VAT and Indirect Taxes

Interview preparation summary · AU track

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INT.TV.1.a · How VAT works

Explain how VAT is charged along the chain of supply, and calculate output tax, input tax and the net amount a business pays.

VAT is a tax on consumption that is collected in stages. Each registered business charges output tax on its taxable sales and deducts the input tax it has paid on its business purchases, then pays the difference to the tax authority, or claims a refund if input tax is the larger figure. Because every business in the chain recovers what it paid its supplier, the tax is neutral for a fully taxable business, and the whole amount, the rate times the final price, is borne by the final consumer, who cannot recover it. It is worked out from invoices rather than from profit, so it can be payable in a loss-making period. Recovery arises on the purchase, not on the sale: a business that buys stock in a period recovers the input tax then, even if the stock is still unsold. Rates and rules differ between countries. The examples here use an illustrative 20% standard rate in the style of the UK, and the current rates should always be checked. Interviewers want a clear chain with the net payment at each step, and the point that VAT is a cash flow rather than a cost for a fully taxable business.

WORKED EXAMPLE: HARLOW MILL: VAT ALONG A THREE-LINK CHAIN

A farmer sells grain to a miller for 400 net, the miller sells flour to a baker for 700 net, and the baker sells bread to consumers for 1,200 net. All sales are standard-rated at an illustrative 20%, and the farmer has no VAT-bearing costs. Work out the VAT each business pays to the authority, the total collected, and who bears it.

Answer: The farmer pays 80, the miller 60 and the baker 100, so 240 is collected, equal to 20% of the final price, and it is borne by the consumer.

> **Interview tip:** Say that each business pays tax only on the value it adds, and that the sum of the payments equals the rate times the final price. Add that the tax is neutral for a fully taxable business.

INT.TV.1.b · How VAT works

Classify supplies as standard-rated, reduced-rated, zero-rated, exempt or outside the scope, and work out the input tax a business can recover under partial exemption.

Classification matters because it decides both what is charged and what can be recovered. Standard-rated and reduced-rated supplies carry output tax at the stated rate. Zero-rated supplies are taxable at 0%, so no VAT is charged but input tax on the related costs can still be recovered, which is why exporters are often in a repayment position. Exempt supplies carry no output tax, but the supplier cannot recover the input tax that relates to them, so that VAT becomes a cost. Supplies outside the scope, such as wages, are not part of the system at all and are generally left out of the recovery calculation. A business making both taxable and exempt supplies is partially exempt. Its input tax is split into amounts directly attributable to taxable supplies, which are recoverable, amounts directly attributable to exempt supplies, which are not, and residual overheads, which are apportioned, often by the share of taxable supplies in total supplies by value under a standard method. A small amount of exempt input tax can often be recovered in full under a de minimis test, whose limits should be checked. Interviewers like to hear that zero-rated and exempt differ in recovery, not only in the tax charged.

WORKED EXAMPLE: ELLSWORTH CLINICS: RECOVERY FOR A PARTLY EXEMPT BUSINESS

Ellsworth Clinics Ltd is invented. It sells skincare products (standard-rated) for 420,000 net and medical consultations (exempt) for 180,000 in a year. Its input tax is 30,000 directly attributable to the products, 8,000 directly attributable to the consultations and 20,000 on shared overheads. Use a standard method based on the value of supplies and an illustrative 20% rate. Work out the output tax, the recoverable and irrecoverable input tax, and the net VAT payable.

Answer: Output tax is 84,000, recoverable input tax is 44,000, irrecoverable input tax is 14,000 and the net payment is 40,000.

> **Interview tip:** Name the three buckets first: attributable to taxable, attributable to exempt, and residual. Then say that the irrecoverable amount is a cost the adviser should help the client plan for and price in.

INT.TV.1.c · How VAT works

Explain registration, tax points, invoices and returns, and show how the timing of VAT affects a business's cash flow.

A business must register once its taxable turnover passes a threshold set by the tax authority (in the UK a figure in the tens of thousands of pounds that is reviewed regularly, so check the current one), and it can often register voluntarily below it, which suits a start-up that has large input tax and business customers who can recover VAT. A registered business issues VAT invoices showing its details, the date or tax point, the net amount, the rate and the VAT, because the customer normally needs a valid invoice to recover input tax. It files periodic returns, commonly quarterly, and pays or claims the net amount a set time after the period ends (in the UK, one month and seven days). Under standard accounting, output tax falls due by reference to the tax point, usually the invoice date, even if the customer has not paid, so a slow-paying customer means the business is funding the VAT. Cash accounting schemes for smaller businesses, and relief for bad debts after a set period, soften this effect. Interviewers value a candidate who can put a number on the funding gap in days and suggest a remedy.

WORKED EXAMPLE: TARN JOINERY: WHEN THE VAT GOES OUT AND THE CASH COMES IN

Tarn Joinery Ltd is invented and files quarterly VAT returns for quarters ending 31 March, 30 June, and so on. It uses standard accounting and pays one month and seven days after the quarter end. On 12 February it invoices a customer 100,000 plus 20,000 VAT. The customer pays on 12 June. When does Tarn pay the 20,000 to the authority, how long is it out of pocket, and what would change under a cash accounting scheme?

Answer: Tarn pays 20,000 on 7 May, 36 days before it receives the cash on 12 June. A cash accounting scheme would remove the gap, subject to eligibility.

> **Interview tip:** Give the dates and the number of days. Say that the VAT is a timing cost, not a permanent one, and name the practical fixes.

INT.TV.2.a · Cross-border, other taxes and errors

Explain in general terms how VAT applies to cross-border goods and services, including import VAT, exports, the place of supply and the reverse charge.

