Value Added Tax (VAT) Explained

What is it?

It is Tax that is levied on goods and services provided by VAT registered businesses in the United Kingdom, to other VAT registered business and/or general public (Once your registered you must charge VAT and the selling of your goods and services, does not matter who your selling to in the UK.)

However if you exporting outside the UK, VAT is charged at a rate 0% but It is charged on goods brought in from outside the UK and European Union at the full rate of 20%.

Are all goods and services vatable?

No, Supply of goods and services are broken down into three main Categories:

1. **Exempt Supply** – Common examples include Insurance, postal services & Financial Services

Note If any of the above examples is the trade of your business then you cannot register for VAT & cannot reclaim any input VAT.*

If you purchase exempt supplies then there would be no VAT to claim back.

2. **Outside the scope of VAT** – Common examples include Wages, dividend, other taxes (eg. road tax for your business vehicle)

Note There is no option to claim back VAT as the above have nothing to do with VAT.*

3. **Taxable supply** - This is further broken down into two headings

   a) Zero-rated supply – Common examples include Baby clothing, Newspapers, Luxury food, medicine etc.

b) Standard rated supply – Is deemed to be everything else other than that mentioned above. There is a standard rate of 20% and the reduced rate is 5%

How does it work

VAT is split into two categories:

Output VAT – VAT charged on sales and/or services to the customer (represents the VAT that is to be paid over to the government)
E.g. When you make sales, you charge the customer Vat (net sales of £100.00 = Gross sales of £120.00 inc. Vat (£100.00 + 20%)

Input VAT – VAT charged on Purchases and/or services to your business (represents the VAT owed to you from the government)
E.g. when goods are purchased from suppliers that are VAT registered, the VAT is included in the amount you them.
If Output VAT is greater than Input VAT = VAT to be paid over to HMRC (Output – Input VAT= xxx)
If Input VAT is greater than Output VAT= VAT to be claimed back from HMRC (Output –Input VAT= -xx)
Note To calculate the gross amounts (inc. VAT) multiply by 1.2*
To calculate the net amounts (ex. VAT) divide by 1.2

The VAT return

Vat registered business and companies are required to file Vat returns to HMRC. This return is where the Output and Input VAT is declared for certain period (usually three months)

The VAT return

This is usually done quarterly and is illustrated below:

	£
Output VAT	
Standard rated supplies	X
Zero rated supplies	nil
Input VAT	
Standard rated purchases and expenses	X
Zero rated purchases and expenses	nil
Net VAT Payable/receivable	**X**
Outputs net of VAT	**X**
Inputs Net of VAT	**X**

Note* the return and payment is due one month after the day your VAT quarter ends.

Two types of registration

1. Compulsory registration – Registration is a must, once the threshold for taxable supplies is exceeded above a certain limit (see rates)

2. Voluntary registration - when you register by choice not by requirement.

   Benefits include, enhances the perception of the business (gives a bigger profile,) can claim input VAT & if zero rated supplies

   Drawbacks – increase admin work (as you need to carry out the return) & you need to start charging VAT to customers, this could result in customers moving elsewhere due to increased prices, hence potentially lower profits.

Important Notes and rules

Pre-registration input VAT:

Goods – It is possible to claim back VAT on goods purchased from last 4 years from the date of registration, if you still have those goods on the date of registration.

Services – It is possible to claim back the VAT incurred in starting/running the business (legal & accounting, business premises costs etc.) incurred last 6 months from the date of registration.

Small business options:

There are different schemes that are available for VAT:

1. **Cash accounting**
   - VAT accounted for when cash is paid and cash received basis. Not when the invoice is raised or received.
   - Conditions – if you turnover is < or = £1.35 mil, your VAT payments are up to date
   - Benefits – Bad debt relief is automatic (as if customer does not pay, the VAT is never included on the return) & cash flow is better as you do not pay VAT until the cash is received from the customer.

2. **Flat rate**
    - Charge output VAT and invoice your customer the normal way.
    - But you do not take into consideration any input VAT paid out and you do not do a normal VAT return.
    - The VAT payable is calculated as (Total VAT inclusive turnover including exempt supplies) x (Fixed % for the trade sector you're in)
    - Conditions – taxable supplies for the next 12 months < or = £150k, must leave the scheme once you exceed £250K
    - Benefits – less admin work (You do not have to keep records of input VAT on purchases. If your trade sector % is low, can possibly reduce the VAT payable.

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