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Recent trends of Web 3.0 related taxation in Japan

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I. Introduction

The Semantic Web (the so-called “Web 3.0”) related business, such as NFT transactions, has been expanding in Japan in recent years.

However, Japanese tax treatment of Web 3.0 related transactions have sometimes become a heavy burden on Web 3.0 related business operators, especially those who would like to issue tokens in Japan. For example, The Nikkei, the most famous financial newspaper in Japan, reported that several block-chain companies have avoided issuing tokens in Japan, due to the tax burden derived from the application of the Year-End Mark to Market (“MTM”) Rules under the Corporation Tax Act (Act No. 34 of March 31, 1965, as amended. “CTA”) in Japan. These rules require a corporation which holds cryptocurrencies (i.e., “crypto-assets” as specified by Article 5(5) of the Payment Services Act (Act No. 59 of June 24, 2009, as amended)) traded in “active markets” (see IV.(1) below) to change the acquisition price/booked price of the cryptocurrencies to their current fair market values (i.e., “Mark to market (MTM)”) and realize the gains/losses derived from such change at the end of each business year (Article 61(2) and (3) of the CTA).

In addition, there has been some unclearness regarding the tax treatment of Web 3.0 related transactions, which may affect much on activities of Web 3.0 corporations.

On these grounds, on December 23, 2022, the Japanese government announced the outline of the

2023 tax reform which includes a revision of the Year-End MTM Rules.

Furthermore, in the first two months of 2023, the National Tax Agency of Japan (“NTA”) released FAQs on the tax treatment of NFT transactions (“[NFT FAQs](#)”) and FAQs on the Year-End MTM Rules (“[YEMTMR FAQs](#)”). (These FAQs are only in Japanese.)

In this newsletter, we set out a summary of the said tax reform and these FAQs.

II. The 2023 Tax Reform on the Year-End MTM Rules

Under the 2023 Tax Reform, the Year-End MTM Rules will not apply to cryptocurrencies which have already been issued and not yet distributed to third parties as long as either of the following requirements is met:

- (i) Technical measures for restrictions on transfer have been imposed on the cryptocurrencies;
or
- (ii) The cryptocurrencies have been entrusted to the trustee with the conditions specified under the CTA.

The details of these requirements are expected to be disclosed in April 2023 or thereafter.

The 2023 Tax Reform also provides that a corporation shall recognize gains or losses where the corporation borrows cryptocurrencies from a third party other than an Crypto-Asset Exchange Service Provider and sells those cryptocurrencies but has not bought back the equivalent cryptocurrencies by the end of the same year, as if it buys back the same cryptocurrencies at the year end.

These tax reforms will be applicable to the business years of corporations which start on or after April 1st, 2023.

III. Summary of the NFT FAQs

The NTA has released the NFT FAQs, which is the first officially issued practical guidelines on taxation of NFTs in Japan. In these guidelines, the NTA explains the general tax treatment of NFTs with regard to individual income taxes, corporate taxes, consumption taxes, inheritance/gift taxes and statutory reporting obligations, mainly by way of examples where art NFTs, which are backed by the grant of copyrights for digital designs, have been distributed.

We set out below a summary of the tax treatment applicable to a foreign business operator who distributes NFTs in the Japanese market. Please note that the tax treatment of NFTs would differ depending on the legal characteristic of the NFTs, thus we recommend to consult with tax experts

to determine the tax treatment of each NFT.

(1) Individual income taxes/corporate taxes

The NFT FAQs explain that a US individual tax resident is not subject to the Japanese income taxation when he creates a digital art and sells art NFT related to such digital art through a market place in Japan.

Although the NFT FAQs do not give a detailed reason for this conclusion, it can be understood that an individual/corporation who is not a tax resident in Japan and has no permanent establishment in Japan is generally not subject to Japanese taxation on the income derived from the issuance (first-sale) of NFTs, unless the NFTs are backed by real assets which trigger Japan-sourced income separately.

(2) Consumption taxes (Japanese value added taxes)

One feature of the NFT FAQs is that the FAQs introduced different approaches on the issuance of art NFTs and the secondary transfer of art NFTs.

