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VAT matters for the smaller business

This briefing focuses on VAT matters of relevance to the smaller business. A primary aim is to highlight common risk areas as a better understanding can contribute to a reduction of errors and help to minimise penalties. Another key ingredient in achieving that aim is good record keeping, otherwise there is an increased risk that the VAT return could be prepared on the basis of incomplete or incorrect information. This aspect is not considered further here but useful guidance can be found in www.hmrc.gov.uk/factsheet/record-keeping.pdf

Input VAT matters

Only registered traders can reclaim VAT on purchases providing:

- the expense is incurred for business purposes and
- there is a valid VAT invoice for the purchase.

Only VAT registered businesses can issue valid VAT invoices. VAT cannot be reclaimed on any goods or services purchased from a business that is not VAT registered. Proforma invoices should not be used as a basis for input tax recovery as this can accidentally lead to a duplicate VAT recovery claim.

Most types of supply on which VAT recovery is sought must be supported by a valid VAT invoice. This generally needs to be addressed to the trader claiming the input tax. A very limited list of supplies do not require a VAT invoice to be held to support a claim, providing the total expenditure for each taxable supply is £25 or less (VAT inclusive). The most practical examples of these are car park charges and certain toll charges.

The following common items however never attract input VAT and so no VAT is reclaimable - stamps, train, air and bus tickets, on street car parking meters and office grocery purchases like tea, coffee and milk!

Business purpose

This is often an area of contention between taxpayers and HMRC as VAT is not automatically recoverable simply because it has been incurred by a VAT registered person.

In assessing whether the use to which goods or services are put amounts to business use (for the purpose of establishing the right to deduct input tax), consideration must be given as to whether

the expenditure relates directly to the function and operation of the business or merely provides an incidental benefit to it.

Private and non-business use

In many businesses, personal and business finances can be closely linked and input tax may be claimed incorrectly on expenditure which is partly or wholly for private or non-business purposes.

Typical examples of where claims are likely to be made but which do not satisfy the 'purpose of the business' test include:

- expenditure related to domestic accommodation
- pursuit of personal interests such as sporting and leisure orientated activities
- expenditure for the personal benefit of company directors/proprietors and
- expenditure in connection with non-business activities.

Where expenditure has a mixed business and private purpose, the related VAT should generally be apportioned and only the business element claimed. Special rules apply to recover input tax claimed on assets and stock (commonly referred to in VAT as goods) when goods initially intended for business use are then put to an alternative use.

Example

Three laptops are initially bought for the business and input VAT of £360 in total is reclaimed.

One is then gifted by the business owner to his son so VAT will have to be accounted for to HMRC of £120 (1/3 x £360)

Business entertainment

VAT is not reclaimable on many forms of business entertainment but VAT on employee entertainment is recoverable. The definition of business entertainment is broadly interpreted to mean hospitality of any kind which therefore includes the following example situations:

- travel expenses incurred by non employees but reimbursed by the business, such as self employed workers and consultants
- hospitality elements of trade shows and public relations events.

Business gifts

A VAT supply takes place whenever goods change hands, so in theory any goods given away result in an amount of VAT due. The rule on business gifts is that no output tax will be due, provided that the VAT exclusive cost of the gifts made does not exceed £50 within any 12 month period to the same person.



Where the limit is exceeded, output tax is due on the full amount. If a trader is giving away bought-in goods, HMRC will usually accept that he can disallow the tax when he buys the goods, which may be more convenient than having to pay output tax every time he gives one away.

Routine commercial transactions which might be affected include such things as:

- long service awards
- Christmas gifts
- prizes or incentives for sales staff.

Cars and motoring expenses

Input tax errors often occur in relation to the purchase or lease of cars and to motoring expenses in general. Some key issues are:

- Input VAT is generally not recoverable on the purchase of a motor car because it is not usually exclusively for business use. This prohibition does not apply to commercial vehicles and vans, provided there is some business use.
- Where a car is leased rather than purchased, 50% of the VAT on the leasing charge is not claimed for the same reason.
- Where a business supplies fuel or mileage allowances for cars, adjustments need to be made to ensure that only the business element of VAT is recovered. There are a number of different methods which can be used, so do get in touch if this is relevant to you.

Output VAT issues

Bad debts

Selling on credit in the current economic climate may carry increased risk. Even where credit control procedures are strong there will inevitably be bad debts. As a supplier, output VAT must normally be accounted for when the sale is initially made, even if the debt is never paid, so there is a risk of being doubly out of pocket.

