

RI Quick guide to value added tax

What is taxed

Value added tax (VAT) is a tax on **supplies**.

Most supplies are sales, but it should be remembered that there are some VAT supplies that are not sales, such as:

- gifts (above an allowed level)
- supplies to yourself (such as taking stock for personal use)
- barter transactions (which are treated as two supplies)

Conversely, some sales are not treated as supplies, such as:

- sale of a business as a going concern
- supply of a statutory service (such as planning permission).

Only a trader that has registered for VAT may charge it.

VAT is therefore only charged when all these conditions are met:

- the supplier is VAT-registered
- a supply is made
- the supply is in the course or furtherance of a business.

Who pays?

Everytime a registered trader makes a supply, VAT is added at the appropriate rate.

If the supply is made to another registered trader, that trader will usually claim back this VAT. This is called **input tax**. The claim is usually made by deducting this VAT from the sum that the trader charges to his or her customer.

Suppose A creates £100 worth of timber which he sells to B. B makes it into furniture and sells it to C for £150. C sells it to customer D for £200. All these figures are before 20% VAT is added.

The sequence is:

Seller	Price	Output tax	Price + VAT	Input tax	Net tax
A	£100	£20	£120	-	£20
B	£150	£30	£180	£20	£10
C	£200	£40	£240	£30	£10

So A sells the timber to B for £120. That is the amount that B owes to A. It is the amount that appears in A's sales ledger and B's purchase ledger. It is the amount for which A may sue B if he

does not pay.

This £20 is the **output tax**. There is no input tax, so the whole £20 is paid to HMRC.

B sells it to C for £180 of which £30 is output tax. B has already paid £20 VAT to A. This is **input tax**. B calculates output tax – input tax: £30 - £20 = £10, and pays £10 to HMRC.

C sells it to D for £240 of which £40 is output tax. C has £30 input tax. So C pays £10 to HMRC.

B created **value added** of £50, and pays 20% tax on this value added, hence the name “value added tax”. This is £10, as shown above. C has done the same.

So in this example, £40 VAT has been added to the £200 sale price. This has been collected in three stages: £20 from A, £10 from B, and £10 from C.

VAT is therefore ultimately paid by the **final consumer** as the previous purchasers claim back the VAT they have paid.

VAT has been popular with governments as it is a difficult tax to evade. In the example above, B and C will both want to claim back their input tax which imposes an effective check on A and B to pay it as output tax.

VAT also means that the government receives its revenue in instalments. It does not have to wait until the final sale, as happened under the previous system of purchase tax.

Value subtracted

This system works even if value is **subtracted**. Suppose in our example that C is also a registered trader. He sells the furniture to D for £120. In other words, he makes a loss of £80.

The sequence now is:

Seller	Price	Output tax	Price + VAT	Input tax	Net tax
A	£100	£20	£120	-	£20
B	£150	£30	£180	£20	£10
C	£200	£40	£240	£30	£10
D	£120	£24	£144	£40	(£16)

In this case, D claims back £40 input tax against £24 output tax and so gets a rebate of £16.

If D has other VAT to pay for that quarter, the rebate of £16 is netted off. Otherwise HMRC will send a cheque or credit transfer for £16. Unless HMRC has reason to suspect that something is wrong, this payment is usually made promptly.

VAT returns

The example considers the position of a single item. If, unusually, that was the only transaction that A, B and C made, the tables above would represent their VAT position.

In practice, traders do not identify items specifically in this way. They simply add up all their output tax for a period, add up all their input tax for the same period, subtract the latter from the former, and either pay the difference or claim it back from HMRC.

In general, no distinction is made between capital and revenue items, as there is for income tax and corporation tax. A company that buys a new lathe or photocopier can claim back all the input tax on it.

There are a few items where a business may not claim back input tax, these are:

- items for personal use rather than business use,
- cars (with a few limited exceptions),
- business entertainment.

Tax point

VAT is charged at the **tax point**.

This is the date the supply is made, except that:

- the tax point is brought forward if payment is made in full before supply, or
- the tax point is moved back to the invoice date, if the invoice is sent within 14 days of the supply (or a longer period agreed with HMRC).

