Demystifying partial exemption: getting VAT recovery right

Indirect Tax

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Clear understanding of partial exemption, de minimis and special methods helps businesses maximise VAT recovery.

Key Points

What is the issue?
Partial exemption determines how much VAT a business with both taxable and exempt activities can recover, but the rules are complex and errors can lead to significant under-claims or over-claims.

What does it mean to me?
Accurate attribution, correct apportionment and careful application of the *de minimis* rules can materially affect VAT recovery, particularly for property

businesses, charities and other partially exempt organisations.

What can I take away?
With disciplined forecasting and, where appropriate, the use of a special method, businesses can improve VAT recovery while remaining compliant – provided the approach is fair, well-documented and defensible to HMRC.

Partial exemption is one of the trickiest and most misunderstood areas of VAT. It governs how much VAT a business can recover and sits at the crossroads of compliance and complexity. Getting it wrong can be costly. For any organisation with a mix of income streams – whether a charity, property business or financial services firm – understanding how exempt and taxable activities interact is crucial to ensuring it pays and recovers the right amount of VAT.

All business income – the payments received for goods or services – has a VAT status. HMRC defines which supplies are exempt, zero rated (0%), reduced rated (5%), or standard rated (20%). If a supply is not on a list confirming otherwise, it defaults to being standard rated. Certain sectors, such as finance, education, welfare, sport and land, are commonly associated with VAT exemption. However, each comes with detailed conditions, and not all activities within these sectors are automatically exempt.

When income is exempt, VAT cannot be charged on it. Crucially, this also means that VAT incurred on costs directly related to making those exempt supplies cannot be recovered. If all of an entity’s activities are exempt, it cannot even be VAT registered at all. But what happens if a business earns both taxable and exempt income? That is where partial exemption applies.

Once an enterprise has correctly identified its income streams, the next step is to determine how much VAT it can reclaim on its expenditure. This involves a two-step process.

Step 1: Attribution

The first – and most important – step is to categorise the VAT incurred on costs. All input tax (the VAT paid on purchases) must be sorted into one of three categories:

- **Directly attributable to taxable supplies:** VAT on costs used exclusively to make taxable supplies (including zero-rated supplies). This input tax is recoverable in full.
- **Directly attributable to exempt supplies:** VAT on costs used exclusively to make exempt sales. This input tax is not recoverable and is often referred to as ‘exempt input tax’.
- **Non-attributable (the ‘pot’):** VAT on general overheads that cannot be directly linked to a specific supply, such as accountancy fees, office rent or utilities. This residual input tax forms the ‘pot’ that must be partially recovered.

Step 2: Apportionment

The standard method of apportioning the non-attributable VAT ‘pot’ is based on the value of income. The recoverable percentage is calculated using the following formula:

Taxable income

(Taxable income + Exempt income) x 100

The resulting percentage, which must be rounded to the nearest whole number, determines how much of the residual VAT pot can be recovered.

This calculation can be performed for each VAT return period. Alternatively, a business may apply a provisional recovery rate based on the previous year’s figures. In either case, an annual adjustment is required at the end of the VAT year to true up the position using the actual data for the full year. This may result in additional VAT being reclaimed or an over-claim being repaid.

The *de minimis* test: a vital lifeline

After completing the partial exemption calculation, a business will have identified both its recoverable input tax and its irrecoverable (exempt) input tax. However, the *de minimis* test provides a valuable opportunity to recover VAT that would otherwise be lost. If exempt input tax falls below a certain threshold, it can be treated as if it were recoverable.

Whilst there are simplified tests available, this article focuses on the traditional test. For a business to be deemed as *de minimis* and recover all its input tax for a period, both of the following conditions must be met:

- The total exempt input tax must be less than £625 per month on average (equivalent to £7,500 per year).
- The total exempt input tax must also be less than 50% of the total input tax incurred in the period.

If both conditions are satisfied, the business is treated as *de minimis* and can reclaim all its input tax, including VAT directly attributable to exempt supplies and the exempt element of overheads.

Notably, these *de minimis* limits have been frozen for more than 30 years. If they were inflation-adjusted, the annual threshold would be closer to £20,000 – a reminder that the framework has not kept pace with modern business realities.

Case study: PropertyCo Ltd

To illustrate how the partial exemption rules work in practice, consider PropertyCo Ltd, which owns a mixed property portfolio. In its most recent financial year, the company generated total rental income of £400,000.

Of this, £300,000 arose from commercial properties over which PropertyCo had exercised an option to tax, meaning the rents were subject to VAT at 20%. The remaining £100,000 related to residential lettings, which are VAT exempt and cannot be opted to tax. This gives PropertyCo an income split that is 75% taxable and 25% exempt.

