JAPAN'S CONSUMPTION TAX: SETTLED IN TO STAY

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Now in its second decade, Japan's consumption tax remains unpopular and controversial at home while hailed internationally for its functional structure.[1]
The tax is fundamentally a value-added tax levied on the domestic sale or lease of goods or services. Exports are tax-free while imports are taxed when they enter the country. Although the tax base has narrowed since its adoption, through the expansion of the exemptions, it remains a broad-based tax, levied at a single rate of 5%.
Small businesses are exempt from the tax. Those businesses that pay and collect the tax may use a simplified accounting structure to calculate input credits and thereby arrive at the amount of tax to be paid.
The single low rate and the simplified accounting structure are features designed to promote equity and efficiency. They have not, however, improved the domestic acceptability of the tax.

HISTORY OF THE TAX

Japan enacted its Consumption Tax Law in December 1988, to take effect from 1 April 1989.[2] While the government had established that it needed to revamp its disjointed indirect taxes and derive a greater portion of revenue from indirect taxation,[3] the introduction of the consumption tax was highly controversial and extremely unpopular. The government that enacted the

1 See generally, Schenk A, "Japanese Consumption Tax After Six Years: A Unique VAT Matures" (13 November 1995) 69 Tax Notes 899.

2 Consumption Tax Law (*Shohizei-ho* (Law No 108, 1988) as amended) Art 4 (hereafter "CTL").

3 Ishi H, The Japanese Tax System (2nd edn 1993 Clarendon Press) at 313-14; Beyer V and Ishimura K, "The Progress of the Japanese National Consumption Tax" (1993) 3:2 *Revenue LJ* 115 at 116; Freiman B, "The Japanese Consumption Tax: Value-added Model or Administrative Nightmare?" (1991) 40 Am *UL Rev* 1265 at 1272.

Consumption Tax Law also found itself voted out at the next election, in July 1989.[4]

That a broad-based consumption-type tax would be unpopular should have been well understood by lawmakers. Japan had adopted a value-added tax in 1950 as part of its post-war tax reform but was forced by public opinion to repeal it before it came into effect.[5] The memory of the defeat of this unpopular tax contributed to the failure of several successive governments between 1979 and 1987 to introduce any form of broad-based indirect tax. The LDP government of Noboru Takeshita learned from these mistakes, however, and was finally able to enact the tax law through political manoeuvring. The government convinced the public that the consumption tax would help secure stable revenues in a time when the tax-paying population was rapidly ageing.[6] It also enacted the tax quickly, thereby minimising debate and the potential for dissent.[7]

In a sense it was not the Consumption Tax per se that was unpopular. Taxation itself is so unpopular in Japan that politicians and bureaucrats have gone to great lengths to make taxes as invisible as possible. Many taxes are withheld at source, so that the taxpayer is only minimally aware that taxation has taken place.[8] For wage earning taxpayers even finalisation of personal income taxation is usually handled by the employer through the so-called "year end adjustment" system.[9] This system requires that the employer gather from employees information about other income as well as allowable deductions, calculate the employee's annual tax liability and adjust the tax withheld in the final salary payment for the year to ensure that the taxpayer's exact tax liability for the year is paid.[10] The approximately 75% of Japanese Income Tax payer eligible for this treatment[11] are thus spared the burden of filing a tax return, and are, accordingly, only minimally aware of having been taxed at all. On the other hand, taxes such as the Inheritance Tax and the Consumption Tax are highly visible, and in the case of the Consumption Tax, encountered on a daily basis.

Due to its controversial nature, the new Consumption Tax was carefully crafted to promote its acceptability. The rate was kept low to mollify

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4 Ibid at 1268. The new government, the Japan Socialist Party, was unable to muster support to repeal the CTL, however, and the Liberal Democratic Party regained government in February 1990.

5 Ishi, above n 3 at 316; Beyer and Ishimura, above n 3 at 116.

6 Beyer and Ishimura, above n 3 at 117.

7 Ibid at 118.

8 Japan, Ministry of Finance, *An Outline of Japanese Taxes* (1999 Ministry of Finance (hereafter "MOF, 1999")) chart beginning at 314.

