

Chapter 1

How VAT is applied in the UK

In this chapter we will look at Indirect Tax. We will see how VAT is the most important indirect tax and we shall see how and when companies should register for VAT. We will look at how VAT applies only to the final customer. We will look at the various rates of VAT and we will look at examples of items which are charged at each rate.

Indirect Tax

Indirect tax is a charge levied by the state on goods and services. Direct tax is levied by the government directly on a taxpayer (such as income tax), whereas indirect taxes are collected by an intermediary (such as a retail shop), usually in the form of higher prices, and passed on to the government.

Examples of indirect taxes include the taxes on alcohol, tobacco and petrol. Stamp duty is an indirect tax levied on certain documents, particularly those associated with land transactions. But the most important of the indirect taxes in the UK is VAT. Value Added Tax (VAT) is a tax on buying and selling and, along with income tax, is the most important way the UK government gets its income. Businesses registered for VAT must charge the tax on most of the goods they sell. There are some exceptions to this, but we will look at them later in this chapter.

In January 1973, the UK joined the European Economic Community, and as a consequence the old Purchase Tax was replaced with VAT. Whereas Purchase Tax was levied at the point of manufacture and distribution, whereas VAT is levied at the point of sale. Initially, VAT was charged at a single rate of 10% on most goods and services. Since then, the rate of VAT has changed several times, and currently there are three rates of 20%, 5% and 0%. There are also goods and services which are exempt and outside the scope of VAT.

After Brexit, in theory, the UK could abolish VAT, but it is unlikely to do so because it is a major revenue raiser for the government. The VAT rules for transactions within the UK have remained largely unaltered, but trade with the EU has changed considerably. There are also some issues with trade between the Irish Republic, Northern Ireland and the rest of the UK.

The government department which administers and collects VAT is **Her Majesty's Revenue and Customs (HMRC)**. The rules covering VAT are set by legislation, primarily the **Value Added Tax Act (1994)** and the annual **Finance Acts** (as set out in the budget every year).

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Registration for VAT

You can only register for VAT if you are in business. HMRC defines a person as being in business if:

- they earn an income by carrying on a trade, vocation or profession - by being self-employed or through another entity such as a limited company
- they provide membership benefits as a club, association or similar body in return for a subscription or other form of payment
- they provide certain other activities as a club or other recreational body, charity or other non-profit making body
- they charge admission to a premises

You can register for VAT if you're in business and you are one of these:

- a sole proprietor
- a partnership
- a company
- a club
- an association
- a charity
- any other organisation or group of people acting together under a particular name, such as an educational or health institution, exhibition, conference, etc.

For VAT purposes, the individual or organisation that is in business is known as a '**taxable person**'. It is the taxable person who is registered for VAT. A 'person' can be either an individual or a legal entity (such as shown in the list above). Each registration covers all the business activities of the registered person, but if an individual is, for example, a sole trader and also a partner in a partnership, they will normally need two VAT registrations.



A 'business' must have a degree of frequency and must be carried on over a period of time. Even if the activity meets the criteria for it to be a business, for VAT purposes it cannot be considered as a business if it is recreational, a hobby or an isolated transaction. If you occasionally sell goods over the internet or sell goods at a car boot sale, you will not be considered as carrying on a business and so you cannot register for VAT. If you regularly buy goods for resale, however, it will be seen as a business activity.

You cannot register for VAT even if you are a business, if you only sell goods which are exempt from VAT. We will look at exempt goods later in this book.

As long as you are in business according to the regulations set out above you should carry out two tests every month. The **historic turnover test** is where the annual turnover (or sales) reaches £85,000 (this figure is correct as at April 2021). It is calculated monthly over the previous 12 months. You cannot use your company's accounting year to calculate the turnover; you must monitor the sales month on month. However, the value of the turnover

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should be calculated on taxable sales, whether full rate, reduced rate or zero rate. (We will look at the rates later on in this book). Any exempt sales are not included in the calculations for annual turnover. (Again, we will look at exempt sales later in this book).

Where a business goes over the threshold, they must register within 30 days of the end of that month. The effective date of registration will then be the first day of the second month after they had gone over the threshold.

For example, a business finds that it has gone over the VAT registration threshold on 15th June. It must register for VAT by 31st July and the effective date of registration will be 1st August.

The effective date of registration is important because this is the date from which the business must charge its customers VAT.

The second test is the **future turnover test**. This applies continuously. If there is reason to believe that the registration threshold will be exceeded in the next 30 days, then you must notify HMRC within 30 days.

