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29 October 2014

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Subject: VAT and Foreign-Based Supplies of Electronic Services

Dear Abe san:

The continued expansion of the digital economy has created challenges for tax administrations around the world. In the consumption tax area, cross border supplies of remotely delivered services and intangibles present especially difficult tax collection issues. The Japanese Tax Authority (“NTA”) has been analysing these issues and has recently released updated recommendations for possible changes to the Japanese Consumption Tax Act (“JCTA”) aimed at addressing them. The proposed new rules would significantly change the current treatment, especially for services delivered to Japanese customers from suppliers located outside the country. Tax Executives Institute (“TEI” or the “Institute”) welcomes the invitation by the Ministry of Finance (“MOF”) for stakeholder comments on the proposed changes. This letter identifies our concerns and some suggestions for best practices.

I. Background

Founded in 1944 to serve the professional needs of business tax professionals, TEI is the preeminent association of in-house tax professionals worldwide. The Institute’s approximately 7,000 professionals manage the tax affairs of over 3,000 of the leading companies across all industry sectors around the world. TEI members are accountants, lawyers, and other corporate and business employees responsible for the tax affairs of their employers in an executive, administrative, or managerial capacity.

Many of these companies are involved in the sale, distribution, and purchase of digital products and services on a global basis, including in Japan. TEI members working for those companies and other businesses constantly monitor VAT developments around the

world. TEI espouses organizational values and goals that include integrity, effectiveness and efficiency, and dedication to improving the tax system for the benefit of taxpayers and tax administrators alike.

TEI believes it is critical to maintain a dialogue between businesses and revenue authorities when developing new rules for consumption taxes to ensure they are workable and not overly burdensome on either business or tax authorities. In relation to cross border transactions, it is also critical to protect the neutrality of the consumption tax system by ensuring that supplies are taxed only once.

II. Recent Proposals from the MOF

On 14 November 2013, the MOF issued a report entitled, “*Consumption Tax Treatment of Cross-Border Supplies of Services and Intangibles*,” which summarised current law and proposed alternatives for addressing concerns with the existing rules (“Cross-Border Service Paper”). The International Taxation Discussion Group of the Tax Commission published a follow-up report on 27 June 2014 (“Follow-Up Report”) that included some modifications to these original proposals.

Under current law, the Japanese Consumption Tax (“JCT”) does not apply when services and intangibles are supplied from outside Japan to Japanese customers. The JCT does apply, however, when suppliers located in Japan provide those same supplies to Japanese customers. This disparity creates an uneven playing field for domestic and foreign suppliers of services and intangibles (*i.e.*, domestic supplies are burdened with the JCT while foreign supplies are made tax free).

The Cross-Border Service Paper includes a number of proposals to address this disparity. Those proposals focus on two types of transactions: business-to-final consumer sales (“B2C”) and business-to-business sales (“B2B”). For B2C transactions, the Cross-Border Service Paper proposes a registration system similar to that used in Europe, where foreign service providers would be required to register with the Japanese tax authorities and collect consumption tax on sales to consumers in Japan. For B2B transactions, the Cross-Border Service Paper contains three separate methods for applying the JCT and notes concerns with each:

- Option 1:* Utilise the same registration system as proposed for B2C transactions.
- Concerns:* Full registration for B2B supplies creates a significant administrative burden on suppliers engaging in transactions that would generally be subject to no net JCT liability (*i.e.*, tax collected from the supplier would effectively be refunded through input tax credits claimed by business purchasers) and is also difficult for the NTA to enforce. The Cross-Border Service Paper observes that this approach would create an incentive for foreign suppliers not to register in Japan, which would further distort competition within the business community between those who are compliant and register and those who are not. In the case

of a supply which has an ancillary digital element, the taxpayer may face uncertainty as to whether some or all of the supply creates a registration liability (with the risk that neither the supplier nor the recipient takes responsibility for administering the tax). While a solution may be to apply for an opinion from the NTA, given that service contracts increasingly have a digital element, the NTA risks being inundated with opinion requests for no real increase in revenue.

