



**HM Revenue  
& Customs**

# VAT Partial Exemption Toolkit

Effective from 1 February 2011

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## Introduction

Tax agents and advisers play an important role in helping their clients to get their tax returns correct. This toolkit is aimed at helping and supporting tax agents and advisers in completing VAT Returns on behalf of their clients, although it may also be of use to anyone who is completing a VAT Return. It may also be of use to tax agents and advisers who do not complete their client's VAT Return but wish to use it as a source of reference when advising their client on VAT matters or for reviewing their client's VAT declarations at the year end.

This toolkit is applicable from 1 February 2011. Its use is entirely voluntary.

The content of this toolkit is based on our view of how tax law should be applied. Its application to specific cases will depend on the law at the relevant time and on the precise facts.

This toolkit reflects legal changes introduced with effect from 1 January 2011. These changes only apply to input tax incurred on or after 1 January 2011 and can be summarised as:

- Allowing a business to apply to HMRC to use a formalised special method to carry out its business/non-business calculation (excluding any restrictions required to reflect private use).
- Allowing a partly exempt business to apply to HMRC to use a single special method (a 'combined method') to carry out its business/non-business calculation and its partial exemption calculation. A partly exempt business must apply for a single 'combined method' - separate business/non-business and partial exemption special methods cannot be authorised.
- Extending the 'clawback' and 'payback' rules which adjust input tax claimed on the basis of intended use to include changes in actual or intended non-business or private use - for this purpose non-business use is considered as exempt business use.
- Extending the Capital Goods Scheme (CGS) to include purchases of aircraft, ships, boats and other vessels with a standard or reduced rate value of £50,000 or more.
- Extending the CGS to require input tax adjustments to reflect changes in levels of non-business use (including any private use) of the asset over the adjustment period.
- Making a number of technical changes to the operation of the CGS.

For further information see [Revenue & Customs Brief 53/10](#).

For further information on using this toolkit and reasonable care under our penalty system see [Toolkits to help reduce errors - essential information](#).

For guidance on matters not dealt with in this toolkit you should refer to our full guidance in the Partial Exemption Manual (PE):

<http://www.hmrc.gov.uk/manuals/pemmanual>

## Areas of risk within VAT partial exemption

A VAT registered business can reclaim the input tax that it incurs on expenditure which relates to supplies which are:

- UK taxable supplies (standard, zero or reduced rate).
- Supplies made outside the UK which would be taxable if made in the UK.
- Certain exempt supplies specified by Treasury Order known as 'specified supplies' which are a range of supplies made to persons belonging outside the European Union (EU) that would be exempt finance or insurance supplies if made in the UK, supplies which relate directly to the export of goods to a place outside the EU or supplies made by intermediaries in relation to these types of supplies. There are further 'specified' supplies relating to investment gold.

For the purposes of this toolkit all these supplies are referred to as 'taxable supplies' and the input tax on the related expenditure as 'taxable input tax'.

Input tax which relates to exempt UK supplies or supplies that would be exempt if made in the UK (other than 'specified supplies') cannot be claimed unless it is below a prescribed de minimis limit. These supplies are referred to in this toolkit as 'exempt supplies' and the related input tax as 'exempt input tax'.

When a business makes only taxable supplies the process for claiming input tax is generally straightforward. However, when a business incurs input tax that relates to both taxable and exempt supplies it becomes partly exempt. The partial exemption standard method sets out the mechanism for calculating how much input tax can be claimed in these circumstances and must be followed unless an alternative special method is formally agreed with HMRC.

## Record keeping

Good record keeping is essential, as poorly kept records can mean that the VAT Return is prepared on the basis of inaccurate or incomplete information.

A partly exempt business must correctly determine the VAT liability of supplies it makes or intends to make in order to correctly attribute its input tax for partial exemption purposes. The accounting system should therefore be adequate to ensure that all relevant transactions are identified and accurately recorded.

For further information on record keeping see [Record keeping fact sheet](#).

## Recognition of the need for a partial exemption calculation

Many businesses do not realise that they are partly exempt as they do not recognise that they are making or intending to make exempt supplies. For a list of exempt supplies see [Q2](#). Alternatively a business may be unfamiliar with the partial exemption rules or conclude incorrectly that its exempt input tax is below the de minimis limit. A partly exempt business is only de minimis in any VAT period where its total exempt input tax is less than £625 per month on average and no more than 50 per cent of its total input tax, or it meets one of the simplified de minimis tests for smaller businesses - for further information see [VAT Information Sheet 04/10](#). It is common for a business to become partly exempt as a result of exempt land and property transactions which may be outside its main business activities.

