Japan’s Consumption Tax: Lessons for the United States
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With the Congressional Budget Office projecting a $1.3 trillion deficit for 2010,¹ the U.S. government is now considering all possible means to increase revenue. The choices it faces are limited: It can reduce spending, increase taxes, or try something new.

President Obama’s economic stimulus package makes it unlikely that the government will substantially reduce spending soon. As a result, debate over whether the United States should introduce some form of VAT has been intensifying.

The introduction of a VAT in the United States, when coupled with spending cuts and reform of the tax code, could lead to the elimination of national budget deficits. Alan Greenspan has called the VAT the “least worst” way to raise revenue.²

Although many agree on the beneficial impact that the introduction of a VAT would have — the Congressional Research Service has estimated that each percentage point of a VAT would raise about $50 billion each year — Congress has yet to be convinced, highlighting the politically sensitive nature of the tax. Given its recent spending patterns and limited revenue sources, the United States may soon have little choice but to follow in the footsteps of every other OECD member state in implementing a VAT.

Japan was in a similar position in 1989. Faced with declining tax revenue resulting from the bursting of an economic bubble,

the Japanese government introduced its own version of a VAT. The tax had almost universal support among Japanese business analysts, economists, and bureaucrats. The public, however, strongly opposed it. Its opposition was fueled by privacy concerns, political scandals, and the apparent wastefulness of government expenditures. The government’s battle to introduce the VAT claimed several political careers, including those of some prime ministers. Since its introduction, though, Japan’s VAT has generally been regarded as a success. It now accounts for approximately 20 percent of the country’s overall tax revenue, while creating minimal economic distortions.

Given the similarities between where Japan stood in 1989 and the current fiscal climate in the United States, a closer look at Japan’s VAT may provide some insight on the strategies and methods that U.S. policymakers might use in rolling out a similar tax regime.

**Japan’s CTAX Explained**

Japan’s VAT is known nationally as the federal consumption tax (herein CTAX). It was introduced in 1989 and replaced several other indirect and excise taxes. The initial CTAX rate was 3 percent, the lowest of any VAT system in the world. The rate has been increased only once, in 1997, to its current rate of 5 percent.

Unlike most other VATs, Japan’s CTAX has a single flat rate. The government resisted the temptation to implement preferential or zero rates in categories of goods and services like healthcare and food. The primary benefit of the single-rate structure is that it significantly reduces complexity. Policymakers also believed multiple rates would encourage tax avoidance as taxpayers would try to replace taxable goods with nontaxable goods.

The CTAX functions as a typical VAT in that it’s levied on the consumption of goods and services at all stages of the supply chain, from manufacturing and importation to wholesaling and retailing. Each business in the supply chain collects a 5 percent CTAX from the purchasers of its goods or services, and in turn pays a 5 percent CTAX to each business from which it purchased goods or services. Businesses are responsible for administering
the tax (remitting payments to the government), but are not
ultimately liable for paying it. As with other VAT systems, the
end-user is left footing the bill.

For example, a shoe retailer in Tokyo purchases a pair of shoes
from a wholesaler for ¥105 (¥100 for the shoes plus ¥5 CTAX). The
retailer then sells the shoes to a customer for ¥210 (¥200 for the
shoes plus ¥10 CTAX). Because the retailer has collected more tax
than was paid to the wholesaler, the retailer is required to pay
that excess (¥10 minus ¥5) to the tax authorities. The wholesaler
is also required to pay the ¥5 in CTAX it collected from the
retailer, less applicable credits.

The CTAX is not limited to corporate entities. In principle, it
applies to any business entity or individual that makes taxable
supplies of goods or services in the course of doing business in
Japan. Those taxpayers may include sole proprietors, corpora-
tions (both domestic and foreign), associations, foundations, and
the government itself.

In the case of imports, the party responsible for importation
(that is, removing the imported goods from a bonded warehouse)
is deemed a consumer/taxpayer, whether it is a sole proprietor,
corporation, or end consumer. Nonresidents with CTAX obliga-
tions and without a fixed place of business in Japan must appoint
a tax representative to handle CTAX administration.

**Tax Base**

Japan’s CTAX is different from many other VATs in that it has
a broad base with few material exemptions. At its most basic
level, CTAX is levied on the following two categories of transac-
tions: goods transferred or services performed within Japan and
goods imported into Japan. The approach is simple. The tax base
for the transfer of goods and provision of services is the price
charged. For imported goods, the tax base is the total of the cost,
insurance, freight, customs duties paid, and excise taxes paid.

Tangible assets are subject to CTAX if legal title passes in
Japan, while intangible assets incur CTAX if the intellectual
property being transferred is registered in Japan. Intellectual
property transactions for which registration is not required, such
as copyright, are subject to CTAX if the licensor’s head office is in
Japan. While the treatment of services is less clear, CTAX generally does not apply on services performed for parties located outside Japan.

CTAX also does not apply to the following:
- ownership, transfer, or leasing of land;
- financial transactions conducted in Japan;
- medical care;
- education;
- registration or licensing fees charged by governmental bodies;
- services performed in an international context, including international postal money transfers, communications, and foreign currency transactions; and
- exported goods.

