

Beginners Guide to VAT

This fact file aims to give a **broad overview** of the main principles behind the operation of the VAT regime. It provides an outline of the rationale and workings of the VAT system, together with the compliance and reporting requirements. For more detailed information

A. What is VAT?

EC Directive 2006/112

VAT is a tax on **the supply of goods and services and imports**, which is charged at each stage in a supply chain as goods or services flow from one trader to another. It is not a tax on profits.

The VAT system is designed to allow every taxable person in the supply chain to **recover** any VAT that is incurred by the taxable person on costs. In this way it is the end consumer who bears the tax burden.

VAT is charged on:

- the supply of goods and services in the UK;
- the acquisition of goods and receipt of services in the UK from another EU member state; and
- the importation of goods and services from outside the EU.

Scope

The current VAT system forms the basis of measurement of contributions by each member state towards the budget of the European Union (EU). It is designed to establish a **common basis of indirect taxation** and provide a means of harmonising the fiscal treatment of transactions within the EU.

The principles of the system are contained in EU Directive 2006/112. Many, although not all, of the provisions of this Directive are binding on member states. This means that national law in the EU member states must **implement** the provisions in the Directive, although member states often have a choice as to the methods they use to achieve that. However, if a member state fails to implement a provision, or does so incorrectly, those subject to the tax are entitled to rely on the **direct effect** of the provision.

All member states are obliged to introduce and operate VAT to the exclusion of any other turnover tax. In addition, many other non-EU countries have introduced VAT in some form or another. It is often called Goods and Services Tax (GST), if not VAT.

B. How does VAT operate?

VAT is a transaction-based tax; the charge is levied on any transaction that is:

- a supply of goods or services;
- made within the UK (see below);
- by a **taxable person**;
- in the course or furtherance of a **business**;
- in return for consideration; and
- neither exempted from, nor specifically outside the scope of VAT.

Memo Note

1. In general the **UK** includes:

- England, Scotland, Wales, Northern Ireland and the Isle of Man, but not the Channel Islands or Gibraltar; and
- the territorial waters surrounding them.

In certain circumstances the Isle of Man is excluded from the definition.

2. Special rules apply to treat certain **cross-border transactions** as being made in the UK.

Taxable person

Broadly, under UK legislation a taxable person is an individual, partnership, company or other trading entity which is either **registered** for VAT, or is **required** to be so registered.

In the UK a person is required to be registered if it makes taxable supplies above certain value limits. Traders that make supplies below these limits can choose to be registered voluntarily.

Memo Note

1. Any person who makes **wholly exempt supplies** is unable to register for VAT. There is an extensive list of exempt supplies, contained in statute, including health and welfare services, education, etc.

2. **Person** takes its legal meaning and therefore includes individuals, partnerships, companies and charities.

3. The EU uses what appears to be a wider definition of a taxable person, as a person who independently carries out any **economic activity**, irrespective of the purpose or results of that activity. However, “business” is interpreted as synonymous with “economic activity” for this purpose, so there is no practical consequence of this different wording.

Place of supply

For a supply of goods or services to fall within the scope of UK VAT, it must be **made in the UK**. It is therefore necessary to determine the place of supply. The rules differ depending upon whether the supply is one of goods or services. Particular rules apply for cross-border transactions to determine whether they are within the scope of VAT.

To be treated as supplied in the UK, goods must either be:

- located and supplied in the UK; or
- installed or assembled in the UK.

Goods that are installed or assembled by, or on behalf of, the supplier are supplied where the installation or assembly takes place. This may result in a UK trader being required to register overseas, or an overseas trader being required to register in the UK.

Memo Note

1. If the contract between the parties is for two supplies (one for the supply of goods, the other for installation), they will usually be treated as a single composite supply.
2. If the installation or assembly is subcontracted to a third party, the place of supply for the manufacturer remains the place of installation or assembly.

1. Mechanics

At a very simple level, each VAT-registered business in a supply chain will pay VAT on the supplies of goods and services it buys and charge VAT on the supplies it makes by selling goods and services. The VAT charged by a business on supplies made (sales) is known as output tax, whereas the VAT paid by a business on supplies received (purchases) is known as input tax.

Output tax

Output tax **must be charged** on all taxable supplies at the appropriate VAT rate, depending upon whether they are standard-rated, reduced-rated or zero-rated

supplies. The tax must be accounted for according to the time at which the supply is made.

Where the value of a supply is quoted as exclusive of VAT, the VAT is simply the appropriate percentage of that value. However, where a supply is quoted at a VAT-inclusive value, the amount of VAT is calculated by applying a VAT fraction to the value, as follows:

Supply	VAT rate	VAT fraction
Standard-rated	20%	1/6
Reduced-rated	5%	1/21
Zero-rated	0%	0

Example

Ms A makes a standard-rated supply to Mr B valued at £3,000.

If this was the VAT-exclusive amount, the VAT due is £600. ($20\% \times £3,000$)

If £3,000 was the VAT-inclusive amount, the VAT due is £500. ($1/6 \times £3,000$)

Memo Note

Special methods of computing output tax are available for:

- retailers; and
- sales of second-hand goods.