## Attribution

In each VAT period a partly exempt business must allocate its input tax as fully and accurately as possible to one of three categories:

- directly attributable taxable input tax (incurred on expenditure only to be used to make taxable supplies and recoverable in full)
- directly attributable exempt input tax (incurred on expenditure only used or to be used to make exempt supplies and not recoverable subject to the de minimis rules)
- residual input tax (incurred on expenditure that cannot be wholly attributed to either taxable or exempt supplies)

Most business overheads (such as accountancy fees and stationery) are generally residual, as is expenditure which partly relates to both taxable and exempt supplies (such as an advertisement for both taxable and exempt products).

Residual input tax is sometimes referred to as being 'non-attributable' or 'the pot'.

While the principle of attributing input tax to use is straightforward, it can sometimes be difficult to apply in practice. Whether any individual item of expenditure can be directly attributed to taxable or exempt use is a question of fact to be decided on the particular circumstances of each case.

Accurate attribution is also dependent on the understanding and consistency of the person entering individual purchases and expenses to the records, and errors can often occur as a result of oversight or misunderstanding.

## Apportionment

Once input tax has been directly attributed as far as possible to taxable and exempt use, the purpose of any partial exemption calculation is to determine the proportion of residual input tax which is attributable to taxable supplies and can therefore be claimed.

The standard method, which apportions residual input tax on the basis of the ratio of taxable supplies to total supplies, must be followed unless an alternative special method has been formally approved by HMRC.

If a business considers that the standard method does not produce a fair apportionment of residual input tax, it may apply to HMRC to use a special method. This toolkit does not address the detail of individual special methods which are particular to the circumstances of each business and must be considered accordingly.

## The annual adjustment

Under the standard method a partly exempt business uses the recovery rate calculated under the previous year's annual adjustment to apportion its residual input tax through the course of the current partial exemption tax year. A business may alternatively choose to carry out a separate partial exemption calculation for each monthly or quarterly VAT Return period. Whichever approach is adopted, the amount of input tax claimed as a result of each period calculation is provisional and is only finalised through a 'longer period calculation' which is often known as the 'annual adjustment' and generally covers a period of 12 months. The annual adjustment uses the values for the whole of the period in question, comparing the result to the cumulative result of the individual return period calculations. It also accounts for any changes in use or intended use during the annual adjustment period. Any resulting difference is payable to or recoverable from HMRC. The need to carry out an annual adjustment can be overlooked altogether or the calculation may be carried out incorrectly.

Adjustments to partial exemption calculations may also be required if input tax is claimed, or credit notes issued or received, after the annual adjustment period to which they relate.

## Changes of intention

Input tax is initially attributed on the basis of intended use. However, if a business subsequently changes its plans and the liability of the intended use changes before actual use occurs, this initial attribution must be revisited. If the change of intention occurs after the end of the longer period in which the input tax is incurred, the required adjustment is known as 'clawback' when input tax must be repaid to HMRC or 'payback' when additional input tax can be recovered. The need for such adjustments is often overlooked.

## Capital Goods Scheme

For most purchases the final level of input tax recovery is determined by the annual adjustment calculation. However, for specified assets the level of taxable use must be monitored for up to five or ten years, with any variation in the extent of taxable use requiring an adjustment to the initial input tax deduction. The Capital Goods Scheme (CGS) applies to purchases of land and buildings where the value of the standard and reduced rate supplies received (excluding VAT) is £250,000 or more, and to purchases of computer equipment with a value of £50,000 or more (excluding VAT). With effect from 1 January 2011 the CGS has been extended to include purchases of aircraft, ships, boats and other vessels with a standard or reduced rate value of £50,000 or more (excluding VAT). A business may either fail to identify assets subject to the CGS or make errors in the CGS calculation.

For purchases of items subject to the CGS which are made after 1 January 2011, the CGS calculation requires adjustments to input tax in relation to changes in levels of non-business or private use of the asset in question, as well as to changes in levels of taxable and exempt use. For more information on changes to the CGS see **Revenue & Customs Brief 53/10**.

## Using links within the document

Blue underlined text are links within this document.

**Green bold text** are hyperlinks to external documents on the internet (access to the internet is necessary to view these).

We have a range of services for people with disabilities, including guidance in Braille, audio and large print. Most of our forms are also available in large print. Please contact any of our helplines if you need these services.

