

# Ray Coop's Beginner's Guide To VAT



VAT can be a very complex area. The rules are constantly changing and getting it wrong can be a very costly mistake.

In this article we set out some of the basic things that you should be aware of if you are either VAT registered, or if you believe that you may need to register for VAT in the future.

This information is correct at July 2007. Most major changes to VAT, such as registration limits etc, take place after the Budget each March, but it is always worth checking with us to ensure that the information below is still the most up to date.

This guide covers the following topics:

1. An Introduction to VAT
2. VAT Annual Accounting Scheme
3. VAT Cash Accounting
4. VAT Flat Rate Scheme
5. VAT Bad Debt Relief

# An Introduction to VAT

VAT registered businesses act as unpaid tax collectors and are required to account both promptly and accurately for all the tax revenue collected by them.

The VAT system is policed by HMRC with heavy penalties for breaches of the legislation. Ignorance is not an acceptable excuse for not complying with the rules.

We highlight below some of the areas that you need to consider.

It is however important for you to seek specific professional advice appropriate to your circumstances.

## What is VAT?

### *Scope*

A transaction is within the scope of VAT if:

- § there is a supply of goods or services
- § made in the UK
- § by a taxable person
- § in the course or furtherance of business.

### *Inputs and outputs*

Businesses charge VAT on their sales. This is known as output VAT and the sales are referred to as outputs. Similarly VAT is charged on most goods and services purchased by the business. This is known as input VAT.

The output VAT is being collected from the customer by the business on behalf of HMRC and must be regularly paid over to them.

However the input VAT suffered on the goods and services purchased can be deducted from the amount of output tax owed. Please note that certain categories of input tax can never be reclaimed, such as that in respect of business entertainment and for most business cars.

## Points You Need to Consider

### *Supplies*

Taxable supplies are mainly either standard rated (17.5%) or zero rated (0%).

There is in addition a reduced rate of 5% which applies to a small number of certain specific taxable supplies.

There are certain supplies that are not taxable and these are known as exempt supplies.

There is an important distinction between exempt and zero rated supplies.

- § If your business is making only exempt supplies you cannot register for VAT and cannot therefore recover any input tax.
- § If your business is making zero rated supplies you should register for VAT as your supplies are taxable (but at 0%) and recovery of input tax is allowed.

### *Registration - is it necessary?*

You are required to register for VAT if the value of your taxable supplies exceeds a set annual figure (currently £64,000).

If you are making supplies below the limit you can apply for voluntary registration. This would allow you to reclaim input VAT, which could result in a repayment of VAT if your business was principally making zero rated supplies.

If you have not yet started to make taxable supplies but intend to do so, you can apply for registration. In this way input tax on start up expenses can be recovered.

#### *Taxable person*

A taxable person is anyone who makes or intends to make taxable supplies and is required to be registered. For the purpose of VAT registration a person includes:

- § individuals
- § partnerships
- § companies, clubs and associations
- § charities.

If any individual carries on two or more businesses all the supplies made in those businesses will be added together in determining whether or not the individual is required to register for VAT.

#### *Administration*

Once registered you must make a quarterly return to HMRC showing amounts of output tax to be accounted for and of deductible input tax together with other statistical information.

This must be completed within one month of the end of the period it covers (except for those on the annual accounting scheme who have two months - see below).

Businesses who make zero rated supplies and who receive repayments of VAT may find it beneficial to submit monthly returns.

Businesses with expected annual taxable supplies not exceeding £1,350,000 may apply to join the annual accounting scheme whereby they will make monthly or quarterly payments of VAT but will only have to complete one VAT return at the end of the year.

#### *Record keeping*

It is important that a VAT registered business maintains complete and up to date records. This includes details of all supplies, purchases and expenses.

In addition a VAT account should be maintained. This is a summary of output tax payable and input tax recoverable by the business. These records should be kept for six years.

#### *Inspection of records*

The maintenance of records and calculation of the liability is the responsibility of the registered person but HMRC will need to be able to check that the correct amount of VAT is being paid over. From time to time therefore a VAT officer will come and inspect the business records. This is known as a control visit.

The VAT officer will want to ensure that VAT is applied correctly and that the returns and other VAT records are properly written up.

However, you should not assume that in the absence of any errors being discovered, your business has been given a clean bill of health.

#### *Offences and penalties*

HMRC have wide powers to penalise businesses who ignore or incorrectly apply the VAT regulations. Penalties can be levied in respect of the following:

- § late returns/payments
- § late registration
- § errors in returns.

#### *Cash accounting scheme*

If your annual turnover does not exceed £1,350,000 you can account for VAT on the basis of the cash you pay and receive rather than on the basis of invoices.

### *Retail schemes*

There are special schemes for retailers as it is impractical for most retailers to maintain all the records required of a registered trader.

