



Value added tax

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Nature

Value added tax (VAT) is an indirect tax. That means it is not paid directly to HMRC in the way that income tax and corporation tax are, but is paid to suppliers who pass it on to HMRC.

VAT is an **EU tax**. Every EU member state applies VAT, though with some significant differences. It also means that EU law applies directly in the UK and has sometimes overruled UK law. The position when the UK leaves the EU in 2019 is not yet clear.

The tax is charged on the **value added** by the business. So if a business buys goods for £200 plus £40 VAT (at the 20% standard rate) and sells it for £300 plus £60 VAT, the business has created value added of £100 on which £20 value added tax is charged. This is accounted for as £60 output tax minus £40 input tax, giving a balance of £20 paid to HMRC.

Input tax is not restricted to items sold. It may generally be claimed back for all acquisitions by the trader and used in the business, unless specifically excluded. So VAT input tax may be claimed for the audit fee and for capital expenditure, such as for a new photocopier. VAT law generally does not distinguish between capital and revenue items.

Exceptionally, input tax may not be claimed for **cars**. It may be claimed for other vehicles such as vans, lorries, carts, bicycles, boats and aircraft.

In practice, a business simply totals all output tax charged on supplies made and deducts all input tax on supplies received for a period, usually three months. The balance is paid to HMRC. If the balance is negative, ie input tax exceeds output tax, HMRC pays the amount to the business.

These provisions apply regardless of what goods or services the business provides. The tax is charged equally on wholesalers and retailers, and on agents. Where there is a supply chain, each link accounts for output tax on its supply to the next link and claims back input tax for its acquisition from the previous link. The consequence is that the whole amount of VAT is borne by the final consumer. It also means that the total tax borne is the same regardless of how many links there are in the chain.

The main **law** for VAT is Value Added Tax Act 1994. It is also bound by the VAT directive of the European Union 2006/112/EEC, which replaces the old Sixth Directive. There also some statutory instruments, cases and VAT Notices, some bits of which have the force of law.

Scope

VAT is a tax on supplies and imports of goods and services.

A charge is made when:

- there is a supply or import of goods or services
- in the course or furtherance of a business
- by someone who is, or should be, registered for VAT.

All three conditions must be met.

A **supply** usually means a sale, but this is not always the case. Supplies also include commissions, royalties, business gifts (above a limit), barter, leasing and renting, some sales of land and buildings, sales to staff, and recharges of salary. For VAT, a disbursement is defined very narrowly, so many ordinary disbursements are subject to VAT.

The sale of a business and payments of wages are not regarded as supplies.

If there is no supply, there is no VAT. So VAT may not be payable on a cancellation charge. However, a *right* to do something is considered a service. So a cancellation charge for a hotel room was held to be a supply as the hotel had provided the service of holding a room.

A **business** means an activity undertaken commercially. So there was no business when a landowner asked for a contribution towards a social shoot, nor when someone donated money to a barrel organ player on the street.

Rates of VAT

It is convenient to think of all supplies coming within one of five scopes:

- standard-rated:
- reduced-rated
- zero-rated
- exempt
- outside the scope.

All supplies are **standard-rated** unless they are specifically brought within the scope of another category.

The standard rate has been 20% since 2011. Note that if a price includes VAT, the VAT element is 20/120 (ie one sixth) of the price. If a registered business charges 5p for a carrier bag, it charges 4.17p for the bag plus 0.83p VAT.

Reduced rate of 5% applies to a handful of goods and services, such as domestic power.

Zero-rate is a tax but at 0%.

Exemption means that VAT is not charged, but input tax may not be claimed for those supplies.

These four rates can be illustrated by examples showing an acquisition of £200 plus £40 VAT on which the business gives value added of £100. We look at the final price for each of the four scenarios:

	Standard	Reduced	Zero	Exempt
Acquisition price	£240	£240	£240	£240
less input tax	<u>(£40)</u>	<u>(£40)</u>	<u>(£40)</u>	-
Price less input tax	£200	£200	£200	£240
valued added	<u>£100</u>	<u>£100</u>	<u>£100</u>	<u>£100</u>
price plus value added	£300	£300	£300	£340
output tax	<u>£60</u>	<u>£15</u>	<u>£0</u>	-
price plus VAT	<u>£360</u>	<u>£315</u>	<u>£300</u>	<u>£340</u>

The final category is **outside the scope**. These are not subject to VAT as they are not regarded as a supply in the course of a business. Examples include statutory charges (such as a licence fee), wages and transfer as a going concern.

A **statutory charge** is one where a public body has to provide the service and is not competing. So a local authority's charge for planning permission is outside the scope, but a charge for hiring a hall is not. On 8 January 2018, the Severn Bridge crossings returned from the private to the public sector. So the fee for a car reduced from £6.70 (ie £5.60 plus £1.10 VAT at 20%) to £5.60 as VAT was no longer charged.

