VAT – PARTIAL EXEMPTION

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A business is partly exempt if it makes a **mixture of taxable and exempt supplies** known as partly exempt supplies.

Input tax recoverable

A partly exempt business

- can recover input tax directly attributable to taxable supplies and non-attributable input tax (NAIT) relating to taxable supplies
- may or may not be able to recover input tax relating to exempt supplies.

Methods that determine the recoverable NAIT relating to taxable supplies and input tax relating to exempt supplies

- Standard method
- Special method- De minimis method
- Special method- Test 1 and 2 method

A) **Standard method** is the only method that does not require HMRC's written approval. This method determines the NAIT related to taxable supplies which is recoverable. Any input tax relating to exempt supplies is not recoverable.

NAIT relating to taxable supplies (Xa) ==➔ $\frac{\text{Value of taxable supplies}}{\text{Value of total supplies}}$ * Total NAIT

(This fraction excludes VAT and is rounded to the nearest whole %
No rounding for businesses whose NAIT $\geq$ £400,000 p/m)

B) **De minimis method**

- If the total amount of input tax relating to exempt supplies (Xb) is < the de minimis limits, then all input tax is recoverable in full.

De minimis limit
Xb is $\leq$ £625 per month on average and
Xb is $\leq$ 50% of the total input tax incurred for the VAT period
(where Xb= Total NAIT – Xa + input tax directly attributable to exempt supplies)

- Where the de minimis limit is exceeded in any VAT period then only the relevant VAT (i.e. those attributable to taxable supplies) is recoverable.

C) **Test 1 and 2 method**

Test 1➔ Total input tax incurred $\leq$ £625 p/m on average and
Value of exempt supplies $\leq$ 50% of the value of all supplies

Test 2➔ Total input tax incurred less input tax directly attributable to taxable supplies $\leq$ £625p/m on average and
Value of exempt supplies $\leq$ 50% of the value of all supplies

For VAT periods commencing on or after 1.4.2010,

- Where a business satisfies either test 1 or 2, it can treat itself as having satisfied the de minimis limit and as such, recover total/all input tax provisionally.
- However, at the end of the year, the business is required to carry out an annual test to review its de minimis status for the whole year. As part of its annual adjustment, any resultant under/over recovery of input tax is accounted for as input tax recoverable from HMRC or repayable to HMRC respectively.
- Businesses also have the option of applying the de minimis test once a year, if it satisfies the new annual partial exemption test.

  Conditions for annual test

  The annual test can be applied where the following conditions are met
  The business must:
  - pass the de minimis test for its previous partial exemption year
  - consistently apply the annual test throughout any given partial exemption year
  - have reasonable grounds for not expecting to incur > £1m input tax in its current partial exemption year

  If any of the conditions are not satisfied, then only the de minimis method is used for each VAT period.

Special methods- De minimis and Test 1 & 2 methods require negotiation with and agreement in writing by HMRC.

One situation where partial exemption has been of particular significance recently, is where house builders let dwellings before selling it.
Many house builders are fully taxable businesses that can recover all of their input tax because for VAT purposes, the sale or first grant of a major interest in a dwelling is a taxable supply. However, the letting of a dwelling is an exempt supply and input tax on related costs might not be recoverable.

Worked Examples

1. In the VAT quarter to 30.6.2010, Deloitte & Co makes both exempt and taxable supplies (excluding VAT) of £210,000 and £600,000 respectively.
   Most of the goods purchased are used for both types of supply which means that much of the input tax cannot be directly attributed to either type of supply.
   After directly attributing as much input tax as possible, the following arises

	£
- Attributable to taxable supplies	2,400
- Attributable to exempt supplies	1,200
- Non attributable input VAT	16,400
	20,000

Required- How much input tax can Deloitte & Co recover using the de minimis Method?

Solution

De minimis limit➔ Xb ≤ £625p/m on average and 50% of total input tax incurred

1st step - Determine Xa

2nd step – Determine Xb (de minimis method)

Xa= NAIT relating to taxable supplies = value of taxable supplies / value of total supplies * Total NAIT (rounded to nearest whole number)

$$= \frac{£600,000}{£810,000} = 0.7407 * 100 = 74\% \text{ rounded}$$

Xa= 74% * £16,400 = £12,136 for the quarter

	£
Xb= £(16,400 – 12,136)	**4264**
+tax wholly attributable to exempt supplies	**1200**
	5464

Xb per month= £5464/3mths= £1821pm

Xb of £1821pm > £625 pm on average therefore fails the de minimis test.