### *Flat Rate scheme*

This is a scheme allowing businesses with taxable turnover not exceeding £150,000 and total turnover not exceeding £187,500 to pay VAT as a percentage of their total turnover. Therefore no specific claims to recover input tax need to be made. The aim of the scheme is to simplify the way small businesses account for VAT, but for some businesses it can also result in a reduction in the amount of VAT that is payable.

## How We Can help

Ensuring that you comply with all the VAT regulations is essential. We can assist you in a number of ways including the following:

- § tailoring your accounting systems to bring together the VAT information accurately and quickly
- § ensuring that your business is VAT efficient and that adequate finance is available to meet your VAT liability on time
- § providing assistance with the completion of VAT returns
- § negotiating with HMRC if disagreements arise and in reaching settlements
- § advising as to whether any of the available schemes may be appropriate for you.

If you would like to discuss any of the points mentioned please contact us.

# VAT Annual Accounting Scheme

HMRC have introduced a number of VAT schemes over the years designed to reduce the administrative burden on small businesses. One such scheme is the annual accounting scheme.

## What is the Annual Accounting Scheme?

The annual accounting scheme helps small businesses by allowing them to submit only one VAT return annually rather than the normal four. During the year they pay instalments based on an estimated liability for the year with a balancing payment due with the return. The scheme is intended to help with budgeting and cash flow and reduce paperwork.

## Joining the Scheme

A business can apply to join the scheme if it expects that taxable supplies in the next 12 months will not exceed £1,350,000.

Businesses must be up to date with their VAT returns and cannot register as a group of companies.

Application to join the scheme must be made on form 600(AA) which can be found at the back of VAT Notice 732. HMRC will advise the business in writing if the application is accepted.

## Paying the VAT

Businesses that have been registered for 12 months or more will pay their VAT in nine monthly instalments of 10% of the previous year's liability. The instalments are payable at the end of months 4-12 of the annual accounting period.

Alternatively such businesses may choose to pay their VAT in three quarterly instalments of 25% of the previous year's liability falling due at the end of months 4, 7 and 10.

The balance of VAT for the year is then due together with the VAT return two months after the end of the annual accounting period.

Businesses that have not been registered for at least 12 months may still join the scheme but each instalment – whether monthly or quarterly – is based on an estimate of the VAT liability.

In all cases HMRC will advise the amount of the instalments to be paid.

The annual accounting period will usually begin at the start of the quarter in which the application is made. If the application is made late in a quarter it may begin at the start of the next quarter.

All businesses are able to apply to HMRC to change the level of the instalments if business has increased or decreased significantly.

## Leaving the Scheme

Any business can leave the scheme voluntarily at any time by writing to HMRC.

A business can no longer be in the scheme once its annual taxable turnover exceeds £1,600,000.

## Advantages of the Scheme

- § A reduction in the number of VAT returns needed each year from four to one.
- § Because the liability to be paid each month is known and certain, cash flow can be managed more easily.
- § There is an extra month to complete the VAT return and pay any outstanding tax.
- § It should help to simplify calculations where the business uses a retail scheme or is partially exempt.

## Potential Disadvantages

Interim payments may be higher than needed because they are based on the previous year. However, they can be adjusted if the difference is significant.

A business is obliged to notify HMRC if the VAT liability is likely to be significantly higher or lower than in the previous year.

## How We Can Help

We can help you to plan your VAT administration and consider with you whether the annual accounting scheme would be beneficial for your business.

# VAT - Cash Accounting

Cash accounting enables a business to account for and pay VAT on the basis of cash received and paid rather than on the basis of invoices issued and received.

## Advantages and Disadvantages of the Scheme

The advantages of the scheme are as follows.

- § Output tax is not due until the business receives payment of its sales invoices. If customers pay promptly, the advantage will be limited. Even so, the gain may be material.
- § There is automatic bad debt relief because, if no payment is received, no output tax is due.
- § Most businesses find it easier to think in terms of cash flows in and out of their business than invoiced amounts.

The potential disadvantages are as follows.

- § There is no input tax recovery until payment of suppliers' invoices.
- § The scheme will not be beneficial for net repayment businesses - for example, a business just starting up, which has substantial initial expenditure on equipment, stocks etc so that input tax exceeds the output tax, should delay starting to use the scheme. That way, it recovers the initial input tax on the basis of input invoices as opposed to payments.

## Key Rules

From 1 April 2007 a business can join the scheme if it has reasonable grounds for believing that taxable turnover in the next 12 months will not exceed £1,350,000 provided that it:

- § is up to date with VAT returns
- § has paid over all VAT due or agreed a basis for settling any outstanding amount in instalments
- § has not in the previous year been convicted of any VAT offences.