VAT regulations do not permit the issue of a credit note to cancel output tax simply because the customer will not pay! Instead, where a customer does not pay, a claim to recover the VAT on the sale as bad debt relief can be made six months after the due date for payment of the invoice.

Example

A trader supplies and invoices goods on 19 October 2010 for payment by 18 November 2010 (ie a normal 30 day credit period). The earliest opportunity for relief if the debt is not settled would be 18 May 2011. The relief would be included in the return into which this date fell, depending on the return cycle of the business.

The amount of the claim

The taxpayer can only claim relief for the output tax originally charged and paid over to HMRC, no matter whether the rate of VAT has

subsequently changed. In the above example the standard VAT rate charged would have been 17.5% (not the current 20%) so a claim can be made for only 17.5%. The claim is entered as additional input VAT - treating the uncollected VAT as an additional business expense - rather than by reducing output VAT on sales.

The customer

A customer is automatically required to repay any input VAT claimed on a debt remaining unpaid six months after the date of the supply (or the date on which payment is due if later). Mistakes in this area are so common that visiting HMRC officers have developed a programme enabling them to review Sage accounting packages and to list purchase ledger balances over 6 months old for disallowance.

Preventing the problem?

Small businesses may be able to register under the Cash Accounting Scheme, which means you will only have to account for VAT when payment is actually received. The scheme is considered in more detail later in this briefing.

Special schemes for the smaller business

Several special schemes relate to smaller businesses. These are mainly aimed at reducing the compliance burden.

The Flat Rate Scheme (FRS)

FRS is an attempt to simplify VAT accounting for the small or growing business. This optional scheme provides currently registered traders with an alternative mechanism for accounting for VAT, and offers an additional incentive for new registrations.

The scheme enables eligible businesses to calculate their VAT payment as a flat percentage of total turnover. The percentage to be used depends on the type of business activity carried on. If the business is newly registered for VAT and also decides to operate this scheme then a further 1% flat rate reduction applies in that first year of registration.

Example

Jonas runs a takeaway and all sales are standard rated. He has recently registered for VAT. If he registers for FRS his output VAT will be calculated for the next 12 months as 11.5% on total turnover. That is 12.5% for that business sector from 4 January 2011 less the 1% discount for his first year as a VAT registered trader. He will not be able to reclaim any input VAT except for any input VAT on capital assets purchased for the business with a VAT inclusive cost in excess of £2,000.

If he does not register for the scheme then he will have to account for output VAT at 20% on all sales less a claim for all receipted allowable input VAT. A facility exists on HMRC's website to estimate whether in his specific circumstances this is economically worthwhile.

Who is eligible?

The scheme is generally open to small businesses whose annual taxable turnover excluding VAT does not exceed £150,000. Traders must now leave the scheme when their taxable turnover (including VAT) exceeds £230,000. This calculation must be made annually on the anniversary of the trader joining the scheme.

Tax pitfalls

Specific risk areas to watch when operating the scheme include:

- calculating turnover on which the VAT liability is based and
- selecting the correct flat rate percentage for the business sector.

However, if you consider this scheme may be useful we can assist on these matters.

Annual Accounting Scheme

The Annual Accounting Scheme is also generally aimed at the smaller business. It can either be combined with FRS (described above) or used by a business which uses standard VAT accounting. The scheme allows the business to complete just one VAT return each year, instead of the usual four. However, it retains a smooth cash flow position as instalment payments of the expected VAT liability are made on account, so that the business is not faced with a large VAT bill at the end of the year.

A choice of three (quarterly) or nine (monthly) instalments can be made towards the end of year VAT liability. These must be paid by direct debit, standing order or other electronic means.

A business with a taxable turnover up to £1.35 million can apply for entry into this scheme.

Cash Accounting Scheme

Another popular small business scheme is the Cash Accounting Scheme.

Under standard VAT accounting, VAT is payable on sales whether or not the customer has paid and can lead to a need to claim bad debt relief (as detailed earlier). Under this scheme VAT does not need to be paid over until the customer has paid. If the customer does not pay then the VAT is not payable. This clearly has cash flow benefits for traders which sell on credit.

A business can enter this scheme provided the estimated VAT taxable turnover for the next VAT year is not more than £1.35 million. It can continue to use the scheme until the VAT taxable turnover exceeds £1.6 million.

Flipping the coin

Where your business is registered under the Cash Accounting Scheme, do remember that this also means that VAT cannot be claimed on purchases and other inputs until you have actually made the payment, rather than the standard method of accounting for the reclaim when you receive the invoice.

We can advise you if this scheme would be suitable for your business.