A **transfer as a going concern** means that someone takes over an existing business and runs it. It is not enough that the assets are taken over, nor that the business is acquired and then run as a different business.

Identifying the rates

VAT is charged according to which is supplied, not to what is acquired. If someone buys potatoes (zero-rated as food) and uses them to make potato prints for art, they are still zero-rated.

Similarly, if children's clothing is sold to an adult small enough to wear them, they are still zero-rated.

The rate can depend on how an item is sold. So gelatine sold for food use is zero-rated whereas gelatine sold for photography is standard-rated.

It can then depend on what the item is. Every supermarket puts Jaffa cakes with biscuits (which are standard-rated as an exception to food zero rating). Yet a tribunal famously found that in substance they were cakes, and so zero-rated them.

The exact details are listed in the Schedules to Value Added Tax Act 1994. Further guidance is given in more than 100 Notices. These Notices may be challenged.

The rates can change according to the nature of the business. For example, a publisher could buy standard-rated paper and ink to produce zero-rated books. A restaurant will buy (largely) zero-rated food to produce standard-rated catering.

A business needs to be particularly careful for supplies of **land**, buildings and related services. VAT can become very arbitrary on supplies with high figures and small profit margins. Almost every month there are sad cases when it was thought that a supply was zero-rated or exempt, but held to be standard-rated.

Reduced rates apply to domestic fuel and power, certain energy-saving installation, some grant-funded work, women's sanitary products, children's car seats, residential conversions, contraceptives, welfare advice, mobility aids for elderly, smoking cessation products, some caravans and cable car rides.

Zero rates apply to food, water, books, public transport, residential caravans and houseboats, gold, bank notes, drugs and appliances for the handicapped, exports, some charitable supplies, children's clothing and some protective clothing, and emissions allowances.

Exemption applies to land, insurance, postal services, betting and gaming, finance, education, health, burial and cremation, professional subscriptions, sports competitions, works of art, charity fund raising events, cultural services and investment gold.

In all cases, it is essential that the exact position for the specific supply is checked. Never rely just on these headings. The zero-rating for food, for example, has many exceptions. Confectionery, ice cream, biscuits, crisps and liquor are all standard-rated.

Registration

A business may only charge VAT if it is **registered** to do so. A registration is either compulsory or voluntary. Once registered, the rules are the same.

A business must register if its taxable supplies exceed the threshold then in force. For 2017/18, the threshold is £85,000. This has been frozen until 2020. The UK threshold is much higher than for most other EU countries.

Note that the threshold applies to turnover, not profit. This means that a sole trader, such as a local handyman, or woman, could reach the threshold if he or she provides materials as well as their labour.

Turnover applies to supplies subject to the standard, reduced or zero rate of VAT. These are all taxable supplies. It does not include exempt or outside the scope supplies.

Turnover is also considered on a cumulative basis, meaning that registration is compulsory when the last 12 months' turnover have reached the threshold. So small businesses need to keep an eye on their turnover figures.

A business must also register if it reasonably believes its turnover will exceed the annual threshold in the next 30 days.

The registration is of the *person* not the business. So if a shopkeeper registers, he or she must charge VAT on *any* supplies they make in the course of a business, even if it has nothing to do with the main business. This can be avoided by running one of the businesses as a separate “person”, such as a partnership. (Although a partnership is not a separate legal person under English law, it is treated as if it were for VAT purposes.)

A limited company must register if in business with turnover above the threshold. Where there is a **group** of companies, they may apply for a group registration and decide which companies to include in that group. VAT is not charged on supplies between group members.

A business may apply for **voluntary registration** even though its turnover is below the threshold. A business is likely to do this if:

- all its customers are VAT-registered
- it makes zero-rated supplies, or
- it wishes to conceal that its turnover is below £85,000 a year.

In the first two cases, the consequence of registering is that the business can claim back its input tax, saving one sixth of the cost on many purchases, while not increasing prices to customers. Perversely, a business can save tax by registering to pay it.

A business in another EU state selling goods by **mail order** to UK private customers must register in UK if the value of sales exceeds £70,000.

There are special provisions for supplies made online across national borders, such as downloads of books, films, software and music.

A **non-commercial entity** may need to register if its business supplies are large enough. This includes local authorities, charities, clubs, trade unions and similar.

When a business registers, it can claim VAT input tax on existing purchases of:

- goods acquired in the previous four years and which it still holds at registration, and
- services for the business in the previous six months.

Do not be attempted to try **disaggregation**, artificially splitting a business into two to stay below the threshold. HMRC has power to aggregate two businesses which are really one. There is much case law on this point. Particular problems have arisen for self-employed hairdressers renting a chair in a salon, and minicab drivers.

A registered business may **deregister** if its turnover falls below a separate threshold. This is £83,000 from 2017. A business must pay VAT on any stock, plant, or other VATable items held at deregistration.

