

VAT AND PARTIAL EXEMPTION

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

A VAT registered business which makes exempt supplies will be making supplies which do not attract VAT. The consequence of this is that the business 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” and will need to take into account special apportionment rules in determining how much input tax can be recovered.

Consequence of partial exemption

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

In brief, a business that is partially exempt will need to follow these steps to determine the input VAT it can recover:

1. Identify the input tax on goods and services used solely for making taxable supplies.
2. Identify the input tax on goods and services used solely for making exempt supplies.
3. Identify any remaining input tax (the “residual input VAT”).
4. Apportion the residual input VAT between taxable supplies and exempt supplies in accordance with one of the methods described below.
5. Add together the amounts of input tax that have been determined to relate to exempt supplies and assess whether this falls below the de minimis limits. Essentially, this will be the case if it falls below the equivalent of £7,500 per year and is less than 50% of the total input tax.

The input tax that is recoverable will be the total of the amount that relates solely to the making of taxable supplies, the proportion of the residual input VAT that is apportioned to taxable supplies, and the input tax that is determined to relate to exempt supplies if this is de minimis.

Methods of apportionment

The “standard method” of apportioning the residual input VAT is on the basis of turnover. In simple terms, the proportion of the value of total supplies that relates to taxable supplies is calculated, and this proportion is then applied to the residual input VAT.

This standard method will usually provide a reasonable result, but as an alternative, a business may be able to agree a “special method” of apportionment with HMRC.

A “special method” of apportionment may be based on any of a wide number of variables, including for example the number of total transactions that are taxable, the proportion of the floor area that is used to make taxable supplies, or the proportion of staff involved in making taxable supplies. The key point is that the method must be fair and reasonable.

It is not possible to use anything other than the “standard method”, or to change the apportionment method, without HMRC’s prior approval.

Annual adjustments

Whether a partially exempt business uses the standard method or a special method, an annual calculation must be made at the end of the business’s VAT year. This calculation must be made by using the relevant annual figures, and any difference between the input tax that would have been recovered on this basis, and the amount that was recovered through the year, must be reflected on either the last VAT return for the VAT year, or the first period return for the new VAT year.

The full rules relating to partially exempt businesses are complex and are not covered in this document. If you have any questions or would like to discuss any elements of the rules further, please get in touch with our specialist tax team at Moore Kingston Smith.

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