CHAPTER 1

VAT GENERAL PRINCIPLES

1.1 VAT legislation and interpretation

Value added tax (VAT) was introduced in the UK on 1 April 1973 by the *Finance Act 1972*. Successive Finance Acts have made amendments to the law which has also been consolidated, most recently by the *Value Added Tax Act 1994* (*VATA 1994*).

The Acts provide the framework of the tax but much of the detail is to be found in statutory instruments, either in the form of *Orders* made by the Treasury or *Regulations* made by HMRC.

The Government have empowered Her Majesty's Revenue and Customs (HMRC) previously known as Customs & Excise (hereafter called "HMRC" in this text) to manage this tax.

1.2 European Community legislation

The overriding law on VAT throughout the European Community (EC) is in the EC *Directives*, notably Council Directive 2006/112/EC which recast the articles of the 1st and *6th VAT Directives from 1 January 2007*. The form and method of compliance is left to individual EC countries but, where any of the provisions are mandatory, EC law takes precedence if there are any inconsistencies with national law.

1.3 Interpretation of the law by HMRC

HMRC issue explanatory notices on VAT, together with VAT notes, news releases and business briefs. These explain how they interpret the law. With certain exceptions, these are not part of the law and this should be borne in mind where the manual indicates a notice or leaflet, etc. as source material.

If a taxable person disagrees with the interpretation, he has a right of appeal, in certain cases, to the First-Tier tax tribunal.

1.4 General Principles of VAT

VAT is a tax on consumer expenditure and is collected on business transactions and imports. The basic principle is to charge VAT at each stage in the supply of goods and services (output tax). If the customer is registered for VAT and uses the supplies for business purposes, he will receive credit for this VAT (input tax). The broad effect is that businesses are not affected and VAT is actually borne by the final consumer.

Basically VAT registered businesses **charge VAT on their sales at 17.5%.** This is the **standard rate** of VAT.

This rate was **temporarily reduced to 15% for the period starting with the 1st of December 2008 until the 31st of December 2009**.

In addition the VAT rate will rise to **20% from 4th January 2011.**

In a later chapter on 'tax points' we will look at the implications surrounding a change in the rate of VAT. For example, you might have a supply that 'straddles' the two rates. But for now, for the purposes of the illustrations and examples in this chapter we will assume that the 17.5% rate applies throughout. As well as the standard rate of VAT, there are other rates that can apply to particular supplies, for example the **zero rate.** We will cover these other rates in later chapters.

Illustration 1

Stage 1

Mr Wood owns a small forest in which he grows trees. He sells the timber commercially and is registered for VAT.

Mr Wood sells £1,000 of timber to a local furniture maker. As Mr Wood is VAT registered, he must add VAT to his selling price. The standard rate of VAT is 17½%. Mr Wood will provide an invoice as follows;

	£
Selling price	1,000
Add: VAT @ 17½%	175
Consideration paid by furniture maker	1,175

The £175 of VAT charged by Mr Wood is "output tax" (being VAT charged on goods going "out").

Mr Wood will complete a VAT return and pay this output tax to HMRC.

The £175 of VAT paid by the furniture maker is "input tax" (being VAT incurred on goods coming "in").

Stage 2

The furniture maker uses the timber to make some chairs. He sells furniture commercially and is registered for VAT.

The furniture maker sells the chairs to Chair World Ltd (a high street retailer) for £3,000. As the furniture maker is VAT registered, he must add VAT to his selling price. The furniture maker will provide an invoice as follows;

	£
Selling price	3,000
Add: VAT @ 17½%	525
Consideration paid by Chair World Ltd	3,525

The £525 of VAT charged by the furniture maker is "output tax".

The furniture maker will complete a VAT return and pay this output tax to HMRC. However as he incurred input tax when buying the timber from Mr Wood, he is allowed to credit the input tax incurred against the output tax he has collected.

The VAT return will therefore be as follows:

	£
Output tax collected	525
Input tax suffered	(175)
Payable to HMRC	350

Stage 3

Chair World Ltd sells chairs to the Mr Smith. The company is registered for VAT.

Chair World Ltd sells the chairs for £8,000. As the company is VAT registered, it must add VAT to the selling price. Chair World Ltd will provide an invoice as follows;

	£
Selling price	8,000
Add: VAT @ 17½%	1,400
Consideration paid by Mr Smith	9,400

The £1,400 of VAT charged by Chair World Ltd is "output tax".

Chair World Ltd will complete a VAT return and pay this output tax to HMRC. However as they incurred input tax when buying the chairs, credit can be claimed for the input tax incurred against the output tax collected.

The VAT return will therefore be as follows:

	£
Output tax collected	1.400
Input tax suffered	(525)
Payable to HMRC	875

Summary

The total VAT paid to HMRC in this chain of transactions is as follows;

	£
From Mr Wood	175
From furniture maker	350
From Chair World Ltd	875
Total collected by HMRC	**£1,400**

The £1,400 is effectively the VAT paid by Mr Smith when he purchased the chairs. As Mr Smith is a member of the public and is not a VAT registered trader, he cannot reclaim this input tax.

This illustration shows how VAT cascades down a chain of transactions until it is ultimately suffered by a person who cannot reclaim (usually a member of the public).

1.5 Scope of VAT

A transaction is within the scope of UK VAT if **all** the following conditions are met.

- It is a supply of goods or services.
- It takes place in the UK.
- *It is made by a taxable person.* A taxable person is an individual, partnership or company, which is registered for VAT.
- It is made in the course or furtherance of any business carried on by that person.

A transaction which does not meet **all** of the above conditions is outside the scope of UK VAT.

