

DISPENSING PRACTICES
VAT IMPACT FROM 1 APRIL 2006

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1 INTRODUCTION

As most GPs and practice managers of dispensing practices are aware there have been some changes that mean that VAT registration has become an issue for medical practices.

The purpose of this guide is to provide assistance and guidance to GPs and practice managers in some of the general areas of VAT that are likely to affect them over the next few months.

VAT is a complicated subject in its own right and therefore this brief guide cannot claim to provide a comprehensive overview. So as always we would recommend that specific advice is sought in relation to particular transactions and queries.

There will be questions about how to deal with VAT in the software/bookkeeping systems currently being used by the practice. We are researching some best practice methods for this and will issue notes on these under separate cover.

One particular area of VAT that is not dealt with below relates to land and buildings. We will be issuing some extra notes on this in due course as there are a number of complexities to this area that are best dealt with in their own right.

2 BACKGROUND

2.1 What is VAT?

Value Added Tax (VAT) is essentially a tax charged on the supply of goods and services in the UK as well as on the import of goods and certain services into the UK.

Generally all supplies of goods and services are taxable, ie VAT has to be charged on them, unless they are specifically exempted.

Income that arises from General Medical Services, as given by a suitably qualified healthcare professional, falls within one of these specific exemptions.

Historically the exception to this has been dispensing of drugs, which is treated as taxable.

VAT can be charged at various rates, the most common rate being 17.5% (standard-rated). However there is also a 5% reduced rate as well as a 0% rate (zero-rated).

The way it is collected is to have each business in the supply chain register, subject to certain limits, for VAT.

Each business collects VAT from its customers and reclaims VAT it has been charged by its suppliers. A return is made periodically to show this and the balance is either paid over to or a refund received from H M Revenue & Customs.

The intention is for VAT to be a tax on consumer expenditure with the effect on businesses being tax neutral. In reality there are anomalies in the legislation that mean that this is not entirely the case, let alone the administrative costs which the business has to bear.

The government department responsible for collecting and monitoring VAT was previously known as H M Customs & Excise. However a recent merger with the Inland Revenue means that VAT is now administered by H M Revenue & Customs. For the sake of this document we will refer to them simply as 'Customs'.

2.2 What are the changes?

Essentially there are two changes occurring, but coincidentally it is likely that both changes will take effect at the same time.

Change no. 1 – From exempt to standard rated

Medico-legal reports and similar non-NHS work have previously been included within the exempt income category for medical practitioners, however a recent decision by H M Revenue & Customs means that this type of income will become standard-rated for VAT purposes.

This change is likely to come into effect on 1 April 2006, although it is possible there may still be a late reprieve on this.

Change no. 2 – PPA Allowances

From 1 April 2006 the Prescription Pricing Authority will be making changes to the allowances that they pay to dispensing practices.

Traditionally the PPA reimbursement to practices that are not VAT registered has included an element to cover the VAT incurred by GPs on the purchase of drugs.

It should be explained at this point that income arising from dispensing is treated as taxable income from a VAT point of view rather than being exempt. This has been the case for a number of years.

However no VAT is actually charged on the supply of drugs as the tax rate for the supply is 0%, also known as zero-rated.

Although no VAT is actually charged on either VAT exempt or zero rated sales the distinction does become important when considering the claiming back of VAT on items that have been purchased.

Where goods are purchased and used to make income that is exempt then any VAT charged on those purchases is not reclaimable.

However where those goods are used to make income that is taxable, even if only at a rate of zero, any VAT charged on those purchases can be reclaimed.

In the case of the dispensing practice this becomes particularly relevant due to the supply of drugs by drugs companies being standard rated, i.e. 17.5% VAT charged.

This leaves the GP practice in the position of not charging VAT when dispensing drugs, but being forced to pay VAT when buying the drugs.

The classification of dispensing drugs supply as zero-rated means that the VAT that has been charged can be recovered.

Theoretically then it has always been possible for dispensing practices to register for VAT so as to make these reclaims. However where VAT-taxable income is entirely made up of zero-rated sales H M Revenue & Customs can grant exemption from VAT registration.

For most dispensing practices it has been better not to register.

The VAT allowance paid by the PPA usually outweighed the amount of VAT that could be claimed back on drug purchases, particularly after discounts are considered. It was therefore preferable to not register for VAT and so gain the extra reimbursement from the PPA.

As of 1 April 2006 the PPA will no longer be paying the VAT allowance making it a priority for dispensing practices to register for VAT so as not to be financially disadvantaged.