Where this happens the registration rules are different. The business must register within a 30-day period.

For example, where a business realises that they will go over the threshold on 1st June, they must register by 30th June. The effective date of registration is then the date the business realised it would exceed the threshold. In this case it would be 1st June.

You can deregister for VAT if your annual taxable turnover is £83,000 or less (this figure is correct as at April 2021). The calculation for this threshold is the same as for registration, i.e., the sales month on month. This deregistration threshold usually changes at the same time as the registration threshold, so businesses wishing to deregister should check the current threshold level. However, the government have said that the current thresholds will remain until at least March 2024.

Where a business makes taxable sales which temporarily takes it over the £85,000 threshold, the business can apply to stay unregistered, but the business must be able to prove to HMRC that this is a one-off occurrence and the threshold will drop back immediately below the threshold.

When a company or individual registers for VAT they **must** charge VAT on all qualifying goods they sell. However, VAT paid on goods brought into the business and expenses paid for the running of the business can be reclaimed from HMRC.

A business whose turnover does not reach £85,000 may voluntarily register for VAT. The reason for doing this will usually be so that the VAT on all its purchases can be claimed back. On the other hand, they will have to charge VAT on the goods it sells. Whether to voluntarily register for VAT will be a matter for each individual company, weighing up the advantages and disadvantages of charging and reclaiming VAT. It should be remembered that if your

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company supplies other businesses, the other businesses will probably be able to claim back the VAT charged. If, on the other hand your business supplies consumers, then the added tax will be borne by the customer.



If a person runs more than one business, the sales in all those businesses must normally be added together to determine whether or not they must register for VAT. However, if there are several separate legal entities, they may not need to combine the sales of those businesses to find whether they need to be VAT-registered. For example, a hotel business which serves meals in its restaurant will normally have to combine the accommodation and the restaurant figures, but a person who owns a grocery store and provides plumbing services at the weekend may not.

Where a business is taken over as a going concern (i.e. a business which will continue to operate as before for the foreseeable future), the cost of buying the business is outside the scope of VAT. However, if you are not already registered for VAT, then to find out if you have to be registered, you must add your own VAT taxable turnover over the previous 12 months (if any) to that of the VAT-registered business you're taking over. If the total exceeds the registration threshold, you'll have to be registered for VAT from the day of the transfer.

If HMRC decides that a person has artificially separated one business into smaller parts to avoid registering for VAT, it can decide that the entire business is a single taxable person and therefore must be registered for VAT.

Situations that HMRC may consider a single taxable person for VAT purposes include:

- Separate entities selling to registered and unregistered customers. The VAT registered entity sells only to VAT-registered customers, and the entity not registered for VAT sells to customers who are not registered for VAT.
- The same equipment or premises being used by different entities on a regular basis. The premises and/or equipment are owned by one of the parties, who charges rent to the others. This situation may occur in businesses such as launderettes and takeaway food operations.
- Splitting up what is usually a single sale. This is common in industries such as the bed and breakfast trade, where one business supplies the bed and another the breakfast.

If you don't register when you should have, HMRC will make an estimate of the VAT that should have been charged to your customers. If it is some time since you should have registered this can amount to quite large sums, and remember it is VAT that you didn't charge so you will have to pay it out of your own business funds unless you can recover this from your customers. HMRC may allow you to treat the invoices as VAT inclusive. In addition, a penalty will be charged. The penalty will be a percentage of the VAT due (the difference between the VAT you should have charged your customers and the VAT you paid on buying goods and services). The percentage will depend on the circumstances.

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The business faces a failure to notify penalty. Essentially, where there is a reasonable excuse which led to the late registration, there will be no penalty. However, there is a sliding scale of penalties which can be applied in other situations.

HMRC have different rates of penalties dependent on the type of inaccuracy. These inaccuracies come under three headings.

- **Non-deliberate.** This is where the business failed to tell HMRC the liability to tax within the relevant time limit, but the failure was not deliberate or deliberate and concealed.
- **Deliberate.** This is where the business knew that they should have told HMRC about the liability to tax within the relevant time limit, but you chose not to tell them.
- **Deliberate and Concealed.** This is where the business knew that they should have told HMRC about the liability to tax within the relevant time limit, but they chose not to. As well as choosing not to tell HMRC, they also took active steps to hide the failure to notify.