Input tax

Input tax is incurred on all taxable purchases made by a trader for the purposes of its business. This tax is **recovered** by offsetting it against any output tax charged by the trader. The net figure after this offset is either paid to or repaid by HMRC, as appropriate. VAT is therefore a real cost when charged to an **end consumer** (any person who is not a VAT-registered trader), because a non-registered person cannot offset or reclaim VAT incurred. VAT can also be a real cost to a trader which makes exempt supplies.

Example

C Ltd (a VAT-registered trader) incurred the following standard-rated purchases and made the following standard-rated supplies in the course of its business:

Transaction	Value		VAT	
	£		£	
Purchases (inputs)	16,000		3,200	
Supplies (outputs)	40,000		8,000	

The net payment due to HMRC is £4,800. (£8,000 - £3,200)

Memo Note

1. A trader's input tax and output tax are **accounted for** on a quarterly basis to HMRC (or sometimes monthly, if the trader requests) on the VAT return.
2. Any person that makes **wholly exempt supplies** is unable to register for VAT and is therefore treated as an end consumer (so that any VAT paid on inputs is a real cost).
3. The extent to which a trader can recover input tax depends upon whether it makes wholly taxable supplies, or a **mixture of taxable and exempt** supplies.

2. Exceptions

There are two exceptional circumstances where the basic principles of VAT are not followed - that is, in the case of:

- abuse; or
- fraud.

Where there is **abuse**, the VAT effect of the transactions actually undertaken is ignored. Instead a non-abusive alternative series of transactions is deemed to have occurred. These transactions will have as closely as possible the same end result in commercial terms as the abusive transactions and the VAT effect of these deemed transactions will be attributed to the trader concerned.

In case of **fraud**, a trader may not be entitled to

recover input tax claimed. Alternatively, it may be inherent in the fraud that no actual supplies have taken place. However, where actual transactions have been carried out, a fraudulent motive will not prevent those transactions from being part of an economic activity (and thus being within the scope of VAT). *Optigen Ltd and others v C & E* [2006]

Identification of abuse

If the apparent VAT effect of an actual series of transactions is potentially to be replaced with the (different) VAT effect of a deemed series of transactions, it is obviously important to know when that substitution might take place.

The CJEU has stated that abuse will occur where:

- the transactions concerned, although apparently in compliance with VAT legislation, result in the accrual of a tax advantage contrary to the purpose of that legislation; and
- the essential aim of the transactions concerned is to obtain a tax advantage.

The CJEU added that abusive transactions "must be redefined so as to re-establish the situation that would have prevailed in [their] absence". *Halifax and others v HMRC* [2006]

Identification of a **tax advantage** is relatively straightforward (generally, paying less or claiming more than otherwise) but whilst it is helpful to know that the test is whether the effect of the transactions is **contrary to the purpose of the legislation**, knowing what that purpose is, or is not, in a given set of circumstances will not always be easy. The Courts have certainly not found it plain sailing so far (although this is a relatively new area of the law and settled principles are at least starting to emerge). Here are some examples for illustration.

C. Procedure

The VAT compliance regime is self-administered by VAT-registered businesses. In particular, traders are responsible for:

- **registering** for VAT when required;
- maintaining appropriate **records** of all transactions;
- **calculating and reporting** the net output or input tax for each period; and
- **paying** the appropriate amount to HMRC.

Normal compliance

VAT **returns** are generally made for a 3-month period, known as a **VAT period** or **accounting period**. When registering for VAT, each person is allocated a VAT period. To spread the VAT cycle, different persons will have return periods ending in different months. This is known as having a different **stagger**.

Example

D Ltd has a VAT period of 3 months, with the first return being due for the period to 31 January.

Subsequent returns are made for the quarters to 30 April, 31 July and 31 October.

Mr E also has a VAT period of 3 months but prepares his returns to 31 March, 30 June, 30 September and 31 December.

Memo Note

1. A person may apply to HMRC to **change its stagger**, so that the VAT cycle (or a return period) coincides with its accounting year end.
2. HMRC may authorise a person to complete **monthly returns**. This is generally reserved for businesses that are due to receive regular refunds of VAT and provides a cash flow advantage.
3. Where smaller businesses operate the **annual accounting scheme**, they are required to submit only one VAT return per year.
4. HMRC has the power to require all **associated businesses** to account for VAT on the same cycle where there is little or no commercial rationale for different cycles to apply.

Special schemes

VAT compliance responsibilities are extensive and can be onerous. To recognise this, special schemes (the flat rate scheme, cash accounting and the annual accounting scheme) aim to simplify matters for **smaller businesses**.

In addition, certain **trade sectors** enjoy special VAT regimes due to the specific nature of their business, including:

- farmers;
- racehorse owners;
- retailers; and
- tour operators.

Enforcement

All compliance obligations are subject to **supervision** by HMRC. To this end HMRC has extensive powers, ranging from authority to request documentation to the physical search of premises.

These powers can generally only be exercised by an **authorised officer**, defined as any person acting under the authority of the Commissioners of HMRC. In addition, the National Crime Agency (NCA), working in conjunction with HMRC, has specific authority in relation to the enforcement of VAT in order to prevent and detect serious organised crime, including tax fraud.

Get help and support

VAT is unfortunately an inherently complicated area. If you have any questions please don't hesitate to get in touch with us on 01929 550802.

Information in this fact sheet is taken from the Tax Essentials website.