Charging and Accounting for VAT

Business Information Factsheet
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Introduction

Following registration for Value Added Tax (VAT), VAT-registered traders are responsible for charging the correct amount of VAT to customers, keeping VAT records and a VAT account, submitting VAT returns and paying any VAT due to HM Revenue & Customs (HMRC). Traders can also reclaim the VAT paid on certain purchases made before registration (subject to time limits) as well as reclaiming VAT paid on purchases following registration.

HMRC is responsible for ensuring that VAT-registered traders comply with the legislation relating to VAT and meet their responsibilities with regard to registering and accounting for VAT and paying the tax due.

The legislation covering VAT is complex and it is important to seek professional advice or contact HMRC for guidance to ensure compliance with current law.

This factsheet briefly explains the VAT process, and also covers starting to charge VAT, calculating the VAT to charge, what must be shown on VAT invoices, and record keeping for VAT accounting. It explains what a VAT return is, VAT accounting schemes, how to account for VAT through a VAT return, paying VAT, what happens if a VAT return is not submitted, and the penalties for inaccuracy or late payment of VAT.

Starting to charge VAT

Traders are required to register for VAT when their 'taxable turnover', which is the total value of their sales of goods and services that are liable for VAT (known as their taxable supplies) exceeds the mandatory VAT registration threshold.

Although traders must account to HMRC for VAT from their 'effective registration date', which is the date their taxable turnover exceeded the VAT registration threshold, they cannot issue VAT invoices before being issued with a VAT number, and therefore should not show VAT separately on invoices until they have received it. Instead they can issue customers with a pro forma invoice indicating a total price that is high enough to allow for the VAT that must be accounted for and state on it that a tax invoice will be issued as soon as the VAT number is received. Once they have been issued with their nine-digit VAT number they can provide customers with VAT invoices.

VAT must be charged by VAT-registered traders on any taxable supplies that they make that are not exempt from VAT, including:

- Sales made in the course of business.
- Items hired or loaned out.
- Business assets that are sold.
- Commission.

- Business goods used for personal reasons.
- Items bartered, given as gifts or part-exchanged.

VAT must be accounted for on the full value of each item (for example, even when it has been part-exchanged), and where the VAT is not shown on an invoice the total price recorded is treated by HMRC as having included VAT.

VAT rates

VAT must be charged at the correct rate, and the trader's VAT registration number and the rate of VAT charged must be shown on invoices.

There are several different rates of VAT in the UK covering the various categories of goods and services that are liable for VAT, as well as categories of items that are exempt from VAT altogether. The various rates and examples of categories are as follows:

- The standard rate of VAT for most goods and services supplied in the UK is 20%.
- The reduced rate of 5% is charged on certain specific products and services such as domestic fuel and power, domestic energy-saving products, the renovation and conversion of certain buildings, children's car seats and some healthcare products.
- The temporary reduced rate of 5% for hospitality, accommodation and attractions, which applies from 15 July 2020 to 12 January 2021. It covers food and non-alcoholic drinks sold by restaurants, pubs and similar premises as well as tourist accommodation and admission to attractions across the UK. This temporary reduction is intended to help businesses recover from the coronavirus outbreak.
- The zero rate (0%), applies to specific categories of goods including children's clothes, exports outside the European Union, food (exclusions apply including restaurant meals and catering supplies), books and newspapers.
- Exempt supplies, which are supplies that are excluded from taxable turnover, meaning that input tax cannot be recovered, typically relate to services rather than goods and are commonly found in the following sectors:
    - Financial services.
    - Education.
    - Insurance.
    - Health and welfare services.
    - Some property transactions.

It is important to clarify whether services supplied are exempt from VAT or not, and professional advice can be obtained from an accountant or from HMRC.

Further information about VAT rates applicable to different goods and services is available at www.gov.uk/guidance/rates-of-vat-on-different-goods-and-services.

Calculating the price and amount of VAT to charge

To calculate the price to charge customers, VAT at the appropriate rate for the item being sold should be added to the normal selling price. For example if a jewellery maker intends to sell a necklace for £150 they will need to add 20% VAT to the price, which equates to £30, so they should charge their customer a total selling price of £180.

The total price to be charged for an item or service including VAT at the standard 20% rate can be calculated by multiplying the VAT-exclusive price by 1.2. For example, £150 x 1.2 = £180. If the VAT rate to be charged is the reduced rate of 5%, the VAT-exclusive price should be multiplied by 1.05 to find the total price.

If the trader intends to sell their necklace at a total price of £150 including VAT, they can calculate the net sale price to which VAT should be added by dividing the total sale price including VAT by 1.2 (or 1.05 if the VAT rate to be charged is 5%).

For example £150 ÷ 1.2 = £125 (the net sale price), so the VAT included in the total price and which must be indicated on the sale invoice in addition to the net sale price is £25.

What must be shown on VAT invoices?