The penalties may be reduced if the error is brought to the attention of HMRC by the taxpayer before HMRC has any idea that there is an error. This is known as an **unprompted disclosure**.

The penalty may also be reduced if HMRC discovers the error (a **prompted disclosure**) but where the taxpayer fully cooperates in putting the error right.

The penalty charged will be a percentage of the tax that would have been lost had the error remained undetected. This is the **Potentially Lost Revenue (PLR)**. There is a sliding scale of penalties which is shown in the table below.

There are two tables: one for failure to register within 12 months of the tax being due and another for more than 12 months

(Please note that this information is available during your AAT assessment, so while you need to know what it means, you won't have to learn the percentages by heart.)

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Failure to register within 12 months of the tax being due

Type of behaviour	Maximum penalty	Unprompted Minimum penalty	Prompted Minimum penalty
Reasonable excuse	No penalty	No penalty	No penalty
Non-deliberate	30%	0%	10%
Deliberate	70%	20%	35%
Deliberate and concealed	100%	30%	50%

Failure to register more 12 months of the tax being due

Type of behaviour	Maximum penalty	Unprompted Minimum penalty	Prompted Minimum penalty
Reasonable excuse	No penalty	No penalty	No penalty
Non-deliberate	30%	10%	20%
Deliberate	70%	20%	35%
Deliberate and concealed	100%	30%	50%

Penalties are charged anywhere between the minimum and maximum penalties. HMRC have guidance when applying a reduction but this is beyond the scope of this unit.

In the most serious cases, the person may be subject to criminal proceedings.

HMRC will expect the business to pay the VAT which would have been due had the business registered at the right time. The business then has the option of paying the tax themselves, or going back to their customers and asking for a VAT payment.

Failure to register is likely to prompt a compliance check from HMRC (see p9)

A person can apply to HMRC for an exception from registering for VAT if they can prove that they have gone over the threshold temporarily and in the longer term they will be trading at less than the deregistration threshold. For example, one particularly large order may have taken the trader over the threshold, but this is a one-off order and is not likely to recur.

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IMPORTANT POINT

VAT, as with any tax, is liable to change. VAT rates, thresholds and regulations may change at each Government Budget. Readers are therefore advised to check that the rates given in this book are still current when you read this.

VAT information is available at the following sites:

<https://www.gov.uk/browse/tax/vat>

<https://www.gov.uk/topic/business-tax/vat>

An electronic copy of the VAT Guide (Notice 700) is available online at

<https://www.gov.uk/government/publications/vat-notice-700-the-vat-guide/vat-notice-700-the-vat-guide>

Registered business must notify of certain changes within a specific timescale. For most changes this must be within 30 days. These changes will include a change of business name or address, changes in partnership members, a change of agent, or a change in the activities of the business. However, changes in bank account details must be notified 14 days in advance of the change.

How VAT is applied to sales

A business can register for VAT online at www.hmrc.gov.uk. A registration certificate will then be issued giving the details of registration including a unique VAT registration number. This number must be quoted on all invoices and credit notes as well as some other business documents. The invoices and credit notes must contain certain information which we will look at in a moment. There are various rates of VAT but it is the **supplier's responsibility** to calculate it correctly.

