Mastering the mysteries of VAT

To the hundreds of thousands of small business owners who perform the role of unpaid tax collector on behalf of HM Customs and Excise, Value Added Tax (VAT) is hardly a topic that inspires joy and enthusiasm.

VAT is an indirect tax on consumer expenditure and is collected on business transactions, imports and acquisitions. All goods and services that are VAT rated are called 'taxable supplies'. VAT does not apply to certain services because the law says these are 'exempt' from VAT. These include loans of money, some property transactions, insurance, certain types of education and training and some property transactions (selling, leasing and letting land and buildings, but not garages, parking spaces, hotel or holiday accommodation). Supplies that are exempt from VAT do not form part of your taxable turnover.

There are three rates of VAT in the UK: 17.5% (standard-rate), 5% (reduced rate) and 0% (zero-rate). The current VAT registration threshold is £58,000 and the deregistration threshold is £56,000.

In theory, the concept of VAT is very simple. Input tax is the VAT that you pay out to your suppliers for goods and services that you purchase for your business and can be reclaimed if you are VAT registered. Output tax is the VAT on your sales of goods or services, collected by you from your customers. The value that you remit to HM Customs and Excise or reclaim at the end of your VAT reporting period is, in principle, the difference.

There are, however, many exceptions and special rules, and if in doubt it is always best to call the National Advice Service helpline on 0845 010 9000 or your accountant.

The FAQ section below seeks to provide clear and factual answers to some of the questions asked on PCG forums and pointers to common errors and misconceptions.

Q. *I recently started a new business and my accountant has told me that I cannot register for VAT and reclaim the purchase VAT on my set-up costs.*

A. Your accountant is incorrect. Although your taxable turnover is below the registration threshold you can apply for 'voluntary registration', if you can prove that what you do is a business for VAT purposes. This will allow you to reclaim the VAT that you pay to your suppliers, and may mean increased credibility for your business. Once you are registered, you have to account for output tax on all your taxable supplies, as well as sending in regular VAT returns. Therefore, you need to consider whether registering will really benefit you.

Q. *As a VAT registered business, I charge VAT on both my fees and my expenses, such as hotel charges for overnight stays. I keep the hotel receipt for my company's accounts and provide a copy to the client so that they have proof of the actual costs incurred. Another contractor on the client site says that this is not correct and that the receipt should go to the clients and that I should not be charging VAT on the expense.*

A. You are right. The hotel bill forms part of your input VAT, which you can reclaim. You are obliged to charge VAT to the client on the value that you recharge to them, whether that be at cost or at a marked-up value. You should keep the original receipt for your records.

Q. *What about disbursements?*

A. In some trades and professions, it is customary for some or all of the costs incidental to a supply, such as travelling expenses, to be described as disbursements and shown or charged separately to the client.

They do not usually qualify for treatment as disbursements for VAT purposes though. You may treat a payment to a third party as a disbursement and exclude the amount when you calculate any VAT due on your main supply to your clients only if you acted as the agent of the client when you paid the third party and you satisfy all of the other seven criteria specified in VAT Notice 700, paragraph 25.1.1.

Generally, it is advantageous to treat a payment as a disbursement for VAT purposes only where no VAT is chargeable on the supply by the third party, or where your client is not entitled to reclaim it as input tax.

Q. *We are a marketing business and regularly undertake direct mail campaigns for our clients, charging them postage at cost. As stamps are zero rated, we do not charge VAT on the postage.*

A. Generally speaking, this is incorrect., unless you fulfil all the conditions necessary for these to be treated as disbursements (see VAT Notice 700/24). You should be charging standard rate VAT on the postage, even though it is zero rated, because it forms part of your taxable supplies. Your clients may, if they are VAT registered businesses, reclaim this as input VAT.

Q. *I just bought a seriously expensive rail ticket and it has a VAT number on the receipt. Does the price include VAT at 17.5%; it would be nice if it did.*

A. Unfortunately not; travel is zero rated. General categories of zero-rated goods and services include food (unless supplied in the course of catering), books, transport, gold, bank notes, drugs, medicines, imports and exports, tax-free shops, charities, clothing and footwear.

However, there are exceptions within these general categories and you should check VAT Notice 701/39 for specific information.

