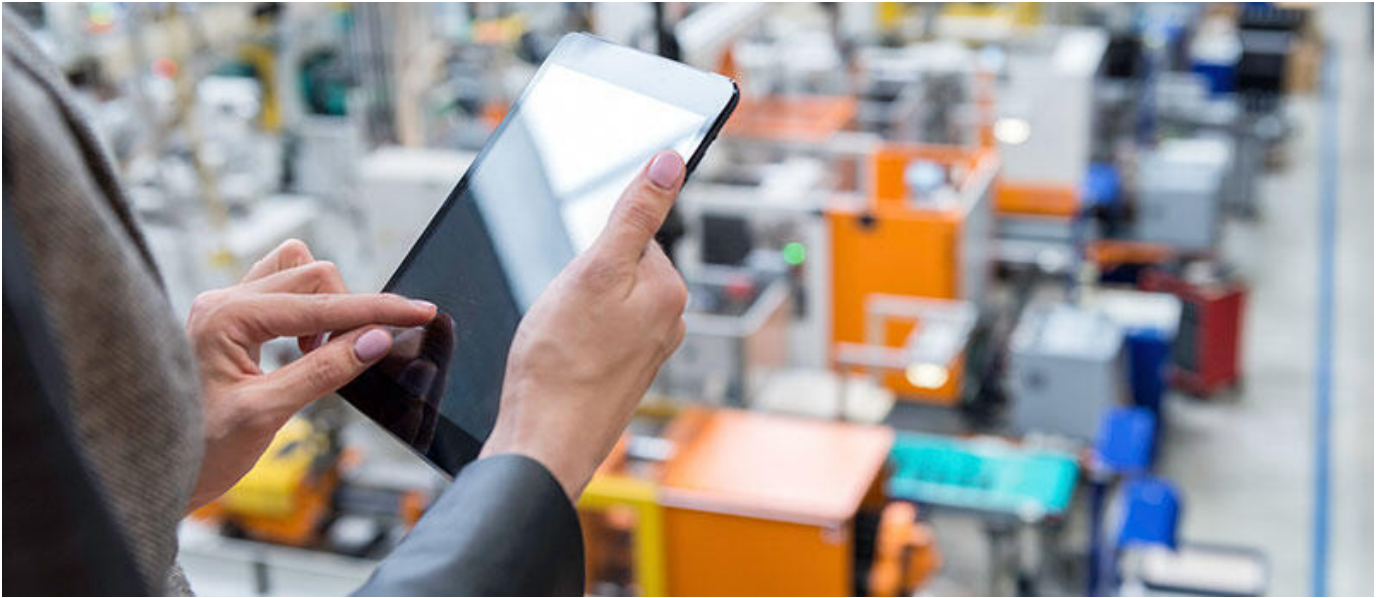


Partial exemption special methods: when the answer is ‘no’

Indirect Tax



20 May 2026

When a VAT-registered business incurs VAT on costs that relate to both taxable and VAT exempt activities, it must consider a fair and reasonable recovery of the input VAT. More complex businesses may need to apply to HMRC for a bespoke calculation method to work out a fair VAT recovery position, known as a partial exemption special method.

Members of the CIOT's Indirect Taxes Committee recently met with representatives from HMRC's partial exemption team to discuss tips and best practice for the situation where a partial exemption special method (PESM) application has been rejected.

VAT notice 706 ([tinyurl.com/yj6rnve2](https://www.tinyurl.com/yj6rnve2)) mentions the rejection of a PESM application in paragraph 6.2 stating: 'If we decide not to approve your method we will write to you explaining the reasons why, and where appropriate, invite you to make further or modified proposals.'

If HMRC reject a taxpayer's PESH application, this means that the method of calculating input VAT recovery that the taxpayer believes to represent a fair and reasonable approach is not acceptable to HMRC. The taxpayer does, however, still need to file its VAT return and, within that, will need to take a position on whether to deduct input VAT and, if so, on what basis. The CIOT asked how taxpayers should manage this input VAT recovery risk if they apply for a PESH and are rejected. Further, how can taxpayers manage any exposure to risk where the rejection letter provides a reason, per the above statement in guidance, but does not detail other concerns that HMRC may have over the methodology proposed?

HMRC reiterated that it is the taxpayer's responsibility to self-assess a fair and reasonable recovery of input VAT incurred. Their policy is for PESH rejection letters to articulate a clear basis for the rejection. Merely stating that 'it does not provide a fair and reasonable outcome' is not sufficient under normal PESH team standards. If this were to happen, however, the taxpayer should write to ask for the reasons.

Where there are multiple issues that are unacceptable to HMRC, those considered material should all be outlined in the rejection letter. Where there are additional areas about which HMRC are uncertain, these may be raised in the letter but may not go into detail; taxpayers can ask questions about the uncertainties should they choose to engage further on the rejected PESH.

We discussed an example where a business had a PESH proposal for three sectors. If HMRC had rejected the PESH application, outlining in their rejection letter an issue concerning say sector one, could the business assume that sectors two and three were acceptable? HMRC commented that it would be best practice for the rejection letter to comment on each of the sectors independently, but if there is no comment on a particular sector it cannot be assumed that the methodology proposed is acceptable. If one sector is rejected, ultimately the whole PESH application is rejected.

The CIOT asked what businesses could do when there is a VAT return due during the period after an initial rejection, where the PESH application may be under internal review or has been resubmitted and being negotiated. HMRC commented that in the absence of a newly approved method, the business should still use its existing method, be it the standard method or an existing PESH. If the business is concerned that a difference exists between the input VAT deducted through the existing method and what it considers to be fair and reasonable, it can use either the

standard method override (see section 5 of Notice 706) or, if on an existing PESH, it has the option of serving a special method override notice to override a use-based recovery from a current date (see section 8 of Notice 706). However, it should be borne in mind that HMRC may still disagree and recalculate their own view of 'use' where a special method override notice is in place. An alternative proposal to mitigate this risk would be to put specific parameters on a proposed sector calculation or discuss a use-based sector with HMRC. Ultimately, as the tax is self-assessed, the decision taken should seek to minimise the risk of filing an incorrect VAT return by deducting too much or too little input VAT. An error correction notice could only be submitted where the business has the right to diverge from its existing method, either via the special method override or special method override notice.

Future engagement

HMRC have a PESH focus group that includes stakeholders from several accountancy firms and representatives from relevant professional bodies (see 'VAT: Partial special exemption methods', Tax Adviser, February 2024 tinyurl.com/ycayfwnb). The priority topic for the next meeting later this year is expected to be attribution.

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