45. The flat rate scheme for small businesses

45.1 Background

45.1.1 Introduction

The legislation for the flat rate scheme (FRS) is found in the *VAT Regulations*, reg. 55A-55V, 57A and 69A. Except where it is absolutely necessary, this chapter focuses mainly on the publicly available guidance, rather than the underlying law.

The principal guidance on the FRS is *VAT Notice* (VN) 733 (referred to in this chapter as "the *Notice*"). This is one of the most user-friendly and comprehensive of the VNs that HMRC publish, and it should answer the vast bulk of the questions that come up in practice. It is worth noting in passing that HMRC appear to have removed VN 733 from their numerical list of notices, and have tweaked the language in recent updates. This is presumably part of their ongoing "improvement" of their online guidance. Nevertheless, the *Notice* can still be found by searching for "*VAT Notice* 733" online, and it is still very helpful.

For this reason, this chapter focuses on the highlights of the FRS, rather than simply reinterpreting the guidance that is already available in a useful form. In particular, the basics of operating the FRS, and of the processes of joining and leaving the FRS, are not discussed in any detail. The *Notice* covers these points very clearly.

Up until 1 April 2017, the FRS was a very attractive option for many small businesses selling to VAT-registered customers. However, as is discussed further in **45.2** below, new rules were brought in from that date to exclude (*de facto*, if not quite *de jure*) many services businesses from the FRS. This was done by way of the "limited cost trader" definitions. There are, inevitably in discussing VAT, then exceptions to the exclusions. However, before addressing the limited cost trader issue, a brief survey of the FRS will be helpful.

Note that the turnover threshold for entering the FRS is £150,000 per annum, and the exit threshold is £230,000. These are discussed in greater detail in **45.3** below.

45.1.2 Basic idea

The FRS comes with two potential benefits:

- **Administrative simplification** – since many records for input VAT purposes need not be kept.
- **A financial saving** – for members of the FRS for reasons explained below. HMRC are much less keen on this benefit than taxpayers and their advisers tend to be.

These benefits derive from the fact that members of the FRS must follow the normal VAT rules in terms of invoicing their customers, etc., but are subject to a number of special simplifications in terms of calculating their liabilities.

The FRS works by allocating the business to a specific category, which brings with it a specific "flat rate percentage". For example, a builder who also provided materials as part of his or her work (i.e. who was not a labour-only builder) would be eligible for a flat rate percentage of 9.5%. The significance of this rate is illustrated in the **Example** below.

Moreover, the FRS prevents any claims for input tax except where the business spends more than £2,000 (including VAT) on "capital expenditure goods". This can sometimes be a tricky term, and some of the issues this raises are addressed in **45.6**.

The following short example should illustrate how the FRS works.

Example

Gerry is a builder based in Sheffield. He has recently started work as a sole trader, having been in partnership with his brother, who has now retired, for many years. Gerry is getting older and does not expect to earn large sums from his work. Nevertheless, his customers will mostly be businesses seeking repairs and refurbishment work, and will be VAT registered and so indifferent as to whether they are charged VAT or not.

Gerry's accountant, Rachel Coates, of Coates Accountants Ltd, has suggested that he registers for VAT using the FRS. After some discussion, they agree that the 9.5% rate for "general building or construction services" will be applicable, as Gerry will typically provide materials as part of the work he does. Gerry is keen to get the VAT back on a used van he is planning to buy for £7,000 plus VAT. Rachel reassures him that it won't be a problem in the FRS.

Shortly, Gerry comes to prepare his first VAT return. He is including the bill for his first job, the refurbishment of an industrial unit, for an agreed

fee of £15,000 plus VAT. In cash terms, Gerry is therefore going to receive £18,000 from his customer. He will also be reclaiming the VAT on the van (£1,400) on the return, but doesn't have any other "capital expenditure goods" in the period. What does he have to pay HMRC?

His output VAT is 9.5% x £18,000, that is, £1,710.

His input VAT is £1,400.

Therefore, his VAT payment is £310.

However, Gerry received £3,000 in VAT from his customer, not £1,710. Therefore, he has made a profit of £1,290 on the flat rate percentage.

Gerry buys Rachel a bottle of wine to say thanks for suggesting he join the FRS!

