

FLAT RATE VAT

&

VAT BASICS

Contents

Overview	2
Method to estimate overall level of VAT	2
“Relevant turnover”	3
Is it worthwhile ? (i.e. VAT expenses covered?)	3
Capital expenditure	3
Application requirements	4
Leaving the scheme	4
Record keeping & VAT invoices	4
VAT liabilities	5
Appendix 1 – International trade	6
Appendix 2 – VAT basics	9
Appendix 3 – Impact on accounts	10

Summary

- The flat rate scheme simplifies the VAT process and reduces the level of administration involved.
- To qualify, you need to have net taxable income (excluding VAT and non-UK sales) < £150k.
- Have to leave the scheme if total gross income (including VAT and non-UK) > £230k.
- For “Computer and IT consultancy or data processing” businesses, the rate of overall VAT is 14.5%. (with a 1% reduction to 13.5% in the first year for new VAT registrations).
- This means that you make 2.6% “profit” as you collect VAT at 20% from the customer.
- You cannot precisely calculate the input VAT, but a company is likely to profit from the flat rate scheme overall as low level of expenses.
- You can reclaim input VAT on large capital items costing more than £2,000 incl VAT.
- Exclude overseas sales from the VAT calculations and do not charge customers VAT.
- Sales to EU businesses may incur local VAT.
- VAT invoices needs to be given to customers and there are a number of details required.
- VAT liability becomes due on earlier of date service provided, payment received or invoice raised. So may be worthwhile raising “pro-forma” invoices to delay VAT payment.

VAT Flat Rate Scheme (FRS)

The legal basis for the flat rate scheme is in the VAT Regulations 1995, SI 1995/2518 regulations 55A-55V, which are referred to below as *(reg 55X)*. HMRC has also produced its own guidance in Notice 733 (October 2012), sections of which are referred to below as *(pXX)*.

The flat rate scheme simplifies the VAT process and reduces the level of administration involved.

Under the normal VAT scheme, 20% of VAT is added to sales invoices (“output VAT”) and collected from customers. This 20% will then need to be paid to HMRC by the business. However, a business can offset the 20% it owes to HMRC by also reclaiming any VAT it paid on expenses incurred (“input VAT”).

The overall level of VAT to paid to HMRC will be: output VAT on sales less input VAT on expenses. The business will get a refund from HMRC if input VAT on expenses exceeds output VAT on sales.

Under the Flat Rate Scheme HMRC will allow the estimation of the overall level of VAT by multiplying relevant turnover by prescribed rates, which vary according to sector/industry.

Method to estimate overall level of VAT

For “Computer and IT consultancy or data processing” and similar businesses, the rate of overall VAT is 14.5% *(reg 55k)*. This means that whilst you collect VAT at 20% from customers in the normal way, you pay less than this over to HMRC.

The difference is supposed to cover input VAT you have suffered on expenses as under the flat rate scheme you cannot precisely calculate the input VAT.

This can be shown in the following example:

	£
Net sales	80,000
Output VAT @ 20%	16,000 (A)
Gross sales payable by the customer	96,000
VAT payable to HMRC @ 14.5% of gross sales	13,960 (B)
VAT saving	2,080 (A minus B)

The amount of VAT actually paid is £13,960 / £80,000 = 17.4% ie a 2.6% “profit” from the using the flat rate.

There is also an additional 1% reduction in the first year for new VAT registrations *(4.5)*. So the rate used would actually be 13.5%.

Relevant turnover

Your relevant turnover for the flat rate scheme calculation is all the “supplies” your business makes, which is the VAT inclusive sales and takings for standard rate, zero rate and reduced rate supplies (6.2, regs 55D, 55G(1)).

Not all income relates to “supplies” and will not be subject to VAT and would therefore be excluded from your flat rate turnover (6.3):

non-business income and any supplies **outside the scope** of UK VAT,

bank interest

private income, for example income from shares

Outside the scope of UK VAT

If you sell services to businesses outside of the UK, then these supplies are outside the scope of UK VAT, and so can be left out of your flat rate turnover (p6.4). This will depend on the place of supply of the services – refer to APPENDIX 1.

But note that sales to businesses in other Member States of the EU will be subject to VAT in those countries.

example

Going back to the above example, the relevant turnover is gross sales, which is net sales plus VAT. However, as discussed above, any sales of services outside of the UK made to businesses which are outside the scope of UK VAT are excluded.