9 Beyer V, "Tax Administration in Japan" (1994) 4 *Revenue LJ* 144 at 153.

10 Income Tax Law (*Shotokuzei-ho* (Law No 33, 1965) as amended) (hereafter "ITL") Art 190 to Art 193.

11 Beyer, above n 9 at 153.

consumers. To minimise the impact on business, the structure of the tax was kept simple - taxing across a very broad base but using simplified calculation and reporting methods and exempting small businesses.

TAX BASE

The Consumption Tax is levied on transfers of goods or services in Japan as well as on the removal from a Bonded Area of foreign goods.[12] Goods or services that are leaving Japan, for example, exports or foreign travel, are exempted from taxation.[13]

There is also a list of goods or services whose transfer, even domestically, is exempted from taxation:

1 Sale or lease of land;
2 Sale of securities;
3 Certain financial services (including interest on loans, fees for money changing, and insurance services);
4 Postage and revenue stamps;
5 Fees for specified government documents (for example, passport fees);
6 Fees for medical services;
7 Fees for specified social welfare services;
8 Midwifery fees;
9 Burial and cremation fees;
10 Transfer or lease of items for use by physically handicapped persons;
11 Fees for specified education-related goods and services; and
12 Residential rent.[14]

This list has been expanded since the original enactment of the law, largely for policy or political reasons. Additions to the list include: burial services; goods for use by physically handicapped; educational textbooks; residential rent in 1991;[15] expansion of the scope of medical fees to include meals served in hospital and certain kinds of home nursing care costs in 1994;[16] and expansion of the scope of home nursing care in 1997.[17]

Whether to exempt food or not has long been controversial. Needless to say consumers rally for its exemption, as its inclusion contributes greatly to the

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12 CTL Art 4.
13 Ibid at Art 7.
14 Ibid at Art 6 and Appendix I.
15 Law No 73, 1991.
16 Law No 56, 1994.
17 Law No 124, 1997.

regressivity of the tax.[18] Although the government seems willing to consider exempting food, the definitional problem of what should constitute food for purposes of defining the exemption has been too problematic.[19] Further, it seems that when the government floats the idea of exempting food the opposition's response is to propose the complete abolition of the tax.[20]

In any event, Japan's high income tax threshold (3.3 million yen)[21], combined with its very low (10%) initial marginal rate,[22] has arguably cured much of the regressivity of levying consumption tax on food. For most low to medium-low income earners, the consumption tax is the only tax they pay.

BUSINESSES SUBJECT TO THE TAX

Businesses transferring goods by sale or lease are liable to collect the tax and remit it to the government.[23] In recognition of the burden this places on small businesses, those businesses with turnover of less than 30 million yen are exempted from this tax liability.[24] According to one government estimate, in 1992 this exemption applied to about 60% of businesses in Japan, although those businesses only accounted for 2-3% of total domestic taxable sales.[25]

During the early years of the tax, there was a transitional partial exemption for growing businesses whose sales just exceeded 30 million yen. The partial exemption applied to businesses with sales between 30 million yen and 50 million yen[26] and was calculated as a deduction against regular tax liability.[27] The purpose of the partial exemption was to ensure that growing businesses were not caught out if at the end of the year they had crossed the 30 million yen threshold but had not been charging the tax. This measure was repealed effective 1 April 1997.[28]

There has been some speculation that the repeal of the transitional partial exemption will result in small businesses under-reporting sales in order to

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18 Freiman, above n 3 at 1293-94.

19 Schenk, above n 1 at 904.

20 Freiman, above n 3 at n 19.

21 Approximately A$50,000 at July 2000 exchange rates.

22 ITL, Art 89.

23 CTL, Art 5 and Art 42.

24 Ibid at Art 9.

25 Schenk, above n 1 at 904.

26 Prior to October 1991 the maximum eligible sales was 60 million yen. Law No 73 of 1991.

27 CTL, Art 40.

28 Law No 109 of 1994.

retain their exempt status.[29] While this is possible, it is unlikely for three reasons.

First of all, exempt businesses are ineligible to claim input credits and therefore must bear the burden of the consumption tax on everything they purchase. This forces those businesses to either raise their prices to reflect that additional cost of business or to reduce their profit margins. In recognition of this fact, exempt businesses have always been allowed to "opt in" to the consumption tax system.[30] For most businesses on the cusp of the exemption, the reasonable business decision may be to be subject to the tax.

