

VAT



As VAT (Value Added Tax) has the potential to impact on every business transaction it should not be ignored. This is especially so given most businesses will have no choice but to register for VAT once their sales reach £67,000 a year. Therefore it is important to understand the basics. Failing to meet deadlines or declaring the wrong amount can lead to interest charges and penalties.

This briefing explains:

- How VAT works.
- Whether you need to register.
- How to charge and reclaim VAT.
- How to complete your VAT return.

1 How VAT works

VAT is a tax on business transactions that potentially affects all supplies. It is not a tax on profits. VAT is charged at 15 per cent on any supplies unless they fall within a specific relief. These include 0 and 5 per cent as well as some exemptions (see 2).

1.1 Any VAT paid by businesses on their purchases is called **'input VAT'**.

1.2 The VAT charged by VAT-registered businesses is called **'output VAT'**.

1.3 The **difference** between the output VAT you charge and the input VAT you reclaim is handed over to HM Revenue & Customs (HMRC), usually on quarterly VAT returns.

A large proportion of goods are standard-rated (15 per cent). For example, a VAT-registered shop selling a vase for £30 will add £4.50 (15

per cent) VAT, making the total price £34.50. However, as the shop will reclaim any VAT it paid to its supplier the net amount paid to HMRC will be 15 per cent of the shop's profit margin – being VAT on the value added by the shop. This applies right through the entire chain of earlier transactions. For example:

Company	Product	Selling Price
Clay Co.	clay	£1 + £0.15 VAT
Pottery Co.	vase	£10 + £1.50 VAT
Shop Co.	vase	£30 + £4.50 VAT

Hence, the net VAT paid to HMRC by each company is output VAT less input VAT as follows:

Company		
Clay Co.	£0.15 less £0.00 =	£0.15
Pottery Co.	£1.50 less £0.15 =	£1.35
Shop Co.	£4.50 less £1.50 =	£3.00
	Total paid to HMRC =	£4.50

2. What is VAT charged on?

For VAT purposes, goods and services are divided into three categories.

2.1 A large proportion of sales of goods and services are standard-rated (15 per cent). There are exceptions that are either exempt (see 2.2), zero-rated (see 2.3), or charged at five per cent, known as reduced-rated (see 2.4). If you make VATable supplies, you can or may have to register for VAT (see 3).

- Once registered, a business charges VAT to their customers.

- Registered businesses then claim back any VAT paid on business purchases.

2.2 Exempt supplies include finance; health insurance; land and property (subject to an option to tax) and charitable fund-raising amongst others.

A business that only makes exempt supplies cannot register for or reclaim the VAT paid on associated purchases. If it makes both VATable and exempt supplies, VAT claims will only be allowed for the purchases directly attributable to their VATable supplies.

2.3 Zero-rated supplies include necessities, like food and children's clothing as well as construction of new houses, books, printed matter and prescription drugs.

- A business that makes only zero-rated supplies can register for VAT and reclaim VAT paid on purchases even though they do not charge their customers VAT.

There is also VAT relief applicable to many supplies to non-EU customers and EU business customers. This works on essentially the same basis as zero-rating but relief should not be assumed to apply to all non-UK supplies.

2.4 Reduced rated supplies include domestic fuel; residential conversions and certain refurbishments; energy-saving materials and children's car seats.

Even though VAT at 5 per cent will be charged on all reduced rate supplies, all associated VAT paid on business purchases, regardless of the rate paid, should be reclaimable.

3 Should you register?

The advantage of registering is that a business can reclaim VAT paid on business purchases. But if a business mainly deals with members of the public and it begins adding 15 per cent VAT to its prices, it may lose customers.

3.1 A business must notify **HMRC**, within 30 days of the end of the month, in which VATable sales in the last 12 months exceeded £67,000.

- Exceptionally, if a business expects sales to fall back below this level, it can ask HMRC to allow it to remain unregistered. Otherwise, it will be registered immediately.
- A business must also register if sales during

the next 30 days are expected to exceed £67,000 — eg if a new company is set up with orders already in place totalling £67,000.

- Penalties for late notification can be as much as 15 per cent of the VAT due in the first return, although HMRC now have discretion on how they apply them to businesses with turnover of up to £150,000 a year.

3.2 A business can **opt** to register for VAT if sales are below the registration level but VAT is being incurred on business purchases. It may be worth registering if:

- Your supplies are zero-rated.
- Customers are themselves VAT-registered.
- You intend to set up a business making VATable supplies. This will allow you to reclaim VAT on your pre-trading expenses. You will need to provide evidence of an intention to make VATable supplies.

