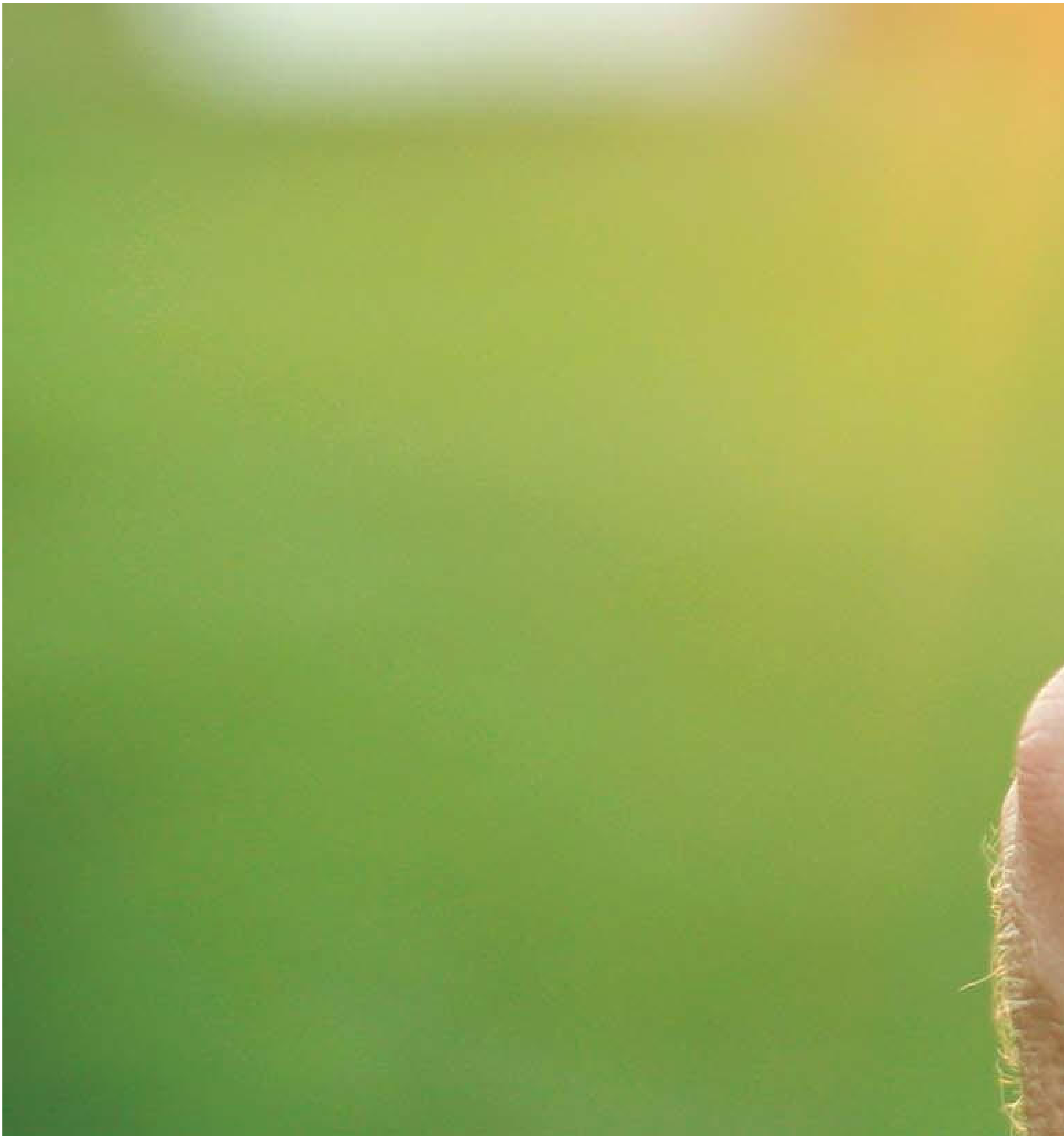
Value added tax: is it time to leave the flat rate scheme?

Indirect Tax



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Many businesses should now consider leaving the flat rate scheme or not join in the first place. The business world has changed massively since its introduction in 2002.

Key Points

What is the issue?