For many businesses in the FRS (bottles of wine apart), this is pretty much how the scheme works. The business benefits from a profit on the flat rate percentage.

Of course, Gerry is being a bit hasty. If he compared his "profit" with what he would have received in input VAT on his other purchases, he may have found that the benefit was rather less impressive.

Moreover, this example must be tempered by a number of points, not least the limited cost trader rules, set out in **45.2**.

45.2 Limited cost traders

45.2.1 Introduction

The limited cost trader (LCT) rules are so important that, where a business finds it is caught by them, it almost certainly should not consider the FRS any further. For this reason, we examine it first.

The effect of the LCT rules is to impose a flat rate percentage of 16.5% on any business covered by the rules. Given that the VAT fraction (see **5.2.2**) is 16.67%, this would give only a negligible allowance for input VAT. The 1% discount available for the first 12 months of registration (see **45.4.2**) would reduce this percentage to 15.5%, so it may be advantageous to join the scheme initially, but then withdraw when the discount period expires.

It may be that some businesses would still find the relief for capital expenditure goods and the administrative simplifications (such as they are) beneficial, but these cases will be rare.

This section (**45.2**) examines when the LCT rules apply, and their impact. It also examines some of the key exceptions to the rules, which mean that businesses that would otherwise be caught by the LCT rules escape them.

45.2.2 When do the LCT rules apply?

HMRC summarise the LCT rules at para. 4.4 of the *Notice* as follows:

> "You're a limited cost business if the amount you spend on relevant goods including VAT is either:
>
> - less than 2% of your VAT flat rate turnover
> - greater than 2% of your VAT flat rate turnover but less than £1,000 per year
>
> If your return is less than one year the figure is the relevant proportion of £1,000. For a quarterly return this is £250.
>
> For some businesses this will be clear, other businesses, particularly those whose goods are close to 2%, may need to complete this test each time they complete their VAT Return. This is because you can move from a limited cost rate of 16.5% in one period to your relevant sector rate in another. This would happen if your costs fluctuate above and below 2%."

This is reasonably clear, and for many services businesses, which do not buy much of anything by way of goods, the LCT rules will apply. The definition of "relevant goods" (addressed below) makes it all the more obvious how disadvantageous it is to be an LCT, and how difficult it will be for most services businesses to avoid being covered by the definition.

HMRC do acknowledge, in the same part of the *Notice*:

> "If you're a limited cost trader this means that you may pay more VAT than you do on standard accounting – you may want to check to make sure the Flat Rate Scheme is still right for you."

This is the heart of the matter. The LCT rules were, it is widely believed, a rather ham-fisted attempt by HMRC to clamp down on what they felt were abusive VAT registrations under the FRS that were being undertaken principally because of the FRS profit. The result of the rules is to make the FRS distinctly unattractive to a very wide range of businesses that would otherwise benefit.

The definition HMRC provide above, however, requires further definitions of a number of important terms. As noted above, "relevant goods" are addressed immediately below. "Flat rate turnover" is dealt with in **45.5**.

Guidance: VAT Notice (VN) 733, para. 4.4

45.2.3 Relevant goods

The narrowing of scope of the FRS with the advent of the LCT rules is all the more obvious when the definition of relevant goods, at para. 4.6 of the *Notice*, is considered:

> "Relevant goods are goods that are used exclusively for the purposes of your business, but do not include:
>
> - vehicle costs including fuel, unless you're operating in the transport sector using your own, or a leased vehicle
> - food or drink for you or your staff
> - capital expenditure goods of any value (read paragraph 15)
> - goods for resale, leasing, letting or hiring out if your main business activity does not ordinarily consist of selling, leasing, letting or hiring out such goods
> - goods that you intend to re-sell or hire out, unless selling or hiring is your main business activity
> - goods for disposal such as promotional items, gifts or donations
> - any services."

The devil is very much in the detail here. The underlying legislation that defines relevant goods is complex and includes a number of exclusions. These are returned to below.

For now, it will be noted that relevant goods specifically do not include the vast majority of goods that a service business might buy. They also specifically exclude VAT planning by way of intermittent purchases of goods for resale where this is not "ordinarily" what the business consists of. It is not difficult to see that this gives rise to much ground for dispute in practice.