Specific rules apply to the content of VAT invoices to ensure that the necessary information is recorded to enable both traders to account for the output tax due on the sale and customers to account for the input tax they will claim if they are VAT registered. The main details required are:

- An identifying invoice number.
- The trader's name, address and VAT registration number.
- The date the invoice is issued - which must be within 30 days of the date of supply.
- The customer's name and address.
- A clear description of the goods or services supplied.
- A quantity and unit price for the goods or services, plus the rate of VAT applicable.
- Details of any cash discount offered.
- The total amount payable excluding VAT.
- The amount of VAT charged.

Retailers do not have to provide a VAT invoice for every transaction because they are primarily selling to consumers. However, if a taxable person requires a VAT invoice, the retailer must issue one.

Record keeping for VAT accounting

All traders are required to keep accounting records for tax purposes. Once a trader is VAT registered they will need to ensure that their accounting records show all their VAT transactions.

Ideally the following record-keeping ledgers should be maintained:

- **Sales ledger** - to record a summary of each VAT invoice issued to customers and to provide details of the sales turnover (excluding VAT), as well as the amount of VAT that has been charged (the output tax).
- **Purchase ledger** - to record a summary of each invoice the trader has received from their suppliers and to provide details of their purchase turnover (excluding VAT), as well as the amount of VAT that they have been charged (the input tax).
- **Cash ledger** - to record other cash sales and purchases that have not been recorded in the sales or purchase ledgers and any relevant VAT charged.
- **VAT account** - to record the amount of output tax that has been charged to customers and the amount of input tax that has been charged by suppliers. This account will therefore show the net amount of VAT that needs to be paid to, or claimed back from, HMRC. Payments that are made to HMRC for VAT owed will also show in this account.

Computerised accounting software packages greatly simplify the recording of VAT transactions and the interaction of the different ledgers, as well as producing reports for regular VAT returns, and can save substantial time in producing the information needed for VAT returns.

Accountants can also help traders to comply with VAT legislation and complete VAT returns.

What is a VAT return?

All taxable persons have a legal requirement to complete and submit regular online VAT returns to HMRC. The return provides a summary of the VAT transactions during the reporting period and identifies the amount of VAT to be paid to, or refunded by, HMRC.

VAT returns are most commonly completed quarterly. When registering for VAT traders are allocated four accounting period end dates from one of the three options below:

- 31 January, 30 April, 31 July and 31 October or
- 28 February, 31 May, 31 August and 30 November or
- 31 March, 30 June, 30 September and 31 December.

For example, if a trader's first VAT return is for the period ending 31 March, the actual period covered will be the three months from 1 January to 31 March. At the end of the accounting period they have a further month in which to complete their VAT return. This means that the return for the period ending 31 March is due to be submitted to HMRC by 30 April.

It is quite common for traders to change their VAT return periods to coincide with their business accounting year end, as this simplifies the reconciliation of annual accounts with VAT returns. An application can also be made to complete VAT returns monthly if the business regularly receives a repayment of VAT.

VAT accounting schemes

HMRC operates a number of different schemes to account for VAT, some of which have been created specifically for small firms. The choice of scheme depends on the firm's particular trading circumstances. Go to www.gov.uk/topic/business-tax/vat for further information. Schemes include:

- **Standard accounting scheme**

  Output VAT is levied as soon as a sales invoice is issued, while input VAT is reclaimable as soon as a purchase invoice is received. The date on which payments are actually received from customers or the date when suppliers are paid is irrelevant. The quarterly VAT return is made based on issued and received invoices in that period and then payment of any VAT owed is made at the end of the next month.

- **Cash accounting scheme**

  This scheme is available only to firms with a taxable turnover of less than £1,350,000 and is designed to reduce the cash flow implications of VAT. Instead of accounting for VAT using issued and received tax invoices, VAT is accounted for based on when customers actually pay and when the firm pays its suppliers. Quarterly VAT returns must still be completed and payments must be made at the end of the next month. The key benefit of the scheme is that traders do not need to account for VAT and pay it to HMRC until they have received the money from their customers.

- **Annual accounting scheme**

  If a trader has a turnover of less than £1,350,000 they can join the annual accounting scheme, under which only one annual VAT return is submitted and regular interim payments of a fixed amount are paid. This reduces the administrative burden and helps traders to predict their cash flow. The annual return is submitted within two months of the accounting year end and a balancing payment or refund is then made.

- **Flat-rate scheme**

  If a trader has a taxable turnover of less than £150,000 it may be possible to join the flat-rate scheme, which aims to simplify the administration of VAT for very small firms. Under the scheme, traders calculate their VAT payment by using a fixed percentage of their VAT-inclusive turnover. Different percentages have been assigned to different trade sectors. Newly VAT-registered businesses use the flat rate for their sector minus 1%. So, if the rate for the sector is 9%, a flat rate of 8% is applied in a trader's first year of VAT registration. Details of the percentages that apply to each sector are available at www.gov.uk/vat-flat-rate-scheme#5.

