

INTRODUCING VAT

INTRODUCING VAT FOR CONTRACTORS

Most Limited Company contractors register their company for VAT purposes and benefit financially from doing so. There are different types of VAT registration to consider, so make sure to discuss your options with your Personal Accountant before applying for registration. The following guide is written to help you understand how VAT works and the various options available to you.



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WHAT IS VAT?

Everyone has heard of value-added tax, or VAT, but what actually is it? VAT was introduced in 1973 and is a consumption tax placed on goods and services whenever value is added from production to point of sale. VAT can be shown on top of a price if it's a business-to-business sale and shown within the price if it's a direct or consumer sale.

VAT GLOSSARY

- **Output Tax** - The VAT charged on your income. Also referred to as 'taxable supplies to clients'
- **Input Tax** - The VAT you pay when you buy something. Also referred to as 'taxable purchases' from suppliers to your company
- **Tax Point** - The date used to determine when a purchase or sale is reportable on the VAT Return
- **VAT Return** - The form used to submit VAT details to HMRC
- **VAT Payable** - The amount of VAT that is payable to HMRC when Output tax exceeds Input tax
- **VAT Repayable** - The amount of VAT repayable to you when Input Tax exceeds Output Tax
- **Standard Rate** - The standard rate of VAT - currently 20%
- **Reduced Rate** - A lower rate of VAT - currently 5%
- **Zero Rate** - The zero rate of VAT is 0%
- **Exempt** - Purchases or sales that are exempt from VAT
- **Standard Scheme** - VAT that is accounted for according to the date on invoices
- **Flat Rate Scheme (FRS)** - A simplified way of accounting for VAT and typically used by contractor companies. More on this later.
- **Cash Accounting Scheme (or Cash Basis)** - VAT is accounted for based upon the cash received or cash paid out. There are individual versions for both the Standard and Flat Rate Scheme
- **EC Sales List** - A list of sales outside the UK within the European Community
- **Exports** - The income charged to clients that are outside the UK
- **Imports** - The purchases from suppliers that are not in the UK

HOW VAT WORKS

When you buy something you usually have to pay VAT on top of the value of the goods or the services that you are buying. This is called Input Tax. When your company is VAT registered it means that your company will charge VAT on top of the value of your services to the agency or client. This is called Output Tax.



Example

You invoice your client for 40 hours of chargeable time at £30 an hour = £1,200
 You would add VAT at 20% to this net amount (£1,200 × 20%) = £240, so the client must pay £1,440
 The client can normally recover the £240 VAT paid to you and so the net cost is £1,200

The amount of VAT charged depends on several factors, such as the VAT rate applied to what is being supplied and whether your work is supplied within the UK or not.

As a VAT registered company you must charge VAT regardless of whether or not the agency/client can recover the VAT, (although most can). You cannot charge VAT if you are not VAT registered.

Your company then reports the Output Tax it has received from clients and deducts the Input Tax the company is able to recover on purchases. The net amount is then VAT payable to HMRC.

Do you have to be registered?

You have to be VAT registered if your income during specific periods is expected to exceed the thresholds that apply at the time. You can also register for VAT voluntarily, even if your income does not exceed that limit.

Should you voluntarily register for VAT?

Generally VAT registration is good for most contractor companies as they benefit financially.

There are circumstances where this may not be the case, for instance where the client cannot reclaim the VAT you charge on top of your services. In this case, it may not be sensible for them to contract with your company because their cost of using you is increased by the VAT you have to charge, which they cannot recover.

At Intouch, your Personal Accountant would discuss your circumstances and help you decide if registration is right for you.

Cash Accounting or Flat Rate Scheme?

In some circumstances the cash basis provides a cash flow advantage. For most contractors the advantage is fairly limited but if you expect the value of your services to increase over time, or your clients take extended credit periods, or you are at risk to bad debts, then you may want to consider the cash basis.

The Flat Rate Scheme (FRS) is a simplified way of accounting for VAT and most contractor companies benefit financially by adopting it. At Intouch, your Personal Accountant would discuss your circumstances and help you decide which scheme is right for you.

How does the Flat Rate Scheme (FRS) work?

The scheme works by calculating the amount of VAT payable to HMRC as a flat percentage of the value of your services plus the VAT charged, instead of working out the actual difference between VAT received and paid. The financial benefit is that the amount you pay to HMRC is less and you get to keep more of the VAT charged to clients.

Example

You invoice your client for 40 hours of chargeable time at £30 an hour = £1,200
You would add VAT at 20% to this net amount ($£1,200 \times 20\%$) = £240, so the client must pay £1,440

Your FRS percentage is 14.5% so the amount paid to HMRC ($£1,440 \times 14.5\%$) is £208.80 and you keep the difference of ($£240.00 - £208.80$) = £31.20



FRS is not good for you when you have income that is not subject to VAT. You still have to pay the percentage on all your income (although interest received is excluded) even if you don't charge VAT. This can become a serious cost to your business.

If Intouch were to manage your accounts, your Personal Accountant would discuss your circumstances and help you decide if the FRS is right for you.

What percentage applies under the FRS?

There are different percentages that apply to different trades. In the first year of your registration the percentage is automatically reduced by 1%, adding to the financial benefit. From April 2017, HMRC created a new category under FRS called Limited Cost Trader. This category imposes a standard percentage of 16.5% (15.5% in year 1), which is applied to calculate VAT due to HMRC. As a contractor, you are most likely going to default into this percentage rate. At Intouch, your Personal Accountant would discuss in detail the situation around Limited Cost Trader and how it will apply to you.

A full list of rates and trades can be found on the [HMRC website](#).

What are the downsides to being VAT registered?

Most contractors recognise that being registered does add additional levels of tax compliance and admin, but it's important to understand that the benefits of registration usually far outweigh this burden.

THE NEXT STEP - WHAT YOU SHOULD CONSIDER

If you're new to contracting and considering appointing a new contractor accountant, consider the following questions when discussing VAT with them:

1

Do you operate in an industry that limits VAT?

2

Will registration be beneficial for you?

3

Which registration suits your circumstances?

4

What percentage is appropriate to the skills you provide?

VAT is a very important discussion to have with your Accountant and will help you make the right decisions to get the most out of running your own company; including how to keep your taxes low and maximise the money available to you personally. If you decide to join Intouch, your Personal Accountant will run through all of this with you, so there's no need to worry about remembering what to discuss and when.

HOW INTOUCH CAN HELP

At Intouch Accounting, we work with contractors every day, helping them understand their options, make the right decisions for their business and save money.

Whether you're looking to switch accountants or just starting out in contracting, your dedicated Contractor Accountant will handle everything for you, helping to maximise your income, while staying on the right side of the tax man.



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