CHAPTER 29

THE FLAT-RATE SCHEME

29.1 Introduction

The flat-rate scheme (FRS) was introduced for small businesses from 25 April 2002. Before studying the finer points of the flat-rate scheme, it is worth considering an overview.

VATA 1994, s. 26B

An accountant issues an invoice for £10,000, plus VAT of £1,750 in 2010. In the quarter, the accountant incurred costs of £960 plus VAT of £168. His VAT return shows the following:

	£
Output tax	1,750
Less: input tax	(168)
VAT due	1,582

That is the normal way of accounting for VAT.

If the accountant adopted the flat-rate scheme, he would have a different method of **accounting** for VAT. Accountants currently have a flat-rate percentage under the scheme of 13.0% (when the standard rate was 17.5%). The accountant would **not need to change the way he invoiced his customers**. He would still charge VAT of £1,750 and would still incur the same costs.

However, when preparing his VAT return, his outputs will simply be the **VAT inclusive income of £11,750 times the flat-rate percentage of 13.0%. This gives** £1,527.50. There is **no input tax reclaim** under the scheme. His VAT return now shows the following;

	£
Output tax (£11,750 x 13%)	1,527.50
Less: input tax	(nil)
VAT due	1,527.50

The VAT saving is £(1,582 - 1,527.50) = £54.50. In addition, administration is easier under the FRS as simply look at turnover and multiply it by the flat-rate percentage.

The flat-rate scheme can be used in conjunction with annual accounting. A summary of the flat-rate, annual accounting and cash accounting schemes can be found at the end of this chapter.

29.2 Eligibility

A trader may join the scheme if there are reasonable grounds to believe that **taxable turnover in the next year will be £150,000 or less**. Taxable turnover is standard-rated, zero-rated or lower-rated sales. SI 1995/2518 Reg 55L

In the above test the amounts are VAT exclusive and exclude any anticipated sales of capital assets.

Once in the scheme, the trader **must leave the scheme if total tax inclusive turnover exceeds £225,000.** (This is set to rise to £230,000 from 4th January 2011, and a trader will have to leave unless the rise is due to a one-off transaction and income is likely to drop below £191,500 in the following year. A trader will also be required to leave the scheme if he anticipates his income will exceed £230,000 in the next 30 days.)

This test is done on every anniversary date of joining the scheme. If the trader exceeds the £225,000 ceiling on any anniversary date, he will be required to leave the flat-rate scheme from the end of the period following the anniversary. SI 1995/2518 Reg 55M

For example, if he joined the scheme on 1 January, he will check annual turnover on 1 January in future years. If in one particular year he exceeds the £225,000 ceiling, he will be excluded from the flat-rate scheme from the quarter commencing 1 April.

29.3 Flat-rate Percentage

HMRC have estimated the percentage of VAT due compared to the VAT inclusive turnover for different types of businesses. **The table below shows the percentages that apply from 1st January 2010.** Note that when the VAT rate increases to 20% on 4th January 2011, the flat rate percentages will also change. SI 1995/2518 Reg 55K

TRADE SECTOR	Flat-rate Percentage
Accountancy or book-keeping	13
Advertising	10
Agricultural services	10
Any other activity not listed elsewhere	5
Architect, civil and structural engineer or surveyor	13
Boarding or care of animals	10.5
Business services that are not listed elsewhere	10.5
Catering services, including restaurants & takeaways	11
Computer and IT consultancy or data processing	13
Computer repair services	9.5
Dealing in waste or scrap	9.5
Entertainment or journalism	11
Estate agency or property management services	10.5
Farming or agriculture that is not listed elsewhere	6

Film, radio, television or video production	11.5
Financial services	12
Forestry or fishing	9.5
General building or constructions services*	8.5
Hairdressing or other beauty treatment services	11.5
Hiring or renting goods	8.5
Hotel or accommodation	9.5
Investigation or security	10.5
Labour-only building or construction services*	13
Laundry or dry-cleaning services	10.5
Lawyer or legal services	13
Library, archive, museum or other cultural activity	8.5
Management consultancy	12.5
Manufacturing fabricated metal products	9.5
Manufacturing food	8
Manufacturing that is not listed elsewhere	8.5
Manufacturing yarn, textiles or clothing	8
Membership organisation	7
Mining or quarrying	9
Packaging	8
Photography	10
Post Offices	4.5
Printing	7.5
Publishing	10
Pubs	6
Real estate activity not listed elsewhere	12.5
Repairing personal or household goods	9
Repairing vehicles	7.5
Retailing food, confectionery, tobacco, newspapers, or children's clothing	3.5
Retailing pharmaceuticals, medical goods, cosmetics or toiletries	7
Retailing that is not listed elsewhere	6.5
Retailing vehicles or fuel	6
Secretarial services	11.5
Social work	10
Sport or recreation	7.5
Transport or storage, including freight, removals and taxis	9
Travel agency	9.5
Veterinary medicine	10
Wholesaling agricultural products	7
Wholesaling food	6.5
Wholesaling that is not listed elsewhere	7.5

*"Labour-only building or construction services" means building or construction services where the value of materials supplied is less than 10 per cent of relevant turnover from such services; any other building or construction services are "general building or construction services".

Once a trader has established which category he falls into, the relevant percentage is applied to tax inclusive turnover to arrive at the amount of VAT due. In theory this should be approximately the same as if the business accounted for output tax minus input tax.

From 1 January 2004, HMRC introduced a further reduction of 1% off the normal flat-rate percentages for businesses in their **first year of VAT registration.** This is to recognise the special circumstances of newly VAT registered businesses and encourage them to use FRS from the beginning of their VAT registration.

For example, a newly registered business with a trade sector of financial services, instead of using a flat-rate of 12% will apply a flat-rate of 11% to turnover in the first year of registration.