4 Charging customers VAT

A business will be liable to pay VAT on all supplies it makes from the date it is required to register rather than when registration is complete.

4.1 As soon as VAT registration is required (see **3.1**), an **application** should be made to HMRC to start the process. Forms can be downloaded from www.hmrc.gov.uk/.

4.2 While the application is processed, pricing should reflect the **VAT liability** less any input tax that can be reclaimed.

- Show only the gross amount - VAT cannot be invoiced as a separate item until a VAT number is allocated. Tell customers that proper VAT invoices will be issued (see 5) once you are registered.
- If a business decides to hold its prices to avoid losing customers, it will still have to pay VAT to HMRC calculated by treating the sales value as including VAT (sale price x 15/115).

5 VAT invoices

5.1 Once registered for VAT, a business must issue **VAT invoices** — and retain a copy for its file — for every sale to a VAT-registered customer. This does not apply to sales of exempt or zero-rated supplies unless they are included in a sale with other VATable items — in which case the invoice should

“Timing transactions in relation to the three-month VAT cycle can help your cashflow. Buy at the very end of the VAT period and you'll effectively get your VAT money back straight away. Send out goods and invoices just after the period ends and you can delay paying in the VAT for three months.”
Jon Hughes,
Newport & Gwent Enterprise

show separate totals.

5.2 The **invoice** must show a unique invoice number; tax point (see **7.3**) and, if different from the tax point, the date of issue; your name, address and VAT registration number; the customer's name and address; type of supply (eg sale, lease, rent); description of goods or services supplied; quantity; unit cost and VAT rate; discounts, if any; total cost excluding VAT; total VAT and total payable including VAT.

5.3 A less detailed invoice can be used for sales **below £250**, showing just the date; suppliers name, address and VAT number; a description of the supply; VAT rate and total VAT inclusive cost.

5.4 A **VAT invoice** is not necessary for sales direct to the public unless one is requested.

6 Reclaiming VAT on purchases

6.1 To **claim back** input VAT a VAT invoice must be held.

6.2 If input VAT is reclaimed on **fuel** used in cars, output VAT will be payable to HMRC under 'scale charges'. Depending on values a business may benefit by opting to forego input VAT and avoiding the scale charge.

6.3 Input VAT is not reclaimable on any **non-business purchase**. VAT cannot generally be claimed on company cars and is 50 per cent blocked on car leasing costs.

6.4 If a business makes only **exempt supplies**, it cannot register for VAT and cannot reclaim input VAT. If both exempt and taxable supplies are made, it should be entitled to VAT registration and can recover part of any input tax incurred. Special rules apply known as 'partial exemption'.

6.5 If a business is run from **home**, it should be possible to reclaim a proportion of VAT on certain expenditure. For example, VAT on business related phone calls.

6.6 Self-imposed VAT due on purchases of goods made from suppliers in other **EU countries** is declared as Acquisition Tax in box 2 of the VAT return. VAT is also due on services bought from non-UK suppliers. If recoverable under normal rules, such self-imposed VAT can be reclaimed as input VAT in box 4.

6.7 Purchases of goods made from suppliers

based **outside the EU** will generally attract an import VAT charge which can be reclaimed as input VAT provided correct documentation is held. Any import duty paid cannot be reclaimed.

7 VAT returns

7.1 In general, VAT is paid to HMRC on a **quarterly basis**, known as 'VAT period'. Administration can be made easier by asking HMRC for VAT periods that fit in with your accounting year.

- Once registered, you will receive a VAT return (VAT 100) each quarter.
- The completed VAT return, plus any VAT owed, must be received by HMRC by the end of the month following the VAT period.

7.2 Figures declared on the VAT returns should be taken directly from your **accounting records**.

- The records, which must be kept for **six years**, should show input VAT, output VAT and payments due to or from HMRC. Records must separate out standard-rated, reduced-rated, exempt and zero-rated supplies. They must also detail any overseas sales.
- If a simple book-keeping system is used to control the business, little additional work will be required to complete VAT returns (see **Simple book-keeping**). If a business makes both exempt and VATable supplies, more complex accounting is likely to be required.

7.3 Each sale has a **tax point**. This is the date by reference to which a business becomes liable to pay VAT. The tax point is usually the earliest of the date of supply, the date the invoice is issued or the date payment was received.

7.4 HMRC visit businesses to check their records. If VAT returns are found to be incorrect, **interest and penalties** may be charged.