Option 2: Employ a reverse charge mechanism similar to that used in Europe.

Concerns: For a reverse charge system to work, suppliers would need a way to determine whether their customers were end consumers or business customers. European countries issue VAT identification numbers to businesses to address this issue. Japan, however, neither issues VAT numbers nor has any existing system that would provide suppliers with information to distinguish between end consumers and business customers.

Option 3: Employ a combined reverse charge system for businesses selling solely to business customers and a registration system for all other suppliers.

Concerns: Japanese businesses purchasing from foreign suppliers would face an increased administrative burden; they would need to make a determination of whether their foreign suppliers were registered to know whether consumption tax should apply to the transaction.

The Follow-Up Report discussed updates to the proposals in the Cross-Border Service Paper based on further analysis and discussions with stakeholders. Of note, the Follow-Up Report discussed possible changes to the rules for determining the place of supply for sales of services and intangibles and clarifications to the definitions for identifying what transactions would be subject to the new rules. It also introduced an alternative to the three options discussed in the Cross-Border Service Paper. The alternative method would apply as follows:

- a reverse charge system for: (i) services which are by their nature provided to business customers (*e.g.*, advertisements, legal advice), and (ii) services which can be provided to both consumers and business customers but are clearly provided only to business customers in light of transactional conditions; and
- a registration system for (i) services which are provided most often to consumers (*e.g.*, e-books, music), and (ii) services which can be provided to both consumers and business customers when the status of the customer as a business or end consumer is unclear.

III. Approaches Used in Other Regions

Taxation of the digital economy and of remotely supplied services and intangibles has become an issue of increasing concern to jurisdictions around the world. Recently, high-level officials from 100 jurisdictions and organisations endorsed guidelines on taxation of cross-border B2B supplies of services and intangibles at the OECD's 2nd Global VAT Forum in Tokyo. These guidelines encourage the use of the destination approach for determining the place of supply to ensure tax accrues only once and only in the country of consumption. The next phase of the OECD's work in the consumption tax field will concentrate on cross-border B2C sales of services.

In Europe, the European Union ("EU") recently finalised systems and rules governing the VAT treatment of electronically delivered goods and services. Many of those rules will go into effect on 1 January 2015. TEI worked extensively with the European Commission on guidance interpreting amendments to the law that will make it easier for businesses to comply with the new rules and for EU Member States to administer them.

TEI's work with the European Commission was informed by experience with other jurisdictions in which TEI members already comply with similar rules. In particular, since 1 July 2011 Norway has been taxing sales of electronic services made by foreign (non-established) vendors to Norwegian customers through a simplified registration and collection system. The Norwegian system has generally been viewed as satisfying the demands of both the Norwegian tax administration and businesses. Unlike the EU, the Norwegian system was devised to deal with a single country, rather than a trading block, and it was even recommended as a model for taxing digital sales to final consumers during a plenary session of the OECD's 2nd Global VAT Forum.

We are not suggesting that Japan should simply duplicate regulations that have been designed for other countries with different legal frameworks, customs, and backgrounds. Rather, our comments focus on the practical implementation of these rules, as we expect all countries will have common objectives of fair taxation, maintaining (or achieving) a level playing field between domestic and foreign vendors, as well as efficient collection and enforcement of their tax systems. In the specific context of electronic commerce, it is in the interest of all parties to ensure a consistent global approach in line with OECD principles and guidelines.

