Consumption Tax and the Invoice System

White Paper

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Background

Japan has imposed consumption tax on businesses since 1989 when the tax rate was just 3%. Since then, the consumption tax rate has been increased three times, and it now stands accounts for approximately 15% of all tax revenue collected in Japan.

Consumption tax in Japan works very much like a value added tax (VAT). Businesses charge consumption tax to their customers, but they also pay consumption tax to their suppliers. Consumption tax paid out to suppliers (called input credits) may be deducted from the consumption tax collected from customers. For many businesses, the difference between these two amounts is the consumption tax amount it pays to the government (which also roughly reflects the value that the applicable business has added).

Until September 2023, Japan adopted a method whereby each business would calculate and report its own consumption tax in a loose manner. There were no strict invoicing requirements, and there was no requirement for businesses to note the consumption tax rate or amount on tax invoices. When it came time to calculate consumption tax owed, each business could use its own accounting and financial records to do so, and sometimes this did not even require actual invoices. Such a system was naturally open to miscalculation, misstatement and sometimes fraud (as is often pointed out by the authorities themselves), but there also existed an even larger issue.

Japan allows businesses with revenue under JPY10 million to be exempt from payment of consumption tax (exempt businesses). An exempt business might nominally charge consumption tax to its customers (including larger, non-exempt businesses), but then it would often pocket this amount since it was not required to remit the collected consumption tax to the government. Since more than half of businesses in Japan qualify as exempt businesses, this led to a significant bleed in tax revenue. The National Tax Authority (NTA) estimates that if even 1/3 of the current exempt businesses could be converted to consumption tax paying businesses, this would generate an extra JPY248,000,000,000 (USD 1.6 billion at today's exchange rates) in tax revenue.

Qualified Invoice Reporting

To address these issues, from October 2023 Japan became the last OECD nation (except for the United States) to implement 'qualified invoice reporting'. In Japanese, this came to be called simply the 'invoice system'. This is an enormous change, because it requires consumption tax paying businesses in Japan to alter their invoicing methods and effectively leaves many small businesses no other option but to relinquish their exempt status. By using qualified invoice reporting, the NTA can also identify and address discrepancies between the amounts reported by buyers and sellers.

This new system has been a long time in coming. Japan wished to introduce the qualified invoice system from the very beginning in 1989, but a strong opposition movement (which still exists today) delayed its implementation for decades. Originally, the invoice system was scheduled to be introduced in April 2022, but was postponed to October 2023 due to changes in the economic environment caused by Covid and delays in the development of the systems necessary to implement it.

Impact on Exempt Businesses

Under the 'invoice system', if a downstream customer wishes to deduct the full consumption tax on its purchases from another business, it will need to retain 'qualified invoices' which meet certain conditions. Accordingly, most non-exempt businesses operating in Japan will need to register as a qualified invoice issuer by October 2023 and follow the new rules on invoice issuance and retention. Moreover, most sellers will eventually be pressured to issue such qualified invoices by their downstream business partners, even if they might otherwise continue to qualify as exempt businesses.

In many cases, businesses do not fully understand the impact of these changes on their administrative systems and processes. For example, aside from registering as a qualified invoice issuer, businesses may need to require their suppliers (especially smaller suppliers) to register as qualified invoice issuers.

Without such measures, your business may face tax penalties after claiming an input credit from exempt businesses, or your business may find your input credits disallowed. Moreover, if you issue or receive invoices in an electronic form, failure to store these records in a proper retention system may also lead to penalties or disallowance.

Electronic Transactions and Electronic Record Retention

While the invoice system has been coming into effect, closely related changes have been made to the broader Japanese national tax framework. These changes affect record keeping for national tax purposes (including consumption tax), especially where the parties are already transacting electronically.

Starting from January 2022, the records of any transaction that takes place electronically must also be stored electronically. Now that transitional measures are in place to prevent these requirements from affecting most businesses, those transitional measures are set to expire on December 31, 2023. Accordingly, from January 1, 2024, businesses in Japan will face a new and inescapable reality regarding their electronic transactions.

'Electronic transaction' might conjure up images of electronic data interchange (EDI) and similar transactions, but it includes many more types of transactions that one might not intuitively consider to be 'electronic'.

Where transaction information is sent and received through electronic means including transactions via the internet, e-mail (including through attached files), websites, or other similar transactions the transaction is likely to be considered 'electronic' for this purpose. Also, 'transaction information' includes information contained in invoices, purchase orders, contracts, receipts, quotes, and similar documents.

For instance, today it is extremely common for businesses in Japan to generate invoices in electronic form (e.g., in PDF format) and to send these to customers via email (so-called 'e-invoices'). Previously, it was allowed for the recipients of such electronic invoices to print out the invoice and retain it in paper form while destroying the original data, and this form of record keeping was considered acceptable in preparation for a tax audit. That is no longer the case.

Going forward, taxpayers must retain records of electronic transaction information, including e-invoices, in an electronic archive. Certain rules and standards apply to handling and storing such information electronically, and compliance with these rules creates significant risk for businesses to have their records disallowed in a tax audit. Moreover, the rate of tax penalty levied on underreporting due to concealment will be raised by an additional 10% on top of existing penalties.

Specifically, in terms of requirements, records must be kept with an elevated level of accuracy. Businesses must adopt one or more methods to objectively

prevent tampering with the content of records. Electronic records must also provide significant transparency. In the past, paper invoices need not have been searchable, and many businesses chose only to organize them chronologically or by counterparty. Following these changes, electronic records must be searchable, at a minimum, by date of transaction, transaction amount, and counterparty. Electronic records must also be made and kept at a certain resolution and color quality, and the display of these records must retain all these attributes.

While it is still theoretically possible for some smaller companies with low revenue and/or few electronic transactions to comply with these requirements without adopting dedicated systems, there are clearly many points for potential failure in a do-it-yourself solution, and the risk only increases as the organization size and transaction quantity increases.

In the past, none of the capabilities noted above were required, and e-storage of tax records was a cumbersome and expensive matter. If a business wanted to keep tax records electronically, it needed to apply to the NTA for advance permission and the required standards for valid record retention were far stricter. However, as these mandatory changes show, the NTA has embraced electronic records retention to increase tax audit efficiency.

Today, a paper invoice can still be retained as a paper invoice for audit and record-keeping purposes, but the legal framework has already been relaxed to allow businesses to start scanning paper records to retain electronically. This is quite intentional. If the general trend seen in recent years continues, it may not be long before businesses are either strongly incentivized or required to keep these types of records electronically as well.

Conclusions

The implementation of the invoice system and the changes to the electronic record retention rules are coming into force at the same time for a reason. They both represent indirect tax control measures which seek to reduce tax evasion and to promote a digital transformation in Japan. As a result, the way the NTA conducts tax audits is expected to change rapidly over the coming years, and an updated approach to compliance is well-advised.

Businesses would do well to reexamine their administrative processes to ensure that they can accommodate these and additional future changes. New rules will bring additional bookkeeping and record-keeping requirements, and companies should ensure that their resource planning is adapted to handling them. Needs may include alignment of accounting systems with invoicing and record retention systems, alteration of electronic data interchange systems, adopting compliant electronic storage systems, and more.