

A guide to VAT for contractors

As a contractor, there are two payment structures you can use:

- o Limited company
- o Umbrella company

This article explains VAT and discusses VAT issues associated with both of those options.

What is VAT?

Value Added Tax (VAT) is levied on most business transactions and on many goods and some services. It doesn't apply to services such as insurance, some types of education, training and loans, as these are deemed to be 'exempt'.

How does it work?

There are two types of VAT:

- o Output VAT: Added to your company invoices.
- o Input VAT: Paid on purchases the company makes.

Every quarter the difference between the amount of input VAT collected and output VAT paid is then paid to Customs and Excise as part of the quarterly VAT return.

Do you have to register?

It is compulsory to register for VAT if your turnover reaches the VAT registration threshold limit (£60,000 – April 2005).

Businesses with turnovers of less than the limit can also register if they wish.

Companies over the limit which fail to register can be fined.

How much is it?

As a contractor, if you register for VAT you would use the 'standard rate' of 17.5%.

Contractors using Umbrella companies

A contractor working under an umbrella company solution does not need to concern themselves with VAT.

The umbrella company itself will be VAT registered and will simply add VAT to their invoices, which the agency will pay to the umbrella company and the umbrella company will then pay it over to Customs & Excise.

When the contractor claims expenses that contain a VAT element these will be fully reimbursed.

The contractor never sees VAT and is not affected by it.

Contractors using a Limited Company

Most contractor limited companies are VAT registered.

It is advisable to apply for VAT registration at the formation stage of your company activities. Whilst it is not compulsory at the start of your business (or until VAT exceeds £60K per annum) most consultants will wish to take "voluntary registration" in order to recover input VAT on expenses incurred, e.g. professional fees, computer costs and other costs on which VAT is charged.

As a VAT registered trader, you will add VAT at the standard rate of 17.5% to your invoices which is paid by your client.

This is paid to Customs and Excise on a quarterly basis, giving your company a cash flow advantage – you can even earn interest on the money!

Another advantage of registering is to avoid anybody dealing with your company knowing that your turnover is below £60k per annum.

Reasons for not registering

The only reason for not wishing to be VAT registered at the start would be if your customer is not VAT registered themselves, e.g. a financial services company.

In such a case, they would not thank you for adding the VAT to the invoices, which they could not recover themselves and in these circumstances, it may be to your commercial advantage to remain non VAT registered for as long as possible, i.e. your turnover remains below £60k per annum.

Disadvantages of being registered



An obvious disadvantage of being VAT registered is that you will need to prepare VAT returns on a quarterly basis and ensure that your accounting records provide the required information for disclosure on the VAT returns.

As a VAT registered trader, you will also be subject to periodic VAT inspections, usually once every six years.

VAT Schemes

There are 3 schemes for VAT:

- **Cash Accounting:** Turnover must be less than £660k pa. You only account for VAT actually received from your customers and paid to suppliers. Recommended for contractors.
- **Flat Rate VAT Scheme:** Pay a fixed rate of VAT based on revenue. Cannot claim VAT back, but can be more profitable depending on level of VAT purchases. [Find out more](#)
- **Annual Accounting:** Under this scheme, you make a single annual return and payment is normally made in nine equal instalments, with a tenth balancing payment to settle the liability. The maximum turnover limit for this scheme is £660k. Few contractors actually use this scheme in practice and it is probably better to ensure that your books/VAT accounting is fully up to date on a quarterly basis, rather than be faced with an entire year to account for as the annual return deadline approaches.



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