

VAT



VAT (Value Added Tax) has the potential to impact on every business transaction. Most businesses will have no choice but to register for VAT once their sales reach £73,000 a year. 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 purchases and sales. It is not a tax on profits. VAT is charged at 20 per cent on most supplies, though some are taxed at either 0 or 5 per cent. There are also 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 can reclaim is handed over to HM Revenue & Customs (HMRC), usually quarterly.

For example, a VAT-registered shop selling a vase for £30 will add £6.00 (20 per cent) VAT, making the total price £36. However, the shop can reclaim any VAT it paid to its supplier. This applies right through the entire chain of earlier

transactions. For example:

Company	Product	Selling Price
Clay Co.	clay	£1 + £0.20 VAT
Pottery Co.	vase	£10 + £2.00 VAT
Shop Co.	vase	£30 + £6.00 VAT

The net VAT paid to HMRC by each company is output VAT less input VAT as follows:

Company		
Clay Co.	£0.20 less £0.00 =	£0.20
Pottery Co.	£2.00 less £0.20 =	£1.80
Shop Co.	£6.00 less £1.80 =	£4.20
Total paid to HMRC =		£6.00

2 What is VAT charged on?

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

2.1 A large proportion of sales of goods and services are standard-rated (20 per cent). There are exceptions that are either exempt (see **2.2**), zero-rated (see **2.3**), or charged at 5 per cent, known as reduced-rated (see **2.4**). If you make supplies that are not exempt, you can or may have to register for VAT (see **3**).

- Once registered, a business charges VAT to their customers.
- Registered businesses can normally claim back VAT paid on business purchases.

2.2 Exempt supplies include finance; insurance; land and property (unless you opt for VAT to apply) 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, it can normally only reclaim the VAT on purchases relating to VATable sales.

2.3 Zero-rated supplies include most food, children's clothing, 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.

Exports to customers outside the EU and to VAT-registered customers within the EU can also normally be zero-rated. Special rules and procedures apply.

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

Even though VAT at 5 per cent is charged on reduced-rated 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 20 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 £73,000.

- Exceptionally, if a business expects sales to fall back below this level, it can ask HMRC to allow it to remain unregistered.
- A business must also register if sales during the next 30 days alone are expected to exceed £73,000 — eg if a new company is set up with orders already in place totalling £73,000.
- Penalties for late notification can be as much as 15 per cent of the VAT due in the first return, and you still have to pay HMRC the VAT you should have been charging customers.

3.2 A business can **opt** to register for VAT if sales are below the registration threshold in order to reclaim VAT paid on business purchases. It may be worth registering if:

- Your sales 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/vat.

4.2 While the application is processed, your 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 (ie paying HMRC one-sixth of the price charged).

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

- A less detailed invoice can be used for retail 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.

6 Reclaiming VAT on purchases

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

6.2 If a **car** is used exclusively for business purposes, you can reclaim input VAT on fuel in the normal way. Otherwise, you can opt either to reclaim VAT only on fuel used for business purposes, or to reclaim all the VAT and pay a 'fuel scale charge'.

6.3 Input VAT is not reclaimable on any **non-business purchase**. VAT cannot generally be claimed on company car purchases and is 50 per cent blocked on car leasing costs, unless the car is exclusively for business use.

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, the business is 'partially-exempt', can register for VAT and can recover part of the input tax incurred. Special rules apply.

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 Purchases from suppliers based **outside the EU** generally attract an import VAT charge at the same rate as if bought in the UK. This can be reclaimed as input VAT provided correct documentation is held. Any import duty paid cannot be reclaimed.

6.7 Purchases from suppliers in other EU countries can usually be made without paying VAT when the goods enter the UK. Instead, the VAT due is declared as 'acquisition tax' on your VAT return — but also normally reclaimed as input tax on the same return.

7 VAT returns

7.1 In general, VAT is paid to HMRC on the basis of quarterly VAT periods. Administration can be made easier by asking HMRC for VAT periods that fit in with your accounting year.

- From April 2012, all VAT returns must be filed online and VAT must be paid electronically.
- Online VAT returns and payments are due one month and seven days after the end of 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 imports or exports.
- If a simple book-keeping system is used to control the business, little additional work will be required to complete VAT returns. If a business makes both exempt and VATable supplies, more complex accounting is likely to be required.

7.3 Each sale or purchase has a tax point — the date used for VAT accounting.

- The basic tax point is the date of supply.
- If a VAT invoice is issued or payment is received in advance, the tax point is whichever is earlier.
- The tax point is delayed to the invoice date if a VAT invoice is issued within 14 days of the date of supply.

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 £10,000 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 £10,000 can be made on the next VAT return, but records need to be retained to justify the entry.

8 VAT accounting schemes

8.1 Apart from retailers, most small businesses use the **cash accounting system**, where you account for VAT on the basis of the date cash is received (from sales) or paid out (on purchases) rather than the tax point.

- A business can use cash accounting if estimated VATable turnover for the next tax year is no more than £1.35 million.
- Once using cash accounting a business can remain in the scheme until VATable turnover reaches £1.6 million.
- 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 or three quarterly **interim VAT payments** are made based on an estimate of the total annual VAT bill. A balancing payment is due when the annual return is submitted.

- Businesses with an estimated VATable 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.

- Individual transactions are ignored and input VAT cannot normally be reclaimed.
- Instead, VAT is paid to HMRC as a fixed percentage of your VAT-inclusive turnover according to the category of business, ranging from 4 to 14.5 per cent (invoices issued still show the normal VAT rates). There is a one per cent reduction for businesses in their first year of VAT registration.
- The scheme can be used if estimated VATable turnover is up to £150,000. Once in the scheme, you can stay until total business income exceeds £230,000.

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 You should normally contact HMRC to **deregister** from VAT if you sell or liquidate your business.

- You can also apply to deregister if VATable sales are expected to be less than £71,000 in the next 12 months.
- De-registration involves completion of a final VAT return. Output VAT must be accounted for if the VAT due on assets and stock would be more than £1,000.

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; and supplies to employees or for personal use.

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