RESEARCH NOTE 5

Indirect Taxes, Invoice Systems, and Input Tax Deductions

in the UK and US

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1. Introduction

With the implementation of the Qualified Invoice System (Invoice System)[1] in Japan in October 2023, input tax deductions[2] for taxable purchases from tax-exempt businesses (businesses with annual taxable sales of 10 million yen or less) were, in principle, completely disallowed (Ministry of Finance, 2023). However, to cushion the rapid increase in tax burden on buyer-side businesses (including public interest corporations, small and medium-sized enterprises, Silver Human Resources Centers, etc.) trading with tax-exempt businesses, as well as to prevent the exclusion of tax-exempt businesses from commercial transactions[3], transitional measures were introduced to gradually reduce the deductible percentage. Put simply, under this system, buyer companies purchasing from tax-exempt businesses can initially deduct a portion of the consumption tax amount incurred on purchases from their own consumption tax liabilities, but this percentage will shrink in phases and eventually reach zero.

Under the transitional measures, buyers are permitted to deduct 80% of the input tax equivalent for the three-year period from October 1, 2023, to September 30, 2026; 70% for the two-year period from October 1, 2026, to September 30, 2028; 50% for the two-year period from October 1, 2028, to September 30, 2030; and 30% for the one-year period from October 1, 2030, to September 30, 2031 (Ministry of Finance, 2023). On or after October 1, 2031, the transitional measures themselves will expire, and all taxable purchases from tax-exempt businesses will become completely ineligible for input tax deductions.

To illustrate with a specific example, if a company purchases services with a base price of 10,000 yen from a tax-exempt business, the consumption tax equivalent is 1,000 yen. Currently (until September 2026), 800 yen of that amount can be deducted from the buyer's consumption tax liability, and from October 2026 onward, 700 yen can be deducted. However, starting in October 2031, this 1,000 yen cannot be deducted at all, and the buyer company will have to bear the full amount out of pocket.

In light of these concerns regarding outsourcing work to Silver Human Resources Centers for elderly workers and the impact on public interest activities partnered with sole proprietors and small non-profit organizations, practical field representatives—including our association—are strongly requesting the "continuation and permanent extension of the 70% input tax deduction transitional measure (starting October 2026) for taxable purchases from tax-exempt businesses" (Japan Association of Charitable Organizations, 2026).

Against the backdrop of these tax reform requests, this research note aims to analyze and compare the structure of indirect tax systems in major countries, specifically the United States and the United Kingdom, as well as tax-relief

[1] Qualified Invoice (Invoice): An invoice or receipt issued by a seller to accurately inform a buyer of the applicable consumption tax rate and tax amount. Only "Qualified Invoice Issuers" registered with the National Tax Agency can issue them, and buyers can receive consumption tax input tax deductions by retaining these invoices (National Tax Agency, 2026)

[2] Input Tax Deduction: A mechanism where a business calculates its tax liability by subtracting the consumption tax paid on its own purchases from the consumption tax received on sales. Without this deduction, tax on the same product would stack double or triple at each stage of distribution; the mechanism exists specifically to prevent such double taxation.

[3] Compliance and Anti-Competitive Concerns: Relevant government ministries and agencies have issued guidelines warning that forcing tax-exempt businesses to convert to taxable business status or unilaterally demanding price cuts could constitute violations under the Antimonopoly Act and the Subcontract Act (including the Act on Ensuring Proper Transactions Involving Freelancers and Sole Proprietors) (Ministry of Finance, Fair Trade Commission, Ministry of Economy, Trade and Industry, Small and Medium Enterprise Agency, Ministry of Land, Infrastructure, Transport and Tourism, 2022).

measures for procurement from small or unregistered businesses (equivalent to tax-exempt businesses) and consideration methods for non-profit and public interest sectors, thereby organizing the challenges and countermeasures surrounding Japan's Invoice System.

