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Pre Budget Report
What the VAT rate change means for you

Introduction
The Chancellor has announced that the standard rate of VAT will be cut from 17.5% to 15%.

This is the first change in the rate of VAT for 17 years and the first reduction in almost 30 years. The change will take effect on 1 December 2008 and is a temporary measure which will elapse on 31 December 2009 (when the rate will revert to 17.5%).

So what does the VAT rate change mean?
It is estimated that the cut will cost the Treasury around £12bn in reduced VAT receipts.

The impact of the change on consumer spending is debatable. However, provided that suppliers pass the rate reduction on, both consumers and organisations which are not entitled to recover VAT in full will enjoy a reduced VAT bill for 13 months.

Irrespective of the impact on spending, businesses which account for VAT need to consider how to deal with this change both in terms of VAT accounting and in pricing for consumers.

This document highlights the basic VAT rules to consider and some of the key challenges and considerations for businesses in the wake of the change in VAT rate.
The introduction of the new tax penalty regime next year with its "reasonable care" requirement, place a considerable onus on VAT registered businesses to ensure that the changes are implemented correctly. On a positive note HMRC have stated they will implement a "soft touch" approach for the first VAT return under the new rate.

Change highlights
Key considerations for businesses arising from the change are:

- the potential to reduce payments on account to reflect the reducing VAT bill;

- HMRC's "soft touch" will apply for the first VAT return following the rate change – but this will soon be replaced by a harder approach to the new tax penalty regime from 1 April 2009;

- there are many systems issues to address to implement the rate change, and;
- retailers in particular will need to consider whether they pass on the rate change in full and how they deal with customer expectations in doing so.

If you would like to discuss these in more detail please speak to your usual Deloitte contact. Further detail on the changes is provided below.

Mechanics of the change
The change in the VAT rate takes place with effect from 1 December 2008. Standard-rate VAT is therefore due at 15% on supplies made on or after this date.

With a change in the VAT rate there are a number of important rules to consider.

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Tax points and output tax

As a general rule, the rate of VAT will be determined by the tax point of the supply and this is determined by one of a number of rules:

- the basic tax point for goods occurs when the goods are "removed or made available"; or
- the basic tax point for services is the time the services are "performed"; or
- the basic tax point is generally overridden by advance payment or issue of an invoice before the basic tax point, or the issue of an invoice up to 14 days after the basic tax point.

It is critical to fully understand how these rules work and how they apply within your business so that you apply the new VAT rate at the right time. This is particularly important in light of the introduction of the new penalty regime.

The 15% rate will have effect for:

- supplies of goods and services made on or after 1 December 2008;
- imports on or after 1 December 2008; and
- acquisitions of goods from other Member States on or after 1 December 2008.

Credit Notes for payments received and invoices issued in advance of 1 December 2008.

Where payment has been received or a VAT invoice issued before 1 December 2008, VAT will have been charged at 17.5%. But where that payment or invoice relates to goods or services that are made available or provided after 1 December 2008, the supplier will be allowed to apply the new 15% rate to the earlier payment or invoice.

Businesses that choose to apply the 15% rate to the earlier payment or invoice are required to issue a credit note to their customer (if they have issued a VAT invoice) to evidence the reduction in VAT that is now due.

The normal rules stipulate that a credit note must be provided to the recipient of the supply within 14 days after the change of rate. The PBR measures anticipate a new provision which will extend this time limit to 45 days.

Continuous supplies of services and leases of goods

As a general rule, continuous supplies of services are deemed to be subject to VAT when invoices are raised or payments made. As a result they will be subject to the VAT rate in force when those events occur. However, businesses issuing VAT invoices covering longer periods will need to use an apportionment to record the VAT accurately.

Existing contracts

For existing contracts where the VAT rate changes before the services take place, the new VAT rate is generally deemed to apply unless the contract specifies otherwise.

Credit and contingent discounts

Where a credit note shows VAT, this should be at the tax point of the original invoice. This also applies to retrospective discounts such as volume bonuses.
As a result, businesses will need to ensure they maintain both the old and new rates in their systems. In fact, many businesses will want to maintain both rates in their systems so that the transition back to 17.5% in 13 months will be simpler – though maintaining both rates can of course lead to confusion and error.

