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MELVILLE & CO
Chartered Accountants

VAT – Seven Key Points for the Smaller Business

FACTSHEET

This factsheet 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 on the GOV.UK website www.gov.uk/vat-record-keeping.

See our factsheet 'Making Tax Digital for VAT' on the mandatory digital record keeping and digital VAT returns.

VAT return and payment deadlines

For the businesses that complete quarterly or monthly returns, both the VAT return and any VAT payable are normally due to HMRC one month and seven days after the end of the VAT period.

Where the due date falls on a weekend or bank holiday the business should ensure that submission of the return and payment of any VAT due has reached HMRC no later than the last working day prior to the deadline.

Input tax

When VAT incurred on expenditure is recoverable in a VAT return it is termed 'input tax.' Only VAT registered businesses can reclaim VAT on purchases providing:

- the expense is incurred for business purposes
- the business is the recipient of the supply of goods or services
- there is a valid VAT invoice for the purchase.

Only VAT registered businesses can issue valid VAT invoices. Hence 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 VAT and so there is no VAT to be reclaimed - 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, or because the supplier has been paid by the business.

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 the VAT as 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 risk areas where claims are likely to be made but which do not satisfy the 'purpose of the business' test include:

- expenditure related to domestic accommodation where there is no business connection
- pursuit of personal interests such as sporting and leisure oriented 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 adjust input tax claimed on assets and stock 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)

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Business entertainment

VAT is not reclaimable on most forms of business entertainment although VAT incurred on employee entertainment is recoverable. The definition of business entertainment is broadly interpreted to mean hospitality of any kind provided to someone who is not an employee, which can include 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 business goods change hands, so in theory any goods given away by a business will result in an amount of VAT due. The rule on business gifts is that no output tax will be due on gifts to the same person, provided that the VAT exclusive cost of the gifts to that person does not exceed £50 within any 12-month period.

Where the £50 limit is exceeded, VAT is due (output tax) on the full amount. There is a deemed supply of the goods for VAT purposes. Where this occurs HMRC will usually accept the business can disallow the VAT when buying the goods, which may be more convenient than having to calculate output tax every time a gift is given.

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 with motoring expenses in general. Some key issues are:

- VAT on the purchase of a motor car is generally blocked from recovery because it is assumed there will be availability for private motoring and hence the vehicle is not exclusively for business use. This prohibition does not normally apply to commercial vehicles and vans, provided there is an element of business use.
- Where a car is leased rather than purchased, 50% of the VAT on the leasing charge is blocked from recovery for the same reason.
- Where a business supplies fuel or mileage allowances for cars, adjustments need to be made to ensure that only VAT on the business element of the expense 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 tax issues

Bad debts

Selling goods or services on credit in the current economic climate may carry increased risk. Even where credit control procedures are strong there will inevitably be a risk of suffering bad debts. A supplier must normally account for output tax when the sale is made, even if the debt is never paid by the customer, 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, then provided the output tax has been accounted for by the supplier, a claim to recover the VAT as bad debt relief can be made six months after the due date for payment of the invoice.

Example

A business supplies and invoices goods on 19 October 2022 for payment by 18 November 2022 (ie a normal 30 day credit period). If the debt is not settled, the earliest opportunity for relief would be 18 May 2023. The relief would be included in the VAT return into which this date falls, 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. The claim is entered into box 4 of the VAT return - treating the uncollected VAT as an additional business expense - rather than by reducing output tax.

The customer

A customer is automatically required to repay to HMRC any input VAT claimed on a purchase where the supplier remains 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 six months old, making it easy to issue an assessment to disallow the VAT claimed.

Preventing the problem?

Smaller businesses (with annual turnover less than £1.35m) may be entitled to join the Cash Accounting Scheme, which means they will only have to account for VAT on sales when payment is actually received from the customer.

There is a clear cashflow benefit as well as built-in relief VAT from bad debts. The trade-off is that cash accounting only permits a business to recover VAT on expenditure at the time it makes payment to suppliers.

How we can help

Please contact us if you require any further guidance on VAT issues for your business.

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