

Partial exemption

(Lecture B1069 – 14.41 minutes)

The challenge for a partly exempt business is to allocate its expenses into three different input tax categories:

1. Taxable input tax – expenses relate wholly to taxable sales and can be fully reclaimed, subject to normal rules.
2. Exempt input tax – expenses wholly relate to exempt activities – no input tax claim here subject to de minimis considerations (below)
3. Residual input tax – sometimes described as ‘the pot’ – and relates to mixed costs or general overhead items e.g. telephone bills, accountancy fees, website costs, premises costs i.e. expenditure relevant to both parts of the business. A proportion of this input tax can be claimed, usually based on the standard method of calculation based on income:

$$\text{Residual input to claim} = \frac{\text{Taxable sales (excl VAT)} \times \text{Residual input tax}}{\text{Taxable sales (excl VAT)} + \text{Exempt sales}}$$

This fraction is rounded to the next whole percentage if unattributed input tax is not more than £400,000 per month, so for example, 60.1% would be rounded to 61%.

If the unattributed input tax is more than £400,000 per month, the fraction is rounded to 2 decimal places.

Sale of capital goods used in business and anything which is not the normal sales of the business are excluded from the calculations.

Partial exemption special methods

Businesses can apply for a special method of apportioning residual input VAT between taxable and exempt supplies if it gives a fairer allocation than the standard method.

Examples include:

- output values
- numbers of transactions
- staff time or numbers
- inputs or input tax
- floor area
- costs allocations
- management accounts

HMRC can impose particular methods or stop a business using an existing special method but generally only where they believe there is abuse.

Partial exemption de minimis tests since 1 April 2010

Original test – exempt input tax is less than £625 a month on average; and also less than 50% of total input tax (exempt input tax consists of input tax directly relevant to exempt supplies plus the proportion of residual input tax that is not claimed);

Simplified Test One - total input tax 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;

Simplified Test Two - total input tax incurred less input tax 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 simplified tests supplement the original test. A business is de minimis if it passes Test One, Test Two or the original test, and if it passes any one test there is no need for it to consider the other two.

A partial exemption calculation is made at the end of each VAT period, and superseded by an annual adjustment to the end of March, April or May each year, depending on the VAT periods of the business in question.

Example

A partially exempt trader has the following information for his VAT year ended 30 April 2017:

	Q1	Q2	Q3	Q4
Taxable sales	40,000	75,000	25,000	60,000
Exempt sales	10,000	25,000	5,000	40,000
Attributed to exempt supplies:	1,200	2,400	700	3,100

Input VAT on exempt supplies in Q1 and Q3 is less than £1,875 (i.e. £625 per month on average) can be recovered in those quarters' VAT returns.

Input VAT attributed to exempt supplies in Q2 and Q4 cannot be recovered in their respective VAT returns.

The annual calculation will have total input VAT on exempt supplies of £7,400.

As this is less than £7,500 per annum it can all be recovered so there will be an adjustment to recover the £5,500 input VAT from Q2 and Q4

Contributed by Malcolm Greenbaum