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VAT – BASIC RULES
& OPTIONS REGARDING ACCOUNTING FOR VAT

VAT can be an issue whatever business structure you use to carry on your business (sole trade, partnership or limited company).

Whether you can or must register for VAT is determined by 2 factors:

1. The nature of exactly what you do – called the nature of your supply or supplies
2. The level of your turnover

1. The nature of exactly what you do – called the nature of your supply or supplies

Most things businesses do are “taxable supplies”. This means if their income is high enough (see 2. Below), they usually have to register for VAT.

The normal rate of VAT in the UK is currently 20%.

However, there are some business activities which are treated as “exempt” from VAT – this usually means you won’t be allowed to register for VAT.

There are also some business activities which are supplies at a reduced rate of VAT currently 5% - such as light & heat costs).

Finally, some activities are “zero rated” supplies – this often the means such businesses get regular VAT repayments if they register for VAT. They charge VAT, albeit at 0%, but can recover VAT in full on costs.

We will usually discuss with you exactly what supplies your business is making so as to determine whether VAT can or should apply to your circumstances. We will also consider whether the supplies you make are “Business to Business” (B2B) or “Business to Consumer” (B2C). The VAT treatment also differs depending on whether the supplies are B2B or B2C.

2. The level of your turnover

A business which makes taxable supplies must register for VAT once their turnover exceeds £85,000 (current threshold). This is called compulsory VAT registration.

However, a business whose turnover is less than £85,000 could be better off **voluntarily** registering for VAT. This can be advantageous where the supplies being made are wholly or mainly B2B.

The two main ways of accounting for VAT

There are two main ways of accounting for VAT, **cash accounting** and **standard accounting**. The former is better suited to smaller businesses, which are those whose turnover is, or is expected to be, less than £1,350,000 (see a) and b) below).

Whether you adopt the cash or standard method of accounting for VAT, small businesses with a turnover of less than £150,000 excluding VAT also have the option of using a **flat rate scheme** for accounting for VAT rather than the **normal scheme** (see (i) and (ii) below).

a) Cash Accounting

Using cash accounting for VAT, you:

- pay VAT on your sales when your customers pay you
- reclaim VAT on your purchases when you pay your suppliers

You can use cash accounting for VAT if your estimated turnover ('taxable supplies') during the next tax year is not more than £1.35 million. Taxable supplies include any standard, reduced and zero-rate sales and other taxable supplies, but exclude VAT itself, supplies that are exempt from VAT and capital asset sales.

Once you start to use cash accounting, you can continue to do so until your annual turnover reaches £1.6 million.

b) Standard VAT accounting

Using standard VAT accounting you:

- pay VAT on any invoices you have issued, even if you have not received the payment from your customer
- reclaim VAT on any invoices you have received, even if you have not yet paid your supplier

The pros and cons of cash accounting for VAT

Benefits of cash accounting

Using cash accounting helps your cash flow, especially if your customers are slow payers. You do not need to pay VAT until you have received payment from your customers. So if a customer never pays you, you don't have to pay VAT on that bad debt as long as you continue to use the cash accounting scheme.

Disadvantages of cash accounting

Using cash accounting may affect your cash flow in that:

- You cannot reclaim VAT on your purchases until you have paid your suppliers. This can be a disadvantage if you buy most of your goods and services on credit.

- If you regularly reclaim more VAT than you pay, you will usually receive your repayment later under cash accounting than under standard VAT accounting, unless you pay for everything at the time of purchase.
- If you start using cash accounting when you start trading, you will not be able to reclaim VAT on most start up expenditure, such as initial stock, tools or machinery, until you have actually paid for those items.
- When you have to leave the cash accounting scheme when your turnover exceeds £1.6 million or directed to do so by HMRC, you will have to account for all outstanding VAT due including any bad debts.

Additional record keeping for cash accounting for VAT

Changing to cash accounting doesn't mean you can just keep a record of your cash position - you must also keep track of debtors and creditors, so you know the real position with regard to what you are owed and what you owe. You need this information for Income Tax or Corporation Tax purposes.

In addition to keeping all required VAT records and accounts for standard VAT accounting, you must also use the following procedures for sales and purchases:

Invoices

If you are paid in cash you must, if asked by your customer, endorse the customer's copy of your sales invoice with the amount and date paid.

If you settle an invoice using cash, you must keep a copy of the purchase invoice endorsed with the amount and date paid.

Payment records

Your records must clearly cross refer payments received or made by you to the corresponding sales or purchase invoices. You must also make sure that you cross refer these payments and receipts to evidence such as bank statements, cheque stubs and paying-in slips.

As already mentioned, whether you adopt the standard or cash method of accounting for VAT, small businesses with a turnover of less than £150,000 excluding VAT also have the option of using a flat rate scheme for accounting for VAT rather than the normal scheme..

(i) Normal Scheme

Under the normal method of accounting for VAT, you pay over to HM Revenue & Customs (HMRC), usually each quarter, the difference between the VAT you charged your customers on your sales and the VAT you suffered on your purchases and costs. In the case of cash accounting, the only difference is that you pay over to HMRC, usually each quarter, the difference between the VAT monies received from customers for sales and the VAT you have paid out on your costs/expenses.

(ii) Flat Rate Scheme (FRS)

When you use the FRS, instead you simply apply a flat rate percentage **to the VAT inclusive turnover** (or in the case of cash accounting, **to the VAT inclusive**

amount of sales received in that VAT return period) and pay over the resulting figure to HMRC.

From April 2017 businesses which purchase goods to the value of 2% of their turnover (where this exceeds £1,000 in total) can make a profit from using the FRS rather than normal method of accounting for VAT. However, service-based businesses which generally do not spend 2% of their turnover on the purchase of goods (not services) generally will not benefit from being on the flat rate scheme.

Please see our separate fact sheet specifically on the Flat Rate Scheme. This shows an example of a Photography business which makes a post-tax profit of £3,432 using the flat rate scheme on sales of £80,000.

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