**<http://www.hmrc.gov.uk/contactus/particular-needs.htm>**

# Checklist for VAT partial exemption

	Yes	No	N/A
<b>Recognition of the need for a partial exemption calculation</b>			
1	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
3	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<b>Attribution</b>			
4	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<b>Apportionment</b>			
5	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
6	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
7	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
8	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
9	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<b>The annual adjustment</b>			
10	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
11	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
12	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
13	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
14	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
15	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<b>Capital Goods Scheme</b>			
16	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
17	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Capital Goods Scheme continued

Yes No N/A

18 If a Capital Goods Scheme [item has been sold or otherwise disposed of](#) within its adjustment period, have any necessary adjustments been made?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
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# Explanation and mitigation of risks

## Recognition of the need for a partial exemption calculation

1. If exempt supplies are made or intended, has the need for a partial exemption calculation been recognised?

### **Risk**

A business may not recognise that it is making or intends to make exempt supplies. For a list of exempt supplies see [Q2](#). Alternatively a business may be unfamiliar with the partial exemption rules or mistakenly conclude that its exempt input tax is below the de minimis limit (see [Q9](#)). For example, a business which has been historically de minimis may incur unusually high levels of exempt input tax in refurbishing a number of exempt rental properties without realising that it has now exceeded the de minimis limit and must carry out a partial exemption calculation to determine how much input tax it can properly claim.

### **Mitigation**

Consider all of the activities of the business, including those which are secondary or incidental, to identify existing or intended exempt supplies. If exempt supplies are identified, ensure that a partial exemption calculation is carried out.

For an example of a partial exemption calculation using the standard method see [paragraph 4.8 of Public Notice 706 Partial Exemption](#).

### **Explanation**

A business is partly exempt from the moment it first incurs input tax which relates wholly or partly to exempt supplies. When a business is involved in property development, exempt input tax may be incurred long before the corresponding exempt supply is finally made.

If a business is using the Flat Rate Scheme for small businesses, no separate partial exemption calculation is required. All exempt income must, however, be included in the turnover to which the appropriate scheme percentage is applied.

For further information see [Flat Rate Scheme for VAT](#).

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2. Has the VAT liability of existing and intended supplies been correctly identified?

### **Risk**

Accurate partial exemption calculations depend on the correct VAT liability of existing or intended supplies being identified. If a liability is incorrectly determined or recorded, the direct attribution of input tax (see [Q4](#)) and/or the apportionment of residual input tax (see [Q7](#)) may be incorrect.

### **Mitigation**

Review existing and intended business activities and consider whether the correct VAT liability has been determined. Confirm that the recording of zero-rated, exempt and outside the scope income is accurate and consistent.

## Explanation

Exempt supplies are listed in Schedule 9 to the VAT Act 1994:

- Land - **V1-8: Land and property**
- Insurance - **VAT Insurance Manual**
- Postal Services - **Public Notice 700/24 Postage and delivery charges**
- Betting, gaming and lotteries - **Public Notice 701/26 Betting and gaming**
- Finance - **VAT Finance Manual**
- Education - **V1-7 Chapter 21: Education**
- Health and welfare - **VAT Health Manual** and **VAT Welfare Manual**
- Burial and cremation - **VAT Burial and cremation Manual**
- Trade unions, professional and public interest bodies - **VAT Trade unions and professional bodies Manual**
- Sport, sports competitions and physical education - **VAT Sport Manual**
- Works of art etc. **Public Notice 701/12: Disposal of antiques, works of art etc**
- Fund raising events by charities etc - **Public Notice CWL4 Fund raising events: Exemption for charities and other qualifying bodies**
- Cultural services - **VAT on Cultural Services Manual**
- Supplies of goods where input tax cannot be recovered (for example cars available for private use, assets used for business entertainment)
- Investment gold - **VAT on Gold Manual**

For further information on VAT liability see **Rates of VAT on different goods and services.**

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## 3. Have any necessary adjustments for private or non-business use and other restrictions been made before the partial exemption calculation is carried out?

### Risk

Any necessary adjustments for VAT incurred for private or non-business purposes must normally be made before a partial exemption calculation. With effect from 1 January 2011, however, a business may apply to HMRC to use a formalised special method to apportion the VAT it incurs between business and non-business use (other than private use) as well as between taxable and exempt use. For more information on special methods see [Q5](#).

Input tax restrictions relating to cars available for private use and business entertainment must also be applied before a partial exemption calculation.

### Mitigation

Review input tax records to confirm that any necessary adjustments have been made before the partial exemption calculation is carried out.

