

VAT Schemes for Small Businesses

VAT law provides a number of special schemes designed either to improve the cash flow of small businesses or at least to simplify VAT accounting. In this briefing we explore three schemes specifically designed to benefit small businesses and provide guidance as to how they work. They are the flat rate scheme, the annual accounting scheme and the cash accounting scheme.

THE FLAT RATE SCHEME

It is somewhat surprising that the take-up of this scheme is lower than expected, considering how much simpler it is to prepare VAT returns using it and often, how much less VAT is actually due. Of course, the scheme is actually designed to produce as near as possible the same VAT payment as would be due using normal accounting, but inevitably that does not always follow. For example, professionals with relatively low input tax can often benefit.

This scheme is designed to reduce the cost of complying with VAT obligations by simplifying the way small businesses calculate their VAT.

It is available to businesses who expect their VAT exclusive turnover in the next 12 months to be:

- no more than £150,000 taxable supplies (supplies at the zero, 5% and 17.5% rates, including expected sales of assets), and
- no more than £187,500 total business income (taxable plus exempt income)

Consequently, it could be helpful to businesses with up to £37,500 exempt income (if their taxable income is at the £150,000 limit) or even a higher amount of exempt income, if their taxable income is lower. Non-business income (typically grants and gifts and donations received by charities) does not count towards the threshold.

Of course, the deciding factor in determining whether or not to apply to use the scheme is whether or not the amount due under the scheme produces around the same amount due or less than under normal accounting. A business would obviously use normal accounting if the amount due under the scheme were higher, unless that was more than outweighed by the cost of preparing the return.

The scheme saves time by removing the need to calculate and record output tax and input tax in calculating the net VAT due to HM Revenue & Customs. The VAT in a period is calculated by applying the flat rate percentage to the tax inclusive turnover for the period.

HMRC has published a table showing rates applicable to many business sectors. Some examples are:

<i>Category of business carried on</i>	<i>Appropriate percentage</i>
Retail of food, newspapers, confectionery	3.5
Retail of vehicles or fuel	6
Photography	10
Estate agency	10.5
Hairdressing	11.5
Legal services	13
Computer and IT consultancy	13

A full list of rates can be found on HMRC's website.



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The flat rate to be used depends on which trade sector most accurately reflects any particular business. If a business includes supplies in two or more sectors, the percentage to be used is that appropriate to the main business activity as measured by expected turnover in the year ahead.

If a business makes supplies to other VAT registered businesses, they must give them a VAT invoice showing VAT at the normal rate for the supply (not the flat rate percentage).

Joining the scheme is optional and businesses are entitled to leave it at any time. Leaving the scheme retrospectively is at HMRC's discretion, however, they have stated that they will apply this sympathetically if businesses consider it is no longer helpful to them after the changes.

THE ANNUAL ACCOUNTING SCHEME

This scheme allows eligible businesses to make nine or three payments on account in any year, plus the balance of the actual amount due at the end of the year. The great advantages of the scheme are:

- only having to complete one return per year; possibly at the time annual accounts are prepared
- the annual return and balance are only due two months after the year end
- making regular payments on account (nine monthly or three quarterly payments, plus the actual year end balance)
- reduced administrative burdens
- cash flow benefits
- easier operation of retail schemes and partial exemption
- not having to leave the scheme until the end of the year in which taxable turnover exceeds £1,600,000

Businesses can join the scheme if they do not expect their taxable turnover to exceed £1,350,000 in the next twelve months (excluding capital asset sales). They can even use it in conjunction with the flat rate scheme and withdraw at any time by applying in writing.

Arguably, there are a couple of disadvantages in that seasonal or other variations could create an adverse effect on cashflow. Also, interim payments based on previous years may be higher than necessary (but can be reduced if the difference is significant). However, on balance, the scheme must benefit most eligible businesses provided they monitor actual amounts due closely so the end of year balancing payments do not come as a surprise.

THE CASH ACCOUNTING SCHEME

This is the ideal scheme for businesses that issue sales invoices because it automatically eradicates the potential problem of bad debts. Output tax is only due on payments actually received from customers. However, input tax is only deductible to the extent payments are made to suppliers. Furthermore, bookkeeping is simplified through an appropriately analysed cash book.

It can only be used by VAT-registered businesses not expecting their taxable turnover (excluding the sale of capital assets) to exceed £1,350,000 in the next 12 months. All returns must be up to date and there should be no arrears of VAT due, the settlement of which has not been agreed with HMRC. Approval is not required but businesses should start using the scheme from the beginning of a tax period.

So how does a taxpayer decide whether or not to use this scheme? Perhaps the main questions to answer are as follows:

- How long does it normally take my customers to pay sales invoices? The longer the time lag, the greater benefit cash accounting is likely to be.
- I am in a regular repayment position. Will the scheme help me? Refunds would be received quicker under normal, invoice accounting.
- I am not very good at paying my suppliers. Will the scheme improve my cash flow? The scheme would not be appropriate if it usually takes longer to pay suppliers than it takes customers to settle sales invoices.

The scheme should normally be used for at least two years (unless the threshold tolerance, explained below, is exceeded) and applied to all the activities of the business. However, that is not usually a disadvantage and HMRC even allow businesses to leave the scheme if they are not receiving any benefit or if its accounting system cannot cope with the requirements. Clearly, care is needed during the transition to and from cash accounting to avoid duplication of output tax payments and input tax claims.

There is a tolerance built into the scheme meaning that once a business is using cash accounting, it may continue to do so until taxable turnover for the last year (at the end of any tax period) has exceeded £1,600,000. Note that this includes the disposal of stock and capital assets. On leaving the scheme, all output tax on unpaid sales invoices must be accounted for either immediately or within a further six months of the period in which you leave the scheme. Input tax claims must mirror the method used pay outstanding output tax.

CONCLUSIONS

Any tool designed to improve cash flow, simplify accounting requirements and thus, reduce administrative burdens is welcome. In these difficult economic times, perhaps it is appropriate to promote these schemes again to those who may not have appreciated their benefits.

Do please contact us to discuss any aspect relating to these VAT schemes.