Conclusion

This indicates that all input tax relating to exempt supplies (Xb) is higher than the de minimis limits, thus Deloitte & co can only recover the relevant input vat of:

	£
Input tax directly attributable to taxable supplies	**2,400**
Non-attributable tax relating to taxable supplies	**12,136**
	14,536

2) Jerome made the following supplies in the quarter ended 30.6.2010

	£
Standard rated taxable supplies (excluding VAT)	22,500
Exempt Supplies	17,500
	40,000

Jerome's input tax for the period is £5,250 of which £3,800 is directly attributable to the making of taxable supplies.

Requirement- State the input tax recoverable by Jerome for the quarter using special method test 2.

Solution

Test 2 method

a)Total input tax incurred less input tax directly attributable to taxable supplies ≤ £625p/m on average and
b) Value of exempt supplies ≤ 50% of the value of all supplies

	£
a) Total input tax	**5,250**
Less:	
Input tax directly attributable to taxable supplies	**(3,800)**
	1,450 per qtr

per month = £1,450/3mths = £483.33pm

£483.33pm < £625pm on average→ part (a) test passed

b) $\frac{\textbf{Value of exempt supplies}}{\textbf{Value of all supplies}} = \frac{£17,500}{40,000} * 100 = 43.75\%$

43.75% < 50% → part (b) test passed

Conclusion

Jerome's business satisfies both parts of test 2 and therefore is within the de minimis limits for this period. He can reclaim all his input tax of £5,250 provisionally.

3 Goldman Ltd has a partial exemption year ending on 30.9.2011. During the year it makes the following supplies:

	£
Taxable supplies (standard–rated excluding VAT)	87,000
Exempt supplies	63,000
	150,000

Graham Ltd's input tax for the year is:

	£
Wholly attributable to taxable supplies	26,500
Wholly attributable to exempt supplies	12,200
Non-attributable input tax	13,300
	52,000

During the year, Goldman ltd recovered all the input tax of £52,000 suffered as it was de minimis in the partial exemption year ending 30.9.2010.

Requirement- Determine if Goldman Ltd is de minimis for the year ended 30.9.2011 and calculate any annual adjustment if applicable.

Solution- Annual test

Step 1= Does businesses pass special method test 1 or 2
(If it fails, apply de minimis test)
Step 2= Determine Xa
Step 3= Determine Xb (de minimis method)
Step 4= Determine annual adjustment if applicable

Test 1 method

a) Total input tax incurred ≤ £625 p/m on average and
b) Value of exempt supplies ≤ 50% of the value of all supplies

a) Total input tax incurred per month= £52,000/12mths = £4333.33pm

£4333.33pm > £625pm on average ➔ failed

b) $\frac{\text{Value of exempt supplies}}{\text{Value of all supplies}} = \frac{£63{,}000}{£150{,}000} * 100 = 42\%$

42% < 50% ➔ passed

The business does not satisfy the special method as it failed one part of test 1, therefore the de minimis method will apply.

De minimis method

$Xa = \frac{£87{,}000}{£150{,}000} = 0.58 * 100 = 58\%$

Xa= 58% * £13,300 = £7,714 for the year

	£
Xb= £(13,300 – 7,714)	**5,586**
+tax wholly attributable to exempt supplies	**12,200**
	17,786

De minimis test

a) Xb ≤ £625 pm on average

Xb per month= £17,786/12mths= £1482.17pm

£1482.17pm > £625pm on average➔ failed

b) Xb ≤ 50% of the total input VAT incurred in the period

$$\frac{\text{Value of exempt supplies}}{\text{Value of total supplies}} = \frac{£63,000}{£150,000} * 100 = 42\%$$

42% < 50% of total input tax incurred ➔ passed

Conclusion

Goldman Ltd failed the de minimis test, as one part of the test was unsatisfactory.

This indicates that the total input tax attributable to exempt supplies is higher than the de minimis limit, therefore only the relevant input tax is recoverable.
An over recovery arises as follows:

Annual adjustment (over recovery)

£ (52,000 -26,500-7,714) = £17,786 repayable to HMRC

(£17,786 represents the total input tax attributable to exempt supplies already recovered which will have to be paid back to HMRC)