For further information see **Purchases for both business and private use: reclaiming VAT.**

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# Attribution

## 4. Has input tax been attributed correctly to taxable, exempt and residual use?

### Risk

Whenever possible input tax should be directly attributed to taxable or to exempt supplies. Input tax should, however, only be so attributed if the related expenditure is used or to be used exclusively for making such supplies. If expenditure cannot be wholly attributed to either taxable or exempt supplies, it must be classified as residual. Residual input tax must be apportioned by the partial exemption method in use and not split artificially.

### Mitigation

Consider the nature and circumstances of the business and review input tax records to ensure that input tax has been accurately and consistently attributed to its use.

### Explanation

In many cases the correct attribution of input tax is easily determined. For example, if a builder is invoiced for a single supply of three pallets of bricks which will all be used in constructing a new house for resale, the related input tax can be wholly attributed to taxable use.

However, if the builder also purchases a cement mixer which he will use on both the new housing development and also on the refurbishment of existing properties which he rents out (an exempt supply) it will have mixed use and the related input tax is consequently residual.

Residual input tax must be apportioned by the partial exemption method in use and not split artificially. For example, if the builder is invoiced for a single supply of three pallets of bricks knowing that he will use two pallets in building a house for resale (taxable) and one pallet in repairing the houses he owns and rents out (exempt), he cannot split the invoice on this basis - he must treat the input tax as residual and allow his partial exemption method to make the necessary apportionment.

Most overhead costs of a partly exempt business (such as rent, heat and light) are unlikely to be linked to an individual taxable or exempt supply and are therefore normally classified as residual. However, if an overhead cost relates to an individual set of premises or a department which makes only taxable or exempt supplies (for example a shop making only taxable retail sales or an office making only supplies of exempt insurance) the related input tax may correctly be attributed to taxable or exempt use.

Whether any individual item of expenditure can be directly attributed to taxable or exempt use is a question of fact to be decided on the particular circumstances of each case. For further guidance on how to approach attribution in cases of difficulty see [PE1250](#).

If services purchased from overseas suppliers are accounted for under the 'reverse charge' mechanism, the related input tax must be attributed to their use, not to the reverse charge declaration itself. Similarly, input tax on acquisitions of goods from suppliers in other European Union (EU) states must also be attributed to the use of the goods not to the EU acquisition itself.

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# Apportionment

## 5. Has the correct partial exemption method been used?

### Risk

A business must use the partial exemption standard method unless the use of an individual special method has been formally approved by HMRC. The standard method must be followed precisely - any amendment creates a special method which requires prior approval.

## Mitigation

Review the partial exemption calculation and ensure that the standard method has been followed, unless HMRC has approved the use of a special method.

## Explanation

In some circumstances the standard method calculation may not produce an apportionment of residual input tax that accurately reflects the relative levels of taxable and exempt use and a business may apply to HMRC to use an alternative special method. For example, a special method may be appropriate when:

- timing differences occur between incurring costs and making supplies
- large one-off supplies distort the recovery rate
- residual input tax is not used in proportion to the values of taxable and exempt supplies

A special method must result in the recovery of a proportion of residual input tax which fairly reflects the degree of its taxable use. The method should be easy for the business to operate and for HMRC to check. An application to use a special method must be accompanied by a declaration that it will produce a fair and reasonable result.

With effect from 1 January 2011 a business may apply for a special method (known as a 'combined method') which combines its business/non-business (other than private use) and partial exemption calculations. If the use of a combined method is approved, the normal de minimis limit (see [Q9](#)) does not apply and no exempt input tax is recoverable. For more information see [Revenue & Customs Brief 53/10](#).

For further guidance on special methods see [PE3000](#).

For information on how to apply for a special method see [paragraph 6.3 of Public Notice 706 Partial exemption](#).

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## 6. If a special method has been approved, has it been followed?

### Risk

If a special method has been approved, it must be followed until the use of an alternative method is approved by HMRC. If a business wishes to change its special method, a further application for a new special method must be submitted. If a business operating an approved special method wishes to revert to the standard method, it must also seek prior approval from HMRC.

### Mitigation

Confirm that if the use of a special method has been approved it has been followed unless a change of method has been approved by HMRC or a special method override notice (SMON) has been served.

### Explanation

If an approved special method ceases to produce a fair and reasonable recovery of input tax, either HMRC or the business itself can serve a SMON (which requires residual input tax to be apportioned on the basis of 'use') to correct the position until a permanent replacement method is approved.

For further guidance on special methods see [PE3000](#).

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## 7. If residual input tax has been identified, has it been apportioned correctly to taxable and exempt use?

