VAT Flat Rate Scheme: Limited Cost Traders

Background
From 1 April 2017, the VAT Flat Rate Scheme (FRS) is modified by new provisions reducing the benefits of the FRS for “limited cost traders” (LCT).

Application
The rules apply only to users of the Flat Rate Scheme. Traders using standard VAT accounting are not affected.

A FRS trader has a VAT percentage set according to trade sector. The range is 4% to 14.5%; accountancy is 14.5%, not listed elsewhere is 12%.

If, in a quarter (or year, if on an annual basis), the trader is within the LCT definition, then the VAT payable is 16.5% instead of the sector percentage.

The 16.5% percentage is applied to the turnover plus VAT. So, the VAT payable to HMRC on each £100 of turnover is
16.5% x (£100 plus £20 VAT) or £19.80
Therefore, for a limited cost trader using the FRS, the allowance for VAT on costs incurred by the business is £20 less £19.80 for each £100 of turnover. This is a mere 0.2% of turnover, or costs bearing VAT -whether of goods or services- of 1% of turnover. See the illustration below. This will be an unattractive outcome for many businesses.

Limited Cost Trader definition
For a trader on a quarterly basis, the LCT percentage applies if-

- Goods < 2% of sales, or
- Goods < £250.

The value of the goods includes VAT; the value of sales includes VAT. The rules use the term “relevant goods”.
Relevant goods excludes: capital items (which covers anything not “consumed” within one year, irrespective of accounting treatment); anything not bought exclusively for the business (and so excludes, for instance, computer supplies for both business and personal use); vehicle and fuel costs; food and drink for business purposes.

Other points to note are-

- The rules allowing for the recovery of VAT on capital goods costing £2,000 or over (including VAT) continue, even where the trader is within the LCT rules.

- There is a general 1% “discount” on the normal trade sector percentages for the first year of use of the FRS. The percentage applying to a trader within the LCT rules eligible for that discount is therefore 15.5%.

Illustration
Suppose a trader invoices £100,000 plus £20,000 of VAT in a year; assume for ease of illustration that annual VAT accounting is used.

On standard accounting, the VAT payable would be £20,000 less input tax on all purchases, whether of goods or services.

If the trader was say within a 14.5% sector category, the VAT payable would be 14.5% x (£100,000 plus £20,000) or £17,400. This would equate to £2,600 of input tax, or £13,000 plus VAT of supplies.

If the trader were within the LCT rules, the VAT payable would be 16.5% x (£100,000 plus £20,000), or £19,800. This would equate to £200 of input tax, or £1,000 plus VAT of supplies.

The value of relevant goods to take the trader outside the LCT rules, is 2% of (£100,000 plus £20,000) or £2,400. This means £2,000 plus VAT of such goods. Suppose that £1,500 plus £300 VAT of relevant goods were bought. The LCT rules would apply. The trader would be better off outside the FRS. Standard VAT accounting would allow for the recovery of not only of £300 on goods but also VAT on purchased services and other goods.

Summary
A flat rate trader should look at a typical period. The choices might be-
- Do nothing, and accept the LCT percentage in the quarters where it applies.
- Time the purchase of goods to ensure that the number of LCT quarters is minimised.
- Switch out of the FRS.
- Deregister for VAT, if this were possible.

February 2017 trusted tax adviser