ebrief for freelancers and contractors

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Flat Rate VAT Scheme – The essential guide

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As a Limited Company contractor you will no doubt be keen to understand the changes to the Flat Rate VAT Scheme coming on 1 April 2017. Maybe you've heard conflicting opinions about whether you'd be better off staying in the scheme or going, and whether there's any way to retain your existing category if you do stay.

We know how confusing it can feel. It's changes like these that make contractors wish they had a trusted contractor accountant who's there to offer support and guidance when it's needed most. That's why our expert Personal Accountants have created this essential guide to explain exactly what's changing, how you might be affected, and what your options are.

If you find this information useful and want to get personalised advice on topics like this in future, contact us today to find out what our all-inclusive monthly service can do for you.

In this ebrief we explore:

What is the Flat Rate VAT Scheme?

What is the Flat Rate Scheme (FRS)?

The FRS was designed to simplify VAT for businesses with an expected turnover less than £150,000 (£180,000 including VAT). Many contractors make use of FRS because of the simplicity but also because the financial benefit is greater than using the standard method.

The scheme works very simply. VAT is added to your invoices to clients, typically at 20% on the value of your services. But then, instead of reducing that VAT received from your clients by the VAT you incur on expenses, and paying the net amount to HMRC, you simply pay a fixed percentage of the VAT inclusive turnover. The percentage adopted for this depends on selecting an FRS category that best suits your business activity.

Although the FRS was originally designed to be a simplification of the administrative process and not provide a financial benefit, for many contractors the amount of VAT retained is higher than actually incurred.

Example for an IT consultant (14.5%) with a turnover of £80,000 excluding VAT:

VAT Output tax = £80,000 x 20% = £16,000
VAT inclusive turnover = £96,000
Therefore, under the FRS the VAT paid to HMRC will be £96,000 x 14.5% = £13,920

Many contractors would not be incurring VAT input tax equivalent to the difference between the VAT received and paid (£16,000 - £13,920 = £2,080 above) and financially benefit from adopting the FRS over the standard VAT scheme.

Changes to the Flat Rate Scheme

So why is there any change?

Sadly, the FRS has become the target of abuse and has become a means to compensate for the loss of tax relief on expenses by former Umbrella workers. HMRC has acted quickly to counteract the actions of this abuse and imposed changes that remove that benefit but, in doing so, have also negatively impacted genuine Limited Company contractors.

What do those changes mean?

From 1 April 2017, a new Flat Rate percentage of 16.5% has been introduced. This percentage overrides the existing FRS category percentage rate used, but only when a business falls within a wholly new Limited Cost Trader (LCT) definition.

To explain, if your business has adopted the “Computer and IT Consultancy and Data Processing” category you would normally apply the flat rate of 14.5%. Under the new rules, for a VAT quarter where you meet the meaning of LCT, the 14.5% is replaced by 16.5%.

What is a Limited Cost Trader?

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An LCT is a business that incurs expenditure during a VAT Return period on Relevant Goods less than the greater of:

a) £1,000 per annum (pro rata for the duration of a VAT period) and
b) 2% of VAT inclusive turnover for that period.

If you adopt quarterly VAT Returns this is considered at the end of every VAT quarter, if you adopt the Annual Accounting method then it is assessed at the end of the full year.

If you adopt the cash accounting basis rather than the invoice accruals basis then the turnover considered is the VAT inclusive value of any cash received in the VAT period.

Example for Quarterly reporting, invoicing £20,000 plus VAT in the quarter:
a) A VAT quarter is 3 months, therefore 3/12ths of £1,000 = £250
b) £20,000 plus VAT = £24,000 - 2% of £24,000 = £480

The greater value is £480, therefore if expenditure on Relevant Goods is less than £480 (including VAT), the LCT rate will be applied.

Example for Quarterly reporting, invoicing £5,000 plus VAT in the quarter:
a) A VAT quarter is 3 months, therefore 3/12ths of £1,000 = £250
b) £5,000 plus VAT = £6,000 - 2% of £6,000 = £120

The greater value is £250, therefore if expenditure on Relevant Goods is less than £250, the LCT rate will be applied.

Example for Annual VAT reporting, invoicing £80,000 plus VAT in the year:
£80,000 plus VAT = £96,000 - 2% of £96,000 = £1,920 which is greater than the annual minimum of £1,000, therefore if expenditure on Relevant Goods is less than £1,920, the LCT rate will be applied.

What would becoming an LCT cost me?