Secondly, new record keeping requirements for the purposes of calculating input credits (discussed below) mean that there is more likely to be a paper trail, even for exempt businesses, making it harder for such a business to engage in under-reporting.

Finally, the NTA has announced its intention to audit these small businesses more closely in order to catch any such under-reporting.[31]

CALCULATION OF THE TAX

To minimise the burden on those businesses with tax liability, the tax is calculated using a simplified subtraction method.[32]

Taxpayer businesses must account separately for their total taxable sales and the amount of tax levied on that base.[33] They are then allowed to deduct the amount of tax charged on taxable purchases (inputs).[34] Although the business is required to maintain records as well as documents substantiating the amounts claimed,[35] there is no requirement that the amount of tax be shown separately on sales invoices.[36]

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29 Schenk, above n 1 at 905.
30 CTL, Art 9(4).
31 Schenk, above n 1 at 905.
32 CTL, Art 30.
33 Ibid at Art 45(1).
34 Ibid
35 Ibid at Art 45(7)-(9) and Art 58.
36 Schenk, above n 1 at 901.

This subtraction method permits businesses to claim deductions for tax paid even if the purchase was from an exempt business and no tax was actually paid.[37]

There is a further simplification in tax calculation for businesses with sales of less than 200 million yen. Such businesses may, upon notice to the NTA, deem their inputs to be 60% of their taxable sales and claim an input deduction accordingly.[38] This simplification originally applied to businesses with sales of up to 500 million yen and allowed those businesses to claim 80% of sales as inputs. This was reduced to 400 million yen sales and 60% as inputs in 1991[39] and then to 200 million yen sales in 1997.[40]

The tax rate is currently 5%. This consists of a 4% national tax rate[41] and an additional local consumption tax, which is 25% of the national tax.[42] Prior to 1 April 1997, the tax rate was 3%[43] and a portion of the tax collected was allocated for distribution to local governments. During the early life of the tax, passenger automobiles were taxed at a higher rate: 6% between 1 April 1989 and 31 March 1992 and 4.5% between 1 April 1992 and 31 March 1994,[44] largely for trade protectionist reasons.

Raising the consumption tax rate in the middle of serious economic recession brought the government under harsh criticism. The government argues that it compensated for the economic situation by postponing the tax increase from 1994 to 1997 and implementing various tax reductions, totally 16.5 trillion yen, between 1994 and 1996.[45]

Nonetheless consumer spending dropped from the time of the rate increase.[46] The increase in prices accompanying the rate increase must account for much of this trend. It is worth noting that some merchants used the rate increase as an excuse to change their pricing structure so that while prior to the rate increase the price marked on the item included consumption tax, after 1 April

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37 The consititutionality of the CTL was unsuccessfully challenged on this basis almost immediately after the tax took effect. See discussion in Schenk, above n 1 at note 4.

38 Ibid at Art 37. Specified businesses, eg, wholesalers and retailers, are permitted to use other specified percentages - ranging between 50% and 90%, for this purpose. CTL Enforcement Order (Order No 360, 1988) as amended, Art 57.

39 Law No 73, 1991.

40 Law No 109, 1994.

41 CTL Art 29.

42 MOF, 1999 at 303-04.

43 Law No 109, 1994.

44 CTL Supplementary Provisions, Art 11.

45 Japan, Ministry of Finance, *An Outline of Japanese Taxes* (1997 Ministry of Finance) at 317.

46 "Rising from the Crisis: Is it sustainable?" *BusinessWorld*, 27 July 2000 at 56.

1997, these merchants added the 5% consumption tax at the cash register.[47] The merchants will argue that this was simpler than going through and repricing each item in their stores. However, the result was a price increase of 5% while the tax rate only increased by 2%. Consumers quickly felt the impact of this and curbed spending as a result. Over time the situation has corrected itself, with consumer prices in Japan falling to entice consumers back into the stores.

TAX RETURNS AND PAYMENT

The tax period for sole proprietors and other unincorporated businesses is the calendar year and for corporations it is their fiscal year.[48] This, too, represents a simplification designed to promote efficiency.

