

# ACTIVE PRACTICE UPDATES

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chartered accountants, business advisers and more...

## THE NUMEROUS QUIRKS AND FOIBLES OF VAT

Insight into VAT's barnacles of complexity.

Are Jaffa Cakes biscuits or, as the name implies, cakes?

This question is one of the most famous examples of the kind of debate that happens frequently in the world of VAT because precise definitions can make the difference between sink or swim for businesses that sell the products under discussion.

VAT is a form of what is known in general terms as a 'sales tax'.

Sales taxes, or goods and services taxes as they are sometimes known, are paid by end purchasers but collected on behalf of governments by retailers or service suppliers. To most ordinary consumers, who can't claim VAT back, they're all but invisible and simply make certain products seem more expensive.

VAT was introduced to the UK in 1973 and replaced purchase tax, which applied primarily to luxury goods. The new VAT applied on goods and services across the board at 10%.

A year later, things started to get complicated when the flat rate of VAT was reduced to 8% while a 12.5% rate for luxury goods and petrol, which was then in short supply, was introduced.

It's been made more complex with every passing year with rates changing, being abolished, reintroduced and generally tinkered.

As of September 2019, there are three rates of VAT:

- standard rate at 20%
- reduced rate at 5%
- zero rate at 0%.

The Jaffa Cake debate arises because most consumers simply don't realise they're paying sales tax as it's bundled into the total price of the product at point of sale in most situations.

That means if product A is standard-rated while product B is zero-rated, product A will cost more to ordinary consumers who reclaim VAT, giving cakes (zero-rated) an advantage over chocolate Hobnobs (standard-rated) in the marketplace.

That's why manufacturers in particular sometimes take such cases to VAT tribunal where judges assess such important topics of what exactly it means to be a cake, a biscuit or a chocolate-coated biscuit.

In 1991, the Government altered the classification of Jaffa Cakes, deciding they were biscuits. After all, they're small, round and come in packets and, at first glance, look like biscuits.

Manufacturer McVitie's, with the product suddenly seeming to lurch upward in price as far as most buyers were concerned, understandably objected and lodged an appeal.

At the hearing, Donald Potter QC, adjudicating, approached the issue carefully. As well as the size and appearance of Jaffa Cakes, he also pointed out that they are usually found in the supermarket biscuit aisle. They're also normally eaten with the fingers, not with a cake fork.

On the other hand, they are boldly described as cakes on the packaging. They're also cooked only once, whereas biscuits get their name from the Latin bis coctus, meaning twice-cooked.

Potter sided with McVitie's and ever since, Jaffa Cakes have been treated as cakes for VAT purposes – that is, zero-rated.

A similar conversation broke out earlier this year when Judge Amanda Brown was asked to hear the case of Pulsin Raw Choc Brownies, a vegan-friendly, dairy-free health snack.

Pulsin wanted them classified as cakes but HMRC considered them to be confectionery and thus subject to standard-rate VAT.

To make a decision, Judge Brown had a selection of similar brownies and cakes brought to the hearing where they were 'closely examined'.

She concluded that "put alongside a plate of brownies, or, for instance, at a cricket or sporting tea where it is more likely that bought and individually wrapped cakes will be served on a plate, the products would absolutely not stand out as unusual".

The Pulsin brownie is a cake, and thus zero-rated.

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## THE PASTY TAX

Another notable VAT dispute was over the status of pasties – are they a luxury product when they're sold warm?

This was triggered when then-Chancellor George Osborne introduced the so-called 'pasty tax' in 2012, closing a loophole which had allowed bakeries to treat pasties as zero-rated as they were only incidentally warm rather than being sold as hot food.

Faced with the prospect of charging customers 20% more for the same product, some bakers switched off their warming cabinets and switched to cooking smaller batches of pasties throughout the day.

Others simply absorbed the price rise as best they could to avoid driving away customers.

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## AN ENDLESS LIST

Other products that have been the subjects of specific VAT tribunals and debates include 'slankets', eBooks, digital newspapers, Bombay mix, breakfast muffins delivered to eat at home, and ambulance rides.

Some of the distinctions are subtle – fruit pulp is zero-rated, for example, while fruit juice is standard-rated. Which categories do smoothies come under? At a tribunal in 2010, it was decided they were beverages rather than "liquefied fruit salad", as Coca-Cola subsidiary Innocent had argued.

There is very little in VAT that can be taken for granted.

If your product or service deviates from the norm – if you've got a new angle or twist on an existing zero-rated item, like that vegan brownie – you'll need to think hard about its VAT status.

Equally, of course, you shouldn't assume it's standard-rated and thus risk missing out on a potential boost to sales from zero-rated status.

It's important in that case to be rigorous and honest with yourself: unless your business is a Coca-Cola or McVitie's with the time, money and energy to fight back, it's safest to act within the spirit of HMRC's guidance.

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## AVOIDING THE ISSUE

In the UK, only businesses with annual taxable turnover of more than £85,000 have to be registered for VAT.

Some businesses deliberately keep their turnover under the threshold – a problem known in the world of tax policy as 'bunching' because of the sheer number of businesses that sit just below the £85,000 VAT-registration threshold.

What puts them off growing naturally is that once you are registered for VAT, it usually means either putting prices up by 20% or, alternatively, charging the same but covering the VAT out of your own profits.

In a 2017 report on the bunching phenomenon, the Office for Tax Simplification (OTS) gave the example of two businesses – one turning over £84,000 and another just over £85,000: "If VAT applied to the whole of the turnover, the VAT-registered business would be liable for an additional £17,000".

It noted that "in practice the net figure is likely to be less... as the newly-registered business will be able to recover VAT on its purchases, which it was unable to do before registration".

Then, in addition, handling VAT bureaucracy takes up a huge amount of time that might otherwise be spent on something more productive.

In 2017, British businesses spent 25 hours managing VAT on average – several full working days.

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## SIMPLIFICATION NOT IMMINENT

Critics of VAT have called it regressive and excessively complicated – why should businesses have to spend so much time on this? Why should we have tribunals simulating cricket teas?

The official guidance is incredibly long and detailed, covering thousands of pages, and yet still leaves many manufacturers, retailers and consumers confused.

For all the criticism it receives, however, VAT is also relatively efficient to administer from the Government's point of view and generates some 21% of the UK's total annual tax revenue.

Although simplification of the system has long been called for, it doesn't seem as if it's likely to happen anytime soon.

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