3 VAT REQUIREMENTS

3.1 When do I have to register?

Registration is only required when taxable income reaches certain limits. Note that exempt income is not included in this calculation, and taxable income is calculated before any expenses are deducted.

The registration limit is currently set at £60,000.

You become liable to be registered for VAT at the end of any month if the taxable income in the year ended on the last day of that month has exceeded £60,000.

To eliminate the effect of unusual one-off peaks in income, if you can demonstrate that taxable income in the next twelve months will not exceed £58,000 then registration can be avoided.

It is not enough to check the turnover level only at the end of the accounting year. The limit must be checked each month on a 12 month rolling basis.

Customs have to be notified within 30 days of the end of the month where the yearly limit was exceeded. Registration will then normally take effect from the first day of the following month.

In addition if you expect taxable income in the next 30 days to be greater than £60,000 then you are required to register within the 30 days. Registration will normally commence at the start of the 30 day period.

As already mentioned, for GPs NHS income is exempt and therefore does not need to be included in calculating taxable income.

VAT registration therefore affects practices as follows:-

Non-dispensing practices

Private work such as medical reports etc, are likely to become taxable from 1 April 2006.

Therefore from this date the level of this income needs to be monitored on a regular basis to ascertain whether or not the registration limit has been reached.

Once the limit is reached then there are 30 days in which to register. From the beginning of the next month VAT will have to be charged on all work of this type.

For many smaller practices this type of work is unlikely to reach the registration limit, and VAT is unlikely to become an issue for them.

Dispensing practices

Zero rated drugs dispensing income is almost certainly likely to have been above the registration limit for a number of years.

Most practices will have taken advantage of the exemption from registration available to those providing zero rated goods.

It will no longer be financially worthwhile to continue with this exemption. The loss to a practice for not registering could amount to many tens of thousands.

It is therefore important for all dispensing practices to be registered from 1 April 2006. Registration forms should be completed and submitted as soon as possible.

Note that this registration will cover the private work, such as medical reports, mentioned earlier. Therefore it will be necessary to start charging VAT at 17.5% on these services from 1 April 2006.

Once Customs have processed the application to register they will issue a certificate, which will confirm the registration and provide the VAT registration number.

3.2 How do I register?

Application for registration is done on form VAT1, a copy of which is attached.

This form can be downloaded as a .pdf file from Customs website (www.hmrc.gov.uk). Alternatively a form can be requested from the National Advice Service, which can currently be contacted on 0845 010 8500.

In addition partnerships need to provide details of each partner and this is done on form VAT2. A copy of this form is also attached.

This form can again be downloaded in .pdf form or requested from the helpline.

Registrations can be made online, however at present there is no facility to input the VAT2 form details so this is probably not a practical choice for most practices.

The Customs website provides help documentation in relation to the forms and of course we are available to assist in all areas of the registration process.

3.3 What records do I need to keep?

Once you are registered for VAT you must keep records of all the income you receive and purchases you make. You will also need to keep a record summarising the VAT for each period that a return is prepared.

Because a VAT return will need to be prepared on a regular basis, not just once a year, it will be extremely important that practices stay up to date with their bookkeeping.

Customs are somewhat more stringent in what they expect from businesses than the Revenue have been in the past. The penalty regime is also a lot more severe when it comes to VAT so it will be important to ensure that the practice's bookkeeping is up to scratch.

The practice bookkeeping system will need to allow for the separate recording of VAT so that it can be easily identified when it comes to preparing the VAT return. We will be providing some best practice notes on this shortly.

In addition it will be vital that there is a VAT invoice to back up any reclaims of VAT, as well as copies of VAT invoices to support any income received.

If there were no VAT invoice to back up a reclaim then in the event of an inspection the claim would be disallowed by Customs. Typically on a visit the Customs officer would look at a reclaim and request sight of the invoice to back up the claim. If the invoice could not be located then it is likely that they would reverse the claim. It would be best for practices to get into the habit of filing invoices in such a way that it would be easy to locate them from the payment records.

For dispensing practices it is not currently clear what format the paperwork from the PPA will take. We imagine that it will be sufficient to satisfy Custom's requirements, but will advise once we are in a better position to do so.

For income from insurance companies etc. for medicals then the practice will need to ensure that it issues a VAT invoice for every report done and keeps a copy. It would be preferable for these invoices to be filed separately from other income.

Of course if several medicals were being billed to an insurance company at the same time then these could all be included on the same invoice.

Another area that currently is not well documented from a paperwork point of view is that of discounts from drug companies. Frequently money arrives in practice bank accounts with little paperwork.

