

# START-UP BRIEFING



Highlands & Islands  
ENTERPRISE

## VAT

● VAT (Value Added Tax) is tedious, but it cannot be ignored. Start-ups need to understand the basics, because most businesses will have no option about registering for VAT, as soon as their sales reach £58,000 a year. If you are going to register, you will also have to cope with the paperwork and the deadlines. Being efficient will minimise the time you spend on VAT. Mistakes or delays can lead to penalties. This briefing explains:

- ◆ How VAT works.
- ◆ Whether you need to register.
- ◆ How to charge and reclaim VAT.
- ◆ How to complete your VAT return.

### 1 How VAT works

VAT is a transactions tax, on sales of goods and services.

It is not a tax on profits. VAT is charged on standard-rated supplies (and some others — see **2A**) made by VAT-registered businesses (see **3**), which act as tax collectors for the Government.

- A** All businesses pay VAT on most purchases. This is called '**input tax**'.
- B** Your business, if you are registered, charges VAT on the goods and services you sell. This is called '**output tax**'.
- C** The **difference** between the output tax you charge your customers and the input tax you claim is handed over to Customs and Excise.

Almost all positive-rated supplies are standard-rated — ie VAT is charged at 17.5 per cent.

For example, a VAT-registered shop selling a vase for £30 will add £5.25 (17.5 per cent) VAT, making the total price £35.25. But VAT may already have been charged on the vase — which started out as a lump of clay — by two other companies:

Company	Product	Selling Price
Clay Co.	clay	£1 + £0.17 VAT
Pottery Co.	vase	£10 + £1.75 VAT
Shop Co.	vase	£30 + £5.25 VAT

The VAT paid to Customs and Excise by each company is output tax less input tax:

Clay Co.	£0.17 less £0.00 =	£0.17
Pottery Co.	£1.75 less £0.17 =	£1.58
Shop Co.	£5.25 less £1.75 =	£3.50
		<b>£5.25</b>

#### FURTHER HELP

There are other Start-up Briefing titles that can help you. These briefings are referred to in the text by name and by the code given to each briefing. For example, SuB 21.

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## 2 What is VAT charged on?

For VAT purposes, goods and services are divided into three categories.

- A** Most goods and services fall into the category '**standard-rated supplies**'. Almost all sales of goods and services are standard-rated, with a few exceptions which are taxed at five per cent, or others which are zero-rated (see **C**). If you make taxable supplies, you can register for VAT (see **3**).
- ◆ Once registered, you charge your customers VAT.
  - ◆ You also claim back VAT on the goods and services your own business purchases,

other than business entertaining.

- B** The '**exempt supplies**' category mainly includes services such as finance (see box).
- ◆ If you only make exempt supplies, you cannot register for VAT. You cannot claim back VAT paid on purchases directly attributable to these exempt supplies.
- C** The '**zero-rated supplies**' group includes necessities, like food and children's clothing (see box). If you make zero-rated supplies (like a greengrocer), you can register for VAT.
- ◆ You do not charge customers VAT on sales. But you can claim back VAT on your business purchases, if you are registered.

► VAT rules change from time to time. This briefing reflects the situation after the Chancellor's Budget of 17 March 2004.

► **Customs and Excise** provides a wide range of publications, forms and notices on VAT. Call its National Advice Service on 0845 010 9000 or visit [www.hmce.gov.uk](http://www.hmce.gov.uk).

### Out of the ordinary

*The full lists of exempt and zero-rated supplies are long and complicated, with many exceptions and special cases, and there may be many situations where even your tax adviser will have to study the rules carefully.*

**A** **Exempt supplies** include:

- ◆ Insurance — also includes most services of intermediaries, such as brokers.
- ◆ Credit (eg interest on a loan).
- ◆ Certain sales and leases of property.
- ◆ Some education and training services.

**B** **Zero-rated supplies** include:

- ◆ Books and newspapers.
- ◆ Young children's clothing.
- ◆ New house construction.
- ◆ Public transport (not including taxi hire).
- ◆ Most food (but not catering).
- ◆ Exports of goods to countries outside the EU, or to VAT-registered businesses in other EU member states.

**C** There are also **special rules** covering:

- ◆ Retailers.
- ◆ Property.
- ◆ Import and export.
- ◆ Company cars.
- ◆ Secondhand goods.
- ◆ Buying a business.
- ◆ Bad debts.
- ◆ Free gifts.

*Ask your tax adviser, or Customs and Excise, how your business is affected by the VAT rules. If in doubt, safeguard your business by getting a decision in writing from Customs and Excise.*

## 3 Should you register?

The advantage of registering is that you can claim back VAT on business purchases. But if you suddenly add 17.5 per cent VAT to your prices, you may lose customers (see box, page 3).