- **Retail schemes**

  If a trader operates a retail business and makes the majority of their sales to the general public, they may be able to join one of the retail schemes. These schemes simplify the accounting rules required for the issuing of VAT invoices and reduce paperwork because a VAT invoice does not have to be issued unless the trader is asked for one. Traders can be registered for a retail scheme as well as one of the other specialist schemes listed above. For more information about retail schemes, see BIF506 VAT Retail Schemes.

Accounting for VAT through the VAT return

A VAT return provides a summary of all the relevant VAT transactions in an accounting period. Accurate accounting records must therefore be kept for each VAT accounting period covering both sales and purchases and traders must be able to produce detailed reports that support the return.

Accounting software and online accounting packages can be used to produce detailed reports as well as a summary in the format of the VAT return. Alternatively, an accountant or a specialist bookkeeper can collate and prepare this information and complete the return.

The VAT return includes nine boxes for the accounting period that cover the VAT due on sales and other outputs including acquisitions from European Union member states, the VAT on purchases, the total amount of both sales and purchases and the amount of VAT to be paid to or reclaimed from HMRC.

There are a number of regular business transactions that should not be included in figures on a VAT return. The most common are:

- VAT payments to, or repayments from, HMRC.
- Wages or salaries paid to employees.
- PAYE, National Insurance, student loan and pension contributions.
- Loans, dividends or drawings.
- Business rates.

Completed VAT returns should be carefully checked to ensure they are accurate before they are submitted to HMRC.

Paying VAT

Payments of VAT should be made electronically by, for example, Direct Debit, online banking, debit or credit card, Bankers Automated Clearing Systems (Bacs) or Clearing House Automated Payment System (CHAPS).

For a return period ending 31 March, for example, the following dates would apply:

- Return due to be submitted by 30 April.
- Payment by Bacs due by 7 May, or the fifth working day of the month, whichever comes earliest.
- Payment collected by Direct Debit on 10 May.

If the annual accounting scheme is being used, regular monthly or quarterly payments are made on account. The amount of the payment is based either on the VAT paid in the previous 12 months or the expected VAT to be paid within the next 12 months.

Traders that have difficulty in paying the VAT they owe should contact HMRC to request an extension of time in which to pay their tax bill. For further information, go to www.gov.uk/difficulties-paying-hmrc.

What happens if a VAT return isn't completed?

In the absence of a return, HMRC will send a computer-generated assessment that demands payment. The amount of tax will be calculated based on past returns as well as other trade factors. Payment of the assessment does not exempt traders from sending a return. A trader that does not send in their return and is sent an assessment by HMRC is in default and a penalty will apply.

HMRC penalties

HMRC can impose penalties on traders who file incorrect VAT returns, fail to file them by the relevant deadline or fail to pay the VAT due by the deadline.

The HMRC penalties for filing incorrect tax returns are based on the reason for the inaccuracy. If a trader can prove that they took 'reasonable care' when compiling their return, they will not incur any penalties. The penalties are calculated based on a percentage of the additional tax that is due so it is advisable to disclose any inaccuracies in a return to HMRC as soon as they are noticed in order to reduce the potential penalty they could impose.

Penalties may also be incurred if a trader does not produce the records requested by an HMRC officer within a reasonable time.

Traders that have not submitted their VAT return or sent the full payment due on time are regarded as being in default. Penalty rates are based on the amount of net tax due shown on the return (or assessment in the absence of a return) and vary according to turnover, ranging from no surcharge for the first default, to a surcharge on top of the VAT due of 10% of net tax for the fifth default and 15% of net tax for any subsequent defaults for a firm with a turnover of less than £150,000 per year.

Although there is a reasonable excuse defence against a surcharge, it is not acceptable for a trader to claim that they relied on a bookkeeper or accountant who did not submit the return on time. Traders have 30 days to appeal.

For more information about the penalties, go to www.gov.uk/vat-returns/surcharges-and-penalties.

Hints and tips

- It is important to keep up to date with changes to the VAT rules. HMRC provides regular 'Business help and education emails'. Go to https://public-online.hmrc.gov.uk/business-emails/subscription to subscribe to the service.
- Backdated claims to recover the VAT paid on supplies prior to registration for VAT can be made but are subject to time limits.
- Traders should ensure that they file accurate VAT returns within deadlines and pay any VAT due promptly to avoid penalties being imposed by HMRC.

Further information

BIF015 An Introduction to Tax, National Insurance and VAT
BIF234 VAT (Value Added Tax)
BIF386 Invoices and Receipts
BIF483 Tax Deadlines in 2021
BIF522 Registering for VAT

Useful contacts

HM Revenue & Customs (HMRC) is the Government department responsible for the collection of taxes in the UK.

Tel: 0300 200 3700 (VAT helpline)
Website: www.gov.uk/topic/business-tax/vat

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