Since these discounts will now include VAT that needs to be declared on the VAT return, it will be necessary to obtain a VAT invoice for any discounts received. The drug company should provide you with this.

It is unlikely to be necessary to have to produce VAT invoices for dispensing drug sales as the current documentation is likely to be adequate.

All VAT records must be kept for at least 6 years. This time limit applies to computer data as well as paperwork.

For full details on keeping records and accounts it may be worth reviewing Customs Notice 700/21. This can be located on their website, or requested from the helpline.

3.4 What details must be included on a VAT invoice?

- An identifying number (i.e. an invoice number);
- The practice name, address and VAT registration number;
- Date of supply of service;
- The customer's name and address; and
- A description of what is being supplied.

For each description of services you must show the:

- The quantity of goods or extent of services;
- Charge made, excluding VAT;
- Rate of VAT;
- Total charge made, excluding VAT;
- Each rate of VAT charged with the amount charged at each rate and shown in sterling;
- Rate of any cash discount offered;
- Total amount of VAT charged shown in sterling

We have prepared a sample VAT invoice and this is attached should you wish to adapt this for your own use.

3.5 At what point do I need to account for VAT?

Invoice Accounting

The main way to account for VAT is on an invoice date basis. You may need to be wary of invoices that separately specify a 'tax point' date as well as an invoice date. For VAT purposes it will be the tax point that will be relevant.

This will mean that VAT has to be paid over to Customs, and can be reclaimed from Customs on the invoice date regardless of when payment is made.

For example, the VAT period ends on 30 June. An invoice from Drugs'r'us is received dated 28 June, but is not paid until 20 July. The VAT can be claimed on the June VAT return.

In the same VAT return period an invoice is issued by the practice to Insurance Limited on 15 June, but payment is not received until 2 July. The VAT has to be paid over on the June VAT return.

Cash accounting

An alternative to this scheme is to use the cash accounting scheme, where the invoice date can be ignored and the relevant date is when payment is made.

So taking the above examples the VAT on the Drugs'r'us invoice could not be claimed on the June VAT Return. Likewise the Insurance Limited VAT would not have to be paid over on the June VAT return.

Most dispensing practices are likely to be in a refund position because VAT being reclaimed on purchases will be greater than VAT being paid over on income.

It would therefore be of greater cashflow advantage to the practice to use the invoice accounting method. In some cases it is possible that the VAT could be refunded to the practice before the invoices to the drugs company have even been paid.

Most practices currently only make entry in their accounting system when payments are made or received. To use invoice accounting is going to require making some changes to this procedure.

3.6 So what am I charging VAT on?

VAT Registered Practices will need to charge VAT on

- Medical reports

But don't need to charge VAT on

- Exempt NHS income
- Dispensing drug sales

3.7 So what can I reclaim VAT on?

VAT Registered Practices can reclaim VAT on all business purchases and expenses where a valid VAT invoice is held, subject to partial exemption adjustments.

Note that VAT cannot be reclaimed on any private expenses even if they are paid for by the partnership. However if a purchase is made which is used partly for business and partly for non-business activities then a pro-rata adjustment can usually be made to claim the business element.

Certain business expenses are specifically excluded from claim. For example VAT incurred on business entertainment cannot be reclaimed under any circumstances.

4 PARTIAL EXEMPTION

4.1 What is this partial exemption adjustment?

Because the practice supplies some services that are exempt as well as some that are taxable it is not deemed fair that VAT can be reclaimed on all expenses.

Therefore an adjustment has to be made to apportion the VAT incurred on purchases (also known as **input tax**) between that which relates to taxable services and that which relates to exempt services. The part that relates to exempt services is then barred from claim (subject to de minimus limits).

For some expenses it is obviously quite easy to tell which type of income they relate to and so the apportionment can be made or not as appropriate. But this is not so easy when it come to general overheads that could be said to apply to both types of service.

Customs have provided a standard method for businesses to use. This is imaginatively entitled The Standard Method!

There is facility to use an alternative method by coming to an agreement with Customs, but we feel it is unlikely that any practice would want to do this. Please speak to us if you would like some specific advice in this regard.

4.2 The Standard Method explained

The Standard Method enables you to calculate the proportion of VAT on general overheads that can be allocated as being related to taxable income and so be claimed.

It works by calculating a ratio of taxable income against total income as follows:-

$$\frac{\text{Taxable income in the period (excl. VAT)}}{\text{Total income in the period (excl. VAT)}} \times 100 = \text{Recoverable \% - age of unallocated VAT}$$

Where the resulting percentage is not a whole number it should be rounded up to the next whole percentage.

