

Basic Guide To VAT

A simple guide to the basic principles of this tax

Introduction

VAT is known as an indirect tax. That is, the tax is not directly charged to a named person instead it is charged on goods and services, which can be bought by anyone.

The basic idea behind the tax is simply to make customers of VAT registered businesses pay an extra 17.5% on goods and services purchased. Customers may or may not be able to recover this VAT at a later date.

Terminology

Input VAT	the VAT that you have paid on goods and services that you have bought
Output VAT	the VAT that you have added to your invoices to customers
VAT registered	a vat registered business is one that is allowed to charge VAT on sales and recover VAT on its purchases. A business must register for VAT when its turnover is expected to exceed a certain limit. This brings with it requirements for regular returns to HM Revenue & Customs and knowledge of the relevant regulations which are quite onerous
Cash accounting scheme	this is a special scheme whereby the business is allowed to account for VAT on the basis of payments made and received as opposed to invoices. This matters when you have customers who are slow to pay, this scheme allows you to wait for the money to be collected before you have to pay HM Revenue & Customs the output VAT. It is a valuable cash flow benefit but is only applicable to businesses that have turnover up to £660,000.
VAT return	HM Revenue & Customs will send you a form every three months that will have printed on it a date by which it has to be returned to them. It is very important that you observe this date, the financial penalties are severe. There are alternative schemes whereby you can account monthly if your turnover is large or annually with payment by regular instalments if cash flow is an issue.
VAT invoice	The components of a VAT invoice are defined by HM Revenue & Customs and it has to have certain features in order to be acceptable to them. See the section below for details

How do I know when to register?

You are required to register a business for VAT when the following conditions are met:

- The vatable turnover of the business is expected to exceed £60,000 or
- There are reasonable grounds for believing that your turnover for the next 30 days will exceed £60,000

In both cases you should take the advice of your accountant who will greatly simplify the application process for you.

Note that you are required to register and also it is your duty to inform HM Customs and Revenue. The onus is on you and your business and financial penalties do apply if you do not comply.

In addition, you may be allowed to register if you do not meet the above conditions but have reasonable grounds and a bona fide business.

Who can recover VAT?

Only VAT registered businesses can recover VAT paid on goods and services. Note that there are restrictions that can apply to certain types of business and transaction. Not all transactions are VAT recoverable.

What can I never reclaim VAT on?

Common transactions that disallowed are:

- Purchase of motor vehicles (except in very special circumstances)
- All costs associated with entertaining
- VAT on goods and services used for private purposes. If you have invoices that contain an element of both you should only recover the VAT relating to that part of the invoice that covers the business use. For instance if only 50% of the invoice is actually for a business expense then you should only reclaim 50% of the VAT.

Other requirements

Record keeping – you must keep sufficient records that allow you provide a complete breakdown of your VAT returns right back to invoice level.

This process is greatly eased if you have a good quality software package such as Sage Line 50. The relevant reports are generated for you and it is a simple matter of copying the totals to your VAT return form.

I would recommend that you have a file for each VAT return that you submit. Start the file with the return itself and have a section for VAT outputs and VAT inputs that give a complete breakdown of the figures you entered onto the return.

Imagine the VAT inspector has come to visit, you want to be able to show him or her that you have an efficient system that quickly shows the reader the breakdown of the particular figures they are querying. The quicker and easier they can do this, the more likely they are to be lenient on minor errors and the quicker they can be away from your premises!

Another word on VAT inspections, only supply as much information as is requested. You only need to sufficiently answer questions asked, you do not want to attract them to other areas of your business if they do not have this on their schedule.

Duration of record keeping – normally you should keep your records for 6 six years. HM Customs and Revenue can request this information at any time. If necessary keep the records offsite and if possible, try to keep invoice and account numbers for items shown on your returns. This makes it much easier to request copies from suppliers at a future date if the need arises.

VAT invoices – certain details must be shown on a document in order for it to be called a VAT invoice:

- Date of supply of goods or services and the date of the invoice
- Unique reference number – usually a numerical invoice number
- Your VAT registration number
- Your business name and address
- Your customers name and address
- Itemised descriptions of each component being invoiced. Each item should display the unit cost(price) the VAT rate applicable and the total cost before VAT for that item(s).
- The invoice should summarise to a total payable before VAT, then below that show the total VAT payable and below that the grand total of the invoice. If you look at invoices you have received in the past, particularly those where you have ordered more than one item, then you will see the kind of informatio you have to present.
- Note that you must always obtain VAT invoices on expenditure that you incur. The VAT invoice is your only proof of the recoverability of the VAT. This will probably be familiar to you as your accountant will be constantly reminding you of this. Naturally, it is with good reason, HM Customs and Excise will refuse to repay you input VAT unless you can prove to them that a VAT invoice is in your possession.

The VAT process

If you own a reasonably sized business then it is highly likely that you will be VAT registered. This means that you have to add VAT to all of your sales invoices but in return can recover VAT you have paid on bought in goods and services.

The actual process of VAT charging is like a chain and I illustrate this below:

Person	Event	VAT paid	VAT added to sales invoice	HM Revenue & Customs receives (net)
		A	B	= B - A
Original supplier	Sells raw materials to manufacturer from their resource, say a quarry	0.00	100.00	100.00
Manufacturer	Buys materials and sells product to wholesaler	100.00	110.00	10.00
Wholesaler	Sells to retailer	110.00	130.00	20.00
Retailer	Sells to individual	130.00	150.00	20.00

Notice in each case that the 'VAT added to sales invoice' is immediately recovered by the next business in the chain. Until of course we get to the final customer, say the man or woman in the street or exempt business who cannot recover VAT, which is where the chain stops.

The essence of the process is that VAT is paid over to HM Customs & Revenue on the value added by each business – the difference between cost of materials versus invoice to their customer.

In total £150 is due to HM Customs & Revenue and you will notice that this process allows them to collect it in stage payments.

Disclaimer

Please note that this guide is only intended to offer a better understanding of the VAT system in the UK. Nothing in this article amounts to advice of any kind and you should always consult your accountant about your own circumstances. The VAT legislation is very detailed and each business has to be assessed individually before applying the rules.

About the author:

Trevor Sadowski has worked in finance departments for the past 23 years and has been a member of the Chartered Association of Certified Accountants (ACCA) since 1994.

Trevor currently provides contract accountancy support through short-term placements or interim management in the UK. To find out more, visit his web site at www.moveaheadonline.com