IV. Specific Comments

Our comments focus on the following areas:

- 1) Comments on the proposals in the Cross-Border Service Paper and Follow-Up Report
- 2) Distinguishing B2B and B2C Supplies and Issues with the Absence of JCT Registration Numbers
- 3) Identification of Customer Residence

- 4) Retention of Data and Records
- 5) Intermediaries and Chain Transactions

1. Comments on the proposals in the Cross-Border Service Paper and Follow-Up Report

The Follow-Up Report proposes a dual system that includes a reverse charge mechanism for B2B sales and a registration mechanism for B2C sales. This system would apply solely to suppliers located outside Japan and would assign taxation and registration requirements according to whether a service or intangible would normally be consumed by a business (*i.e.*, a B2B sale subject to a reverse charge) or by a consumer (*i.e.*, a B2C sale requiring registration and tax remittance by the foreign supplier). When not absolutely clear whether a transaction would fall into either the B2B or B2C category, suppliers would need to evaluate each supply to determine if it was clearly only provided to a business customer or an end consumer in light of transactional conditions related to the supply.

The reality of the marketplace would make this system difficult to apply. While certain services and intangibles are normally purchased only by a business versus an end consumer, the range of “cross over” services and intangibles (*i.e.*, items that both types of customers would purchase) is extremely large. For example, even supplies that would seem easy to categorize, such as subscriptions to periodicals (magazines, books, or journals) and legal services, are often supplied to both business and to end consumer customers. This would require suppliers to evaluate the transactional conditions for countless supplies and the NTA to audit those determinations. The benefits of additional consumption tax collections realised through such a system would clearly be outweighed by the administrative costs imposed on businesses and tax administrators.

Also, this dual system approach would require constant updating to keep up with the fast pace of technological change. The definitions of what supplies are normally purchased only by businesses or end consumers would need frequent revisiting as new products and services are developed and new methods of delivering existing or new content and services electronically enter the marketplace.

Rather than distinguishing between B2B and B2C transactions based on the type of supply, TEI urges the NTA to focus on creating a system that distinguishes registration and collection requirements based on the type of customer (*i.e.*, businesses versus end consumers). This approach is discussed in more detail below and appears to be the intent of the third option provided in the Cross-Border Service Paper. One of the main benefits of following that approach is it would align closely with the regimes already in use in other countries. Also, since the types of supplies causing concern tend to be high volume, low value, transactions, they tend to be supplied using highly automated computer systems. Making the new JCT system similar to those in use by other countries would facilitate compliance and likely result in fewer errors.

2. Distinguishing B2B and B2C Supplies and Issues Associated with Absence of JCT Registration Numbers

The first option for addressing collection of JCT on foreign supplies of electronically delivered services and intangibles discussed in the Cross-Border Service Paper envisions the use of a single registration system for both B2B and B2C supplies. Generally, however, non-compliance in this area occurs with B2C supplies where JCT is a cost, rather than at the B2B level where it is rarely a cost (except for “exempt” or “input taxed” businesses). Requiring collection of JCT on B2B supplies by foreign suppliers, rather than by their domestic customers through a reverse-charge mechanism would create a new administrative burden without enhancing compliance with, or collection of, local JCT. Thus, we urge the NTA to exclude B2B supplies from the new rules and employ a reverse charge to capture JCT on those supplies. Doing so would make the JCT collection process more efficient for both the NTA and businesses. That approach would also better align with OECD recommendations recently endorsed by governments at the 2nd Global VAT Forum in Tokyo, where the reverse charge mechanism was recommended as the preferred collection mechanism in B2B scenarios.

The absence of an existing reverse charge mechanism in Japan would undoubtedly present a challenge for the NTA, but one that could be overcome by adopting a framework similar to those in use by other countries. The EU requires all EU VAT registered businesses to account for local VAT on all purchases from non-registered foreign suppliers. While that approach establishes a fairly clear rule, it would increase the administration necessary for compliance and enforcement. The reverse charge systems in use by Australia and New Zealand provide a less burdensome process while retaining the framework necessary to ensure local consumption tax is collected. Businesses in those two countries that import services from non-registered overseas suppliers must apply a reverse charge, but only if they would not have been able to recover the full amount of the tax on the particular transaction (*e.g.*, because of the use to which the supply would be put). In Australia, business customers that must remit local consumption tax on these transactions are referred to as “input taxed.”