4.3 Step by step walk through using the Standard Method

Step	Action
1	Identify how much input tax (i.e VAT suffered on purchases) is directly attributable to your exempt income.
2	Identify how much input tax is directly attributable to your taxable income.
3	Calculate how much input tax is 'residual' (this will be the total value of input tax less the VAT attributed in steps 1 and 2).
4	Calculate the recoverable percentage as laid out above.
5	Apply the percentage calculated at step 4 to the residual input tax calculated at step 3. The value produced is the amount of VAT that can be claimed.
6	Add together the input tax directly attributable to taxable services from step 2 and the residual input tax claim from step 5. This amount can be recovered in full.
7	Add together the input tax directly attributable to exempt services from step 1 with the amount of residual input tax not claimed in step 5. This amount then needs to be considered against the 'de minimus limits'.

Note that input tax on blocked items such as business entertaining would not be included in steps 1-3. This input tax cannot be reclaimed in any circumstance. In addition, input tax which relates to non business activities, such as private use, should also not be included in steps 1-3. This input tax is also completely irrecoverable.

4.4 What are the de minimus limits

The de minimus limit allows you to still make a claim for exempt input tax (as calculated at step 7) if the total value is less than certain limits as set out by Customs.

Currently these limits are that the exempt input tax must be not more than:-

- £625 per month on average; **and**
- half of your total input tax for the relevant period

If your exempt input tax is below these limits then the exempt input tax can be claimed as well as the input tax already calculated in step 6.

If your exempt input tax is above these limits then **none** of the exempt tax can be claimed. Your input tax claim will only be for the amount calculated at step 6.

4.5 Annual Adjustment

The above Standard Method procedure together with the de minimus check needs to be done for every period that a VAT return is completed. However this is not the end of the matter.

In order to compensate for distortions that can occur in a short period the calculations need to be reviewed over a longer period. Usually this longer period is a year.

Essentially the procedure is the same as detailed above, but the figures you use would be the totals for the whole year. In addition you would need to revisit the apportionment in steps 1 and 2. Potentially some items that at the time were intended for use in delivering taxable services might actually later be used in exempt services and vice versa. Where this has happened the attribution would need to be altered.

Any resulting difference between the claim as revealed by this longer period review and what has already been entered on the returns is your annual adjustment.

This annual adjustment is then included on the next VAT return to be completed, i.e. if your partial exemption year ended on 31 March the annual adjustment would **not** be entered on the 31 March return, but would go on the following VAT return.

Partial exemption is covered in more detail in VAT Notice 706.

5 THE VAT RETURN

5.1 What does a VAT Return look like?

A copy of a blank VAT return is enclosed. This is a fairly brief one page document.

Customs produce individual VAT returns for each VAT registration number – copies are not acceptable. This will usually be sent to you in the post in good time. If you lose your VAT return then you can contact the helpline to obtain a further one.

Alternatively there is an option for you to complete your VAT return online.

5.2 How often will I fill a VAT return in?

Typically businesses complete VAT returns on a quarterly basis. However there is provision for completing monthly returns.

Since dispensing practices will be in a refund position it would be better for cashflow purposes to complete returns on a monthly basis. This will also better compensate for the loss of VAT allowance from the PPA, which arrives on a monthly basis.

Where we have dealt with the VAT registration for dispensing practices we have requested monthly returns. Once any documentation starts to arrive from Customs please can you advise us if this has not been actioned.

5.3 How long do I have to fill the form in?

The return has to be sent to Customs by the due date as shown on the form. This is usually one month from the end of the VAT period for paper returns. However returns submitted online can be given up to 7 extra days to submit.

So if completing monthly paper returns your July VAT return would have to be with Customs by the end of August.

5.4 If I end up having to pay Customs

Payments by cheque are due on the same date as the paper VAT returns. You will see from the copy VAT return that there is a box to tick to enclose payment with the return. In this case the cheque would go off to Customs in the same envelope as the VAT return.

Alternatively a direct debit can be set up with Customs and they will collect this from your bank account a further 3 days after the extended 7 days for filing online.

5.5 When will I get my refund?

Usually Customs process repayments within a couple of weeks of receiving the return. If nothing has been received within three weeks then they recommend that you contact them.

In the event of the repayment being delayed by more than 30 days you may be entitled to some compensation.

5.6 Filling out the VAT Return

The VAT return has numbered boxes. Below is a brief summary of what entries should be made on each return.