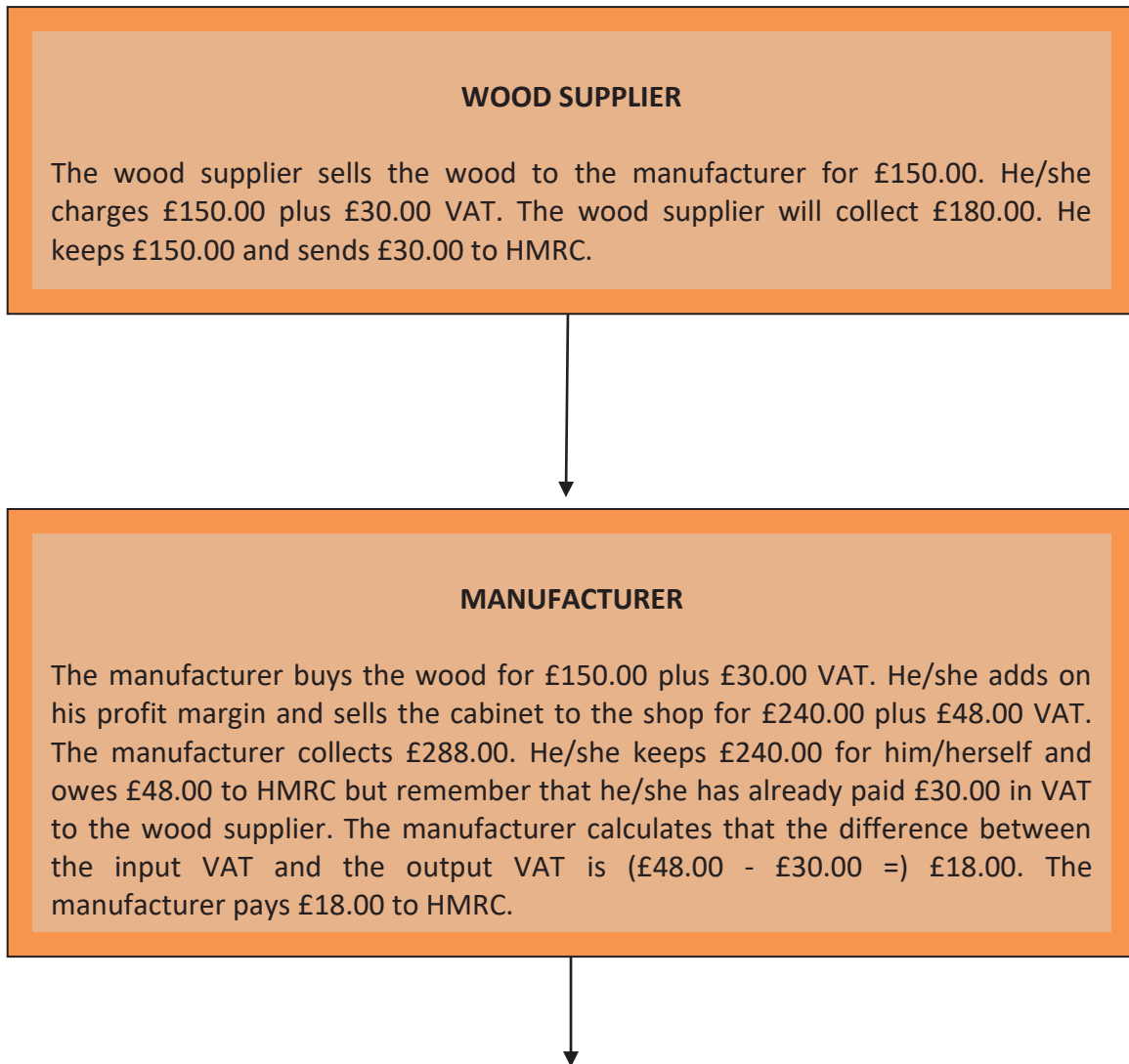
Once registered a business **must** charge VAT on all qualifying sales, but it may also reclaim any VAT it has paid on goods for sale or other items and expenses needed for the running of the business. The VAT paid on expenses in setting up the business can also be reclaimed even if these were incurred before the registration date. However, the expenses must be directly involved in setting up the business and in the case of goods, they must still be in use at the date of registration. The time limit for claiming pre-registration VAT is 4 years for goods and 6 months for services.

In simple terms, a VAT registered company will charge VAT on all its sales. This is called **output tax**. The company will pay VAT on all its purchases. This is called **input tax**. Usually, a business works out the difference between the output tax and the input tax every three months. If the output tax is more than the input tax then the company pays the difference

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to HMRC. If the input tax is more than the output tax then the company will receive a refund of the difference from HMRC.

Let us now take a look at how VAT is only a tax on the final consumer. (The definition of a consumer is someone who buys goods or services for their own personal use.) We will use an example of making a cabinet for sale of £300 plus VAT. VAT at 20% on £300 is £60.00. The following example shows how HMRC only collects £60.00 even though there are four stages to the sale, each of which involves VAT.



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SHOP

The shop buys the cabinet for £240.00 plus £48.00. The shopkeeper adds on a profit margin and sells the cabinet to the final customer for £300 plus £60.00 VAT. The shop keeper collects £360.00. He/she keeps £300.00 for him/herself and owes £60.00 to HMRC but remember that he/she has already paid £48.00 VAT for the cabinet to the manufacturer. The shopkeeper calculates that the difference between the input VAT and the output VAT is (£60.00 - £48.00 =) £12.00. The shopkeeper pays £12.00 to HMRC



FINAL CONSUMER

The final customer buys the cabinet for £300.00 plus £60.00 VAT. He/she cannot claim back any VAT so he/she has to pay £360.00 to the shopkeeper. He/she pays nothing directly to HMRC.



