Guide from

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VAT

While VAT creates additional paperwork, it can also reduce your costs by allowing you to reclaim the VAT you pay on your business purchases. Many businesses have no choice but to register for VAT once their sales reach £85,000 a year.

You need to understand whether you can or should register for VAT, and what you must do as a VAT-registered business. You may be able to simplify your VAT requirements by using an appropriate VAT accounting scheme.

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 currently charged at 20% on most supplies, though some are taxed at either 0 or 5%, or exempt (see 'What is VAT charged on?').

All businesses pay VAT on their VATable purchases

- Any VAT you pay is called 'input VAT'.
- VAT-registered businesses can usually reclaim the input VAT they pay from HM Revenue & Customs.

VAT-registered businesses charge VAT on their VATable sales

- Businesses that make significant VATable sales are required to register (see 'Should you register?').
- The VAT you charge is called 'output VAT'.

VAT-registered businesses are collecting VAT on behalf of HMRC

- The difference between the output VAT you charge and the input VAT you can reclaim is handed over to HMRC, usually quarterly.
- For example, a VAT-registered shop selling a £30 vase will add £6 (20%) VAT, making the total price £36. The shop might have bought the vase from its VAT-registered supplier for £12 (ie £10 plus £2 VAT). So the shop owes HMRC £4 (ie £6 output VAT less £2 input VAT).

2. What is VAT charged on?

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

Standard-rated supplies

- A large proportion of goods and services are standard-rated.
- VAT is charged at 20%.

Reduced-rated supplies

- These include domestic fuel, residential conversions and some refurbishments, installing energy-saving materials in residential accommodation, and children's car seats.
- VAT is charged at 5%.
- Even though VAT is charged at 5%, all associated VAT paid on business purchases, regardless of the rate paid, should be reclaimable.

Zero-rated supplies

- These include most food, children's clothing, construction of new houses, books, printed matter and prescription drugs.
- VAT is charged at 0%.
- 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.
- Even though no VAT is charged on zero-rated supplies, a business can still register for VAT and reclaim the input VAT paid on associated purchases.

Exempt supplies

- These include finance, insurance and many property transactions.
- VAT does not apply to exempt supplies. Unlike standard-rated, reduced-rated and zero-rated supplies, they are not VATable. Businesses that only sell exempt supplies cannot register for VAT.
- No VAT is charged on exempt supplies, and input VAT paid on associated business purchases cannot be reclaimed.

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% VAT to its prices, it may lose customers.

A business must register if VATable sales reach the registration threshold

- You must notify HMRC within 30 days of the end of the month in which VATable sales in the last 12 months exceeded £85,000.
- Exceptionally, if you expect sales to fall back below this level, you can ask HMRC to allow you to remain unregistered.
- You must also register if sales during the next 30 days alone are expected to exceed £85,000. For example, if a new company is set up with orders already in place totalling £85,000.
- Penalties for late notification can be as much as 15% of the VAT due in the first return, and you still have to pay HMRC the VAT you should have been charging customers.

You can opt to register for VAT even if sales are below the registration threshold

Doing this can allow you to reclaim the 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. Registering will allow you to reclaim VAT on your pre-trading expenses. You will need to provide evidence of an intention to make VATable supplies.

Registered businesses can deregister

- You should normally contact HMRC to deregister from VAT if you sell or liquidate your business.
- You can apply to deregister if VATable sales are expected to be less than £83,000 in the next 12 months.
- Deregistration 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.

4. Charging customers VAT

Apply to HMRC as soon as VAT registration is required

- You are liable to pay HMRC the output VAT due on all supplies you make from the date you are required to register, rather than when registration is complete.

Adjust your pricing at the same time

- While the application is processed, your pricing should reflect the VAT liability less any input tax that can be reclaimed.
- Even if you decide to keep your prices unchanged to avoid losing customers, you will still have to pay VAT to HMRC, calculated by treating the sales value as including VAT. For standard-rated supplies, output VAT will be one sixth of the total price charged.
- You must still only show the gross amount on your invoices. VAT cannot be shown as a separate item until a VAT number is allocated. Tell customers that proper VAT invoices will be issued once you are registered.

5. VAT invoices

Once registered for VAT, a business must issue VAT invoices

- You do this 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. If so, the invoice should show separate totals.
- You must retain copies of VAT invoices for your files.

The invoice must include specified details

These are:

- a unique invoice number;
- the tax point (see ‘VAT returns’) 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;
- total payable including VAT.

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;
- total VAT inclusive cost.

6. Reclaiming VAT on purchases

To claim back input VAT a VAT invoice must be held

Special rules apply to fuel for cars

- 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'.

Input VAT is not reclaimable on any non-business purchase

- VAT cannot generally be claimed on company car purchases and is 50% blocked on car leasing costs, unless the car is exclusively for business use.

Special rules apply if a business makes exempt supplies

- If a business makes only exempt supplies, it cannot register for VAT and cannot reclaim input VAT.
- If both exempt and VATable supplies are made, the business is 'partially-exempt'. It can register for VAT and recover part of the input tax incurred.

A business run from home should be able to reclaim a proportion of VAT on some costs

- For example, VAT on business-related phone calls.

The VAT treatment of imports depends on the supplier's country

- 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.
- 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

VAT is generally 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.
- 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.

Figures declared on 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.

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.

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

Various accounting schemes are available to reduce the amount of administration for smaller businesses. Whichever scheme is used, the net amount of VAT collected is intended to be broadly the same.

Apart from retailers, most small businesses use the cash accounting system

- 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.
- This avoids the problems that can otherwise arise with late payment of credit sales or bad debts.
- 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.

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 confirmation 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.
- Any business under the threshold can use the scheme from the date of VAT registration.

A flat rate scheme is available for small businesses

- 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%. There is a 1% reduction for businesses in their first year of VAT registration.
- From 1 April 2017 a new category ,"limited cost trader", applies with a flat rate of 16.5% if the cost of direct goods is less than either 2% of VAT inclusive turnover or £1000 pa. This will add to the VAT bill for those who are now in the new category so it is vital to only include "relevant goods" in deciding eligibility to stay on a lower rate.
- VAT invoices are still issued showing the normal VAT rates.
- The scheme can be used if estimated VATable turnover in the next 12 months is up to £150,000. Once in the scheme, you can stay until total business income exceeds £230,000.

9. Out of the ordinary

Be careful if your business is doing something out of the ordinary

Stepping outside your normal accounting system creates the potential for costly errors. For example, if you decide 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.

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.

There are areas where special rules apply

Take advice from your accountant if necessary. Areas covered by special rules include:

- retailers;
- property;
- import and export;
- company cars;
- margin schemes applying to second hand goods and tour operators
- buying or selling a business;
- bad debts;
- free gifts and other business promotions;
- supplies to employees or for personal use.

Signpost

- Find detailed VAT guidance from HMRC.
- Register for VAT online with HMRC.
- Make a VAT enquiry to HMRC (0300 200 3700).
- Find an ACCA accountancy firm.

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