All standard and zero-rated supplies count towards the £1,350,000 except anticipated sales of capital assets previously used within the business. Exempt supplies are excluded.

When a business joins the scheme, it must be careful not to account again for VAT on any amounts already dealt with previously on the basis of invoices issued and received.

A business can start using the scheme without informing HMRC. It does not cover:

- § goods bought or sold under lease or hire-purchase agreements
- § goods bought or sold under credit sale or conditional sale agreements
- § supplies invoiced where full payment is not due within six months
- § supplies invoiced in advance of delivering the goods or performing the services.

Once annual turnover reaches £1,600,000 the business must leave the scheme immediately.

On leaving the scheme, VAT is due on all supplies on which it has not already been accounted for. However outstanding VAT can be accounted for on a cash basis for a further six months after leaving the scheme.

## Accounting for VAT

Output tax must be accounted for when payment is received.

Cheque. Treated as received on the date the cheque is received or if later the date on the cheque. If the cheque is not honoured an adjustment can be made.

Credit/debit card. Treated as received/paid on the date of the sales voucher.

Standing order/direct debits. Treated as received/paid on the day the bank account is credited.

Part payments. VAT must be accounted for on all receipts/payments even where they are part payments. Part payments are allocated to invoices in date order (earliest first) and any part payment of an invoice allocated to VAT by making a fair and reasonable apportionment.

## Records

Under the cash accounting scheme the prime record will be a cash book summarising all payments made and received with a separate column for VAT. The payments need to be clearly cross-referenced to the appropriate purchase/sales invoice.

In addition the normal requirements regarding copies of VAT invoices and evidence of input tax apply.

## How We Can Help

We can advise on whether the cash accounting scheme would be suitable for your business.

# VAT Flat Rate Scheme

The flat rate scheme for small businesses was introduced to reduce the administrative burden imposed when operating VAT.

Under the scheme a set percentage is applied to the turnover of the business as a one-off calculation instead of having to identify and record the VAT on each sale and purchase you make.

## Who Can Join?

The scheme is optional and open to businesses whose VAT exclusive:

- § annual taxable turnover does not exceed £150,000 and
- § total turnover (including the value of exempt (eg rents) and non-taxable income) does not exceed £187,500.

Turnover for these purposes does not include proceeds from the sale of capital assets.

The turnover test applies to your anticipated turnover in the following 12 months. Your turnover may be calculated in any reasonable way but would usually be based on the previous 12 months if you have been registered for VAT for at least a year.

To join the scheme you can apply by post, email or phone and if you are not already registered for VAT you must submit a form VAT1 at the same time.

You may not operate the scheme until you have received notification that your application has been accepted and HMRC will inform you of the date of commencement.

## When is the Scheme Not Available?

The flat rate scheme cannot be used if you:

- § use the second hand margin scheme or auctioneers' scheme
- § use the tour operators' margin scheme
- § are required to operate the capital goods scheme for certain items.

In addition the scheme cannot be used if, within the previous 12 months, you have:

- § ceased to operate the flat rate scheme
- § been convicted of an offence connected with VAT
- § been assessed with a penalty for conduct involving dishonesty.

The scheme will clearly be inappropriate if you regularly receive VAT repayments.

## How the Scheme Operates

VAT due is calculated by applying a predetermined flat rate percentage to the business turnover of the VAT period. This will include any exempt supplies and it will therefore not generally be beneficial to join the scheme where there are significant exempt supplies.

The percentage rates are determined according to the trade sector of your business and range from 2% to 13.5%. The table in the appendix to this factsheet summarises the percentages. In addition there is a further 1% reduction off the normal rates for businesses in their first year of VAT registration.

If your business falls into more than one sector it is the main business activity as measured by turnover which counts. This can be advantageous if you have a large percentage rate secondary activity and a modest major percentage trade. You should

review the position on each anniversary and if the main business activity changes or you expect it to change during the following year you should use the appropriate rate for that sector.

Although you pay VAT at the flat rate percentage under the scheme you will still be required to prepare invoices to VAT registered customers showing the normal rate of VAT. This is so that they can reclaim input VAT at the appropriate rate.

## Example of the Calculation

Cook & Co is a partnership operating a café and renting out a flat. Its results are as follows:

VAT inclusive turnover:	£
Standard rated catering supplies	70,000
Zero rated takeaway foods	5,500
Exempt flat rentals	3,500
	<hr/>
	£79,000
	<hr/>

Flat rate 12% x £79,000 = £9,480

Normally £70,000 x 7/47 = £10,425 less input tax

## Treatment of Capital Assets

The purchase of capital assets costing more than £2,000 (including VAT) may be dealt with outside the scheme. You can claim input VAT on such items on your VAT return in the normal way but if you do you must account for VAT on a subsequent sale of the asset at the normal rate instead of the flat rate.

