


VAT guidance

VAT STANDS FOR VALUE ADDED TAX

All businesses must become VAT registered when their annual turnover (ie, sales in the year) reaches a certain level (currently £83,000). Once it is VAT registered, the business must charge VAT on its goods and services which is then paid to Her Majesty's Revenue & Customs (HMRC). A VAT registered business may also reclaim the VAT it has had to pay on business expenditure.

The following example shows why the tax is called value added tax. As well as reading the narrative below, have a look at the spreadsheet in Appendix B of this toolkit, which shows the gradual payment to HMRC of the VAT over each stage of the transactions explained below.

The VAT rate is currently set at 20% and we have used this figure for all examples in this workbook. Please note, however, that the rate of VAT is set by HMRC and is subject to change.

 **Example: Tom sells to Dick, who sells on to Harry, who sells on to the final customer, Charlie.**

Tom, a raw materials merchant, sells goods to Dick, a manufacturer, for £1,000 plus VAT of £200. Tom must pay the £200 he has received through VAT to HMRC. Dick may reclaim the same amount back as input VAT. The net effect on both businesses is £Nil.

Dick sells the goods on to the retailer, Harry, with a mark up of 25%, therefore charging £1,250 plus VAT of £250. Dick must pay the £250 to HMRC. Harry may reclaim the same amount back as input VAT. The net effect on both businesses is £Nil.

Harry sells the goods on to a customer, Charlie, with a mark up of 50%, therefore charging £1,875 plus VAT of £375. Harry must pay the £375 to HMRC. As Charlie, the customer, is not VAT registered he must suffer the VAT in full, while the net effect on Harry's business is £Nil.

So, from an initial cost of £1,000 the goods are eventually sold for £1,875 and HMRC eventually collects VAT on the original cost of the goods plus the value added as the goods pass through the business cycle.

The amounts collected on the 'value added' at each stage are:

From Tom	£1,000 x 20% =	£200
From Dick	£250 x 20% =	£50
From Harry	£625 x 20% =	£125
IN TOTAL		£375

INPUT AND OUTPUT VAT

Output VAT is the VAT charged by a business on the goods and services that it sells. Input VAT is the VAT incurred by a business on the goods and services that it buys.

If the output VAT is more than input VAT, the business will pay the remaining balance to HMRC. If the input VAT is more than output VAT, the business will recover the remaining balance from HMRC.

HOW TO CALCULATE VAT

Find the VAT from the gross value

Gross value x 20 ÷ 120 = VAT

Find the VAT from the net value

Net Value x 20% = VAT

OTHER INFORMATION ON VAT

There are different rates of VAT. The most commonly used are standard rated (currently charged at 20%) and zero rated (0%).

Examples of items that have VAT on them at standard rate are:

- sweets
- chocolate
- adult's clothes
- stationery.

Examples of items that are zero rated are:

- books and newspapers
- public transport
- children's clothes
- water rates.

Some goods and services are VAT exempt. This is different to being zero rated. A zero rated item is already in charge for VAT so the rate can be changed easily; an exempt item is not in charge for VAT so parliament has to pass legislation if it wants to change this.

A business can recover input VAT on purchases relating to standard or zero rated sales. It can't recover input VAT on purchases relating to exempt sales. Postage is exempt from VAT.

There are also items which are outside the scope of VAT - these include wages and salaries and taxation.

A business usually submits a VAT return every three months. This contains the total input and output VAT for the quarter and the amount to be paid or recovered to/from HMRC. It also includes net sales for the period and other statistical data.

VAT starts simply but can then become very complicated. You only need to know about the easy bits at this stage, so don't worry!