Q. *I have been a sole trader for some years, operating below the threshold for VAT registration. Last year I set up a limited company for a subset of the business; this company blossomed and had to register for VAT. If I keep separate accounts for the two businesses, can I continue to operate as a sole trader, not VAT registered?*

A. Potentially, as long as the two businesses really do operate separately. Where a business has been artificially separated into smaller parts and this results in the avoidance of VAT, HM Customs and Excise has the power to direct that the persons running these activities be treated as a single taxable person and registered.

Q. *What can I not reclaim as input tax?*

A. You cannot normally reclaim VAT you have been charged on goods and services not used for your business, on a car (including fitted accessories and delivery charges), on business entertainment expenses or on purchases that relate to exempt supplies, to name a few. See 10.3 of VAT Notice 700 for the full list.

Q. *One of our sales invoices remains unpaid after four months, and I think that the client is going to default. Can we claim relief in our next return?*

A. You can claim relief from VAT on the bad debt provided that you have paid the VAT to Customs and Excise, you have written the debt off in your accounts and six months (but not more than three years and six months) have elapsed since the later of the date of supply or the due date for payment.

Q. *We are doing a £1,000 fixed fee project for a client, who has paid a deposit of £500 in advance. They want a VAT invoice, but we haven't started work yet.*

"I've had two VAT inspections in 20 years. My experience, in both cases, was that the inspectors were polite and helpful. In the first case they charged me about £60 for a genuine mistake, but overlooked others, and the second time they wished me a good day and advised me to claim for a couple of refunds that I couldn't be bothered with."

A. You have to account for the VAT when the deposit payment is received, in this case showing the deposit as £425.53 and 17.5% VAT as £74.47. When you invoice the completed project, you need to bill the £1,000 fee, less the deposit of £425.53, that is, a net amount of £574.47 plus VAT at 17.5% being £100.53, a total of £675.00.

Q. *After 12 years in business, I have been 'invited' to a VAT inspection covering my accounts for the last three years. What should I do? As a member covered by PEI, must I notify PCG's insurers?*

A. HM Customs and Excise usually inspects businesses every three or four years, so you have done well. Make sure that all your records are in order before the visit, and do whatever you can to be helpful. You do not need to notify PCG unless a VAT dispute arises.

As one PCG member noted in the forums, "I've had two VAT inspections in 20 years. My experience, in both cases, was that the inspectors were polite and helpful. In the first case they charged me about £60 for a genuine mistake, but overlooked others, and the second time they wished me a good day and advised me to claim for a couple of refunds that I couldn't be bothered with."

The VAT flat rate scheme

Introduced with the aim of simplifying VAT for small businesses, the VAT flat rate scheme allows you to pay VAT as a percentage of your turnover instead of having to work out the VAT on all your sales and purchases. You are eligible to join the scheme if you expect your taxable supplies (excluding VAT) in the next 12 months to be less than £150,000 and your business income to be less than £187,500 (excluding VAT). The scheme is not beneficial for all small businesses; you really do need to work out whether it will result in savings, given your own specific circumstances.

To see what flat rate to use, you need to look at the categories published by HM Customs and Excise, and decide which one best describes what your business will be doing in the coming year. Examples include 11% for entertainment or journalism, 9.5% for photography and publishing, 11% for computer repair services, 13% for accountancy or bookkeeping, 12.5% for architect, civil or structural engineer or surveyor, 13% for computer and IT consultancy or data processing and 12.5% for management consultancy.

When you make supplies to other VAT registered businesses, you charge VAT at the normal rate for the supply, not at the flat rate percentage. VAT on capital expenditure exceeding £2,000 including VAT may still be claimed. Be aware, however, that under the flat rate scheme you are required to include any zero rated sales invoices in your list of outputs for the purposes of calculating VAT owed.

Savings made on VAT using the flat rate scheme are treated as income for the purposes of calculating your corporation tax or personal tax liability.

Other VAT accounting methods

Cash accounting

If the proportion of your turnover subject to VAT does not exceed £600,000 a year, your business can use the cash accounting scheme. This allows you to record your output tax on your VAT return after your customer has paid you and your input tax when you have paid your supplier. This can be useful if your customers are slow payers.

Annual accounting

You can register to file one VAT return a year instead of quarterly, provided that you meet certain conditions.