

Contractors' guide to VAT

Contractors who work through their own [contracting limited company](#) can potentially save a significant amount of money by becoming VAT registered. [Umbrella contractors](#) can also benefit to a lesser extent from understanding how VAT is applied to business purchases.

VAT, or Value Added Tax, is a sales tax added to the price of most goods and services in the UK. Not all goods and services attract VAT, for example many financial services and products like books and journals are zero-rated whilst other items, such as children's car seats, attract lower rates.

Any contractor whose limited company has a gross income of over £77,000 per year, known as the VAT threshold, must register for VAT or they run the risk of being fined. It is also possible for a contractor whose company is turning over less than the threshold to register voluntarily, and for many contractors this is well worth considering.

Many accountants will process VAT returns for you as part of their service - all you need to do is send in your paperwork and they will work it all out, fill in the form, and you just check it and then sign the cheque - very hassle free! Some don't though, and like all things in life you get what you pay for. So when you are [choosing your accountant](#), it's advisable to check what's included.

Contractor invoices - output tax

The VAT charged on goods and services is called output tax. When a contractor registered for VAT [prepares and issues an invoice](#), they must add VAT at the prevailing rate, which at the time of writing is 20%, to their invoice. So, for example, if invoicing their agency for five days work at £300 per day, the invoice would show:

5 days @ £300 per day = £1,500

VAT at 20% [the calculation is $1,500/100*20 =$] £300

Total including VAT [the calculation is $1,500 + 300$] = £1,800

There are other essential items that need to be included on a VAT invoice, including an invoice number.

At the end of every quarter (or in some cases annually – see below), the contractor must add up all the output tax they have charged their clients, take away any input tax (which is described next) and pay the balance to [HMRC](#) using the VAT return that should be automatically sent to the contractor's registered office address.

Contractor purchases - input tax

Of course, whenever a contractor's contracting limited company buys goods and services, the cost of these purchases include someone else's VAT, charged at 20%, which to the contractor is called input tax.

So if the contractor buys a laptop for £399, and the VAT has been charged by the computer supplier at the prevailing rate, which is currently 20%, then the contractor can offset the VAT on their purchase, the input tax, against any VAT they have charged their clients, the output tax.

For example, the VAT element of the laptop is $£399/120*20 = £66.50$, which means the price of the laptop excluding VAT is £332.50. Let's look at that VAT calculation again:

Price including VAT divided by 120 (that's the original price, 100/120ths, and the VAT, 20/120ths to give the price including VAT 120/120ths) multiplied by 20, which is the VAT percentage, equals the VAT element of the price.

The VAT return

Contractors have to account for VAT every quarter. It is possible to accrue VAT and pay it on an annualised basis, but this is not recommended as the admin' burden and cash flow implications do not suit most contractors.

There is also a [flat rate VAT scheme](#), which may suit some contractors with a certain level and frequency of expenditure, and it is recommended that contractors consult their accountant before considering changing to the flat rate scheme.

HMRC will send the contractor's company a VAT return form at the end of each quarter, which has to be completed and submitted to HMRC together with any net payment by the end of the month immediately following the VAT period.

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In order to complete the VAT returns, contractors must add together all the output tax, which is all the VAT they have charged their agency or client in the quarter.

Let's stay with the example we had earlier, and assume that the contractor has billed 5 days @ £300 per day, although most contractors would have around 90 days of work completed in the quarter and be billing many thousands, with a correspondingly higher VAT total.

The output tax in this invoice, from the previous calculation above, is £300 ($5 \times 300 = 1,500$, then $£1,500/100*20 = £300$ output VAT).

The contractor bought a laptop in that quarter for £399, again as above. The input tax on the purchase of the laptop is £66.50 ($£399/120*20 = £66.50$ input VAT).

The net VAT payable by the contractor's limited company to HMRC is the output tax minus the input tax, which works out at $300 - 66.50 = £233.50$.

So what does this mean? The contractor billed their agency or client £300 in VAT, and has paid their computer supplier £66.50 in VAT, so they get to keep £66.50 of the cash VAT charged to the client/agency and the laptop actually only costs them £332.50 rather than £399.

Imagine how much VAT can be saved when contractors add up the cost of all their company purchases, including office supplies and equipment – it can add up to a considerable saving and is well worth the time spent collecting VAT receipts and completing VAT returns.

When is VAT registration a disadvantage?

Contractors who contract directly with their clients, rather than an agency, and whose clients are in sectors such as financial services, parts of the public sector and charities may find that their clients are not VAT registered. This means that those clients cannot claim back the VAT on the contractor's invoices.

This can put contractors who have gross billings over £77,000 per year in a difficult position, because they are required to register for VAT but their clients will not thank them for adding 20% to their day rate, which is what the contractor has to do.

One alternative is for the contractor to run a separate limited company that is not registered for VAT and only used on contracts with clients who cannot reclaim VAT, so that the gross billings do not exceed the threshold.

For contractors likely to bill in excess of £77,000 per year and who only work with financial services, charity or public sector clients that cannot reclaim VAT, it is also possible and perfectly legal to run two non-VAT registered limited companies in parallel. Both can bill clients, thereby allowing the contractor to bill up to £154,000 before having to worry about registering for VAT.

VAT Inspections

An occupational hazard of being VAT registered is that the contractor's limited company could be subject to a **VAT inspection**. This can happen around once every six years, or more frequently if the VAT-man wishes it.

If the contractor has been reasonable with what has been claimed as a **legitimate business expenses**, and has completed the right paperwork and kept the right records, then VAT inspections should not be a cause for concern, merely an irritating exercise in unpaid work.

However, if the VAT inspectors find that contractors have been claiming VAT on expenses that are not wholly and necessarily for the purposes of the business, then the contractor may find themselves being fined and forced to repay the VAT they claimed in the past, up to six years previously.

As with most financial decisions to do with **running a contractor's limited company**, taking professional advice is likely to be well worth the expense.

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