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# VAT: what the smaller business needs to know

VAT can seem daunting to the smaller business, not least because of a strict penalty regime. But a good grasp of the basics can help reduce errors and minimise the risk of penalties. This Briefing offers guidance in a number of key areas.

## VAT basics

A VAT registered business collects tax on behalf of HMRC. It charges VAT – known as output tax - on its sales. It is then responsible for paying this to HMRC – usually quarterly. Most goods and services which the business purchases are also subject to VAT: this is known as input tax. Input tax is deducted from output tax owed to HMRC - though there are some types of input which cannot be treated like this.

Not every business charges output tax on its sales. Some sales, like financial services, are exempt from VAT. Others, like food and children's clothing, are zero rated. Rather than paying VAT to HMRC, businesses making mainly zero rated supplies may be 'repayment traders' and get a refund of the input tax they've paid.

VAT has major implications for business cash flow. Output tax monies enhance liquidity, but it is important to keep track of what is owed to HMRC. Businesses can be lulled into a false sense of financial security by a strong bank balance, when in fact part of this represents the end of quarter VAT liability. Good systems and record keeping are essential here.

## Common areas of confusion

### Reclaiming VAT on purchases

Registered traders can reclaim VAT on purchases on two conditions: the expense must be incurred for the purpose of the business and there must be a valid VAT invoice for the purchase. There are precise requirements as to what constitutes a valid VAT invoice **goo.gl/SkJkWN**

In limited circumstances, HMRC may accept claims for input tax with alternative evidence, but this is a discretionary area. The evidence required is still precise, and we would be happy to provide specific advice to maximise your input recovery. In addition, there is a very limited list of supplies, such as car park charges and some toll charges, for which it is not necessary to provide a VAT invoice to reclaim input tax, so long as the total expenditure for each taxable supply is £25 or less (including VAT).

VAT can never be reclaimed on: stamps; train, air and bus tickets; on-street car parking meters; office groceries like tea, coffee and milk. These are purchases often causing confusion. Nor can it be reclaimed on goods or services purchased from a non VAT registered business.

### Business purpose

In the smaller business, personal and business finances are often closely interlinked, and problems can also arise with HMRC in this area, too.

Input tax cannot be reclaimed simply because it relates to expenditure by a VAT registered trader. To qualify, expenditure must relate directly to the purpose of the business. Expenditure that can cause confusion includes expenditure related to domestic accommodation, and expenditure on sport or recreational activities; expenditure for the personal benefit of company directors/proprietors, and expenditure in connection with non-business activities. Such expenditure does not satisfy the 'for the purpose of the business' test.

Some expenditure is for a mix of purposes: it has both a business and a private element. Here VAT should be apportioned, with only the business part reclaimed. Where goods (assets and stock) initially bought for business purposes are later put to a different use, special rules apply.

### Example

Beatrix Potter buys three laptops for her business. Total input VAT of £360 is reclaimed.

One is immediately gifted to Beatrix Potter's son. The VAT then has to be accounted for. It is calculated as: 1/3 x £360 = £120. If gifted later, output tax would be based on market value at that point.

### Business entertainment

The VAT treatment of business entertainment is complex. Generally, VAT is not recoverable on business entertainment - defined as the entertainment of clients or customers. The disallowance could also relate to the VAT on travel expenses incurred to facilitate the entertaining, and the hospitality element in trade shows and public relations events. But VAT incurred on entertaining employees, say as a reward for their work, or to boost morale, through staff parties or team-building exercises, is not blocked from recovery, nor is the VAT on employee subsistence costs. We would be pleased to advise on this complex area.

### Business gifts

In theory, giving goods away creates a VAT liability, as a VAT supply has taken place. With business gifts however, no output VAT is due so long as the VAT exclusive cost of the gifts is not more than £50 in any 12-month period to any one person. If the limit is exceeded, output tax becomes due on the full amount. Business gifts are widely defined to include gifts to both customers and staff. To add to the complexity, slightly different conditions, including the need for a conspicuous advert, apply to determine whether or not the cost of gifts to customers is deductible for income and corporation tax purposes.

### Cars and motoring expenses

Input errors are often made here.

- Input tax cannot generally be recovered on buying new motor cars, except for taxis, driving schools or car dealers. Such businesses are also able to recover VAT on a car leasing charge (see below for the general rule).
- Purchase of commercial vehicles and vans is different. Input tax is generally allowable if the vehicle is for business use.
- Generally, only 50% of the VAT on the leasing charge on cars is reclaimable.
- Where a business supplies fuel or mileage allowances for cars, it must make adjustments so only the business element of VAT on fuel is recovered. Various methods can be used. Please contact us if this is relevant to you.