Items under the capital goods scheme are excluded from the flat rate scheme.

## Transactions Within the European Community

Income from these sales is included in your turnover figure.

Where there are acquisitions from EC member states you will still be required to record the VAT on your VAT return in the normal way even though you will not be able to reclaim the input VAT unless it is a capital item as outlined above.

## Records to Keep

Under the scheme you must keep a record of your flat rate calculation showing:

- § your flat rate turnover
- § the flat rate percentage you have used
- § the tax calculated as due.

You must still keep a VAT account although if the only VAT to be accounted for is that calculated under the scheme there will only be one entry for each period.

## Summary

The scheme is designed to reduce administration although it will only be attractive if it does not result in additional VAT liabilities. The only way to establish whether your business will benefit is to carry out a calculation and comparison of the normal rules and the flat rate rules.

## How We Can Help

We can advise as to whether the flat rate scheme would be beneficial for your business and help you to operate the scheme.

## APPENDIX: Table of Sectors and Rates

Trade Sector	Flat Rate Percentage
Retailing food, confectionery, tobacco, newspapers or children's clothing	2
Membership organisation	5.5
Postal and courier services	
Pubs	
Wholesaling food	
Farming or agriculture that is not listed elsewhere	6
Retailing that is not listed elsewhere	
Wholesaling agricultural products	
Retailing pharmaceuticals, medical goods, cosmetics or toiletries	7
Retailing vehicles or fuel	
Sport or recreation	
Wholesaling that is not listed elsewhere	
Agricultural services	
Library, archive, museum or other cultural activity	7.5
Manufacturing food	
Printing	
Repairing vehicles	
General building or construction services *	
Hiring or renting goods	
Manufacturing that is not listed elsewhere	8.5
Manufacturing yarn, textiles or clothing	
Packaging	
Repairing personal or household goods	
Social work	
Forestry or fishing	
Mining or quarrying	
Transport or storage, including couriers, freight, removals and taxis	
Travel agency	9
Advertising	
Dealing in waste or scrap	
Hotel or accommodation	
Photography	
Publishing	9.5

Veterinary medicine	
Any other activity not listed elsewhere	10
Investigation or security	
Manufacturing fabricated metal products	
Boarding or care of animals	10.5
Film, radio, television or video production	
Business services that are not listed elsewhere	11
Computer repair services	
Entertainment or journalism	
Estate agency or property management services	
Laundry or dry-cleaning services	
Secretarial services	
Financial services	11.5
Catering services, including restaurants and takeaways	12
Hairdressing or other beauty treatment services	
Real estate activity not listed elsewhere	
Architect, civil and structural engineer or surveyor	12.5
Management consultancy	
Accountancy or book-keeping	13
Computer and IT consultancy or data processing	
Lawyer or legal services	
Labour-only building or construction services *	13.5

\* Building or construction services, use 'Labour-only' if the value of materials supplied is less than 10% of your turnover. If the value of the materials is more than this, builders use the 'General building' flat rate.

# VAT - Bad Debt Relief

It is quite possible within the VAT system for a business to be in the position of having to pay over VAT to HMRC while not having received payment from their customer.

Bad debt relief allows businesses that have made supplies on which they have accounted for and paid VAT but for which they have not received payment to claim a refund of the VAT by reference to the outstanding amount .

## The Conditions for Relief

In order to make a claim a business must satisfy the following conditions:

- § goods and services have been supplied and the VAT in question has been accounted for and paid
- § six months has elapsed since the later of the date of supply and the due date for consideration
- § all or part of the outstanding amount must have been written off in the accounting records as a bad debt (in the 'refunds for bad debts account').

## Making the Claim

A claim is made by entering the appropriate amount in Box 4 of the VAT return for the period in which entitlement to the claim arises (or any permissible later period).

## Records

Businesses making bad debt relief claims must keep records for four years from the date of the claim to show:

- § the time and nature of supply, purchaser and consideration - normally a VAT invoice will show this
- § the amount of VAT and the accounting period it was paid to Customs
- § any payment received for the supply
- § details of entries in the 'refunds for bad debts account'.

## Repayment of Input Tax by Purchaser

Where a customer has not paid a supplier within six months of the date of the supply or, if later, the date payment is due, VAT previously claimed as input tax, must be repaid. This puts a burden on all VAT registered traders to monitor their transactions to anticipate whether they need to reverse any input tax recovered on goods received from suppliers.

## How We Can Help

We would be pleased to help with further advice in this area.

For information of users: This material is published for the information of clients. It provides only an overview of the regulations in force at the date of publication, and no action should be taken without consulting the detailed legislation or seeking professional advice. Therefore no responsibility for loss occasioned by any person acting or refraining from action as a result of the material can be accepted by the authors or the firm.