The effect can be quite dramatic financially:

Example at 14.5%
VAT on turnover of £80,000 = £16,000
Normal basis: VAT inclusive = £96,000 x 14.5% = £13,920
LCT basis: VAT inclusive = £96,000 x 16.5% = £15,840

A business adopting a category with a percentage rate of 14.5% and with a turnover of £80,000 plus VAT would see the reduction in the VAT retained from £2,080 (£16,000 - £13,920) to only £160 (£16,000 - £15,840). This is a loss of £1,920.

Example at 12%
VAT on turnover of £80,000 = £16,000
Normal basis: VAT inclusive = £96,000 x 12% = £11,520
LCT basis: VAT inclusive = £96,000 x 16.5% = £15,840

A business adopting a category with a percentage rate of 12% and with a turnover of £80,000 plus VAT would see the reduction in the VAT retained from £4,480 (£16,000 - £11,520) to only £160 (£16,000 - £15,840). This is a loss of £4,320.

Examples are great at showing you how you could be affected, but they can't give you an exact answer that's unique to your own personal circumstances. For Intouch clients we've taken out the guesswork and have been actively letting them know how they will be affected and what response we recommend.

If this sounds like the kind of expert advice you need, get in touch today. Our all-inclusive monthly service includes unlimited support from your Personal Accountant.

VAT Return periods

How does this work for VAT Return periods ending in April 2017 or May 2017?

If you are an LCT for any quarter that includes April 2017 then your VAT liability will use the normal category percentage for periods prior to 1 April 2017 and the new 16.5% rate for the period from 1 April 2017.

Finding it tough to calculate what your VAT liability will be? Intouch's Personal Accountants take out the guesswork for clients by calculating this for them. If this sounds like the type of professional support you need, get in touch today.

Should I reassess my VAT periods?

There is no benefit to changing your VAT periods just for the sake of it. However, where your expenditure on Relevant Goods is focused on certain periods in a year then considering the Annual Accounting method could be useful to secure FRS on the normal basis for the whole of the year rather than one quarter in isolation. We consider this further on.

What are Relevant Goods?

Purchases will fall within one of two categories known as Goods or Services. Goods tend to be tangible, moveable items, where title or ownership physically passes from one to another. Services are everything else.

For LCT purposes, Relevant Goods are goods that are used **only for the purposes of your main business activity**, not only excluding costs that are personal or partially so, but also specifically excluding all:

- vehicle costs including fuel and mileage
- food or drink
- capital expenditure goods of any value
- goods that you intend to re-sell or hire out, unless selling or hiring is your main business activity*

** Note that purchasing goods for resale where selling is not your main business activity are not Relevant Goods. This was an amendment to the rules in February 2017 to stop people buying items for resale as part of an arrangement to retain FRS.*

Relevant Goods

Examples of Relevant Goods

This isn't an exhaustive list:

- stationery and other office supplies to be used exclusively for the business (printer consumables would only be included if the printer were solely used for the business and not used personally)
- gas and electricity used exclusively for your business; use of home payments is excluded
- books, magazines etc. provided in a physical form
- standard software, provided on a disc

