VAT made simple

VAT is one of the major sources of tax revenue for the government. **Neil Warren** considers the basic rules of the tax

In simple terms, VAT is a tax on the supply of goods or services made in the UK by a taxable person in the course or furtherance of a business. The key word here is 'supply', which indicates that one person is making a supply of goods or services (and therefore charging VAT in most cases) and a separate person is receiving the goods or services.

A key principle of the tax is that a VAT charge can still be evident even where no money is exchanged. For example, if a gift of goods that exceeds £50 in value is made by a VAT-registered person, then VAT is payable on those goods at their open market value (assuming the goods in question are standard-rated). This is because a supply of goods has taken place.

A 'taxable person' is someone who is VAT-registered (sole trader, partnership, limited company, etc) or someone who should be VAT-registered. So if a person has exceeded the registration limits (discussed later) and not registered for VAT, he is still classed as a taxable person and his date of registration will be backdated if discovered by HMRC.

How many different rates of VAT are there in the UK?

Goods or services supplied in the UK are either classed as being taxable or exempt as far as VAT is concerned. If a supply is exempt, this means that a business does not need to consider the value of the supply in determining if it should be VAT-registered. The supply is outside of the VAT system. Examples of exempt supplies include:

- insurance services;
- rental of property (in most cases); or
- most financial services e.g. arranging a loan.

As far as taxable supplies are concerned, there are three different rates of VAT in the UK:

- 0 per cent – described as zero-rated;
- 5 per cent – known as the reduced or lower rate of VAT; and
- 17.5 per cent – known as the standard rate

A list of items that are chargeable at 0 per cent or 5 per cent VAT are found in Schedule 8 and 7A respectively of the VAT Act 1994. There are 16 different 'groups' of items that qualify for zero-rating and 11 groups of items that qualify for a 5 per cent VAT charge.

Zero-rated items include children's clothing (group 16) and books and printed matter (group 3), while reduced-rated items include smoking cessation products (group 11) and supplies of domestic fuel or power (group 1). Note that the categories of goods or services that are exempt from VAT can be found in 15 different groups in Schedule 9 of VAT Act 1994.

What is the difference between exempt and taxable income?

It is a mistake to conclude that there is no difference between, say, exempt and zero-rated income. This is a bit like saying that football is the same as rugby because they are both sports played with a ball.

The two key differences between taxable and exempt supplies are:

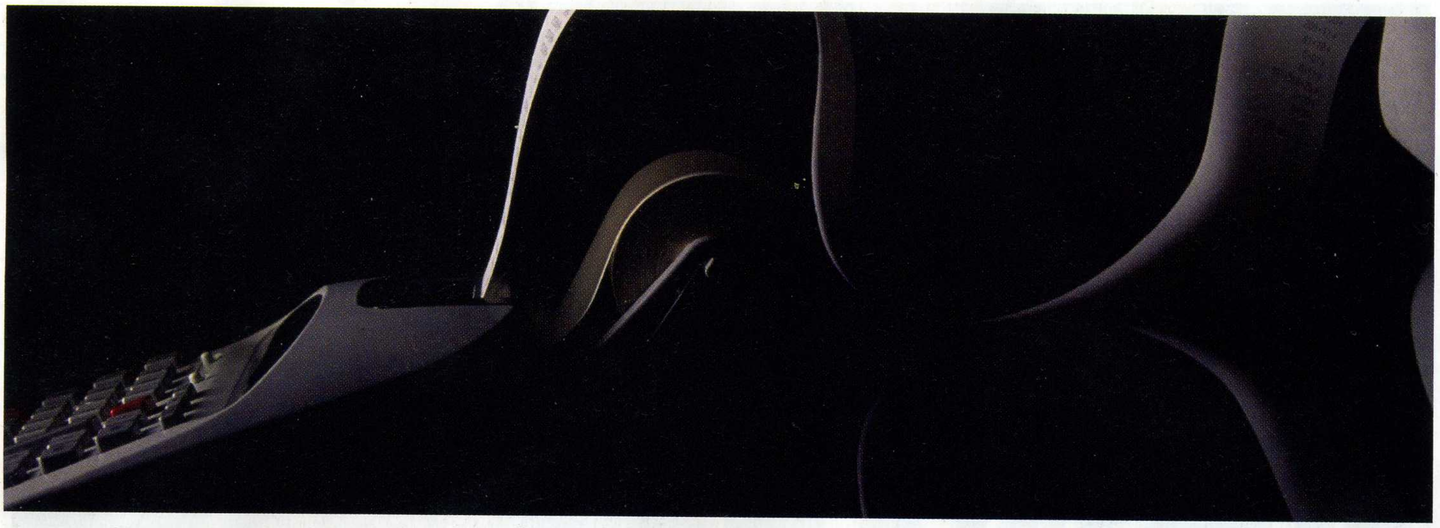
- if a business only makes exempt supplies, it will never need to (or be able to) register for VAT. This rule applies even if the turnover of the business is many millions of pounds, e.g. a large insurance company; and
- as a result of the above situation, a business making exempt supplies cannot reclaim input tax on its costs. This means that it will always need to consider the gross (VAT inclusive) amount of its expenditure.