2. Actual Conditions Under State Retail Sales Tax (RST) in the United States

2.1 Absence of Federal Value-Added Tax (VAT) and the Mechanism of State Sales Tax

In the United States, there is no federal-level Value-Added Tax (VAT)[4] or unified national consumption tax. Instead, state and local governments (such as counties and cities) independently impose a "Retail Sales and Use Tax (RST)" (introduced in 45 states and the District of Columbia, excluding 5 states such as Alaska, Delaware, Montana, New Hampshire, and Oregon) (Tax Foundation, 2025/2026). To break it down simply, while Japan's consumption tax uses a system that "taxes goods and services bit by bit every time they pass from hand to hand", the US sales tax is closer to a system that "taxes only once at the store cash register", making the underlying mechanisms fundamentally different.

The US sales tax is a single-stage tax levied only at the "final consumption" stage. Therefore, the concept of an "input tax deduction" (deducting prior-stage tax)—which is standard in Japan and Europe—does not exist as a general rule (Tax Foundation, 2025/2026).

2.2 Business-to-Business (B2B) Transactions and Procurement from Small Suppliers

Under a sales tax system, when a business purchases goods for the purpose of reselling them (Resale) or buys items that are directly incorporated as raw materials during the manufacturing process, the buyer business presents a "Resale Certificate"[5] to the seller. As a result, the sales tax at the time of purchase is fully exempt (non-taxable) (Sales Tax Institute, 2025).

In other words, because imposing tax on inventory intended for later resale would result in double taxation, the system postpones that tax until the "moment the goods are sold to the final consumer".

On the other hand, for transactions that fall under "final consumption"—where a business purchases operational supplies or various services (such as advertising, consulting, cleaning, etc.)—a final consumption tax (or a complementary "Use Tax")[6] is incurred, regardless of whether the seller is a registered business or a small unregistered business (Sales Tax Institute, 2025).

Unlike purchases from tax-exempt businesses in Japan, whether or not tax must be paid cannot be avoided in the US; the key feature is simply that the party responsible for remitting the tax to the tax authority shifts between the seller and the buyer:

- When the seller is a registered business: Sales tax is charged and collected at the time of purchase.
- When the seller is small and not obligated to collect sales tax (or is an out-of-state unregistered vendor): The buyer company bears the obligation to calculate the "Use Tax" itself and directly self-report and remit it to state tax authorities (Consumer Use Tax).

2.3 Tax Exemptions for Non-Profit Corporations (Section 501(c)(3) Organizations, etc.)

In almost all US states, non-profit and public interest organizations recognized by the Internal Revenue Service (IRS) under Section 501(c)(3)[7] of the Internal Revenue Code are exempt from paying sales tax when purchasing goods and

[4]Value-Added Tax (VAT): A multi-stage indirect tax system that taxes value added at each stage of production and distribution, where businesses deduct the tax paid on purchases when calculating their tax liability. Japan's consumption tax and the UK's VAT belong to this category, and it is adopted by most OECD member countries (OECD, 2024).

[5]Resale Certificate: A certificate presented to a seller by a business purchasing goods for the purpose of resale. When this is presented, sales tax is not levied at the time of purchase, and taxation occurs for the first time when the item is sold to the final consumer.

[6]Use Tax: A complementary tax self-reported and remitted by the buyer when the sales tax that should normally be charged was not collected at the time of purchase. It serves as a mechanism to prevent tax leakage in situations such as purchases from out-of-state vendors where sales tax is not assessed.

[7]Section 501(c)(3) of the Internal Revenue Code: A provision under which the Internal Revenue Service (IRS) recognizes organizations operated

services as buyers by presenting a "Tax Exemption Certificate" (Avalara, 2025). Therefore, the system is structured so that issues like increased intermediate tax burdens during procurement rarely arise, even when dealing with small vendors.

Putting this in the context of Japan, it is close to an image where a public interest corporation or NPO simply presents a single certificate proving "we are a public interest organization", preventing the tax burden on purchases from occurring in the first place.

3. Actual Conditions Under UK Value-Added Tax (UK VAT)

3.1 Basic Structure of UK VAT and High Registration Threshold (Exemption Point)

The United Kingdom adopts a multi-stage taxation (VAT) system using an invoice-based method. The most prominent feature of the UK system is that a very high VAT mandatory registration threshold (exemption point) is established (HM Revenue & Customs, 2024–2026).