- A** You must notify **Customs and Excise**, within 30 days of the end of the month, if your taxable sales in the last 12 months exceed £58,000.
- ◆ Exceptionally, if you expect sales to fall back below this level, you can ask Customs and Excise to let you remain unregistered. Otherwise, you will be registered immediately.
  - ◆ You must also register if your sales during the next 30 days are expected to exceed £58,000 — eg if you set up a new company with customers ready to place orders totalling £58,000 or more.

Penalties for late notification can be as much as 15 per cent of the net tax due, although the authorities now have discretion on how they apply them to businesses with turnover of up to £150,000 a year.

- B** You can **opt** to register for VAT if your sales are below the registration level. It should be worth registering (to claim back VAT on purchases) if:
- ◆ You make zero-rated supplies — because your customers will not have to pay VAT.
  - ◆ Your customers are themselves VAT-registered — because they may be able to claim back VAT you charge them.
- C** **Start-up businesses** may register before they begin trading, in order to reclaim VAT on their pre-trading business expenses.
- ◆ You have to give Customs and Excise evidence of your intention to start trading.

"VAT registration is not all bad news. Early VAT registration enables a new business to reclaim VAT as its business expenses — even before it starts making sales."

*Penny Hamilton,  
Chartered Institute of  
Taxation*

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## 4 Charging customers VAT

Start charging customers VAT as soon as you are required to register. Do not wait until registration is complete. You will probably have to pay VAT from the date you were liable to register.

- A Contact** Customs and Excise and start the registration process.
- B** For the time being, **add 17.5 per cent** to your prices (or less, as you can offset the VAT you will save on purchases). Show only the gross amount — don't show VAT as a separate item on invoices. Explain to customers that you will send out VAT invoices (see 5) once you are registered.
  - ◆ If you hold your prices to avoid losing customers, you will still have to pay VAT to Customs and Excise on all your sales.

## 5 VAT invoices

- A** Once registered for VAT, you must provide a VAT invoice — and keep a copy yourself — for **every sale** to a VAT-registered customer. This does not apply to sales of exempt or zero-rated supplies.
- B** The invoice must show a number of specified pieces of **information**.
  - ◆ Invoice number.
  - ◆ Tax point (see 7C) (and date of issue, if different from the tax point).
  - ◆ Your business name and address.
  - ◆ Your VAT registration number.
  - ◆ Customer's name and address.
  - ◆ Type of supply (eg sale, lease, rent).
  - ◆ Description of goods supplied.

### The VAT trap snaps shut

*A house decorator is a good example of the notorious VAT trap in operation.*

1. *His sales reach the £58,000 threshold.*
2. *He has to register for VAT.*
3. *His customers are not registered for VAT. For them, adding the VAT charge is like raising prices by 17.5 per cent.*
4. *The decorator loses business to decorators who do not charge VAT.*
5. *Sales fall below £56,000.*
6. *He de-registers: prices drop 17.5 per cent.*
7. *Sales increase and the cycle starts again.*

- ◆ Quantity supplied, cost, tax rate (usually 17.5 per cent) and the VAT on each item.
- ◆ Discounts, if any.
- ◆ Total cost, excluding VAT.
- ◆ Total VAT.

- C** A less detailed invoice can be used for sales **below £100**, showing just the name, address, VAT number and total cost.
- D** No tax invoice is necessary for sales **direct to the public** — for example, in a shop — unless one is asked for.

## 6 Reclaiming VAT on purchases

- A** To claim back input tax (the VAT you pay on purchases), you **must keep** all the VAT invoices for the purchases you make.
- B** If you work from **home**, you can claim back a proportion of VAT on certain expenditure. For example, you can claim VAT on work phone calls, though not on private ones.
- C** If you reclaim VAT on **fuel** used by cars, extra VAT will usually be payable.
  - ◆ VAT is payable (on 'scale charges') if some fuel is provided free, or at less than cost, and is used for private journeys.
  - ◆ VAT inspectors often focus on this area.
- D** Input tax is not normally reclaimable on certain types of purchase, such as **company cars** used for private purposes.
  - ◆ It is possible to reclaim 50 per cent of the VAT incurred on lease charges when cars are leased for business use. All the VAT on repair and maintenance costs should be recoverable provided it is shown separately on invoices.
- E** If you make only **exempt supplies**, you are not entitled to register for VAT and cannot reclaim input tax. If you make exempt and taxable supplies, you should be entitled to VAT registration and can recover part of your input tax. Special rules apply.