For example, if the £80k net sales are made up by £25k UK sales, £30k US sales and £25k Italy sales, there is only VAT on the £25k UK sales.

So the gross sales making up the relevant turnover are $£25k + 20\% = £30k$.

14.5% of £30k is £4.35k and this is the amount to be paid to HMRC.

This leaves $£5k - £4.35k = £0.65k$ “profit” from the flat rate VAT scheme.

But note that there may be VAT on the £25k Italy sales.

Is it worthwhile (ie VAT on expenses covered)?

An allowance for input VAT is built in the VAT flat rates (p2.4). Therefore, businesses need to check whether or not they will benefit financially from the flat rate scheme. In the above example, a business with input VAT higher than £2,080 would be worse off under the flat rate scheme.

If a company only expects to have a few invoices each month, their input VAT is not likely to be very much.

Note that pre registration VAT on expenses can also be claimed (p7.6). Record the claim for eligible VAT in your VAT account for your first VAT return.

Capital expenditure (p5.2)

There is an exception to the flat rate scheme simple calculation as you can reclaim the VAT you have been charged on a single purchase of capital expenditure goods where the amount of the purchase, including VAT, is £2,000 or more, for example an expensive laptop. In addition, no apportionments for private use are required, unlike for the normal VAT scheme.

Application Requirements (p3.1-3.5)

You can apply to use the scheme if there are reasonable grounds for believing that your taxable turnover (excluding VAT) in the next year will be £150,000 or less (p2.5).

This means that supplies outside of the UK are excluded from the limit as they are outside the scope of UK VAT.

So if net sales for the year are £150k, but £30k are to the US, only £120k is “taxable turnover” for the purposes of flat rate limit and so the business is still eligible for the flat rate scheme.

(the gross sales would be £120k plus 20% = £144k)

How to estimate future turnover?

HMRC mention (p3.3): “You may forecast this in any reasonable way. If you have been registered for VAT for 12 months or more, the turnover declared on your returns may be a reasonable guide but take into account any expected changes. If you are not VAT registered when you apply for the scheme, you may forecast your turnover by looking at:

any period of trading before you apply
the turnover of the previous business owner, or
information on business plans or loan applications”

Leaving the scheme

If total income (including VAT) and sales outside the scope of UK VAT for the previous year exceeds £230k you have to leave the scheme (p3.5, p12.2, reg 55M). This needs to be checked every anniversary of joining the scheme, however, also need to leave if expect £230k to be breached within the next 30 days of the current year.

Once the business leaves the scheme, it cannot rejoin for another the 12 months.

Record keeping

You must keep a record of your flat rate calculation showing (p7.2):

your flat rate turnover for the VAT accounting period
the flat rate percentage you have used
the tax calculated as due.

This record must be kept with your VAT account.

VAT invoices *(p7.3,7.4)*

You must still issue VAT invoices to your VAT registered customers. Your customers will treat these as normal VAT invoices. You must keep copies of all sales invoices that you issue to your VAT registered customers.

Record VAT on your sales invoices using the normal rate of 20% for the supply and not the flat rate percentage assigned to your trade sector. At the end of the VAT period you add up the VAT inclusive total of all your supplies whether you gave a VAT invoice or not and apply the flat rate percentage to this total to give the amount of VAT you must pay to HMRC.

Keep a record of sales invoices, preferably using sequential invoice numbering.

Minimum details *(per VAT Notice 700 p16.3)*

Need to issue VAT invoices showing:

Invoice no.

VAT no.

your name, address and VAT registration number;

the time of supply (tax point);

date of issue (if different to the time of supply);

your customer's name (or trading name) and address;

a description which identifies the goods or services supplied; and

the unit price

Proof for overseas customers

Please see also HMRC's advice for proof that overseas customers are businesses, not consumers (and therefore no VAT charged):

“VAT registration numbers are the best evidence that the supply is not received for a wholly private purpose and should be requested. If your customer is unable to provide a VAT number, you can accept alternative evidence. This includes certificates from fiscal authorities, business letterheads or other commercial documents indicating the nature of the customer's activities. Such evidence should be kept as part of your records. Where VAT numbers are available, they should be shown on your invoice.”

VAT liability

VAT becomes due on the earlier of:

- the service is provided to the customer
- a VAT invoice is issued
- payment is received

An exception to this is if the VAT invoice is issued within 14 days of the service being completed.