Until 2017, the flat rate scheme produced many VAT savings for an SME with annual sales of less than £150,000 excluding VAT. However, the introduction of the limited cost trader category largely eroded these savings, making it unattractive for most small businesses.

What does it mean for me?

Now is probably a good time to review client lists to check that scheme users are applying the rules correctly and if they should withdraw and revert to traditional VAT accounting. A business can withdraw at any time but not retrospectively.

What can I take away?

The article highlights examples of how errors can arise because of many quirks with the regulations. All errors made in the last four years should be corrected.

My previous article for *Tax Adviser* about the flat rate scheme was published in July 2019. The headline was ‘Where are we now?’ and I considered how the scheme could still be a winner for some businesses, despite the introduction of a new ‘limited cost trader’ category on 1 April 2017 with its draconian rate of 16.5%. More about that later.

However, the main difference between my past and present thinking is that I previously concluded that it was important to keep the flat rate scheme door slightly ajar; there were still worthwhile tax and time saving benefits in some cases. My current opinion is that it should now be completely avoided by clients and advisers because its best days are in the past. It reminds me of an ageing rock star desperately trying to hang on to his youth. I’ll explain why in this article.

Frozen thresholds for 20 years

The flat rate scheme was introduced in 2002 after great acclaim by the government that it would revolutionise VAT accounting but it was adopted by very few SMEs. It could be used by a business with annual taxable sales of less than £100,000 excluding VAT and was promoted as a time rather than tax saver. The main advantage was that users did not need to keep input tax records because their VAT return only applied a specific flat rate scheme percentage – based on their trading activity – to their gross business income.

However, the percentage rates for the 55 different categories were too high. In some cases, a business paid more VAT than it collected from its customer; i.e. negative input tax!

The revised legislation in 2003 moved the goalposts by offering ***tax*** rather than ***time*** savings. We suddenly became interested!

- The annual joining threshold was increased to £150,000.
- A 1% discount on all rates was introduced for the first year of VAT registration.

- The percentage rates were dramatically reduced in most cases and there were some rich pickings now available.
- Input tax could be claimed on capital goods costing more than £2,000 including VAT.

However, the thresholds have been frozen since 2003 and – almost certainly – will be frozen in perpetuity. The joining threshold is still £150,000 over 20 years later – it would exceed £300,000 if it had been increased for inflation. The exit thresholds are also unchanged, meaning that an increased number of businesses must leave in the next few years because of price rises, particularly in these times of high inflation.

Making Tax Digital

In 2002, it was common for many SMEs to give their accountant a carrier bag full of purchase invoices and expect the accountant to complete manual records or spreadsheets for the quarterly VAT returns. However, roll forward to 2023 and it is now compulsory for all VAT registered entities – including voluntary registrations – to keep their records in a digital format and submit returns electronically. That is a massive change of direction.

As an important question, therefore, why would a business in the modern digital world not keep purchase records where a VAT code of, say, T1 or T0 can easily be recorded to deal with input tax? The time saving benefits of the flat rate scheme are now as useful as a cigarette machine at a fitness club.

Changing business models

The brainchild of this article came from an accountant who called me in late January about one of his clients who had used the flat rate scheme for many years, only benefiting from the time savings. Her annual VAT payment was about the same as with normal accounting.

However, three important changes had taken place in the financial year to 5 April 2022:

- The business had moved offices in July 2021 and the new landlord charges VAT on the rent because of an option to tax election. The rent on the previous office was exempt.
- She had recruited two new staff and incurred high costs with a recruitment company, which charged 20% VAT on its services.
- For a major project, she used a VAT registered subcontractor to help with her work.

The accountant asked if the client could retrospectively leave the scheme and revert to normal accounting from July 2021 when these new sources of input tax first arose. He asked if the past overpayment could be included on the next return as an error correction. The answer to both questions is ‘no’. A business can only leave the flat rate scheme from a current date, including part way through a VAT period (see VAT Notice 733 s 12).

In the post-Covid world, many business models have changed. For example, a business might have a new source of income that is zero-rated or exempt, therefore making the continued use of the flat rate very expensive. Alternatively, the mix of sales might have changed; the legislation means that a single rate is applied to all sales based on the activity with the greater or greatest percentage of turnover. A pub with 60% drink and 40% food sales would apply the 6.5% rate for pubs to all sales. But if the balance was reversed, with 60% of sales being for food, it would use the higher rate of 12.5% for restaurants. Is this type of situation relevant to any businesses?

