The journal entry should be as follows;

Dr)	Stationery	100
	Consumption tax receivable-suspense	5
Cr)	Cash	105

When the company sells their products-equipment at 210 inclusive of Consumption tax (“output tax”), the journal entry should be as follows;

Dr)	Accounts receivable	210
Cr)	Sales	200
	Consumption tax payable-suspense	10

For the fiscal year, if the company has the above transactions only, they should calculate the Consumption tax at the year-end, assuming the taxable ratio is 100% and there is no simplified method applied;

Output tax	10
Input tax	5

$$\text{Net5(*)} \leftarrow \text{Proof: } (200 - 100) * 5\% = 5$$

The journal entry is show as below;

Dr)	Consumption tax payable-suspense	10
Cr)	Consumption tax receivable-suspense	5
	Consumption tax payable (definite)	5(*)

The company should pay the Consumption tax of 5(*) to the Tax Offices. Also, please note that the Consumption tax accounts do not appear on Income Statement, as it is a pass-through tax for the company. The calculation of Consumption tax payable (definite) is normally made by professionals, as it is much complicated in practice.

Unlike European VAT (“invoice system”), we do not rely on invoice but should keep the Consumption tax records properly in the accounting books (“bookkeeping or account system”).

For example, if the company buys a pencil, there may be no Consumption tax shown on the invoice or receipt (the supplier may be a non-consumption tax registered business). However, as far as it is a taxable supply, the company can still recognize the input tax as part of the transaction. It does not matter if the supplier charges the Consumption tax

indeed. The point is that the receiving company identifies the Consumption tax in their books **by themselves**. This is a big difference to European VAT as European invoice system follows the VAT shown on the invoices. **It is very important to judge if each transaction is taxable, non-taxable, exemption or out of scope, and keep the records accordingly.** The company will miss the opportunity to take the refund, otherwise.

If the transaction is a taxable supply, the company can calculate the tax as if it were inclusive of Consumption tax, namely, by multiplying “*5/105”. The company can round up at one place of decimals, as Japanese yen does **not** allow to use decimal point (Note that **foreign accounting systems often cannot** cope with the decimal point). By doing so, the company can increase the input tax which shall bring more refunds. It may be an idea to prepare separate accounts for taxable item and others. For example, business trip in domestic is taxable, while business trip overseas is out of scope. It may be troublesome and time-consuming to analyze in a later stage which business trip is taxable even in the same nature of transaction, so it is wise to identify which transaction is taxable at the time of the journal entries.

As for Import Consumption tax, the customs provide the Consumption tax upon importation, so the company should just refer to the input tax amount calculated by the customs. In this sense, the company should **not** create the Import Consumption tax amount by themselves. (Total of Import Consumption tax should be separately mentioned in the tax returns)

On the other hand, when the company which registers under the Consumption tax sells the taxable goods or provides services, they should add the Consumption tax (“output tax”). It is the company’s responsibility to charge and collect the Consumption tax properly. **It does not matter where and by whom an invoice is issued, but the point is where and by whom the goods or services are provided.**

Inclusive of CT method

There is also another method to keep the accounting records; all inclusive of Consumption tax although it is not commonly used in practice. In the example above, it can be explained as follows;

Dr)	Stationery	105 (inclusive of CT)
Cr)	Cash	105
Dr)	Accounts receivable	210
Cr)	Sales	210 (inclusive of CT)

In the year-end, the net tax is calculated on a total basis by related account and reflected in the Income Statement at a time.

Output tax on taxable sales	10 (=210 *5/105)	
Input tax on taxable expenses;		
- Stationery	5 (=105 *5/105)	

The net tax is;	5 (=10 – 5)	
Dr)	Other taxes (in Income statement)	5
Cr)	Consumption tax payable	5

In theory, it should provide the same result. In general, however, the principle approach is often more advantageous as it does not give an impact in the result through the year. Also, inclusive of CT amount is larger than the main transaction by 5%, which may cause small problems with respect to the criteria in entertainment, small fixed assets, inventory valuation and so on for the corporate tax purpose. However, if the company is not confident in identifying each transaction and feels difficulties in doing so, this method may be taken. Non-registered company should take this way although they do not realize the Consumption tax payable/receivable.

Tax filing and payment

Unlike European VAT, no Consumption tax registration number is available. Accordingly, there is no obligation to quote such a number in our invoices. Consumption tax is paid to the tax office in the local jurisdiction based on the Consumption tax returns. The fiscal year is in line with the company's accounting period (normally, one year). Quarterly tax returns may be applied although it cannot be changed for 2 years once applied. It may be good if a large volume of refund is expected all through the year.

The company which registers with Consumption tax should prepared the Consumption tax returns within 2 months of the fiscal year-end and make a payment. If the Consumption tax liability is negative, refund will be made later.

There is an interim payment system depending on the Consumption tax liability in the previous fiscal year; ¥600,000 or less (no interim payment), over ¥600,000 (semi-annual), over ¥5 million (quarterly) or over ¥60 million (monthly).

There is no extension rule available for the Consumption tax filing, as the tax is a pass-through nature and treated as deposit from the government point of view.