As your business takes advance payments / deposits, you may wish to use proforma invoices in case there is a delay between sending the proforma and receiving the money. This will help delay the VAT liability slightly. If use proformas make sure that it doesn't mention any VAT amount or VAT registration numbers, and also write that its not a tax invoice.

Also, when it gets close to the VAT quarter end, be careful with the timing of invoices etc to delay the VAT liability.

APPENDIX 1 – INTERNATIONAL TRADE

N741A p2.1: What is 'place of supply of services'?

For VAT purposes, the place of supply of services is the place where a service is treated as being supplied. This is the place where it is liable to VAT (if any). There are a number of place of supply rules for determining where services of different kinds are made:

where the place of supply of services is in a Member State of the European Community (EC), that supply is subject to the VAT rules of that Member State and not those of any other country. **If the Member State is not the UK, such supplies are said to be “outside the scope” of UK VAT**

where the place of supply of services is outside the EC, that supply is made outside the EC and is therefore **not liable to VAT** in any Member State (although local taxes may apply). Such supplies are said to be **“outside the scope” of both UK and EC VAT**.

N741A p2.2: What does 'place of supply' mean for UK suppliers?

If the place of supply of your services is the UK, you must charge any UK VAT due and account for it to HMRC regardless of where your customer belongs. **If the place of supply of your services is another Member State, you or your customer may be liable** to account for any VAT due to the tax authorities of that country. See paragraph 2.16.

Where the place of supply of your services is outside the UK, you should ensure that your records contain sufficient factual evidence that this is the case. See paragraph 2.7.

N741A p2.4.1: The B2B general rule

The B2B general rule for supplies of services is that the supply is made where the customer belongs (see section 5).

N741A p2.5: What does 'B2B supplies' mean?

For place of supply of services purposes “B2B supplies” means supplies to businesses whose activities are wholly of a business nature. It also includes supplies to entities which have both business and non-business activities such as charities and government departments.

5.2 What is the B2B general rule for supplies of services?

If you supply B2B services, the place of supply of your services is the place where your customer belongs for the purposes of receiving your supply (see section 3).

This is known as the B2B general rule.

If you supply services that fall under this section and your customer belongs outside the UK, your supply is outside the scope of UK VAT.

If your customer belongs outside the EC there may be local taxes which apply.

If your supply is taxable at a standard or reduced rate of VAT (that is to say that the supply is not exempt or zero-rated) and is made to a customer belonging in another Member State who is VAT registered there, with effect from 1 January 2010 you may need to complete and submit an EC Sales List. See Notice 725 The single market.

If however, your customer belongs in the UK, you must account for any UK VAT due.

Sales where the supplier belongs in the UK:

Customer belongs in another Member State and receives a B2B supply of services: services are supplied in the other Member State and are outside the scope of UK VAT.

Customer belongs in another Member State and receives a B2C supply of services: services are supplied in the UK and the supplier accounts for any UK VAT due.

Customer belongs outside the EC and services are supplied outside the EC and are outside the scope of UK (and EC) VAT, unless Services used and enjoyed in the UK are supplied in the UK and the supplier accounts for any UK VAT due.

VATPOSS01350 - Introduction: What is a “relevant business person”?

For many of the place of supply rules it is important to establish whether a supply is made to a **relevant business customer (B2B)** or non-business customer (B2C). A supply is treated as B2B where the customer is a relevant business person. A relevant business person is anyone who is either:

a taxable person within the scope of Article 9 of the Principal VAT Directive (SEE BELOW)

registered for VAT in the UK

registered for VAT in another Member State

registered for VAT in the Isle of Man.

Some recipients of a service may have non-business activities (such as charities or local government bodies) but these are still treated as B2B supplies where the customer meets any of the above conditions, even if the service relates to their non-business activities.

Article 9 of Council Directive 2006/112/EC

“Taxable person” shall mean any person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity.

Any activity of producers, traders or persons supplying services, including mining and agricultural activities and activities of the professions, shall be regarded as “economic activity”. The exploitation of tangible or intangible property for the purposes of obtaining income therefrom on a continuing basis shall in particular be regarded as an economic activity.

VATPOSS06500 - General rule: Evidence that the customer is in business

The business status of the customer is key to determining the place of supply. In most cases a supplier will be able to rely on a valid VAT number provided by the customer as evidence of business status (the supplier should be satisfied that it is the customer's VAT number and should check with the VAT, Excise and Customs Duties Advice Line where there are doubts). However, where the **customer is in business** but outside the EC or is **not VAT registered** in their Member State, **alternative evidence of their business status will be acceptable**. Where no such evidence is provided, the transaction should be treated as B2C.