Limited cost traders

Here is a number challenge: Janet is a retired actress who now earns £100,000 per year plus VAT doing after dinner speaking gigs. She uses the flat rate scheme and her only business expense is for zero-rated train fares, plus fees paid to her accountant who is not VAT registered. How much extra VAT does Janet pay in 2023 compared to 2016?

The answer is £5,400. In 2016, she would have applied a 12% rate to her annual gross income of £120,000 because she qualified for the sweep-up category of 'business services not listed elsewhere' and its favourable rate of 12%. Happy days. In 2023, she is a limited cost trader with its penalising rate of 16.5%.

To summarise: £19,800 in 2023 less £14,400 in 2016 amounts to £5,400. That's a big increase in Janet's liability.

Note: The £19,800 VAT payment is close to the £20,000 of VAT charged to her clients. The limited cost trader rate of 16.5% gives minimal credit for input tax sacrificed by scheme users.

The limited cost trader rules mean that any business spending less than £250 per quarter or less than 2% of its gross turnover on 'relevant goods' must apply the rate of 16.5% to its gross sales. Oh dear! However, the main problem with the law change introduced in April 2017 – intended to reduce aggressive abuse of the scheme by labour-only agency workers – is that it has added many layers of complexity to a scheme that is supposed to be about simplicity:

- The limited cost trader test must be carried out at the end of each period. I wrote a *Tax Adviser* article, 'A new category', in February 2017 about a builder who could end up using five different flat rate scheme percentages in successive periods.
- To prevent a business buying goods to 'get over the line' with the test and avoid being a limited cost trader, the rules about what is classed as 'relevant goods' are very complicated. For example, road fuel can only be included if it is purchased by a transport business; food and drink is excluded if it is purchased for staff but included for a business such as a café or restaurant.

(See VAT Notice 733 para 4.4)

Scheme complications and errors

Compliance checks carried out by HMRC have greatly reduced in recent years, with an emphasis on larger traders and a business that submits a repayment return for its first period after registration.

Therefore, flat rate scheme users have largely escaped checks and it has been left to accountants to identify errors. However, that might change in the future, as HMRC's resource-draining challenges with Covid-19 and Brexit have reduced.

The flat rate scheme complications could open a can of worms if HMRC starts the racing car engine, so to speak. See ***Examples of flat rate scheme errors that underpaid tax***. These are errors alerted to me by accountants that all produced significant underpayments.

Examples of flat rate scheme errors that underpaid tax

- A business owner did not realise that the limited cost trader test is carried out each quarter. She thought she did not have a problem because her annual purchases of goods exceeded the relevant 2% and £1,000 thresholds. However, seasonal and bulk purchasing meant she was a limited cost trader in two quarters each year.

- A florist took advantage of the 1% flat rate scheme discount in her first year of registration but forgot to increase the percentage for the next three years, underpaying VAT by £1,200 each year.
- A management consultant sold a business car for £9,000 – correctly not charging VAT – and was shocked that the proceeds were subject to flat rate scheme tax of 14%.
- A hairdresser spent large sums of money on salon improvements and thought she could claim input tax. However, the flat rate scheme input tax concession only applies to capital goods costing at least £2,000 including VAT – like a van or computer – and not to capital services such as an office extension or building improvements.

Conclusion

The flat rate scheme has diverted many SMEs from the basic principle that VAT payments are based on output tax charged to customers less input tax claimed on invoices received from suppliers. The tax windfalls with the scheme benefited thousands of businesses for 14 years until the limited cost trader was introduced but the game is now over. The final whistle has been blown. The issues I have considered suggest that it is a good time for advisers to rethink their strategy of encouraging some clients to join the scheme and – for existing users – to check they are doing the sums correctly. Is it sensible to head for the exit door and revert to traditional VAT accounting?

Finally, I also think it would be helpful to staff at HMRC if the scheme was abolished. I have enjoyed reviewing and advising about its rules for 21 years, so am familiar with its many twists and turns in the same way as an experienced football referee understands the offside rule. However, inexperienced HMRC officers might find it a baffling and unnecessary diversion. To quote a former Prime Minister from the 1990s… it’s time to get back to basics!