

Flat rate scheme – where are we now?

(Lecture B1080 – 13.04 minutes)

Introduction

It is one year since the most important date in the history of the flat rate scheme (FRS), when a new category was introduced for a 'limited cost business' on 1 April 2017. In a nutshell, this new 16.5% rate applies to users that spend either less than 2% of their gross sales on goods or £250 in a VAT quarter. The excessively high rate has wiped out the financial gains previously enjoyed by thousands of businesses across the UK, particularly those involved in selling standard rated services, with not much input tax to claim. In many cases, these businesses qualified for a favourable rate of 12% for 'business services not listed elsewhere'. So the key question is as follows: does the FRS still serve a purpose for some SMEs? And in this age of easy to use accounting software and apps, are the scheme's time saving benefits that HMRC promote with such enthusiasm really worthwhile?

Background

The main principles of the FRS are as follows:

- A business chooses its relevant category from a list of 54 activities published via Notice 733, section 4 and applies this percentage to its VAT inclusive business income for the period in question. This calculation includes income from zero-rated and exempt sales but not those that are outside the scope of VAT, e.g. most sales of services to B2B customers based outside the UK are excluded.
- A business can claim input tax on capital expenditure goods where the cost of the item exceeds £2,000 including VAT. All other input tax is lost.

The scheme can only be adopted by a business that expects its taxable sales excluding VAT to be less than £150,000 in the next 12 months.

So what has been the outcome of the new limited cost trader category? See Increased VAT bill.

Increased VAT bill

John is a health and safety consultant with annual sales of £150,000 excluding VAT. His annual input tax is only £500. He does not purchase goods where the total cost exceeds £250 in a VAT quarter or 2% of his gross sales.

John's annual VAT bill until 31 March 2017 would have been £21,600 i.e. gross income of £180,000 x 12%. This is because his relevant FRS category would have been 'business services not listed elsewhere'.

After 1 April 2017, his annual FRS liability increased to £29,700 because he is now a 'limited cost business' with a rate of 16.5%.

John's 'annual windfall' of £7,900 compared to normal VAT accounting (£30,000 less £500 input tax compared to £21,600) has been eliminated and he would be £200 better off using normal accounting from 1 April 2017 rather than the FRS i.e. the usual output tax less input tax calculation (£29,700 compared to £29,500).

The time saving benefit

HMRC would argue that the extra VAT paid by John is a worthwhile cost because he is still saving time by using the scheme (he has no need to worry about input tax) and there is less risk of making errors on his returns. However, my counter argument is that there are so many quirks with the FRS that the risk of errors is higher than with normal VAT accounting. See Flat rate scheme quirks.

Flat rate scheme quirks

The sale of a business car is subject to FRS tax, even when no output tax is charged on the sale or input tax claimed on the original purchase of the vehicle.

The opportunity to claim input tax on capital expenditure costing more than £2,000 including VAT is only relevant to 'goods' and not 'services'. So a hairdresser fitting out a new salon or building an extension would not be able to claim input tax on these costs.

If a legal entity has income from buy to let residential property, the income is captured by the scheme.

A builder joining the scheme might come within three different categories, depending on how much he spends on building materials.

The rules on 'relevant goods' for limited cost traders are very complicated with a lot of exclusions from the figures e.g. you exclude spending on food and drink consumed by business owners or staff and only include food or drink for resale (Notice 733, para 4.6).

Many clients get confused about the difference between exempt, zero-rated and outside the scope sales and sometimes forget that the FRS calculations are based on VAT inclusive income.

Some clients find it tricky to identify their correct category – for example, HMRC rightly issued an assessment to a farming contractor for choosing the 6.5% rate for 'Farming or agriculture not listed elsewhere' when he should have chosen the 11% rate for 'Agricultural services'.

Potential tax savings?

Having dismissed the time saving benefits in most cases, the key question is whether there are categories where the rate is quite generous and we should therefore encourage our clients to adopt it and possibly save tax. Here are my 'top five' selections that might be worth considering:

- Advertising 11% - if an advertising business has enough spending on goods to keep out of the limited cost trader category and does not have a lot of input tax on its other spending, 11% is potentially a good rate for any service business;
- Computer repair services 10.5% - the same logic as above;

- Entertainment or journalism 12.5% - the trick here might be for journalists to buy hard copy books rather than online publications for their research. The books are zero-rated (so no loss of input tax) and the spending will also help them reach the £250/2% limit for spending on goods to avoid the limited cost trader category;
- Hotel or accommodation 10.5% - the FRS might be good for a small B&B business but proceed with caution. As soon as a big repair bill hits the fan, or building improvements are carried out, the scheme gains could be instantly wiped out;
- Repairing vehicles 8.5% - an accountant I know decided the scheme would be a winner for a car repair business he acted for but didn't realise that the rent for his garage was standard rated rather than exempt because the landlord had opted to tax the building. This extra input tax made the scheme a non-starter despite the favourable percentage.

Options

In the lead up to the introduction of the limited cost trader category, I took two key measures with my private clients and still apply the same thinking one year on:

1. For those entities registered for VAT on a voluntary basis (annual taxable sales are less than £85,000), and that did not have much input tax to claim, we deregistered the business. I knew at the time that I was also taking them out of the potential problem of having to become MTD compliant from April 2019.
2. For clients where VAT registration was compulsory, or those voluntarily registered with worthwhile amounts of input tax to claim, I withdrew them from the FRS and reverted to normal VAT accounting. Don't forget to notify HMRC of the withdrawal (Notice 733, para 12.1). This proved to be a good decision in the case of one of my clients who does public relations work because she started to use the services of a VAT registered subcontractor on a big project and was able to fully claim input tax on these expenses.

So overall, it is fair to conclude that the tax bonanzas enjoyed by many SMEs between 2003 and 2017 are now in the past. As the old saying goes 'all good things come to an end!'

Contributed by Neil Warren