Given that the policy goals of CTAX were simplicity, equity, and neutrality, Japan was careful not to implement a tax that imposed unacceptably high compliance costs on small businesses. Because compliance costs will undoubtedly be an issue for U.S. taxpayers, it’s worth highlighting a number of CTAX features designed to minimize the burden on small businesses.

Small Taxpayers

A simplified system for calculating the amount of CTAX to be credited is available to taxpayers whose taxable sales during the base period (defined as two fiscal years prior to the current fiscal year) do not exceed ¥50 million. For those taxpayers, the CTAX credit is calculated as a percentage of the CTAX payable on total taxable sales. This is a much simpler method of calculating CTAX credits than requiring businesses to perform a transaction-by-transaction calculation. The applicable percentage can vary from 50 to 90 percent, depending on the taxpayer’s status. An enterprise with taxable base-period transactions not exceeding ¥10 million is exempt from paying CTAX, although it may elect to file CTAX returns if it is owed a refund.

Nontaxable Purchases

CTAX paid on taxable purchases is, in principle, deductible against CTAX collected on taxable sales. However, because of the risk that taxpayers might claim credits on a nontaxable transaction, rules apply to restrict taxpayers’ ability to use these
deductions. Under the partial exemption rule, if the amount of nontaxable sales exceeds 5 percent of total sales, one of two alternative methods must be used to calculate the available CTAX credit.

Invoicing

Under Japan’s CTAX legislation, a taxable entity is not required to provide a tax invoice to purchasers of taxable supplies. That is unique, especially compared with traditional credit invoice VAT systems common across Europe. The lack of an invoicing requirement highlights the priority given to ensuring compliance requirements are kept to a minimum. Rather than being forced to create separate financial records, taxpayers need only produce documentation typically kept for income tax purposes (bills, receipts, etc.) to support their CTAX position. A potential drawback is the difficulty in distinguishing between taxable and nontaxable transactions, which can provide taxpayers with opportunities to claim credits on purchases from exempt businesses. However, the CTAX’s broad base, limited exemptions, and single rate significantly reduce the extent of the problem.

Filings and Payments

CTAX returns are filed annually. The returns are due within two months of the end of a corporation’s fiscal year. For individuals, the return is due by March 31 of the year following the end of the calendar year. An interim return covering the first six months of the current year will be required if the amount of CTAX paid in the previous year exceeded ¥600,000. The interim return must be accompanied by a payment equal to half the previous year’s CTAX liability. Payments may also be required during the current year, depending on the amount of CTAX paid in the prior year. For example, if the prior year’s tax liability exceeded ¥60 million, monthly payments in the current year are required. If the previous year’s tax liability was between ¥5 million and ¥60 million, three interim payments are required.

Lessons for America

Since the CTAX was implemented just over 20 years ago, coping with it has become second nature to many Japanese and
foreign businesses, largely because of its simplicity. Like with the simplified system for small taxpayers noted above, many of the concessions now available to taxpayers have been scaled back from their generous levels when the CTAX was first introduced. The result was a rapid and widespread acceptance of the new regime, which allowed the CTAX to be implemented in a relatively short period of time.

When considering implementation of the CTAX, the Japanese government recognized that a key area of concern for the public would be its effect on small businesses, and in particular the compliance burden. As a result, the CTAX included several features designed to minimize adverse consequences on those firms. To overcome opposition, the government ran an extensive public relations campaign emphasizing the low rate, broad base, and minimal compliance requirements. That approach, which also included coordination with business and trade groups, helped the tax avoid becoming a political football rife with compromises and concessions that would negate its potential benefits.

Concurrent with the introduction of the CTAX, the Japanese government took measures to deal with arguments commonly raised by opponents of the VAT in other jurisdictions. To combat the argument that the CTAX would be regressive and hurt low-income earners, the government lowered individual income tax rates, particularly for low-income taxpayers. Another common anti-VAT argument is that an initially low rate will increase over time and fuel public spending. In fact, the CTAX has increased only 2 percentage points over a 20-year period.

Over the last few years, however, there have been several proposals to increase the CTAX rate. Given Japan’s growing deficit and aging population, a rate increase seems imminent. The latest proposal is to double the rate from 5 percent to 10 percent. If it’s approved, Japan would still be left with one of the lowest VAT rates in the world. The minimum VAT rate permitted in the European Union is 15 percent.

Conclusion

As the United States grapples with whether to introduce a VAT, there are some valuable lessons to be learned from the
Japanese experience. Japan’s approach was simple but effective: Build support by educating the public and implementing a simple, low-tax system with a broad base.

The government’s focus on reducing the compliance concerns of small and medium-size taxpayers was a key to winning over a skeptical public. The United States should recognize that political horse-trading on the fundamental elements of a VAT will significantly undermine the tax’s ability to deliver the benefits experienced by many other VAT jurisdictions.

Japan’s recent debate about a potential rate increase underscores the extent to which the CTAX has become integrated into the business culture. With an honest debate, the United States might reap similar benefits.