During the year, PropertyCo incurred VAT on a range of costs. VAT of £8,000 related directly to repairs to its opted commercial properties and was fully recoverable. A further £3,500 of VAT was incurred on repairs to residential flats, which is directly attributable to exempt supplies and would normally be irrecoverable. In addition, PropertyCo incurred £5,000 of VAT on general overheads such as professional fees and office administration, which could not be directly attributed to either taxable or exempt activities.

The calculation in practice

Applying the standard partial exemption method, PropertyCo's recoverable percentage is calculated by reference to its income. With taxable income of £300,000 out of total income of £400,000, the recoverable percentage is 75%.

This allows PropertyCo to recover £3,750 of the £5,000 VAT incurred on overheads, leaving £1,250 as exempt residual input tax. The total exempt input tax for the year therefore comprises £3,500 of VAT directly attributable to residential repairs, together with £1,250 from the exempt portion of overheads, giving a total of £4,750.

This figure is then tested against the *de minimis* limits. The total exempt input tax of £4,750 is below the annual threshold of £7,500 and also represents less than 50% of PropertyCo's total input tax for the year, which amounts to £16,500.

As both conditions are satisfied, PropertyCo is treated as *de minimis* and is entitled to recover all of its input tax for the year, including the £4,750 that would otherwise have been irrecoverable.

Thinking ahead

The *de minimis* rules can present a significant opportunity where expenditure can be timed carefully. As a general rule, VAT on costs relating to residential property improvements – such as new kitchens, bathrooms or windows – is irrecoverable because it relates directly to exempt supplies and would normally become a sunk cost.

However, assume that PropertyCo undertakes a refurbishment of one of its residential flats, incurring costs of £10,000 plus £2,000 in VAT, and that this work is carried out in the same year as the example above. This would increase PropertyCo's total exempt input tax from £4,750 to £6,750.

As this revised figure remains below the £7,500 annual *de minimis* limit, PropertyCo would continue to be treated as *de minimis* for the year and would be able to recover the full £2,000 of VAT on the refurbishment – VAT that would otherwise have been irrecoverable. This represents a 20% saving on the project, achieved purely through informed VAT management.

Such planning requires diligent forecasting and real-time monitoring of costs and income. While the annual adjustment provides a critical backstop, a miscalculation that pushes the business over the *de minimis* threshold could result in all the exempt input tax for the year becoming irrecoverable.

Beyond the standard method

The standard method applies by default unless HMRC agrees to an alternative, known as a partial exemption special method (PESM). A PESM replaces the standard income-based apportionment of residual input tax, used where that approach does not give a fair and reasonable reflection of how costs are used in making taxable and exempt supplies.

This may arise, for example, where taxable activities generate significantly higher costs but relatively less income than exempt activities, leading to understated VAT recovery under the standard method.

Depending on the nature of the business, alternative approaches might include:

- cost-based methods, appropriate where income does not reflect the underlying use of costs between taxable and exempt activities;
- transaction count methods, suitable where the number of transactions better reflects activity levels than income values; and
- floor-space methods, which allocate VAT based on the proportion of premises used for taxable versus exempt supplies (often used in property sectors).

Securing HMRC approval for a PESM can be challenging. The key is to demonstrate why the standard method is unfair, propose a logical and measurable alternative, and explain how it will be monitored on an ongoing basis.

It is also worth noting that HMRC has the power to impose an alternative calculation where it considers that the standard method produces an unfair result. This is known as the standard method override. While relatively uncommon, professional advice should be sought if HMRC indicates that such an override may apply.

The overlooked calculation: non-business activities

Finally, another area that is often overlooked – especially in the charity and not-for-profit sector – is the requirement to perform a non-business apportionment. This calculation must be carried out *before* the partial exemption calculation.

Where some activities are for a charge (business activities) and others are free or grant-funded (non-business activities), input tax must be apportioned accordingly. Input tax related to non-business activities falls entirely outside the scope of VAT recovery.

Unlike partial exemption, there is no standard method for non-business apportionment. Organisations must adopt a fair and reasonable proxy, such as income, the number of events, attendance figures or costs incurred. Robust documentation is essential, as the organisation must be able to defend its approach if challenged by HMRC.

In conclusion

The VAT recovery rules can become complex in practice, with real-time categorisation of income and expenditure being critical. As the saying goes, ‘poor information in, poor information out’, making it well worth investing time at the outset to get the fundamentals right.

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