Countries employing a reverse charge system typically issue VAT numbers for all businesses. One purpose for the issuance of VAT numbers is to inform purchasers and suppliers of the others’ status as a business customer or an end consumer. Japan does not currently use identification numbers for the JCT that serve this purpose, and that has caused concerns about the efficacy of a reverse charge system in Japan. Experience by businesses engaged in the cross-border trade of services demonstrates that these concerns are misplaced. In countries where reverse charge obligations already exist, business customers will often buy services from countries that do not have VAT registration numbers (or, in some cases, even a consumption tax). Business customers in those countries recognise that purchasing services from overseas triggers the reverse charge rules in the country of consumption regardless of whether the customer has the supplier’s VAT registration number to evidence their status. The VAT registration number is only a strong indicator that the customer is a business; it is not the only possible evidence. Other types of evidence also demonstrate to the supplier that the customer is a business, including a certificate of incorporation, status of taxable person,

and others. Many countries (*e.g.*, EU countries) permit use of this type of evidence, which ensures the proper application of a reverse charge system for B2B suppliers in practice.

Similar concerns exist about whether the lack of JCT registration numbers would hinder the ability for foreign sellers to identify the status of their Japanese customers as either businesses or end consumers. These challenges have also been recognised by other jurisdictions (most notably EU Member States), and have led them to adopt accommodation rules due to take effect from 1 January 2015 whereby, in the absence of any evidence that a customer is a business, a supplier is entitled to treat their customer as a private consumer and tax accordingly.

Even without the benefit of a JCT registration number, many other methods exist for businesses to identify the status of their customers. The name of the customer often provides the main indicator, and typically B2B sales reflect an on-going business relationship where the status of the purchaser is already known (and where the terms of the relationship have been reduced to a written contract). When a supplier has agreed to provide a service prior to receiving payment, the supplier generally does so only after performing some level of due diligence that would provide the information needed to confirm the purchaser's status (*e.g.*, certificate of incorporation as a business, status of taxable person, etc.). For one-time or small value sales, obtaining information to identify a purchaser's status is more difficult. The EU approach of allowing foreign suppliers to charge and remit JCT on transactions where the status of the customer cannot be identified alleviates concerns with the tax not being collected. Also, flexibility by the NTA with how a registered non-Japanese business demonstrates the status (and location) of customers would go a long way to overcoming any challenges caused by the absence of JCT registration numbers.

3. Identification of Customer Residence

Another challenge faced by countries imposing VAT registration requirements on non-established suppliers is identifying where customers are based (*i.e.*, the place of supply). The EU has addressed this problem by introducing the concept of “proxies” that are considered to be acceptable as evidence to support the decision to charge (or not charge) tax. We encourage use of a similar system in Japan to avoid varying approaches by businesses for determining place of supply and difficult audits where the interpretation of existing place of supply rules might differ between businesses and NTA auditors. Such administrative inefficiencies would be costly to businesses and the government.

As mentioned above, the European Commission has done significant work on this issue. On 2 April 2014, after much consultation with business groups (including TEI), the European Commission published its “*Explanatory notes on the EU VAT changes to the place of supply of telecommunications, broadcasting and electronic services that enter into force in 2015*” (the “Explanatory Notes”).¹ The Explanatory Notes are not prescriptive. Rather, they

¹ The latest and final version of the EU guidelines (EU Explanatory Notes) can be found at: http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/telecom/index_en.htm#explanatory_notes

or directly at:

provide a framework within which all suppliers of e-services can find the compliance logic that best suits their business model, their systems, etc. to achieve a reasonable tax result. Large international suppliers of e-services are already designing their systems in line with these EU rules, including identifying the types of documentation and logic to best assess the location of their customers for determining the place of supply.