Box No.	Action
1	Include the VAT due on all income.
2	This is for acquisitions of goods from other EC member states. It is unlikely that any practice would need to complete this so simply write 'none' in the box.
3	This is the sum of boxes 1 and 2.
4	Enter the total of the input tax you are entitled to reclaim for the period.
5	Take the figures in boxes 3 and 4, deduct the smaller from the larger and enter the difference in box 5. If box 4 is larger then box 3 then this figure will represent the refund due to you and vice versa.
6	Enter total income excluding VAT.
7	Enter total purchases excluding VAT.
8	This relates to intra-EC trade and is unlikely to apply. Enter 'none'
9	This relates to intra-EC trade and is unlikely to apply. Enter 'none'

Box 6 would include:-

- Standard rated income (i.e. at 17.5%) – the medical reports etc.
- Zero-rated services – drug dispensing
- Exempt income – NHS income
- Any other business income

Neither Box 6 nor Box 7 should include

- VAT itself
- Money put into or taken out of the business by the partners
- Loan money received by the practice
- Dividends or gifts/legacies received by the practice
- Wages and salaries
- PAYE and national insurance contributions
- Superannuation contributions
- Insurance claims
- Local Authority rates

6 ADDITIONAL AREAS OF INTEREST

6.1 Making a reclaim for the period prior to VAT registration

If you have kept hold of VAT invoices for purchases made prior to VAT registration then you can reclaim the input tax subject to certain conditions.

The input tax must be in relation to taxable goods and services. Please note the partial exemption rules do not cover this area of VAT reclaim.

For **goods** purchased prior to registration

- They must have been supplied to the practice for business purposes
- They must have been supplied no more than 3 years before registration
- You must still possess them
- You must have records showing the quantity and date you obtained them

For **services** purchased prior to registration

- They must have been supplied to the practice for business purposes
- They must have been supplied no more than 6 months before registration
- They can't have been related to goods which you disposed of before registration
- You must have records of the services, showing a description and date

In essence this claim is likely to mainly comprise the VAT on stocks of drugs on the dispensary shelves at 31 March 2006. This stock should not include any stocks held of drugs to be personally administered.

To claim this input tax a stock take should be taken on 31 March. The input tax for each item can be claimed provided that a valid VAT invoice is held to cover the purchase.

6.2 Personal expenses

We expect that many GPs will be wondering about the possibility of reclaiming VAT on personal expenses.

VAT reclaim is possible provided valid VAT invoices are kept and the expense is business related. Of course the additional partial exemption

rules will apply as there will need to be apportionment between how much of the expense relates to taxable and exempt services.

In reviewing the types of expenses usually claimed by GPs it would seem that motor expenses are likely to be the largest area affected by VAT.

Motor vehicles that are not exclusively used for business are specifically blocked when it comes to reclaiming the VAT. The only circumstances where we can see any reclaim being possible, is if the practice purchased a pool vehicle that was kept strictly for business use only. This would probably mean keeping the vehicle at the practice premises overnight, rather than anyone taking it home which would classify as private use.

Even if this were the case then it is likely that the vehicle would be used in relation to exempt NHS services rather than the dispensary, and so would not qualify for VAT reclaim under the partial exemption rules unless the de minimus limits were not breached.

A claim could be made for petrol, however there is a standard private use adjustment on this. Again the partial exemption rules would probably disallow this claim in any case, as they would for VAT incurred on repairs.

Our current opinion is that VAT reclaims on personal expenses are unlikely to be worthwhile.

6.3 Personally administered drugs

Drugs sold through the dispensary are zero-rated for VAT purposes, however personally administered drugs come within exempt medical services.

This means that for each delivery of drugs the purchase invoice will need to be separated between those drugs that relate to the dispensary and those that will be used by GPs to personally administer.

The input tax element of the dispensary drugs can be reclaimed. However the input tax element of the personally administered drugs is exempt and cannot be reclaimed, unless the total amount of exempt input tax for the VAT period comes within the de minimus limits.

7 Conclusion

The changes made by the Prescription Pricing Authority, as well as the changes to the VAT treatment of certain services offered by GPs, will have a large impact on the administration and maintenance of the practice accounts.

The penalties for failing to keep proper VAT records are severe. In addition the financial loss to dispensing practices in losing the VAT allowance from the PPA will be crippling unless the VAT reclaims on drug supplies are dealt with accurately and quickly.

We are here to provide support and advice through the changeover period, and can offer training. Please feel free to make use of these services as appropriate.