Partial exemption

Indirect Tax



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David Graham provides a refresher of the key issues

For many companies and tax advisors partial exemption can be a daunting area of the VAT legislation and one that it is vital to understand should you be working with VAT. This article intends to give a refresher on some of the key rules surrounding partial exemption and how the calculations themselves should be made.

The basic outline

A VAT registered business falls within the scope of partial exemption when it has supplies of both a taxable and an exempt nature. Output VAT cannot be charged on an exempt supply and equally any input VAT incurred directly in making the exempt supply, generally, cannot be recovered.

What is an exempt supply?

Schedule 9 of the VAT Act 1994 details the type of supply that falls within the exemption and includes, amongst others, some supplies relating to health and welfare, finance, insurance, education and land.

It is also important to consider the effect of a partially exempt business having non-business activities. Normally, it must first determine the proportion of VAT incurred relating to these activities and dis-regard this VAT before applying the partial exemption calculation. Any input VAT which is attributed to non-business activities cannot be recovered.

The calculation

The first step to take in determining how much of the input VAT incurred in a quarter can be recovered is to directly attribute the input VAT, where possible. Therefore, if input VAT has been incurred solely in relation to the making of taxable supplies, all of this will be recoverable. If, however, input VAT has been incurred solely in relation to the making of exempt supplies then this is not recoverable (subject to the de-minimis rules, discussed later). Once this calculation has been performed there will usually be input VAT left over (e.g. on overheads) which cannot be directly attributed to either taxable or exempt supplies; this is the residual input VAT.

A partially exempt business will need to use an approved method to work out how much of its' residual input tax can be recovered. This is usually the standard method which calculates recovery on the basis of use, using the split between taxable and exempt turnover in the business as the basis for the calculation.

So, for example, if a business had £100,000 worth of turnover in a quarter, with £80,000 of this relating to taxable expenditure and the remaining £20,000 relating to exempt supplies, 80% of the residual input VAT would be recoverable. The remaining 20% would not be recoverable, again, subject to the de-minimis rules.

If the standard method is deemed not to give a fair and reasonable result it is possible to apply to HMRC, in writing, to use a special method for the calculation. Possible special methods include transaction based and staff number apportionments. Approval is not required to use the standard method.

For tax years commencing on or after 1 April 2009 it is possible to base the initial residual input VAT recovery on the previous year's recovery percentage. This

recovery figure is then finalised, as usual, through the annual adjustment (see later).

The de-minimis limit

When the input VAT, which is attributed (both directly and through the residual calculation) to exempt supplies, is below the de-minimis limit then all the input VAT incurred in that quarter is recoverable.

To be below the de-minimis limits the following two conditions must both be met:

- Input VAT attributed to exempt supplies must not exceed £1,875 for the quarter (£625 for a monthly return and £7,500 for an annual calculation); and
- Input VAT attributed to exempt supplies must not exceed 50% of the total input VAT incurred in that quarter.

Effectively this allows up to £7,500 worth of input VAT, relating to exempt supplies which would not otherwise be recoverable, to be recovered each year by a partially exempt business.

There are also two simpler versions of this de-minimis test which can be used first to check whether or not the limit is breached.

Simple de-minimis test 1:

- Total input VAT incurred is no more than £625 per month on average; and
- The value of exempt supplies is no more than 50% of the value of all supplies.

Simple de-minimis test 2:

- Total input VAT incurred, less input VAT directly attributable to taxable supplies, is no more than £625 per month on average; and
- The value of exempt supplies is no more than 50% of the value of all supplies.

The annual adjustment

Any partially exempt businesses completing their VAT returns on either a monthly or quarterly basis should do a partial exemption working for each period. They will only be able to recover all of the input VAT incurred if the exempt input VAT is below the

de-minimis limit in that period.

At the end of the VAT year (either the March, April or May quarter end) an annual calculation must be performed to identify whether or not the de-minimis limit has been breached in the yearly figures. This can have a positive, negative or neutral effect on the VAT recovery of the business.

If the de-minimis threshold has not been breached in the annual calculation then all the input VAT incurred in the year can be recovered, including the input VAT attributable to exempt supplies. Therefore, if in any of the monthly or quarterly periods the de-minimis threshold was breached and input VAT recovery was restricted then, this input VAT becomes recoverable by means of the annual adjustment. The annual adjustment should be made through the VAT return on either the final return of the year or on the first return of the following year.

On the flip side, if the de-minimis limit is breached on the annual calculation, this could have the adverse effect that input VAT attributable to exempt supplies recovered in an individual period would become repayable to HMRC, by way of the annual adjustment.

Partial exemption is a complicated area and there are many more complexities other than those discussed above. If your business is impacted by partial exemption it is advisable to review the position on a continuing basis.