With regard to the issuance of art NFTs, the NTA deems such issuance as “cross-border provisions of electronic services” (Article. 2(1)(viii-iii) of the Consumption Tax Act (Act No. 108 of 1988, as amended). Accordingly, whether the consideration for the issuance of art NFTs is subject to consumption taxes is determined by the rule applicable to cross-border provisions of electronic services, i.e., the consideration is taxable if the buyer of the art NFTs is an individual located in Japan or a Japanese corporation. Further, a foreign issuer of art NFTs would be subject to the consumption taxes in Japan in respect of primary sale of the issued art NFTs to Japanese purchasers (i.e., reverse charge method is not applicable), unless the issued art NFTs are of the nature that they are usually purchased only by business operators (i.e., not by consumers).

In contrast, the NTA does not deem secondary transfer of art NFTs as “cross-border provisions of electronic services” (i.e., such transactions are treated in the same manner as the ordinary transfer of copyrights), and therefore the sale of the art NFTs is subject to consumption taxes where the seller is located in Japan.

Please note that the obligation to pay consumption taxes is borne only by business operators, and a business operator whose amount of taxable sales does not exceed JPY 10 million would generally be exempt from such tax obligation.

(3) Withholding obligation

In the NFT FAQs, the NTA mentions that payment of the consideration for the issuance would generally be subject to Japanese withholding tax levied on royalties. The NTA explains that the

withholding tax would apply to payment of the consideration by Japanese tax residents, because the consideration for the issuance of art NFTs backed by the grant of copyrights for digital designs includes the consideration for the grant of copyrights.

However, the NTA also states that withholding obligations would not be triggered if both of the following requirements are met:

- (i) It is difficult for the purchaser of the art NFTs to specify/distinguish the consideration for the grant of copyrights from the total amount of NFT sales; and
- (ii) The amount of consideration for the grant of copyrights is likely to be quite small in comparison with the total amount of NFT sales.

Such tax treatment is also applicable to payment of same consideration issuance of art NFTs to non-residents (although it may be overridden by an applicable tax treaty).

(4) Inheritance/Gift taxes

Under Japanese tax laws, an individual recipient of assets located in Japan by way of an inheritance/gift from another individual would be subject to inheritance/gift taxes even if the recipient is located outside of Japan.

In the NFT FAQs, NFTs are included in the scope of taxable assets so long as they have an economic value.

However, in the NFT FAQs, the NTA has not made it clear how to determine the location of the NFTs, and thus non-tax residents who hold NFTs issued by Japanese residents should pay careful attention to the NTA's enforcement of inheritance/gift taxes on NFTs.

IV. Summary of the YEMTMR FAQs

In the YEMTMR FAQs, the NTA gives a detailed interpretation of the requirements of the Year-End MTM Rules. The summary thereof is as follows:

(1) The concept of "active market"

The Year-End MTM Rules are applicable to cryptocurrencies of a taxpayer which are traded in "active markets". Whether a certain cryptocurrency is deemed as being traded in an "active market" would be determined by the following criteria:

- (i) Sales price of the cryptocurrency is announced regularly and such announced price affects the sales price or exchange ratio of the cryptocurrency;
- (ii) There are enough transactions of the cryptocurrency both in quantity and frequency to announce the said sales price; and
- (iii) Either of the following requirements is met:

- (a) The sales price is announced by a corporation other than the taxpayer; or
- (b) Most of the transactions in item (ii) are not transactions executed on the taxpayer's own account.

The YEMTMR FAQs mention that the market would be generally deemed as inactive in cases where sales prices of the same cryptocurrency reported by different exchanges are significantly different each other, or where there is a large difference between the asked price of buyers and the selling price of sellers.

In addition, the YEMTMR FAQs clearly states that a “Decentralized Exchange” (DEX) can be deemed as an “active market”, if the above conditions (i) through (iii) are met.

(2) The application of the Year-End MTM Rules to cryptocurrency under lockup for staking transactions

The word “lockup” under a staking transaction means that a holder of cryptocurrencies set certain restriction on transfer of its cryptocurrencies for a certain period, by which the holder can receive certain compensation for the staking transaction. As a holder of cryptocurrencies substantially loses the control for these cryptocurrencies during the “lockup” period, prior to the issuance of the YEMTMR FAQs, whether the Year-End MTM Rules would apply to cryptocurrencies under a “lockup” was a big issue. The YEMTMR FAQs resolve this problem by clarifying that the Year-End MTM Rules apply to cryptocurrencies under the “lockup” period.

(3) The application of the Year-End MTM Rules in cryptocurrency during lending transactions

Cryptocurrencies may be during a lending transaction at the year-end. The YEMTMR FAQs state that the Year-End MTM Rules generally apply only to the lender of the cryptocurrencies under lending, on the grounds that the lender will benefit from the lending fees and also bears the future price fluctuation risk.

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