

VAT and Partial Exemption

Introduction

The VAT that a business incurs on its purchases and overheads is called 'input tax'. For businesses that only makes taxable supplies (either standard-rate, lower-rate or zero-rate) this input tax, with the exception of certain specifically excluded items, such as business entertaining, is fully recoverable.

A VAT registered business which makes exempt sales cannot charge VAT on those exempt sales, the consequence of which is that it cannot usually reclaim the input tax it incurs on purchases and overheads used in making those exempt supplies. If a business makes both taxable and exempt supplies it is called 'partially exempt'.

Consequence of partial exemption

A business that is partially exempt cannot recover input tax on purchases, costs and overheads relating to the exempt sales. Identifying the input tax that relates solely to the exempt supplies should be relatively straight forward. However a portion of overheads such as: audit fees, light, heat, telephone and communication, and IT costs are also likely to relate to exempt sales and has to be identified.

Briefly the process can be set out as follows:

1. Identify the input tax on goods and services used solely for making taxable supplies, which is recoverable
2. Identify the input tax on goods and services used solely for making exempt supplies, which is irrecoverable unless the amount is lower than the de-minimis limits, see below
3. Identify the input tax on goods and services used for making both taxable and exempt supplies
4. Identify the input tax on overheads used for making both taxable and exempt supplies
5. Apportion the input tax resulting from steps three and four, this amount is often referred to as 'the pot', between taxable supplies and exempt supplies
6. Sum all the input tax relating to exempt supplies and compare the total to the de-minimis limits. If it exceeds the de-minimis limits it is irrecoverable

Methods of apportionment

The standard method of splitting the pot is based on turnover. The recoverable amount is the percentage of taxable sales as a proportion of total sales whilst the exempt amount is the percentage of exempt sales as a proportion of total sales. This usually gives a reasonable approximation of how overheads have been used between taxable and exempt sales and requires no agreement from HMRC. Where the taxable percentage is not a whole number, it should be rounded up to the next whole number, unless the residual input tax is £400,000 per month on average or greater in which case it must be rounded up to two decimal places.

However there are often businesses where it does not give a reasonable approximation, and in these circumstances it is possible to agree in advance with HMRC a 'Special Method'.

There are also anti-avoidance provisions applicable to large businesses called 'Standard Method Over-ride' which apply where the standard method does not give a fair and reasonable result.

Special method

When you propose a special method you must include a declaration that the method is fair and reasonable. If HMRC subsequently find your declaration to be incorrect they may serve a Special Method Over-ride Notice so that from its effective date input tax would be recovered according to the use of purchases in making taxable supplies. A declaration is incorrect if two conditions are met:

- The method does not produce a fair and reasonable attribution of input tax to taxable supplies resulting in an unfair over-recovery of input tax
- The person signing the declaration knew or ought reasonably to have known this at the time they made the declaration

You cannot change your method without HMRC's prior approval. You must continue to use your current method, whether that is the standard method or a special method, until HMRC approve or direct the use of another method or direct termination of its use.

A special method calculation should be rounded up to two decimal places.

Example

A trader uses a building for two activities. It runs a fitness club, and sells insurance. The sales of taxable fitness subscriptions and other fees, and the exempt insurance are equal. Under the standard method it would recover only 50% of the costs. However the fitness club occupies 85% of the building and the insurance is run from a small office occupying 15%, as a result a significantly greater amount of costs are incurred in respect of the taxable activity compared to the exempt one. In this circumstance it would be sensible to apply to HMRC for a special method, probably based on floor area to better reflect use of the costs of the building.

De-Minimis limits

Where the amount of exempt input tax is beneath de-minimis limits it can be recovered in full. To fall under the de-minimis limits the exempt input tax must be, both

- Below £7,500 per year, or £1,875 per quarter or £625 per month; and
- Below 50% of the total input tax

If the amount of input tax is beneath both of the above the de-minimis limits it is recoverable in full, if it exceeds the de-minimis limits it is wholly irrecoverable.

Annual adjustments

Whether you use the standard method or a special method the periodic adjustments are provisional, because there may be seasonal fluctuations which distort the input tax recovery position. Usually, therefore, an annual adjustment is made at the end of the business's VAT year based on the figures for the VAT year, and the adjustment is put through the first periodic return for the new VAT year. A VAT year will depend on the business's VAT Stagger. It will either be the year ended 31 March (Stagger 1), 30 April (Stagger 2) or 31 May (Stagger 3).

Businesses may if they wish use last years percentage on a provisional basis but they must be consistent, they cannot swap and use which ever basis is best.

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