The *Notice* does include two helpful lists of what are, and are not, relevant goods, in para. 4.6, as follows. First, the examples of what *are* relevant goods:

"This is not an exhaustive list, these are examples of relevant goods:

- stationery and other office supplies to be used exclusively for the business
- gas and electricity used exclusively for your business
- fuel for a taxi owned by a taxi firm
- stock for a shop
- cleaning products to be used exclusively for the business
- hair products to use to provide hairdressing services
- standard software, provided on a disk
- food to be used in meals for customers
- goods provided by a sub-contractor and itemised separately
- goods brought into the UK if they are not otherwise excluded
- goods bought without VAT being charged, if they are not otherwise excluded."

It will be seen that consultancy or other professional services businesses are perhaps the least likely to qualify here, unless, perhaps, they purchase unusually large amounts of stationery. Other business sectors – such as hairdressers, restaurants, and taxi and delivery drivers – will usually be able to meet the test.

HMRC also provide a list of examples of what *are not* relevant goods:

"This is not an exhaustive list, these are examples of supplies that are not relevant goods:

- accountancy fees, these are services
- advertising costs, these are services
- an item leased or hired to your business, this counts as services, as ownership will never transfer to your business
- goods not used exclusively for the purposes of your business, for example electricity to supply a home and an office located in the home
- food and drink for you or your staff, these are excluded goods

- fuel for a car this is excluded unless operating in the transport sector using your own, or a leased vehicle
- electronic devices, such as a laptop or mobile phone for use by the business, this is excluded as it is capital expenditure (read paragraph 15)
- anything provided electronically, for example, a downloaded magazine, these are services
- rent, this is a service
- software you download, this is a service
- software designed specifically for you (bespoke software), this is a service even if it is not supplied electronically
- goods which are bought solely to meet the test, as these would not be used exclusively for the purposes of your business, for example, if the quantity of goods being bought cannot reasonably be used by the business and are simply 'stockpiled' or thrown away, even if the business may normally use those items [in] smaller quantities such as office materials
- stamps and other postage costs, these are payments for services."

Guidance: VN 733, para. 4.6

45.2.4 Exclusions from relevant goods rules

There are exclusions in both directions, so:

- there are goods that are specifically not permitted to be relevant goods; and
- there are goods that are specifically permitted to be relevant goods, but only for particular business sectors.

The outline at **45.2.3** sets out the position clearly, but it is worth highlighting the question of fuel, vehicle repairs, etc., on the one hand, and capital expenditure goods on the other.

Drivers

The rise of Amazon has spawned the development of numerous support industries, of which perhaps the most obvious example is the self-employed driver. There is anecdotal evidence that many of these drivers are registered for the FRS. It is important to note, however, that unless these drivers actually purchase the goods in question – principally fuel

in practice – it is not clear that they will actually be able to avoid the LCT rules. It is also important that the driver should actually own or hire the vehicle he or she is driving. Again, failure to do this will mean that the fuel will no longer be regarded as a relevant good.

This example helps to highlight just how complex the relevant goods rules are. Any adviser who considers the FRS for a client should, before proceeding, be very careful to ensure that the LCT does not apply.

Capital expenditure goods

The specific exclusion of capital expenditure goods (on which more in **45.6** below) is a further sign of just how tricky the relevant goods rules can be.

It is definitely not enough to ask whether the client is spending "more than £1,000 per annum on goods". The expenditure will need to be itemised and considered from the perspective both of its purpose and of its accounting treatment.

45.2.5 Summary

The LCT rules have added considerable complexity to what was intended to be a simplification for small businesses.

It is questionable whether businesses that are on the borderline, or for whom determining whether or not the LCT applies to them would require a fairly significant outlay on professional fees, would really benefit from the FRS at all.

Accordingly, while most general practitioners are aware of the FRS and many clients may have heard of it from friends and acquaintances, it makes sense to filter the client's business by way of the LCT tests before going any further.

45.3 Eligibility

45.3.1 Introduction

Assuming that the business is not adversely affected by the LCT rules discussed in **45.2**, it will then be necessary to consider whether or not it qualifies for the FRS in any event. This section (**45.3**) covers the key conditions that need to be met to join.

However, it also considers whether (leaving aside the question of the LCT rules) some potentially qualifying businesses might be better off outside the FRS.