SUMMING UP

The wood supplier pays £30.00 to HMRC	£30.00
The manufacturer pays £18.00 to HMRC	£18.00
The shopkeeper pays £12.00 to HMRC	£12.00
The final consumer pays £0.00 to HMRC	<u>£ 0.00</u>
TOTAL TO HMRC	£60.00
VAT CHARGED TO FINAL CONSUMER	£60.00

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Readers should now see that the only person to actually pay any VAT is the final consumer even though the actual payments have been made in various amounts by the people supplying the goods. The supplier, manufacturer and shopkeeper have all claimed back the amounts they have paid.

VAT officers will visit businesses from time to time, called **compliance checks**, to check that the VAT records are being kept correctly, that VAT is being charged correctly and that only the VAT on eligible purchases are reclaimed. VAT officers have the right to see records going back for **six years**. In practice this means that you should keep documents for the previous six years **plus** the current year, making seven years in total. Each visit takes from a couple of hours to several days, depending on the complexity of the business. The important records to keep are

- Copies of invoices issued
- Invoices received
- Credit Notes
- Records of imports and exports
- Records of items on which VAT cannot be reclaimed
- Records of goods taken for own use
- Records of zero-rated, reduced, or exempt items both bought and sold
- Bank statements, cheque stubs, cash books and till rolls
- VAT Control Account (see next chapter)



How often VAT officers visit will depend on the size and complexity of the business and the business's past record of meeting VAT requirements. If there have been previously submitted late or incorrect VAT payments or declarations, then VAT officers will visit more often. On average a business can expect a visit every 5 years.

VAT officers will question the business owner about the type of business and will examine the documents they have requested. At the end of the visit, the VAT officer will:

- review with the owner, the work carried out during the visit
- explain any areas of concern they have identified, discuss them with the owner and agree any future action needed
- explain any adjustment they need to make to the VAT payable, agree it with the owner as far as possible and explain how it will be made
- tell the owner if they have overpaid or underpaid

VAT officers are also there to help. They will give help and advice on VAT matters which are raised by the business owner.

A person who fails to keep records is liable to a penalty of £500.

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Rates of VAT

In the UK, from January 4th 2011 VAT is charged at the standard rate of 20%. However, some items are charged at a lower rate (5%) such as domestic gas and electricity, or even at zero rate such as many food items and children's clothes. There is no complete list of what is charged at what rate but informative lists are available. The most notable of these is the VAT 700 notice, known as the 'VAT Guide'. This is a booklet free of charge from HMRC and gives an overview of VAT and lists items which may be charged at the lower rate or the zero rate. It is also available online at <https://www.gov.uk/government/publications/vat-notice-700-the-vat-guide/vat-notice-700-the-vat-guide>

Some items are treated as exempt from VAT. This is different to zero rated goods in that any VAT paid by the business on supplies can be reclaimed by a business that makes zero rated sales, but not by one that makes exempt supplies.

You must be clear on the distinction between businesses which make zero rated sales and business which make exempt sales. The important principle to remember is the distinction between those who can reclaim VAT and those who can't. If you make zero rated sales you **can** reclaim VAT on your purchases and expenses, but if you make exempt sales then you can't.

Most goods which are sold are subject to the standard rate of VAT. There is no complete list of the exceptions, but the following shows some goods which are not standard rate. Remember that if you are at all unsure then you should contact HMRC for a ruling. It is always best to get any such rulings in writing. If HMRC makes a ruling about any rate of VAT on particular goods then it is legally binding, even if it subsequently turns out that HMRC was wrong. HMRC can change their mind and tell you they were wrong, but if they do, they cannot make you pay VAT retrospectively if they told you that you didn't have to. On the other hand, if you don't charge VAT on goods which should have attracted VAT and you didn't get a ruling, then HMRC will make an estimate of all the lost tax for the previous six years. This can come to a substantial amount.

Goods and services charged at the lower rate (5%):

- Energy saving materials for residential properties. This includes the installation of central heating controls, insulation and solar panels. (If you do it yourself then the goods are charged at standard rate).
- Smoking cessation goods such as nicotine patches and gum.
- Fuel for domestic premises. (Fuel for businesses is charged at standard rate).
- Renovating or converting a residential building.
- Children's car seats.

Goods and services charged at zero rate:

- Equipment for the blind and disabled.
- Prescriptions from a registered pharmacist.
- The construction of new residential buildings.