### Bad debts

Output VAT must normally be accounted for when a sale is initially made, even if the customer doesn't pay. In the case of a bad debt, a claim to recover the VAT on the sale (bad debt relief) can be made six months after the due date for payment of the invoice. In some circumstances, the Cash Accounting Scheme may provide a better solution for the business (see below).

Be aware that where a business, as customer, has reclaimed input VAT, but not paid its supplier, this should also be adjusted. The time limit here is six months after the due date for payment.

### Record keeping and penalties

These aspects are not covered here but useful guidance can be found at **goo.gl/92tge1** and **goo.gl/L3u4Wc**

## Schemes for the smaller business

### Cash Accounting Scheme

Best suited to sectors which wait to get paid, this Scheme can benefit cash flow, enabling a business to account for, and pay VAT, on the basis of cash received and paid, rather than invoice date. This can help with the problem of bad debt relief. On the other hand, Scheme users must wait to recover input tax until they pay their bills. Businesses can join if annual turnover is below £1,350,000.

### Retail Schemes

Retail Schemes exist to simplify procedure for the many businesses dealing with the public and making supplies at different rates of VAT. Rather than keeping records of every sale and calculating their output tax in the usual way, they have different methods of calculating the value of taxable retail supplies and establishing which rates of VAT to use.

### Annual Accounting Scheme

This Scheme means submitting just one VAT return a year, rather than the normal four, thus reducing paperwork. The Scheme also helps businesses budget, as VAT liability is split into quarterly or (nine) monthly payments during the year. These are based on the last return made, or for businesses new to VAT, on estimates. A balancing payment is made with the return. Businesses may join if taxable supplies in the next 12 months are not expected to exceed £1,350,000, and they are up to date with VAT returns. Businesses registered for VAT as a group or part of a division are not eligible.

### Flat Rate Scheme (FRS)

FRS simplifies VAT calculations for the smaller business. Historically, it has also resulted in a reduced VAT liability in some business sectors.

With FRS, VAT is paid as a fixed percentage of VAT inclusive turnover. Input VAT on purchases is not reclaimed (except for certain capital assets over £2,000), and the business keeps the difference between the sum charged to customers and that paid to HMRC. To use FRS, expected taxable sales in the next 12 months must be less than £150,000, excluding VAT. The flat rate percentage depends on the type of business involved: 14.5% for architects and surveyors, 4% for some retailers, for example.

There has been considerable change to the FRS with the introduction of 'limited cost trader' (LCT) status from 1 April 2017. LCTs use a 16.5% rate, which is higher than other categories. If a business has VAT inclusive expenditure on goods either less than 2% of turnover in a prescribed accounting period, or more than 2% but less than £1,000 per annum, it is classed as an LCT. Any FRS business must now establish each VAT return period if it is liable to such classification.

Because LCT status gives only minimal credit for input tax, FRS may no longer be beneficial for some businesses. We would be happy to advise further.

## MTD for VAT: a new way to submit returns and keep records

MTD for VAT (MTDfV) becomes mandatory for any VAT registered business operating above the VAT threshold (£85,000 until at least 2020) for VAT return periods beginning on or after 1 April 2019.

Businesses operating below the VAT threshold will need to monitor turnover carefully. In future, any business reaching the VAT registration threshold will not just have the VAT rules to comply with, but MTD requirements as well.

Businesses currently voluntarily registered for VAT may elect to join MTDfV, but are not mandated to do so. There will be some exemptions, as with the current system of exemption from electronic filing. However, the categories under which exemption can be claimed are tightly-drawn and unlikely to be applicable to most businesses.

MTDfV requirements mean that VAT records must be kept digitally using MTD functional compatible software (software or a combination of software and spreadsheets) which can connect to HMRC via an Application Programming Interface. VAT returns will be generated and submitted direct from a business' digital records, without manual input. A new VAT Notice outlines 'digital journeys' which could achieve this, though a 'soft landing' period of 12 months is envisaged where HMRC will not impose penalties if digital links do not exist between items of software used.

### How we can help

The timescale to implement MTD-compliant processes and record-keeping is short, and it presents challenges - especially given that it coincides with Brexit. It is recommended that businesses check with their software providers what products they will have available, and plan now for compliance. If you would like to discuss how best to make the transition to MTDfV, we should be delighted to be of service.