Note that the 'win–win situation' is where a business wholly makes zero-rated sales. In such cases, the business will not charge VAT on its sales (output tax) but can still reclaim VAT on its expenditure (input tax). The end result is that the business will be a repayment trader as far as VAT is concerned, and will receive regular repayments of tax from HMRC.

When must a business register for VAT?

There are two main tests for determining when a business must join the 'VAT club'. First, the value of its taxable sales has exceeded the relevant limit in the past 12 months on a historic basis. The relevant annual limit was £64,000 for the year ended 31 March 2008, but this figure increased to £67,000 with effect from 1 April 2008. In this situation, the effective date of registration becomes the first day of the second month after the limit was exceeded. For example, if annual taxable sales were £70,000 for the 12-month period to 31 May 2008, the effective date of registration is 1 July 2008.

Second, the business expects its taxable sales to exceed the relevant limits in the next 30 days. In this situation, the effective date of registration becomes the day when the expectation first



occurred. For example, if it is 1 June 2008 and a large order means that expected taxable sales for June are £70,000, the effective date of registration is 1 June 2008.

How does a business pay VAT and submit returns?
Once registered for VAT, a business usually submits returns on a quarterly basis. It is sensible for the chosen quarters to coincide with the financial year-end of the business (a request can be made to HMRC to change the periods).

In certain situations, a business can submit monthly returns. This is allowed if the business is in a repayment situation on a regular basis (making wholly or mainly zero-rated sales) so that monthly repayments assist the cash flow of the business.

A business with annual taxable sales of £1.35 million or less can apply to join the annual accounting scheme and submit only one return each year. However, the business must still make regular payments of VAT throughout the year, usually based on the previous year's VAT liability. Detailed information about the annual accounting scheme can be found in VAT Notice 732, which can be downloaded from HMRC's website at www.hmrc.gov.uk

The priority for any business is to submit its VAT returns on time, along with full payment of the amount of tax due. A paper return must be submitted and paid within one month of the end of the VAT period. For example, the March 2008 return is due by 30 April 2008. However, HMRC is encouraging taxpayers to file VAT returns onlinE. There are three major advantages of adopting this strategy:

- no postal problems to worry about;
- an extra seven calendar days are given to submit the return each period; and
- an additional three working days are also given before the VAT payment is taken from a taxpayer's bank account electronically.

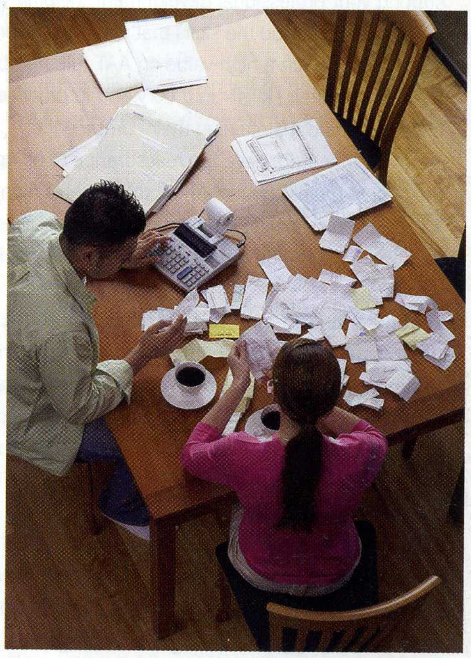
Note that my March 2008 VAT payment was debited to my bank account on 12 May 2008 because the weekend factor meant that the additional three working days equated to five calendar days.

What are the main VAT schemes available to a small business?
The **annual accounting scheme** was discussed earlier. The **cash accounting scheme** means that a business with taxable sales of £1.35 million a year or less can account for output tax according to the date that money is received from a customer rather than the earlier sales invoice date. However, input tax cannot be claimed until payment is made to a supplier. The scheme gives important cash flow benefits for a business that gives extended credit terms to its customers (or whose customers take a long time to pay anyway).

The flat-rate scheme is only available to a small business with annual taxable turnover of £150,000 or less (VAT exclusive) or total income (including exempt and non-business income) of £187,500 or less. The scheme means that a business charges VAT to its customers in the normal way – but instead of completing its VAT return based on output tax less input tax, it applies a given flat-rate percentage to its VAT-inclusive income for the period. This is the amount of VAT payable to HMRC.

For example, the flat-rate percentage for a hairdresser is 12 per cent. If gross income for the period is £30,000 including VAT, the tax payable is £3,600, i.e. £30,000 x 12%.

Do all VAT-registered businesses receive visits from HMRC?
Most VAT inspections are now carried out based on risk analysis. This means that a business with complex VAT issues such as partial exemption or detailed liability problems (e.g. those in the construction industry) will be visited more regularly than a business with simple VAT affairs. And, in reality, traders that receive regular VAT repayments each period tend to get more visits than those that pay huge amounts of tax… C'est la vie.



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