- If, after sending in a return, a miscalculation of over £2,000 is discovered, a voluntary disclosure letter or VAT 652 should be sent to HMRC explaining the error, and enclosing a payment of the VAT due (or asking for a repayment of VAT overdeclared).
- Adjustments of less than £2,000 can be made on the next VAT return but records need to be retained to justify the entry.

► You can submit VAT returns online. You will need to purchase a digital security certificate — costing £25 to £50 plus VAT — to do so. For more information, visit www.hmrc.gov.uk.

► To find a VAT adviser, contact the Chartered Institute Indirect of Taxation on 01883 730658 or enquiries@theiit.org.uk.

“In theory it is easy to avoid VAT ever being a problem. However, to achieve that goal every business needs to consider how VAT should be applied each time it does something new. Unfortunately, when dealing with VAT, logic frequently leads to the wrong answer. This pitfall can be avoided by obtaining advice from a VAT specialist.”
Melanie Lord
AVS VAT

8 VAT accounting schemes

8.1 Apart from retailers, most small businesses use the **cash accounting system**, where the tax point is the date cash is received (from sales) or paid out (on purchases).

- A business can use cash accounting if annual sales are below £1.35 million.
- Once using cash accounting a business can remain in the scheme until turnover reaches £1.6 million.
- For up to six months after leaving the scheme, in most cases a business will be able to account for VAT on a cash basis on sales and purchases made while still in the scheme.
- Businesses using the scheme from the outset should reclaim VAT on pre-registration purchases on the first VAT return otherwise claims may be blocked.

8.2 With the annual accounting scheme, only one VAT return is filed each year. Nine **monthly interim VAT payments** are made based on an estimate of the total annual VAT bill with the balancing payment due when the annual return is submitted.

- Businesses with a turnover of up to £1.35 million may apply to use this system and can remain in the scheme until turnover reaches £1.6 million.
- Businesses under the threshold can use the scheme from the date of registration.

8.3 A **flat-rate scheme** is also available as an alternative to the normal transaction-based method of VAT accounting.

- VAT is declared as a fixed percentage of your VAT-inclusive turnover according to the category of business, ranging from five to 14.5 per cent (invoices issued still show the normal VAT rates).
- Individual transactions are ignored and broadly input VAT incurred on any purchases is not reclaimed which makes the scheme unsuitable for a business that incurs costs in an irregular pattern.
- The scheme can be used if VATable turnover is up to £150,000 and total VATable turnover (including exempt and zero-rated supplies) is up to £187,500. From April 2009, the annual turnover figure will not be counted as part of the qualification process.

Although administration is reduced, whichever method is used the net amount of VAT collected is intended to be broadly the same.

9 De-registration

9.1 A business should contact HMRC to **de-register** if it sells or liquidates the business.

- It can also de-register if sales are expected to be less than £65,000 in the next 12 months.
- De-registration involves completion of a final (brown) VAT return. Output VAT must be accounted for on goods in hand worth £1,000 or more at de-registration.

For more information, visit www.hmrc.gov.uk or call 0845 010 9000.

10 Out of the ordinary

10.1 In practice **VAT accounting** for the vast majority of businesses is quite straight forward. Problems and opportunities are most likely to arise when a business is doing something out of the ordinary. For example, when a business decides to:

- Buy, sell, let, sub-let or develop property.
- Agree a special discount or rebate with a customer or supplier that is documented manually or outside the normal business accounting system.
- Enter into a reciprocal arrangement with another business.

By stepping outside the standard accounting system there is real potential for error which can prove to be costly.

10.2 VAT works on the basis of being due unless there is a **specific relief** for that supply. Ensure that the VAT implications of any business arrangement have been correctly analysed. It is not always possible to change the VAT treatment after a transaction has been concluded.

10.3 There are areas where special rules apply. These include retailers; property; import and export; company cars; margin schemes applying to secondhand goods and tour operators; buying or selling a business; bad debts; free gifts and other business promotions.

Ask your VAT adviser how your business is affected by the VAT rules. It is always advisable to understand the VAT implications of a situation and what options are available before approaching HMRC. If doubts remain, a business may be able to safeguard its position by getting a decision in writing from HMRC.

Expert contributors

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Further help

There are other Start-up Briefing titles that can help you. These briefings are referred to in the text by name, such as **Simple book-keeping**.

Note

On 1 December 2008 the standard rate of VAT fell from 17.5 per cent to 15 per cent. The reduced rate lasts until 31 December 2009. VAT will return to 17.5 per cent in January 2010.

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