

FLAT RATE SCHEME



UNDERSTANDING THE FLAT RATE VAT SCHEME

When first starting out in contracting there are a number of things to consider, one of which is how you account for VAT and whether to use the Flat Rate VAT Scheme (FRS). But what actually is FRS, what are your options and how does it ultimately affect your take home pay? The following guide is written to help you answer those questions.



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WHAT IS THE FLAT RATE SCHEME (FRS)?

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

The scheme works by calculating the amount of VAT payable to HMRC as a flat percentage of the value of your services plus the VAT charged, instead of working out the actual difference between VAT received and paid.

The flat rate 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 to 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

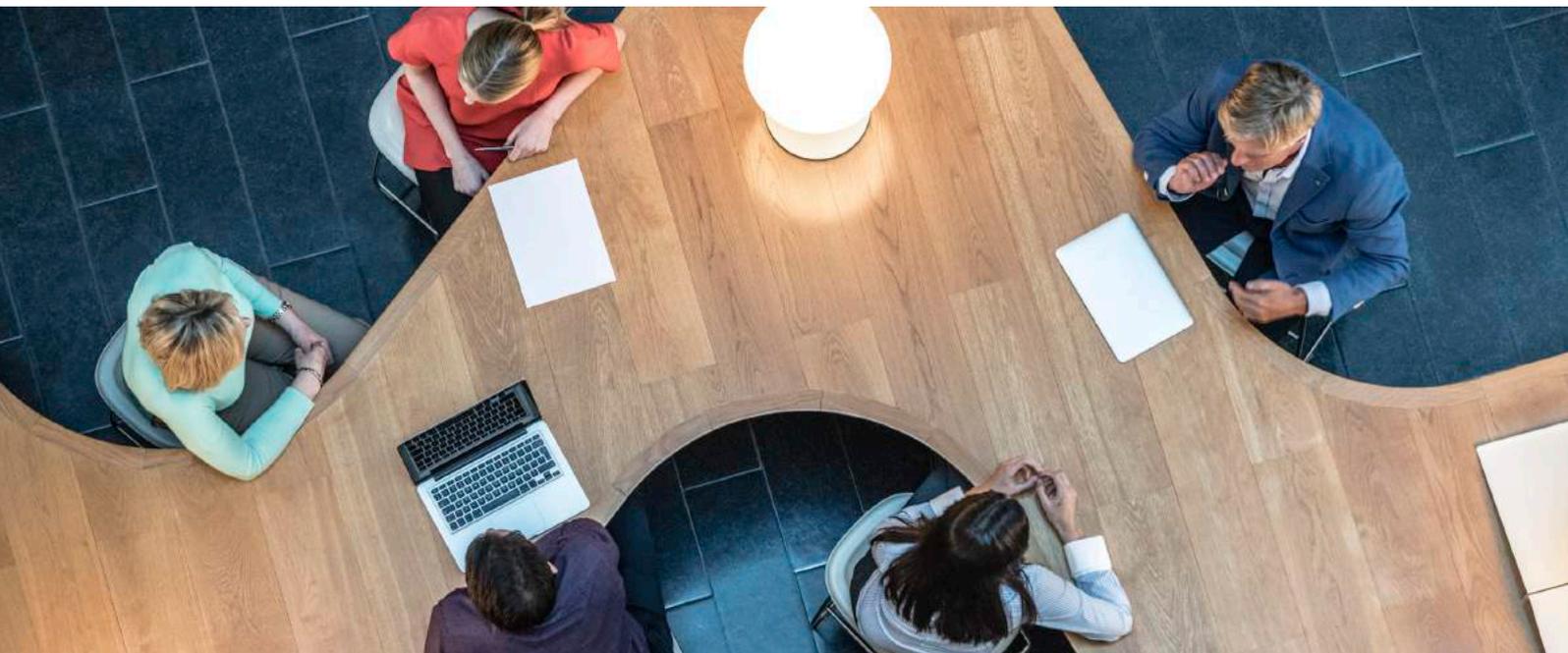
Therefore, under the FRS the VAT paid to HMRC will be £96,000 x 14.5% = £13,920

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

LIMITED COST TRADER

In April 2017 a new Flat Rate percentage of 16.5% was introduced. This new percentage overrode 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?

HMRC will define you as a Limited Cost Trader if your spending on 'Relevant Goods' within the VAT return period is:

a) Less than 2% of the VAT inclusive sales in the VAT period

b) Or greater than 2% if the amount of Relevant Goods is less than £250 per quarter on quarterly VAT or £1000 per year

The difference between applying a standard FRS category versus the Limited Cost Trader category can be quite dramatic financially

Example as an IT Consultant 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.

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.

Examples of Relevant Goods

- Stationery and other office supplies to be used exclusively for the business
- Gas and electricity used exclusively for your business
- Books, magazines etc. provided in a physical form
- Standard software, provided on a disc

NB: This isn't an exhaustive list

Examples of supplies that aren't Relevant Goods

- 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

NB: This isn't an exhaustive list

Should I use the Flat Rate Scheme?

Most contractors will benefit from using the FRS and assessing whether they fall into the Limited Cost Trader category each quarter, and whether to use the 16.5% rate. This is because you will continue to benefit from the FRS's simplification of VAT for your business.

You may want to consider using 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.



HOW INTOUCH CAN HELP

At Intouch Accounting, we work with contractors every day, helping them understand their options, make the right decisions for their business and ultimately save money.

Whether you're looking to switch accountants or just starting out in contracting, your dedicated Contractor Accountant will handle everything for you, helping to maximise your income, while staying on the right side of the taxman.



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