

Vat – Special Schemes

There are several Vat schemes which may be useful for the small trader. However, each has certain pitfalls for the unwary.

Annual Accounting

Under the Annual Accounting Scheme, a trader makes only one vat return per year. Normally it will be convenient for the vat year to coincide with the trader's financial year, and it may act as an incentive to get on and complete the annual accounts at the same time.

Equal payments, which are calculated on the previous year's liability, or for new traders, an estimate of future turnover, are made monthly, starting in month 4 and continuing through to month 12, with a final balancing payment in month 14. Alternatively, quarterly payments may be made.

There may be a cash flow advantage in this, especially if turnover is increasing, and/or if there is a seasonal pattern to trade, and of course the final payment is made one month later than usual.

Consider Toni's Ices, which makes 80% of its sales between April and September, and prepares accounts for the period April-March.

<i>Payments due at month end of</i>	<i>July</i>	<i>October</i>	<i>January</i>	<i>April</i>
Standard Scheme				
Quarterly Payments	4000	4000	1000	1000
Cumulative Payment	4000	8000	9000	10000
Annual Accounting				
Cumulative Payment	1000	4000	7000	9000
Cash Flow Benefit	3000	4000	2000	1000

The risk, as always with future tax liabilities, is that insufficient funds are set aside, although if trade is not increasing year by year, the regular pattern of payments should avoid any significant liability arising.

Vat Notice 732

[http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?
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ertyType=document&columns=1&id=HMCE_PROD_010163](http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_PublicNoticesAndInfoSheets&propertyType=document&columns=1&id=HMCE_PROD_010163)

Cash Accounting

Under the Cash Accounting Scheme, traders calculate their liability on the basis of payments made and received, rather than on the basis of invoices sent and received; ie the normal tax point rules do not apply. This is of course an advantage for traders who are paid in arrears – a common scenario. It also has the effect of giving automatic relief for bad debts, as in such a case, if no payment is ever received from the customer, no payment of Vat will become due.

This also means that it may be possible to time purchases in order to reclaim Vat relatively quickly, by making purchases at the end of the Vat quarter.

There is no need to apply for this scheme, or to notify HMRC that it is being used. However, it is important to track payments and receipts carefully, and *especially so during a transition from the standard method to the cash method, or vice-versa*. Without care, it would be easy to pay vat on an invoice under the normal rules, and then pay Vat again when the invoice is paid.

If paying by cash, it is imperative to have the invoice endorsed by the payee, with the amount and date of payment, as this will be the only proof of the relevant date; the same applies to being paid, if your customer so requests.

In the case of transactions with Europe, different rules apply.

Vat Notice 731

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48&propertyType=document](http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ShowContent&id=HMCE_CL_000348&propertyType=document)

Flat Rate Scheme

The Flat Rate Scheme appears at first sight to be attractively simple, but actually has a number of alarming pitfalls, and is often misunderstood. In brief, it works as follows:

- A. Prepare invoices as normal, adding vat at 17.5%.
 - B. Apply the relevant flat rate to this vat-inclusive total.
- Total B is the amount of vat to be paid to HMRC. Expenses are ignored, except for capital expenditure of £2,000 or more, *inclusive of Vat*.

For example:

Invoices	1000
Vat	<u>175</u>
Vat inclusive turnover	1175
Vat at, say 10%	117.50
Business income	1057.50

It may appear that the business has miraculously increased its income; but remember, no input vat is being reclaimed on expenses.

The flat rate to use is found from a table published by HMRC, with various percentage rates depending on the trade. Whether the rate for the individual's own business will be advantageous will depend on circumstances.

For example, two consultants might each have a part-time assistant: one firm employs the assistant, whereas the other uses the assistant on a self-employed basis. Now suppose the assistant is vat-registered; the latter consultant will suffer vat, but be unable to reclaim this. The other consultant however will have no vat cost on their employee. A similar situation may occur with rent; one business may occupy a property which the landlord elects to tax, while another has a vat-free rental.¹

Points to watch:

There are a number of unexpected complications in the FRS which could easily catch out the unwary.

- The flat rate applies not only to standard and reduced rate turnover, but also to zero-rated turnover, and exempt income,

¹ Property rental is by default exempt from Vat. However, landlords of business property may elect to waive this exemption (which enables the landlord to reclaim input tax).

such as bank interest and residential lettings. *This means that a trader with a buy-to-let property who moves to the FRS is suddenly liable for vat on his rental income.*

- The turnover calculated above, when calculating vat due for a period, is different from that for deciding eligibility for the scheme (see below).
- Sales and purchases outside the UK, whether to the EU, or beyond, introduce further complications.

It is sometimes suggested that this scheme was introduced for the benefit of small traders. Whether this is true or not, it is certainly for the benefit of HMRC, who can now check the trader's vat liability with a simple turnover-based calculation, instead of having to spend hours wading through dozens of expense receipts.

For the trader, however, in order to know whether the scheme is beneficial in purely financial terms, it is necessary to compare the outcome from the FRS with the outcome from using the normal rules; this means that it is necessary to calculate vat in both the normal way, *and* using the flat rate; hardly a simplification.

As explained above, there is normally no claim for vat on expenses within the FRS. However, vat on capital expenditure of £2,000 or more, inclusive of vat (£1,702.13 + vat), can be reclaimed. *Unusually, there is no restriction for private use on such assets.*

As an incentive for newly registered businesses, the flat rate is reduced by 1% for the first year of registration. Careful – this applies to the first year of vat registration, not the first year on the FRS, so will only apply in full if the business enters the FRS immediately on registration.

Vat Notice 733

http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageImport_ShowContent&propertyType=document&columns=1&id=HMCE_CL_000345

This article gives a brief overview of the schemes. It is imperative to read carefully the HMRC Notices, or be advised by your accountant.

For all the above schemes, there are maximum levels of annual turnover for eligibility. All three schemes can be used together.²

Annual Accounting & Cash Accounting

² The Flat Rate Scheme has its own version of cash accounting.