The mandatory VAT registration threshold in the UK is £90,000 in taxable sales over the previous 12 months (equivalent to approximately 19 million to 20 million yen at current exchange rates)[8]. Set nearly twice as high as Japan's 10 million yen threshold, many small businesses in the UK (such as freelancers, sole proprietors, and local non-profit groups) continue to operate as unregistered businesses (HM Revenue & Customs, 2024–2026). In other words, because far more small businesses in the UK can remain in a position where they "do not need to register in the first place", friction like that surrounding Japan's Invoice System is less likely to occur.

3.2 Procurement from Unregistered Suppliers and Input Tax Deductions

Under the UK VAT system (governed by HMRC: HM Revenue & Customs), when goods or services are procured from an unregistered business, VAT (standard rate of 20%) is not included in the invoice (HM Revenue & Customs, 2024–2026). In this case, the tax accounting treatment and economic impact on the buyer side (a VAT-registered business) are as follows:

Table 1: Vendor Categories and Buyer Burden Structure Under the UK VAT System

Transaction Category	Breakdown of Invoiced Amount	Input Tax Deduction (Input VAT Recovery)	Buyer's Net Cost and Tax Impact
Purchases from VAT-registered suppliers	Base Price 100 + VAT 20 = Total 120	Full deduction of 20 possible (Net Cost = 100)	Input VAT is offset against output VAT, resulting in zero net tax cost.
Purchases from unregistered suppliers	Base Price 100 (No VAT charged) = Total 100	0 (Because no VAT eligible for deduction exists)	Because no input VAT is incurred, the buyer faces no additional tax burden even without an input tax deduction (Net Cost = 100).

In the UK, because invoices from unregistered suppliers do not include VAT on top of the base price, buyers do not suffer a financial loss or face an increased tax liability even though they cannot claim an input tax deduction. Since the supplier does not charge VAT, the buyer's cost remains strictly the base price itself.

In contrast, under Japan's consumption tax system, tax-exempt businesses have historically transacted using "tax-inclusive prices" as a common trade practice. Consequently, when the input tax deduction is disallowed without a qualified invoice, buyer companies end up effectively paying the "consumption tax equivalent" out-of-pocket twice—once to the seller and once to the tax office—resulting in a sharp increase in their tax burden.

In short, the decisive difference between the two countries lies in the fact that while in the UK buyers cannot suffer

for religious, charitable, educational, scientific, or other public purposes as non-profit entities, exempting them from federal corporate income taxes and other liabilities (Internal Revenue Service, 2024).

[8] VAT Registration Obligation: In the UK, businesses whose taxable sales exceed the registration threshold (£90,000) are obligated to submit a VAT registration notification to HMRC (HM Revenue & Customs), after which charging, remitting, and filing VAT becomes required (GOV.UK, 2024).

a loss because no tax was added in the first place, in Japan buyers are paying a tax-inclusive amount but are denied the deduction.

3.3 Differences Between Zero-Rated and VAT Exempt

In the UK VAT system, "Zero-rated" and "Exempt" are strictly distinguished from one another (HM Revenue & Customs, 2024–2026):

- Zero-rated: Food items, children's clothing, books and newspapers, equipment for disabled persons, and other specific items. While consumers are not charged VAT, businesses can claim a full refund for all input VAT incurred on their purchases. Put simply, this is a "standard VAT-taxable transaction that happens to have a 0% tax rate," and the key benefit for businesses is that they can fully recover the VAT paid at the purchasing stage.
- Exempt: Financial services, insurance, education, medical care, certain charitable activities, and other select sectors. Businesses cannot charge VAT on these sales, but at the same time, they are not allowed to deduct the related input VAT paid on purchases (requiring complex apportionment calculations under the Partial Exemption rules) [9]. While "Zero-rated" refers to a VAT transaction with a 0% tax rate, "Exempt" refers to a transaction entirely outside the scope of the VAT system, making it essential not to confuse the two in practical tax administration.

