STREETS Knowledge Bank

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Partial Exemption Explained

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A basic concept in VAT law is that input VAT (that incurred on purchases of goods or services) is only recoverable where it relates to the taxable supplies that are made, or are to be made, by that business. In the case of a business which only makes VAT exempt supplies no VAT recovery is possible and as such a business cannot even be registered for VAT with HM Revenue & Customs.

For many businesses this poses a problem as income is received which is exempt from VAT as well as income which is subject to VAT either at the standard rate of 17.5%, the lower rate of 5% or at the zero rate. Such businesses are often referred to as partially exempt traders.

The problem is usually focused on the attribution of 'mixed' costs. Whilst some VAT can be identified as 'taxable' input tax and therefore almost certainly recoverable, and some can be identified as 'exempt' input tax which is potentially irrecoverable, there remains a third category of non attributable VAT which has to be apportioned. HM Revenue & Customs usually refer to this as 'pot' input tax.

There are special rules which are intended to simplify matters for smaller businesses. The intention is to allow full VAT recovery where the 'exempt' element is relatively small within a particular VAT registered business. In practice the rules are somewhat difficult to comprehend for many people, including some VAT officers, but this short guide should help.

When VAT is incurred it should be coded to one of three headings:

1. Fully taxable: VAT incurred wholly in relation to taxable activities
2. Exempt input tax: VAT wholly relating to exempt income (anything that is 100% to do with a property that will generate VAT exempt income – sale or rent)
3. Residual input tax: Tat VAT not entirely relating to either taxable or exempt sales. This will include the VAT on overheads and any 'mixed' items (e.g. charges incurred in relation to the businesses generally such as the telephone bills).

The VAT in (1) above is fully recoverable.

The VAT in (2) above is classed as exempt input tax and may not be recoverable.

The residual 'pot' in (3) above has to be apportioned. VAT incurred on overheads which relate to the business as a whole will fall into this last category. The Standard Method of doing the apportionment is to determine, period by period, the % of output (sales) which are taxable. This %, rounded up to a whole number, is applied to the 'pot'. The remainder of the 'pot' is then also classified as exempt input tax and this is added to the VAT in Code 2 to determine the total amount of exempt input tax for the period.

If the total of exempt input tax in a VAT quarter is both less than £1,875 and less than 50% of all the input tax incurred it can all be recovered. If the exempt VAT is below this 'de minimis' limit the business is treated as being fully taxable and can recover all the VAT incurred with the usual exceptions such as VAT incurred on entertaining.

The partial exemption rules require an annual adjustment to be carried out. The actual monetary adjustment is entered to the next period's VAT return. This means that the business has to look at the figures for the year as a whole and compare the result of this calculation to the VAT recovered period by period. The £1,875 per quarter applies from the first quarter in which exempt input tax was incurred.

This article gives only an overall view of partial exemption and does not explore the VAT recovery position of those VAT registered traders who receive non business income.

VAT associated with non business income is not input tax at all and is never recoverable. Apportionment of mixed costs may also be required where non business activities are involved.

If you have a query about this article or any other area of VAT, please contact or VAT partner, Alan Taylor.

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