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- Transport in a bus, aeroplane or any vehicle as long as it is designed to carry 10 or more people.
- Caravans more than 7 metres long.
- Books, magazines and newspapers.
- Children's clothing.
- Cycle and motorcycle helmets.
- Food and drink, **but not** alcoholic drinks, confectionery, savoury snacks, hot takeaways or food for catering.
- Women's sanitary products.

Goods and services exempt from VAT:

- Many sporting activities, but not admission charges for spectators.
- Betting and gaming.
- Some admission charges to cultural events.
- Antiques and works of art sold to public collections.
- Burial and cremation.
- Medical treatment and health services.
- Education carried out by schools or colleges.
- The sale or leasing of land and buildings in most circumstances.
- Postal services provided by the Royal Mail.
- The supply of loans or credit.
- Insurance.
- Charges associated with a current, deposit or savings account offered by banks.

This list does not cover all items, and some items may be treated differently if certain conditions apply. If in doubt you must contact HMRC.

There are some items that aren't in the UK VAT system at all. They are **outside the scope** of VAT. They are not taxable supplies at all. Items will include

- Non-business activities such as hobbies (you might sell your stamp collection).
- Fees that are fixed by law (for example an MoT test, Council Tax or TV licence).
- Donations to charity and gratuities (tips).
- Supplies within the business, including bank transfers and the payment of wages.
- Bridge and road tolls where it is operated by a public authority.

Chapter Summary

- Indirect tax is a tax levied on goods and services.
- VAT is the most important indirect tax in the UK.
- You must register your business for VAT if your taxable sales reach the registration threshold during the previous 12 months or if it is expected to be reached during the following 30 days.
- You can voluntarily register for VAT even if your sales do not reach the threshold amount.
- VAT is a tax on the final customer only.
- VAT officers visit businesses to ensure that VAT is applied in the correct way and at the correct rate.
- There are three different rates of VAT:
20%.
5%.
Zero rate.
- Some sales are exempt from VAT, while others may be outside the scope of VAT altogether.

Practice Questions

Chapter 1

1.1

VAT is one kind of:

- (a) Direct tax.
- (b) Indirect Tax.
- (c) Input Tax.
- (d) Output Tax.

1.2

Which of the following must register for VAT within the next 30 days?

- (a) A company has determined that over the next 12 months sales will be above the registration threshold.
- (b) A company has sales of £31,000 for the last 6 months and expects the next six months trading to show sales which will take it over the registration threshold.
- (c) A company has been trading for 11 months and has a turnover of £78,000. During the next 30 days sales are expected to take the company above the registration threshold.
- (d) A company makes up its accounts from January to December. Its published turnover for January to December show sales below the registration threshold. However, the sales for February to January are above the registration threshold.

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1.3

Which of the following are entitled to register for VAT?

- (a) A person who advertises their private car for sale in the local paper.
- (b) A person who sells their own private possessions at a car boot sale from time to time.
- (c) A person who regularly buys goods over the internet to sell to customers.
- (d) A school which provides education which is exempt from VAT.

1.4

VAT officers can legally demand to look at relevant documents that are

- (a) Up to 3 years old
- (b) Up to 3 months old
- (c) Up to 6 years old
- (d) Up to 6 months old

1.5

What is the difference between zero rated supplies and exempt supplies?

- (a) Nothing; they mean the same.
- (b) For zero rated supplies the input tax can be reclaimed, but for exempt supplies it cannot.
- (c) Zero rate can only be applied to goods and exempt can only be applied to services.
- (d) For exempt supplies the input tax can be reclaimed, but for zero rated supplies it cannot.

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1.6

For the following goods, state what rate of VAT would be charged:

1. Fish and chips to take away
- 2 Sandwiches to take away
- 3 A packet of biscuits
- 4 A Victoria Sponge cake
- 5 A taxi fare
- 6 A packet of crisps
- 7 A National Lottery ticket
- 8 A shirt from the children's section of a clothes store
- 9 A shirt from the adults' section of a clothes store
- 10 A 'book' of postage stamps
- 11 A pack of envelopes
- 12 Your bus fare home

1.7

A person may wish to voluntarily register for VAT for which of the following reasons:

- (a) They can reclaim the VAT charged to their customers.
- (b) They can reclaim the VAT paid to their suppliers of business goods and services.
- (c) The image of the business.
- (d) They can claim back input VAT on all purchases, even those which are used to make exempt items of sale