## 7 VAT returns

- A** In general, you pay VAT on a quarterly basis. Each three months is called a '**VAT period**'. Ask Customs and Excise to make your VAT periods fit in with your accounting year.
  - ◆ Every three months, you will receive a VAT return (VAT 100).
  - ◆ The completed VAT return, plus any VAT owed by you, must be received by

◆ You can submit VAT returns online. You will need to purchase a digital security certificate — costing £25 to £50 plus VAT — to do so. For more information, visit [www.hmce.gov.uk/business/electronic/electronic.htm](http://www.hmce.gov.uk/business/electronic/electronic.htm).

"Timing transactions in relation to the three-month VAT cycle can help your cashflow. Buy at the very end of the VAT period and you'll effectively get your VAT money back straight away. Send out goods and invoices just after the period ends and you can delay paying in the VAT for three months."

*Jon Hughes,  
Newport & Gwent  
Enterprise*

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Customs and Excise by the end of the month following the VAT period.

- B** Take the information directly from your **accounting records**.
- ◆ The records, which you must keep, should show input tax, output tax and payments due to or from Customs and Excise. Your records must separate out standard-rated, exempt and zero-rated supplies. You must also detail any overseas sales.
  - ◆ If you use a simple book-keeping system to control your business — and for your Inland Revenue tax returns — you have already done most of the work for VAT. (See **Simple book-keeping**, SuB 17.)
- VAT records need not be complex, unless you sell both exempt and taxable items.
- C** Each sale has a **tax point**. This is the date by reference to which you become liable to pay VAT. The tax point may be:
- ◆ The date of supply.
  - ◆ The date of issue of the invoice.
  - ◆ The date you receive payment.
- It is usually the earliest of these three dates.
- D** If your turnover is up to £660,000, you can apply to use **annual accounting**, rather than submitting quarterly returns. If it is under £150,000, you can apply to use the scheme straight away. Otherwise you must have been VAT-registered for a year.
- ◆ This bases provisional VAT payments on an estimate of the year's turnover.
- E** A **flat-rate scheme** is also available as an alternative to the normal transaction-based method of VAT accounting.
- ◆ VAT is charged as a fixed percentage of your VAT-inclusive turnover according to your type of business, ranging from five to 14.5 per cent. Individual transactions are ignored and broadly you are not allowed to recover VAT incurred on your purchases.
  - ◆ You can use the scheme if your taxable turnover is up to £150,000 and your total taxable turnover (including exempt and zero-rated supplies) is up to £187,500.
- The amount of VAT collected will be about the same, but there is much less work.
- F** **Customs and Excise** may visit your premises to check your records. If your VAT returns are incorrect you will be charged interest on late payments and may be fined.
- ◆ If, after sending in a return, you find you have miscalculated by over £2,000, send a voluntary disclosure letter to Customs and

Excise explaining the error, and enclosing a payment of the VAT due (or asking for a repayment of VAT overdeclared).

- ◆ If a Customs and Excise inspection uncovers any 'misdeclaration' of liability, the penalties can be severe.
- G** You must **keep copies** of all your invoices and VAT returns for at least six years.

## 8 Cash accounting

- A** Apart from retailers, almost all small businesses use the **cash accounting** system. This means that the tax point is the date cash is received (from sales) or paid out.
- ◆ You can choose cash accounting as long as your annual sales are below £660,000.
  - ◆ The main advantage is no VAT is paid on a sale until you have been paid for it. This is useful if you have slow-paying customers.
- B** One pitfall of cash accounting specifically affects **start-up businesses**.
- ◆ You may not be able to claim back VAT on purchases made in your setting-up period.
  - ◆ To get round this, complete your initial VAT registration, claim back this VAT and then switch to cash accounting.
- C** If you already use cash accounting, you can continue to do so until your **annual taxable turnover** reaches £825,000.
- ◆ If you have to leave the scheme, in most cases you will be able to account for VAT on sales and purchases made while you were still in the scheme on a cash basis. This concession applies for up to six months after leaving the scheme.

## 9 De-registration

- A** Contact Customs and Excise to **de-register** from VAT if you sell or liquidate the business.
- ◆ You can also de-register if you expect your sales to be less than £56,000 in the next 12 months, and you wish to do so.
- B** You may need to de-register (and re-register under a new number) if you **change** from being a sole trader to a partnership or limited company, or vice versa.
- C** De-registration is **quick and easy**: fill in a form at your VAT office and complete a final, supplementary VAT return. You account for VAT on goods in hand worth £1,000 or more at de-registration.

## EXPERT CONTRIBUTORS

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► To find a local chartered tax adviser, contact the Chartered Institute of Taxation on 020 7235 9381.

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