Input tax

Taxpayers can only reclaim VAT as stated on invoices as issued by suppliers. If any invoices show only a VAT inclusive amount the taxpayer will need to apply the appropriate VAT fraction, this being 3/23 for a rate of 15%. A key issue for businesses in purchasing goods and services will be whether they are entitled to reclaim all the VAT charged by the supplier. If VAT is charged by a supplier at 17.5% when it should have charged 15%, it is likely that HM Revenue & Customs will expect only 15% to be reclaimed.

Practical issues to consider

As well as the VAT accounting issues noted above businesses will also need to deal with a range of other issues and we have highlighted some of these below.

IT/Systems issues

Systems configurations – This is likely to be a particular concern for many retailers (who are likely to be visited by their CRMs next week to see whether they are able to implement the system changes). For instance can the business system be easily amended to take account of the change in VAT rate? Will the rate change need a change in the standard rate in the system or the addition of a new rate? What is the impact to both the accounts payable and accounts receivable departments?
In addition, how quickly can the changes be implemented?

Systems impact – Businesses will need to determine the impact of the new VAT rate on areas such as invoice generation and processing. Invoice templates will need to be updated and self-billing arrangements with suppliers and customers will need to be reviewed carefully.

Personnel – IT personnel will need to understand what is required and provide comfort that the changes can be implemented. Accounts payable and receivable staff will also need to be trained in the changes.

Commercial issues

How will you adjust your pricing? Will the business pass on the full decrease to its customers and how quickly does it intend to do this? Retailers in particular will have the difficult task of re-pricing their goods if they choose to pass on the rate change.

How do you communicate any changes with customers? What marketing or promotional activity do you need to undertake to communicate these changes?

How will you deal with queries from customers? Customers may raise questions about the change, such as whether a business has adjusted pricing and changes that may have to be made to invoicing. Businesses need to consider how such questions will be answered.

How does the change in rate impact upon commercial decisions the company makes? Will the rate change impact on decisions to buy rather than lease assets. It may be more attractive for businesses that cannot recover all the VAT they incur to do this before the VAT rate reverts to 17.5%.

Impact on cashflow? Businesses may also suffer a working capital cashflow squeeze as VAT receipts from sales are reduced, albeit that the impact may be ameliorated by the reduced input tax paid to suppliers. This is an issue FDs and Treasurers may wish to consider.

VAT reporting
A wide range of issues will also need to be considered depending on the nature of the business and its accounting systems. HMRC have indicated that they will adopt a "light touch" in relation to errors or mistakes made in the first VAT return after the change.

VAT payments on account – Should you consider renegotiating existing payments on account with HMRC now that VAT payments may be lower? This would be on the grounds that payments on account are an estimate of future liability, based on past liabilities, which must, if the rate changes, now be wrong.

Rate changes midway through VAT period – How do you properly account for the rate change when your VAT return spans the date of the VAT rate change?

Pro-forma invoices – Does your business raise pro-forma invoices/payment demands? If so, the business needs to ensure that it correctly reconciles the payments received after the rate change where a pro-forma statements have been issued prior to the change.

Employee expenses – Will your expenses system correctly recover VAT under the correct rate? Will the delay between expenses being incurred and being processed lead to errors in applying the correct VAT rate?

Acquisition VAT/reverse charge VAT – Will acquisition VAT and reverse charge VAT be accounted for at the correct rate?

Import VAT – If your business imports goods from outside the EU and has a duty guarantee facility, it should be possible to reduce the value of the guarantee, and so the reduce the related bank charges.

Next steps

- Notify all relevant parties of the change in VAT rate:
  - IT departments should be briefed on the VAT reporting requirements and the required implementation date;
  - Shared Service Centres should be notified of any required changes to their procedures;
  - Accounts Payable and Accounts Receivable departments should be briefed and confirm that staff have adequate understanding of the changes and their impact.
- Consider the global impact on the business across departments such as finance, IT, treasury, procurement, marketing and sales.

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