1.6 Place of supply

To be within the charge to UK VAT, a supply must be made in the UK. Supplies made outside the UK are outside the scope of UK VAT (although they may be liable to VAT in another country).

1.7 Time of supply (tax point)

The time at which a supply of goods is treated as taking place is called the "tax point". VAT must normally be accounted for in the VAT period in which the tax point occurs and at the rate of VAT in force at that time.

Small businesses can, however, account for VAT on the basis of cash paid and received.

The tax point rules will be covered in detail in a later chapter.

1.8 Output tax

Output tax is the VAT due on taxable supplies and is the liability of the person making the supply.

A particular supply may be complicated by being a "mixed supply" where a single inclusive price is charged for a number of separate supplies. Where these supplies are taxable at different rates, a fair and justifiable apportionment of the total price must be made.

Small businesses with turnover below specified annual limits can opt to join a "flat-rate" scheme under which they calculate VAT due by applying a flat-rate percentage to tax-inclusive turnover. The flat-rate percentage varies with the trade sector into which a business falls.

1.9 Input tax

A taxable person is entitled to reclaim input tax suffered on goods and services supplied to him, provided that the input tax relates to taxable business supplies made by him in the course of business.

Taxable supplies are those chargeable at the standard rate (17½%), the reduced rate (5%) or the zero rate (0%).

VAT cannot be recovered on goods and services which are not used for business purposes (e.g. for private use). Where goods are used partly for business and partly for non-business purposes, the VAT incurred is normally apportioned.

VAT incurred on a number of items is non-deductible. The most common of these are motor cars (with certain exceptions) and business entertainment.

Special rules also apply to input tax incurred before registration for VAT, and after deregistration.

1.10 VAT rates

There are currently three main rates of VAT, a standard rate of 17.5%, a reduced rate of 5% and a zero rate.

The effect of a supply being zero-rated is as follows.

- The amount of VAT on the supply is nil but it is still a taxable supply.

- As a taxable supply, it must be taken into account in determining whether registration is required.
- Input tax may be reclaimed subject to the same rules as for standard-rated supplies.
- Where a supply could be either zero-rated or exempt, zero-rating takes priority.

1.11 Exempt supplies

Certain supplies are exempt from VAT. This means that no VAT is chargeable but, unlike zero-rated supplies, related input tax is not recoverable.

Where a person makes both taxable supplies and exempt supplies, he is partially exempt and may not be able to recover all his input tax. Special rules apply to work out how much input tax can be reclaimed.

1.12 Registration

Where a person is in business and making taxable supplies, the value of these supplies is his "taxable turnover".

If, at the end of any month;

- taxable turnover in the previous 12 months has exceeded the "registration threshold" (currently £70,000), or
- there are reasonable grounds for believing that the value of taxable supplies in the next 30 days will exceed the threshold;

that person normally becomes a taxable person and must notify HMRC of his liability to register for VAT. There are financial penalties for failing to do so.

Where, however, only zero-rated supplies are made, HMRC have a discretion to exempt a person from registration.

Even if taxable turnover is below the specified limit, a person who makes taxable business supplies can request voluntary registration.

VAT registration will be covered in detail in the next chapter.

1.13 Invoices

A registered taxable person must issue a VAT invoice where he makes a standard or reduced-rated supply to another taxable person in the UK.

1.14 Returns and payment of VAT

Every taxable person must submit a VAT return declaring the output tax and input tax for each VAT period. A VAT period is normally three months but a one month period is also allowed, particularly where input tax is likely to exceed output tax on a regular basis.

The VAT return must be sent to HMRC (together with any VAT due) no later than one month after the end of the period. The due date for payment will be extended by seven days where payment is made by credit transfer. Certain large VAT payers must make monthly payments on account.

From **1 April 2010** businesses that have an **annual VAT exclusive turnover of £100,000 or more** or **register for VAT on or after 1 April 2010** must file VAT returns online and **pay VAT electronically**. This automatically extends the date payment is due by seven calendar days.

1.15 Annual accounting

Smaller businesses with annual turnover below £1.35m may apply to join the "annual accounting" scheme. This allows them to complete one VAT return each year.

Monthly payments on account are required based on an estimate of the amount of VAT due.

The annual VAT return must be completed and sent to HMRC, with any balancing payment, within two months of the end of the annual VAT accounting period.

1.16 Records

Every taxable person must keep such records and information as HMRC require.

Specifically, these include business and accounting records, the VAT account, copies of all VAT invoices and credit notes issued and received, and documentation relating to imports, exports, and acquisitions of goods from other EC countries.

All such records must be kept for six years unless HMRC agree to a shorter period.

1.17 Bad debts

VAT is normally due by reference to the tax point. The supplier must therefore account to HMRC for the VAT even if the debt, including the VAT, is not paid.

By way of relief, VAT can be reclaimed where a debt has been written off and six months has elapsed from the date payment is due. The problem of VAT on bad debts can also be removed by using the cash accounting system.

1.18 Cash accounting

Provided turnover is below an annual limit (£1.35m), a taxable person may account for and pay VAT on the basis of cash paid and received.

The main advantages of the scheme are automatic bad debt relief and the deferral of the time for payment of VAT where extended credit is given.

1.19 Interest and penalties

Interest is chargeable where VAT has been underdeclared or overclaimed. On the other hand, repayment supplement is due where HMRC do not make a repayment on time and interest can be paid to the taxpayer where VAT has been overpaid or underclaimed as a result of error by HMRC.

There is an extensive range of criminal and civil penalties. Liability for certain civil penalties can be avoided where there is reasonable excuse for conduct and penalties can be mitigated by HMRC or a tribunal.