Adopting a similar approach in Japan would benefit the NTA by providing a solid foundation for building its compliance and audit programs. Also, the NTA and businesses could leverage the work already being done by businesses to adopt systems that comply with the EU rules. This would give all parties comfort that foreign vendors' systems would be tested and audited elsewhere, which would further increase compliance.

4. Retention of Data and Records

Many of the services and intangibles sold by foreign suppliers to their Japanese customers are high volume, low value, transactions that are highly automated. The systems used to deliver those services tend to be centralised in the home country of the supplier or regionally located in strategic locations to best serve a global customer base. Those jurisdictions generally have a solid infrastructure and legal/tax system. As for corporate and financial data, most multinational businesses store this at the place where they are established or some other data centre, determined by reference to their business needs and corporate structure. Creating systems to extract and store data specific to Japanese sales on servers located in Japan that comply with Japanese data protection requirements would require significant investments of capital and information technology resources with no associated benefit inuring to the administration of the JCT regime.

Foreign suppliers can provide data in support of their VAT charges electronically and on demand in the event of a request by NTA in the course of an audit. TEI urges the MOF not to require foreign suppliers of services and intangibles to store all data and records supporting their JCT filings on servers and/or computer systems physically located in Japan.

5. Intermediaries and Chain Transactions

One of the biggest challenges faced in the design of the EU rules was that supply chains in the e-commerce sector can be complex and involve a number of intermediaries, such as virtual marketplaces like an app store. The number of links in the distribution chain for electronic services between producer and final customer varies widely. In some instances, the transaction occurs directly between the owner of the electronic content and the ultimate consumer (e.g., an individual purchases a song directly from an independent artist on the artist's website). Other situations involve transactions between multiple intermediaries playing varying roles, ranging from simply acting as introduction agents to being closely involved in the delivery of the supply. For example, in the case of a ringtone, the content owner may enter into a licensing agreement with an aggregator of ring tones that enters into

agreements with mobile telecommunications providers that sell the ringtones to their mobile customers. Similar arrangements exist with app stores where app creators contract with, for example, Apple's App Store or the Google Play platform, and customers purchase the apps they download by paying Apple or Google.

In the case of a marketplace, for example, NTA could explore permitting the operators of app stores and/or the carriers involved to collect and remit the tax. Many of the suppliers of apps, subscriptions, etc. that sell through this type of marketplace are small operations that would likely be exempt from the registration and compliance system under a small-seller registration threshold. Having larger, established businesses manage the compliance for those transactions would reduce the number of registrations NTA would need to administer and avoid placing heavy burdens on small business.

TEI urges NTA to include clear guidance on how to handle such supplies to ensure that all parties in the distribution chain know the identity of the person responsible for collection of JCT when the new rules come into force. Certainty on this issue would reduce the risk of double taxation and non-taxation. Significant work has been carried out by the EU on this matter (Article 9a of Implementing Regulation (EU) No 282/2011), and other countries (*e.g.*, Norway²) have adopted similar positions. TEI would be pleased to work with the NTA on developing guidance that would benefit all stakeholders in this area.

* * *

TEI welcomes the opportunity to meet with Ministry of Finance and NTA representatives to discuss these comments and other issues relating to the administration of JCT. Such a dialogue would ensure that the system ultimately adopted operates in the most practical, effective, and efficient manner to the benefit of both the government and the business community.

TEI's comments were prepared by the Institute's European Indirect Tax Committee, whose chair is Jean-Francois Turgeon, in consultation with the Institute's Asia Tax Committee. If you have any questions about TEI's comments, please contact Mr Turgeon at +41 228 494 342 or Turgeon.Jean-Francois@cat.com, or Daniel B. De Jong of the Institute's legal staff at +1 202 638 5601 or ddejong@tei.org.

Respectfully submitted,
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International President

² <http://www.voenorway.com/Legal-Information/>