The timing of a supply for VAT purposes is according to the **tax point**. This is when the supply is made, or when payment is made, if earlier. The tax point may be delayed by up to two weeks (or longer if HMRC agrees) to the date of the invoice.

Administration

For periods before April 2019, VAT is accounted for by means of a **return**. This is a single page form requiring figures to be entered into boxes of output tax, input tax, sales and purchase figures and statistics about dealings with businesses in other EU states.

From April 2019, VAT is to be accounted for under provisions of **Making Tax Digital (MTD)**, specific details of which were not available when this article was written.

A return is for a period of three months to the end of a month as chosen by the trader. So if the trader choose January, the other returns will be submitted for April, July and October.

Originally the return was made on a paper form. This form and payment were due by the end of the following month. So a return for the quarter to 31 January was due by 28 February. There remain provisions for people who cannot file electronically or who have religious objections to doing so.

From 1 April 2012, VAT returns must be made online. For online returns, another 7 days is given, so the due date becomes 7 March. If paying by direct debit, the due date remains 7 March but the funds are not taken for another three days, on 10 March.

A business should keep a printed copy of the VAT return with supporting documentation. If the business has any communication with HMRC, that should be kept. Telephone conversations should be documented.

In general, the change to registering and filing online went smoothly, with most businesses finding it easier than paper filing.

VAT returns may be made **monthly** instead of quarterly. A business that routinely receives VAT rebates (usually because its supplies are zero-rated), may wish to do so to help the cashflow. There is also a scheme for annual returns with payments on account.

There are inevitable penalties and interest for being wrong or late with VAT returns and payments.

if the business disagrees with HMRC on any matter, an **appeal** lies to the tax tribunal. Its decision is final on a point of fact, but a point of law may be further appealed to the upper tribunal and the courts.

Special provisions

The ordinary operation of VAT is to take output tax on **invoices** issued and subtract input tax on invoices received in the period. There are regulations about what must appear on a VAT invoice.

Originally there was no provision for **bad debts** as the supply had been made, and VAT is paid on supplies. This has now changed and bad debts may be claimed.

VAT may be added to a **credit note** if there has been a genuine reduction in consideration, such as receiving back goods or agreeing a retrospective discount. A credit note must not be issued to claim relief for a bad debt.

An alternative for smaller businesses is **cash accounting**. Instead of accounting for VAT on invoices issued and received, VAT is accounted on payments received and paid. This also has the advantage of giving bad debt relief automatically.

Small businesses may also use the **flat rate scheme**. VAT is charged and paid in the normal way, but a different method is used to determine how much of this is paid to HMRC. Instead of the usual output tax minus input tax, the VAT-inclusive turnover is multiplied by a percentage according to the nature of the business. This option is usually taken if it saves tax. That saving is itself subject to income tax or corporation tax. There is a separate flat rate scheme for farmers.

For certain large purchases of **property** or computers, there is the capital goods scheme. Broadly if premises are zero-rated when acquired and within ten years change to a standard-rated use, some VAT may be payable.

A business may make some taxed and some exempt supplies. This is called **partial exemption**. For example, an optician may supply exempt eye tests and standard-rated glasses. Input tax for eye testing equipment cannot be claimed back. Input tax for glasses and lenses may be claimed back in full. Input tax for other items, such as general overheads, is claimed back on a proportion basis.

For shops where issuing an invoice for each sale would be unreasonable, there are various **retail schemes** designed to simplify the process. Modern tills and bar codes have largely made these obsolete.

There are special schemes for **second hand goods**, where VAT is charged on the mark-up rather than the price. There is also a special scheme for tour operators.

Vouchers are regarded as a supply if they can only be used for one purpose, such as a telephone card. A voucher that can be used for different purposes, such as a store card, is not in itself regarded as a supply but as payment when the goods or services are acquired.

Exports to countries outside the EU are zero-rated. There are special schemes for supplies to customers in another EU state. Some additional statistical returns may be needed for intra-EU supplies. The arrangements have yet to be determined for what happens once the UK has left the European Union.

Some supplies are subject to **reverse charge** provisions. This includes supplies of mobile phones and computer chips, and can include other goods and services. This means that VAT is determined by the customer and not the supplier.

A landlord may exercise the **option to tax**. This means the landlord may choose whether to charge VAT on rent and any property sales. The option lasts for 20 years. In any tenancy agreement, the position with VAT must be made explicitly clear.

Problems can arise when there are **three parties** to a contract. It is necessary to analyse who is supplying what to whom. For example, a company may not claim back VAT on a solicitor's invoice for services in resolving a dispute between the directors. The supply has been made to the directors and not to the company.

Problems can also arise in determining whether there has been one or **two supplies**, particularly when the two elements are subject to different rates. Jam is zero-rated but jam jars are standard-rated. Jam sold in an ordinary jar is wholly zero-rated as the jar is regarded as ordinary packaging. If the jam is sold in a special storage jar, it may be separately taxed. There are similar issues when, for example, a magazine is sold with a CD.