VAT periods

The VAT period is usually three months. This gives three sets of **stagger periods**:

- ending 31 January, 30 April, 31 July, 31 October
- ending 28/29 February, 31 May, 31 August, 30 November
- ending 31 March, 30 June, 30 September, 31 December.

The trader can choose which stagger period to use. Most traders choose the one that coincides with its year end.

A trader may choose to make monthly

Who is registered for VAT?

There are two types of registration: compulsory and voluntary.

Compulsory registration applies when either:

- you have reached the registration threshold in the last 12 months; or
- you expect to reach the threshold in the next 30 days.

The registration threshold changes each year on 1 April. For the year from 1 April 2011, it is £73,000. There are tough penalties for not registering when you should have done, so you should keep a track of turnover.

Note that the threshold applies to *turnover*, not to profit.

Voluntary registration is when someone *chooses* to register even though they do not have to.

Someone is likely to do this:

- when all their customers are VAT-registered
- when most of their supplies are zero-rated, or
- if the trader wants to hide that his turnover is low.

Note that it is the person who is registered, not the business. So if an individual registers for VAT as an accountant, but also compiles crossword puzzles, he must charge VAT on both business supplies (as indeed I do). If someone has a separate business where they do not want to charge VAT, they may be able to avoid this by forming a partnership.

The registration can be for an individual, a partnership, a company or for a group of companies, or almost any other type of business entity.

When a person is registered, they are given a VAT number which is nine digits long. It is usually grouped in the form 123 4567 89.

When a business registers, it may claim back VAT on any goods purchased in the previous three years for the business and still held by it. It may claim VAT on services provided in the previous six months.

A business may deregister for VAT if its annual turnover falls below a limit. This is currently £71,000.

What is the rate of VAT?

From 4 January 2011, the standard rate of VAT is 20%.

In effect, every supply comes within the scope of one of five treatments for VAT:

- standard-rated at 20%
- reduced-rated at 5%
- zero-rated at 0%
- exempt
- outside the scope of VAT.

The first three of these constitute taxable supplies. A registered trader may claim back input tax that relates to such supplies.

All taxable supplies are subject to the standard rate of 20% unless they are specifically listed in a schedule for one of the next three categories.

The reduced rate of 5% applies to domestic fuel (electricity, gas etc) to private homes and charity buildings. It also applies to some environmental products and to a few other items.

Zero-rating applies to food, children's clothing, international transport, water to domestic premises, a few charitable items, books and magazines, new construction and some other items. It should be noted that VAT on land and buildings is a particularly complex area.

Exemption applies to banking, gambling, education, many financial services and other items, mostly of services.

A landlord can choose whether to standard-rate or exempt his rents. This is known as the **option to tax**. In general, landlords tend to want to use the option (as it means they can claim back input tax), whereas tenants do not. This is a matter to consider in rent negotiations.

In each case, you should be careful to check the exact scope of what is included in each item as this is not always obvious or an item may be subject to specific conditions. There is an article *Test Yourself: Rates of VAT* which illustrates some of the issues.

The final category covers supplies and payments that are completely ignored for VAT purposes. This includes wages, dividends, statutory charges and transfers of businesses as going concerns.

VAT invoice

The general requirement is that every supply must be supported by an invoice, issued by the supplier and showing his or her VAT number, among other information. The invoices must be numbered consecutively in one or more series.

There are less strict rules for invoices below £250, and significant relaxation for those below £25.

Partial exemption

Partial exemption is why dentists sell toothbrushes.

If a business makes taxable supplies, it can claim back all its input tax.

If a business makes exempt supplies, it can claim back none of its input tax.

So what happens if it makes both taxable and exempt supplies?

It can claim back some of its input tax.

A good example is an optician who may make exempt supplies of eye tests, and standard-rated supplies of spectacles and contact lenses.

The answer is that claim back all the input tax that is directly attributable to taxable supplies, such as the purchase of spectacle frames and lenses.

You claim back none of the input tax that is directly attributable to exempt supplies, such as eye-testing equipment.

For other items, such as overheads of maintaining premises, the input tax is split in some equitable ratio between the taxable and exempt supplies. So the optician will claim all the input tax of items directly attributable to supplying glasses etc, plus a percentage of overheads.

And dentists? There is a de minimis level of £625 a month (unchanged from 1994). If your exempt supplies are below this figure, you may claim back all your input tax and not bother with partial exemption.