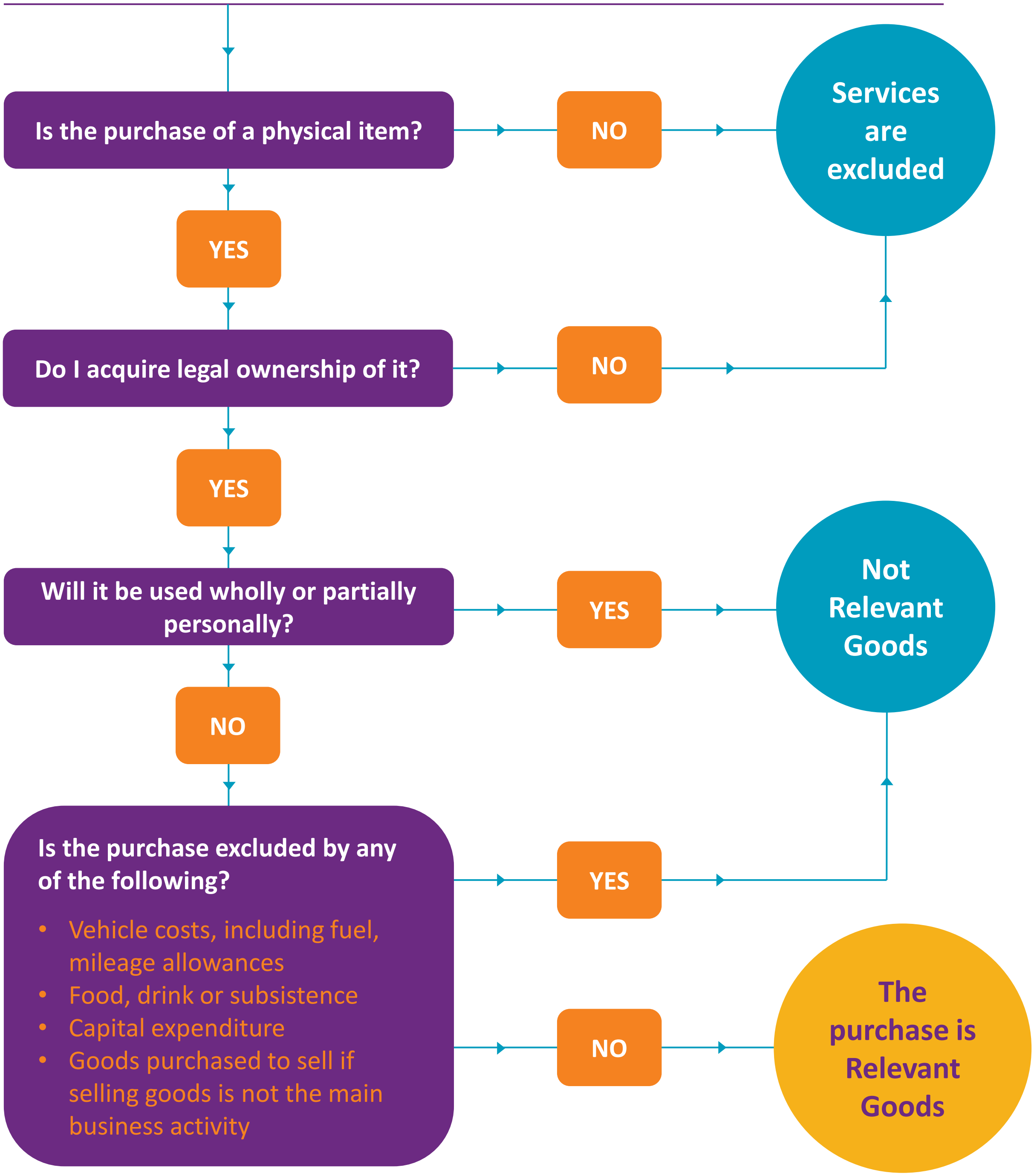
Examples of supplies that aren't Relevant Goods

This isn't an exhaustive list:

- accountancy fees, because these are services
- advertising costs, because these are services
- leased or hired equipment: this counts as services because ownership will never transfer to your business
- food and drink for personal consumption – i.e. subsistence
- all vehicle costs including mileage and fuel
- laptop or mobile phone for use by the business, this is excluded as it is capital expenditure
- anything provided electronically, for example a downloaded magazine, because these are services
- rent or use of home, because this is a service
- software you download or written specifically for your business, because this is a service

Relevant Goods

How do I decide whether a purchase is Relevant Goods?



What are your options?

1 Deregister from VAT

For those that consider LCT to be inevitable and who incur very little VAT on purchases, then deregistering may be something to consider. However, VAT registration is suggestive of a genuine business when looking at IR35, so that may not be wholly appropriate.

2 Switch to the Standard Scheme

Again, those that consider LCT to be inevitable but who are incurring VAT on purchases generally may decide that recovering actual VAT incurred is more beneficial than the low level of recovery under LCT. The downside is that should you discover FRS to be beneficial you will not be able to return to the FRS for at least 12 months.

3 Remain in the Flat Rate Scheme

Your third option is to remain in the FRS and assess whether you fall into the Limited Cost Trader category each quarter and whether to use the 16.5% rate. You will continue to benefit from the FRS' simplification of VAT for your business.

If you choose to remain in the Flat Rate Scheme, you may want to consider switching to the Annual VAT Return cycle rather than completing quarterly returns. This represents an opportunity to manage qualifying for full FRS because costs are often incurred annually.

However, advice needs to be personal and there will be circumstances where this may not be appropriate. The expert team of Personal Accountants here at Intouch Accounting can help you to make an informed decision and to work through the opportunities available.

Trying to decide whether you should stay put in the FRS or move over to standard VAT? Or maybe you've heard about different options to retain your current FRS category and you don't know who to trust? These are decisions you should be making with the support of an [expert accountant].

Our team of Personal Accountants can help by discussing your current circumstances and finding the right path for you.

If you'd like to get unlimited support like this as part of our monthly service, [get in touch today].

Speak to us today about how we can help you be a contracting success.

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