For businesses whose tax liability for the previous year exceeded 4 million yen, interim returns are required quarterly, within 2 months after the end of the quarter.[49] At the same time an interim tax payment must also be submitted.[50]

When the consumption tax was first enacted, interim returns were only required every six months. However, amid concerns that some businesses were making profits on short-term investments with tax collected but not yet remitted, the quarterly frequency was adopted in 1991 for businesses with tax liability of more than 5 million yen.[51] This amount was reduced to 4 million yen in 1997.[52]

Businesses with tax liability between 480,000 yen and 4 million yen are still only required to file every six months, while businesses whose tax liability is less than 480,000 yen are not required to file interim returns at all.[53]

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47 Merchants have always had the option of including the tax in their prices or adding it at the cash register. See Ishimura K, "Introducing the New Japanese National Consumption Tax", *Japan - National Consumption Tax Law*, CCH International, 1989 at xxv.

48 CTL Art 19(1).

49 Ibid at Art 42.

50 Ibid at Art 48.

51 Law No 73, 1991.

52 Law No 109, 1994.

53 CTL 42(8). The lower threshold of 480,000 yen is effective from April 1, 1997. Prior to that, the amount was 600,000 yen. Law No 109, 1994.

CURRENT STATUS/FUTURE TRENDS

The gradual amendments to the tax are typical of Japanese taxation.[54] The tax was enacted at the lowest rate possible and with a number of simplification features and exemptions for those businesses serving as tax collectors. Over time, however, the noose has been gently tightened, with the threshold for special treatment falling. Even in the area of exempted items, the government's capitulation has been minimal.

The fact that the consumption tax remains unpopular in spite of its simplicity and low rate is problematic for the government. There is little more than can be done to make the tax more acceptable. However, the fact that the tax has now been in place more than a decade, and even survived the slight economic downturn resulting from its untimely rate rise, makes it clear that repeal is unlikely.

Indeed, rather than considering its repeal, the government is currently considering how to expand the tax base to include transactions conducted over the Internet.[55] Japan is not alone in this; the EU has issued a directive calling for its VAT to be collected from non-EU firms that sell goods and services over the Internet.[56] In Japan's case, it has been argued that failure to find a way to tax e-commerce transactions will damage the credibility of the tax system overall.[57]

It is also reasonable to expect that the rate will rise further as time passes. Japan's population is ageing rapidly, assuring that less revenue will be available from income taxes in the future. Furthermore, Japan has been forced by international pressure to drop its corporate and income tax rates to bring them in line with those of other industrial nations.[58] Thus, both governmental advisory bodies[59] and the minor voices in the current governing coalition[60] have begun publicly to discuss rate hikes. It is unlikely,

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54 The typical pattern in Japanese legislation, not only in tax but in most areas, is to adopt a law with very general terms and make amendments make it more specific as time passes and those whose behavior is being legislated adjust to the existence of the legislation.

55 "G7 Ministers Welcome Opportunities of IT", *AFX - Asia* (9 July 2000).

56 "Cooking up an E-VAT? The European Commission wants to tax things sold on the Web by foreign firms, but can the proposal work in a virtual world?" *Time* (17 July 2000) at B16.

57 Editorial, "Net poses challenge to the tax man", *The Daily Yomiuri* (16 May 2000) at 6.

58 "Consumption Tax Increase Inevitable, Says Panel", *The Nikkei Weekly* (27 September 1999) at 2.

59 Ibid

60 Analysis, "Election result sends voter-concern message to coalition", *The Daily Yomiuri* (28 June 2000) at 12.

however, that any increase will take place until the Japanese economy has further stabilised.

CONCLUSION

When the Japanese government decided that a Consumption Tax was necessary in spite of the unpopularity of the notion, it made every effort to construct the most palatable tax it could by keeping the system simple to promote efficiency and minimise administration costs while keeping the rate low to ameliorate equity problems. Simply because of general attitudes of the public toward taxation, these efforts did not result in public acceptance of the tax. In fact, many aspects of the simplification have had to be removed to halt abuses. Nonetheless, it is unlikely that this tax will be repealed. Rather, it can be expected that the rate will be raised again in a few years. When it is, the government will probably again rely on the very emotional appeal of needing to collect taxes across a broad base of taxpayers in light of the ageing population as well as the political, if not patriotic, appeal of needing to bring its tax rates in line with international standards.