VAT act 1994 revision:

“7A Place of supply of services

(1) This section applies for determining, for the purposes of this Act, the country in which services are supplied.

(2) A supply of services is to be treated as made:

(a) in a case in which the person to whom the services are supplied is a **relevant** business person, in the country in which the **recipient belongs**, and

(b) **otherwise, in the country in which the supplier belongs**.

(3) The place of supply of a right to services is the same as that in which the supply of the services would be treated as made if made by the supplier of the right to the recipient of the right (whether or not the right is exercised); and for this purpose a right to services includes any right, option or priority with respect to the supply of services and an interest deriving from a right to services.

(4) For the purposes of this Act a person is a **relevant business** person in relation to a supply of services if the person:

(a) is a **taxable person** within the meaning of Article 9 of Council Directive 2006/112/EC,

(b) is registered under this Act,

(c) is identified for the purposes of VAT in accordance with the law of a member State other than the United Kingdom, or

(d) is registered under an Act of Tynwald for the purposes of any tax imposed by or under an Act of Tynwald which corresponds to value added tax,

and the services are received by the person **otherwise than wholly for private purposes**.

Reverse Charge N733 p6.4:

If purchase services from outside the UK to which the reverse charge applies, these supplies should be dealt with outside of the FRS. Exclude them from your flat rate turnover but record them in boxes 1 and 4 of your VAT return, as you would under normal accounting.

Intrastat return N725 p17:

17.1 Why are ESLs necessary?

All businesses registered for VAT have to submit ESLs for their EC supplies of goods and/or services subject to the reverse charge in their customer's Member State. The information provided on the ESL is used in the UK and by other Member States to make sure that VAT has been correctly accounted for. It is a condition of zero-rating for intra EC supplies of goods that you have a valid VAT registration number for your EC customer. The following EUROPA website: VIES VAT number validation provides an electronic checking your VAT Return. These boxes should only be used to record intra-EC supplies/acquisitions of goods and related costs.

17.3 Who must complete an ESL?

You must complete an ESL if you:

- make supplies of goods to a business registered for VAT in another Member State, including transfer of your own goods, (see section 9), or
- are the intermediary in triangular transactions between VAT registered traders in other Member States, (see section 13) or
- make supplies of services subject to the reverse charge in your customer's Member State.

You do not need to complete an ESL if you:

- are involved in triangulation and the goods are exported to a final customer outside the EU, (See VAT Notice 703 paragraph 4.1 for more information). The triangulation simplification measures do not apply in these circumstances.

Appendix 2 - VAT basics

Scope of VAT

The basic premise is underpinned by VAT'94 s.4(1) and (2):

(1) VAT shall be charged on any supply of goods or services made in the United Kingdom, where:

it is a **taxable supply**
made by a **taxable person**
in the course or furtherance of **any business** carried on by him.

If these criteria are not met, a supply is outside the scope of VAT.

(2) A **taxable supply** is a supply of goods or services made in the United Kingdom other than an **exempt supply** (s.4(2) VAT'94).

(There are also registration thresholds, but these change each year, see HMRC's website for the latest information)

Input VAT

The key rules

Under S.26(1),(2) VAT'94 a business could reclaim input VAT attributable to taxable supplies in the course or furtherance of its business (i.e. the same supplies on which output VAT is charged as defined in S.4 VAT'94 mentioned above). This is known as "**input tax**".

Therefore, this excludes non-business activities and exempt supplies.

Non-qualifying input VAT

Input VAT cannot be reclaimed on expenditure relating to:

activities outside of VAT or non-business activities

blocked items such as cars and entertaining

exempt activities unless they are below a set level (de minimis of £625 on average per month and half of total input tax in period)

Appendix 3 - impact on accounts of Flat Rate Scheme

Preparing accounts for Direct Tax purposes

HMRC have confirmed that for businesses who are using the scheme, it is expected that accounts will be prepared using gross receipts less flat rate VAT percentage for turnover and that expenses will include the irrecoverable input VAT. For those businesses using the scheme for only part of a year, accounts figures for the time on the scheme should be added to those for the time not on the scheme to arrive at the total for the year. For both indirect tax and direct tax purposes, there is a requirement to keep a record of sales and purchases. But, for businesses using the scheme, that record does not have to analyse gross, VAT and net separately. The records (whether normal system or flat rate scheme) need only be complete, orderly and easy to follow.