4. Conclusion

The table below provides a comparative summary of the indirect tax systems, invoice mechanisms, and tax burden structures when procuring from small suppliers across Japan, the United States, and the United Kingdom.

Table 2: Comparative Summary of Indirect Taxes and Invoice Systems in Japan, the United States, and the United Kingdom

Comparison Item	Japan (Consumption Tax / Qualified Invoice)	United States (State Retail Sales Tax: RST)	United Kingdom (Value-Added Tax: UK VAT)
Basic Tax Structure	Multi-stage taxation (Invoice method)	Single-stage taxation at the final consumption stage only	Multi-stage taxation (Invoice method)
Business Exemption Threshold	Sales of 10 million yen	State-by-state Economic Nexus standards (e.g., $100,000 in sales)[10]	Sales of £90,000 (approx. 19 to 20 million yen)
Transactions with Unregistered / Tax-Exempt Suppliers	Deduction limitations apply (Transitional measures: 80% → 50% → 0%)	Purchases for resale are exempt via exemption certificates. Final business consumption generates Use Tax.	No input VAT is incurred in the first place (No deduction needed, no financial loss)
Presence of "Tax" in Transaction Prices	Strong trade practice of tax-exempt businesses charging tax-inclusive prices	Tax-exempt and unregistered vendors do not charge tax	Unregistered vendors do not charge VAT (20%)
Special Provisions for Public Interest / Non-Profit Entities	Same invoice rules apply as for general commercial businesses	Sales tax exempted via Buyer Exemption Certificates for 501(c)(3) organizations, etc.	Zero-rated and tax-exempt provisions exist for Charities

Because Japan's consumption tax operated for many years under the "bookkeeping method" (a commercial pricing practice that effectively incorporated the so-called "tax-benefit profit" or ekizei issue), the consumption tax

[9] Partial Exemption Framework: A mechanism where businesses making both taxable sales (transactions eligible to charge VAT) and exempt sales (transactions not eligible to charge VAT) must apportion their input VAT to exclude the portion corresponding to exempt sales from deduction. Because calculation methods are complex, it represents a substantial administrative burden for many UK businesses.

[10] Economic Nexus: A legal doctrine under which even out-of-state businesses become obligated to collect and remit a state's sales tax if their sales revenue or transaction volume within that state exceeds a specified threshold. Following the 2018 US Supreme Court ruling (South Dakota v. Wayfair, Inc.), it was adopted by most states.

equivalent has historically been embedded within the transaction prices of tax-exempt businesses (such as Silver Human Resources Center members, freelancers, and small NPOs). Here, the term "tax-benefit profit" (ekizei) refers to a situation where a tax-exempt business retains the consumption tax equivalent received from clients instead of remitting it to the government; eliminating this ekizei is one of the stated objectives of the Qualified Invoice System.

Under these circumstances, if the transitional deduction rate drops to 70% in October 2026 and the transitional measures themselves expire (0%) in October 2031, sectors that directly support or engage small businesses and elderly workers—such as public interest corporations—will be forced to make a painful choice: "replace (exclude) these suppliers from transactions" or "absorb massive consumption tax liabilities themselves and accept financial deterioration" (Japan Association of Charitable Organizations, 2026).

Practical Policy Recommendations

(1) Promoting the Extension and Permanent Adoption of the 70% Transitional Deduction: As the system designs of the US and the UK demonstrate, consideration for the small business and non-profit sectors is indispensable for tax system stability. At least until transaction environments adjust and unit price revisions take root, indefinitely extending and maintaining the 70% deduction measure is strongly recommended to buffer small businesses and non-profits against drastic shocks to their tax and administrative burdens.

(2) Considering Buyer-Side Special Provisions for Public Interest Corporations: Referencing the US Section 501(c)(3) tax exemption certificate system, policymakers should consider introducing medium-to-long-term special provisions allowing entities engaged in social mutual aid and public interest activities to claim a fixed level of input tax deduction even when procuring from tax-exempt businesses (Avalara, 2025).

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