VAT is a destination tax: the aim is that goods and services are taxed in the country where they are consumed. Exports of goods are normally zero-rated, so the exporter charges no VAT but recovers input tax, provided it holds evidence that the goods left the territory. Imports bear import VAT, calculated on the customs value plus any duty and the cost of freight and insurance to the border, and a fully taxable importer recovers it as input tax. Some systems let the importer account for import VAT on its return instead of paying at the border, which removes the cash cost (in the UK this is postponed VAT accounting). For services, the place of supply rules decide which country taxes them. In general, a service to a business customer is taxed where the customer belongs, and a service to a private consumer is taxed where the supplier belongs or, for some digital services, where the consumer is. When an overseas supplier does not charge local VAT, the customer applies the reverse charge: it accounts for output tax and, if entitled, input tax on its own return. A partly exempt business cannot recover all of it, so the reverse charge can be a real cost. Detailed rules vary by country and are changed often.

WORKED EXAMPLE: CALDER PRESSES: AN IMPORT, A REVERSE CHARGE AND AN EXPORT

Calder Presses Ltd is invented, is fully taxable and uses an illustrative 20% rate. It imports a machine with a customs value of 120,000 plus 6,000 freight and insurance to the border, and duty of 5% is charged on the total. It also buys 30,000 of consultancy from an overseas supplier that charges no local VAT, and exports goods worth 150,000. Work out the import VAT, the reverse charge, and the VAT on the export.

Answer: Import VAT is 26,460, recoverable by a fully taxable business. The reverse charge nets to nil, and the export carries no VAT and keeps input tax recovery.

> **Interview tip:** State the three treatments in one breath: imports, services from abroad and exports. Then ask whether the client is fully taxable, because recovery changes the answer.

INT.TV.2.b · Cross-border, other taxes and errors

Describe the other main indirect taxes in outline: customs duty, excise duty, stamp duty and other transaction taxes, and digital services taxes.

VAT is only one of several indirect taxes, which are charged on transactions, goods or revenue rather than on profit, and so can be due in a loss-making year. Customs duty is charged when goods cross a border, usually as a percentage of customs value that depends on the type of goods and the origin, and trade agreements can lower or remove it. Excise duty is charged on particular goods such as alcohol, tobacco and fuel, often as a fixed amount per quantity or per unit of alcohol, and goods can be held under duty suspension in a bonded warehouse so that the duty falls due only on release for consumption. VAT is then normally calculated on a value that includes duty. Stamp duty and similar transaction taxes, for example on share purchases and on land and property, are charged on the price of the transaction, usually to the buyer. Digital services taxes are a few percent of in-scope revenue of large digital groups such as marketplaces and social platforms, often above an allowance, and are not a tax on profit. All the rates here are illustrative and must be checked. Interviewers want to hear what each tax is charged on, and who bears it.

WORKED EXAMPLE: BRANNOCK IMPORTS: DUTY, EXCISE AND VAT STACKED ON ONE SHIPMENT

Brannock Imports Ltd is invented. It imports 3,000 litres of spirit at 40% alcohol by volume with a customs value of 80,000. Customs duty is an illustrative 5% of customs value, excise duty an illustrative 25 per litre of pure alcohol, and VAT 20% on a value that includes duty and excise. Work out each tax and the total. Then give the tax on a 1,500,000 share purchase at an illustrative 0.5%, and a digital services tax of 2% on 150m of in-scope revenue above a 25m allowance.

Answer: Duty is 4,000, excise 30,000 and VAT 22,800, a total of 56,800 on goods valued at 80,000. The share purchase carries 7,500 and the digital services tax is 2.5m.

> **Interview tip:** Say what each tax is charged on and who pays, then give the stacking order for VAT. Mention that none of these depends on profit.

INT.TV.2.c · Cross-border, other taxes and errors

Spot common VAT errors in a return or a set of records, quantify their effect, and describe how an adviser would put them right.

VAT errors are common because the tax depends on classifying each transaction correctly and holding the right evidence. The usual ones are claiming input tax that is blocked or not for business use, for example business entertainment or a car with private use in the UK; claiming without a valid tax invoice; charging the wrong rate or treating a standard-rated supply as zero-rated or exempt; missing a reverse charge on services from abroad; claiming full recovery when the business is partly exempt; and registering late, when the tax is a cost to the business if it cannot be added to prices already charged. Prices that are tax-inclusive give VAT of one sixth of the gross amount at 20%, not 20% of it. An adviser spots errors by reconciling the return to the ledgers, comparing output tax with turnover to test the average rate, reviewing coding of sales and purchases, and sampling invoices. Net errors below a limit may be corrected on the next return, and larger ones need separate disclosure, with interest and possibly penalties, so the current rules matter. Interviewers want the error found, the amount worked out, and a sensible next step.

WORKED EXAMPLE: FENWICK CAFES: A RETURN REVIEW

Fenwick Cafes Ltd is invented and is partly exempt, recovering 60% of residual and shared input tax. A review of its quarterly return finds four things. It claimed 2,500 of input tax on business entertainment, which is blocked. It coded a 30,000 net sale of standard-rated catering as zero-rated. It claimed 1,800 of input tax on a supplier document that is a quote, not a valid tax invoice. It bought 12,000 of services from an overseas supplier and did not apply the reverse charge. Use an illustrative 20% rate. By how much was net VAT understated, and what would you do next?

Answer: Net VAT was understated by 11,260, made up of 2,500, 6,000, 1,800 and 960. The adviser should check the current correction rules, disclose if needed and fix the causes.

> **Interview tip:** Group errors into rate, evidence, recovery and cross-border. Always give the amount and the fix, and mention interest and penalties as a consequence of not correcting.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.