The discounted rate lasts for one year from the effective date of VAT registration, but only if the trader:

- Notified his liability to register for VAT on time; and
- Asked to use FRS from the date he registered.

If he notified his liability to register late, the discounted rate only runs from the date he notified his liability to register until the first anniversary of his effective date of VAT registration.

29.4 Turnover

The turnover to which we apply the percentage **includes all supplies** made by a business. It therefore **includes exempt supplies**, supplies of **capital assets**, and despatches to other EU member states. VATA 1994, s. 26B(2)

We exclude non-business income and supplies outside the scope of VAT.

Turnover is calculated on **either an invoice or cash accounting basis**.

Even though the trader may be using the flat-rate scheme, he must still raise VAT invoices to customers in the customary way - ie, charging VAT at the **normal rate** and not the flat-rate. The trader is not changing the way VAT is charged to customers – the flat-rate scheme simply changes the way the trader **accounts** to HMRC for the VAT due.

29.5 Costs

Generally, input tax is not deductible under the flat-rate scheme. However, it is **possible to deduct input tax in 2 situations**. SI 1995/2518 Reg. 55E

1) *Capital assets costing > £2,000*

If a trader **purchases a capital asset with a VAT inclusive value of £2,000 or more, he will be entitled to a full input tax reclaim** in respect of that capital asset. By claiming back VAT in full on the purchase, it means that when he sells the capital asset he must account for the full VAT charge on that particular disposal. In the quarter, the sale of the capital asset will be excluded from flat-rate turnover and the VAT accounted for separately on the asset disposal, probably at 17.5%.

2) *Pre-registration input tax*

The other occasion for an input tax reclaim is where a trader recovers **pre-registration input tax.** If a trader reclaims input tax in respect of pre-registration capital assets, when that capital asset is sold it must be excluded from flat-rate turnover and VAT must be accounted for on the sale at the full rate of 17.5%.

29.6 Records and Accounting

A record of the flat-rate calculation must be kept showing the flat-rate turnover for the VAT accounting period, the flat-rate percentage used and the tax due. This record must be kept with the VAT account, so it is easily inspected on any HMRC control visit.

For the businesses using FRS, the Revenue expects annual accounts to be prepared using **gross receipts less VAT paid to HMRC**. Expenses should be shown **inclusive of VAT** as they would be for any unregistered business. This means that any VAT savings achieved as a result of using the FRS, will form part of the business profits and will therefore be charged to tax.

29.7 Ineligibility

The following traders are ineligible to join the flat-rate scheme; SI 1995/2518 Reg. 55(L)

- traders who use the second-hand margin scheme, the auctioneers' scheme, or the Tour Operators' margin scheme;
- traders falling within the capital goods scheme. This will rarely be an issue as most businesses with a turnover of under £150,000 are unlikely to be purchasing assets which will qualify for the Capital Goods Scheme;
- where a trader has ceased to operate the flat-rate scheme in the previous 12 months;
- Where, in the previous 12 months, the trader has been convicted of a VAT offence or a penalty for dishonesty;
- if, within the past 24 months, the trader was part of a VAT group;
- if the trader is "closely associated" with another person. Associated persons include cases where one business is under the dominant influence of another, or two businesses are closely bound by financial, economic and organisational links.

Illustration 1

Adverto Ltd is a small computer repair company which uses the flat-rate scheme. Computer repair companies have a flat-rate percentage of 9.5%.

In the quarter to 31 December 2010, income was £20,000 including VAT. Adverto Ltd also bought a computer for its own use for £4,000 plus VAT. Its old computer was sold for £600 plus VAT. The old computer was originally bought in July 2008 for £1,800 plus VAT.

The VAT due under the flat-rate scheme is as below;

Outputs	£
Income (£20,000 x 9.5%)	1,900
Sale of computer (£600 x 17.5%)	105
	2,005
Inputs	
Computer (£4,000 x 17.5%)	(700)
VAT due to HMRC	£1,305

Note that we account for the computer separately because the original purchase exceeded £2,000 (VAT inclusive), therefore the business would have claimed back the input tax in full on the original purchase. Consequently when the computer is sold, output tax must be accounted for in full.

29.8 Bad debt relief

There is a curious interaction between the flat-rate scheme and bad debt relief.

Assume a trader issues an invoice for £1,000 plus VAT of £175 to a customer. The trader is using FRS and has a percentage of 10%.

The customer goes out of business and the debt goes bad.

Logically, you might expect that bad debt relief would apply to the flat-rate amount paid over to HMRC under the scheme – therefore, on a bad debt of £1,175 suffered by a trader with a flat-rate of 10%, the VAT paid to HMRC would be £117.50 and the reclaim should be the same amount.

But it is not so: the bad debt claim is still at the normal VAT fraction, i.e. £175.

Although it seems peculiar to recover VAT where you had paid none to HMRC, it is possible that the business incurred some input tax in making the supply which has not been repaid. Hence HMRC allow you to receive the equivalent of full bad debt relief.

Example 1

Craig owns a hairdressing and alternative health business and uses the flat-rate scheme with a flat-rate percentage of 11.5%. In the quarter to 31st December 2010, Craig had the following transactions.

	£ (excl. VAT)
Sales (standard rate)	14,000
Sales (exempt)	7,000
Expenses (standard-rated)	6,000
Purchase of computer	1,750
Purchase of car	6,000

Calculate the VAT due.

Answer 1

	£
Qualifying income:	
Sales – standard rate (£14,000 x 1.175)	16,450
Exempt sales	7,000
	£23,450
Flat-rate VAT @ 11.5%	2,696.75
Computer (1,750 x 17.5%)	(306.25)
VAT due	2,390.50