So dentists started selling toothbrushes which are standard-rated. They may only make a few pounds profit, but it meant that they went from being wholly exempt to partially exempt. And if their exempt input tax was below the limit, suddenly they could claim back all their input tax.

To stop this, in 1994 it was made a further requirement that the exempt input tax must not exceed 50% of all purchases. By then dentists had got used to selling toothbrushes.

Bad debts

Suppose a supplier issues an invoice for £1,000 plus £200 VAT, and the customer fails to pay. Not only has the supplier lost £1,000 income, but he has also lost the £200 that must still be paid to HMRC. VAT is a tax on supplies, and the supply has been made. Indeed for five years until 1978, it was not possible to claim any relief at all.

The present position is that the trader may claim bad debt relief for any debt that is at least six months old, where the business reasonably believes it will not be paid, and where it has written the debt off in its books.

The business may still pursue steps to recover the debt. If successful, the VAT again becomes payable.

Special schemes

A business with a turnover of up to £150,000 a year may use the **flat-rate scheme**. VAT is charged in the normal way, but the business only pays a flat rate of VAT-inclusive turnover multiplied by a percentage selected from a table. This simplifies determining the VAT payable, and can result in having to pay less tax. There is a separate flat rate scheme for farmers.

A shop may find it impractical to issue an invoice for every packet of sweets or box of pins sold. They may use a **retail scheme** which allows them to account for VAT on their overall takings.

For **second-hand goods**, it is possible to account for VAT on the profit margin, rather than on the whole price. **Tour operators** may similarly account for VAT on their profit margins.

Cash accounting allows a business to determine its output tax and input tax according to when it is paid and when it pays its bills, rather than the usual tax point. Cash accounting may be used by

a business with a turnover of up to £1.35 million. This simplifies the bookkeeping and means that the business gets bad debt relief automatically.

Import and export

For VAT purposes, an import or export is between the UK and a country outside the European Union. A supply between the UK and another EU member state is an **acquisition** or **despatch**.

Exports are zero-rated. Imports are subject to VAT at the appropriate rate at import. This follows the same rules and procedures as for Customs duty.

Supplies of goods to another business in another EU state may be zero-rated, provided the supplier has the VAT number of the customer and shows that on the invoice. The customer then accounts for VAT in his or her home state. If a VAT number cannot be provided or where the supply is to a non-business customer, the supply must be taxed as if it were a UK supply.

For a supply of services to another EU state, the general rule is that from 1 January 2010, the supply is treated as being made in the country of the *customer* and not the supplier.

Goods are only exported, imported, acquired or despatched when they have physically crossed a national frontier. Evidence must be kept that they have done so.

This is a much simplified summary of an area where specialist advice may be needed.

Other provisions

Where a person takes goods for personal use, there is a **self-supply**. VAT must be accounted for on the goods.

It is possible for a customer to raise an invoice on behalf of the supplier. A customer *must* raise an invoice for supplies of mobile phones and computer chips.

Under the **capital goods scheme**, a VAT charge can arise if a building acquired for business purposes changes to non-business use within ten years, or if computer equipment above a high threshold changes to no-business use within five years.

Payment

VAT is paid or refunded for every VAT period. From 1 April 2010, most VAT returns must be filed on-line. From 1 April 2012, all VAT returns must be.

For such returns, the deadline for payment is the last working day within one month and seven days after the end of the VAT period. So for a period ending on 31 July 2011, the VAT return and any payment should be with HMRC by 5 August 2012. (The 6th and 7th are a weekend.)

A business liable to pay more than £2 million a year in VAT must make monthly payments on account. For the two out of three months when a return is not due, the payment is 1/24 of the annual amount.

There are penalties for non-compliance or late compliance. These can be very high.

The law

The main law is contained in Value Added Tax Act 1994, and the VAT Regulations 1995.

As VAT is a European law, it is subject to EU directives which are directly applicable in the UK. There have been several instances where UK law has been found not to comply with EU law. The main VAT directive is 2006/112.

There are also many statutory instruments, statements of practice and other guidance on VAT.

There are more than 100 VAT notices dealing with particular aspects of VAT or with particular trades. These notices are available free from HMRC or can be accessed and downloaded from HMRC's website. Some of these notices have statutory authority.