### Risk

Once residual input tax has been quantified it must then be apportioned to determine the element which relates to taxable supplies and can therefore be claimed. The basis for this apportionment is specified by the standard method and for most businesses should be rounded up to a whole percentage.

### Mitigation

Review the apportionment of residual input tax to ensure that it has been performed correctly. If appropriate, confirm that the apportionment has been expressed as a percentage and has been correctly rounded.

### Explanation

For provisional quarterly or monthly calculations the final residual input tax recovery rate determined under the previous year's annual adjustment (see [Q10](#)) must be used unless a business chooses to carry out a separate calculation for each VAT Return period.

If a separate apportionment calculation is carried out, the standard method specifies how it should be performed and which supplies must be included - see [Q8](#).

The recoverable proportion of residual input tax established by the calculation is expressed as a percentage and is generally rounded up to the next whole number. However, if the business's average **monthly** residual input tax exceeds £400,000, the percentage is rounded to two decimal places.

In some circumstances, such as when the business has only recently registered for VAT or has become partly exempt for the first time, the apportionment of residual input tax can be made on the basis of 'use'. For example, this may be appropriate if a newly registered business makes few or unrepresentative supplies during its first partial exemption year.

The input tax relating to:

- supplies of financial instruments such as shares and bonds falling within items 1 and 6 of Group 5 of Schedule 9 to the VAT Act 1994
- supplies made from establishments outside the UK

must always be ring-fenced and apportioned on the basis of 'use' outside the standard method calculation.

For further guidance on the standard method see [PE1350](#).

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## 8. Have the correct supplies been included in the apportionment calculation?

### Risk

The standard method apportions residual input tax on the basis of the ratio of taxable supplies to total supplies. It also specifies that the value of certain supplies should always be excluded from this calculation. If the calculation incorrectly includes supplies which should be excluded (such as the sale of capital goods or incidental financial or real estate transactions) or receipts which do not relate to supplies (such as insurance payouts or grants), the recoverable proportion may be understated or overstated and the incorrect amount of input tax claimed.

### Mitigation

If residual input tax has been apportioned on the basis of supplies, review the calculation to ensure that only the correct values have been included.

## Explanation

For the purposes of the apportionment calculation the value of **taxable supplies** includes:

- UK taxable supplies (net of VAT)
- supplies made outside the UK which would be taxable if made in the UK
- 'specified supplies' - for further guidance see **PE1150**

The value of **total supplies** additionally includes UK exempt supplies and supplies made outside the UK that do not carry the right to deduct input tax (essentially supplies that would be exempt if made in the UK other than 'specified supplies').

The standard method specifies that certain values must always be excluded from the apportionment calculation:

- supplies of capital goods that have been used in the business
- incidental real-estate and financial transactions
- supplies of financial instruments and supplies from establishments located outside the UK - see [Q7](#)
- self-supplies (including 'reverse charge' supplies on services received from overseas and European Union acquisitions of goods)
- transactions where there is no supply for VAT purposes (such as transfers of going concerns - TOGCs)

For further guidance on excluded and incidental supplies see **PE1400**.

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## 9. Does the amount of exempt input tax exceed the de minimis limit?

### Risk

The de minimis test allows a business with low levels of exempt input tax to treat itself as fully taxable and to claim all its exempt input tax. A partly exempt business is only de minimis in any period where its total exempt input tax is less than £625 per month on average and no more than 50 per cent of the total input tax for the period, or it meets the simplified de minimis tests for smaller businesses (see [explanation](#) below).

Exempt input tax is the total of input tax wholly attributable to exempt supplies plus the exempt proportion of residual input tax. A business may incorrectly conclude that it is de minimis on the basis of its directly attributable exempt input tax alone and omit to quantify and add in the exempt proportion of its residual input tax.

The de minimis limit is not an allowance. If the limit is exceeded in any period, no exempt input tax can be recovered. The test should be applied at the end of each period calculation and again to the annual adjustment calculation.

### Mitigation

Review the partial exemption calculation to confirm that the de minimis test has been correctly applied to total exempt input tax.

### Explanation

Under the new annual test a business which is de minimis at the end of one tax year (see [Q10](#)) may provisionally treat itself as de minimis during the course of the following tax year, as long as this is applied through the course of the whole year and it has reasonable grounds for not expecting to incur more than £1 million input tax in the current year. A full annual adjustment calculation is, however, required at the end of the tax year in question. If as a result of this calculation the business is not in fact de minimis, all exempt input tax must be repaid.

Simplified de minimis tests are available to businesses where either:

- total input tax incurred is no more than £625 per month on average, and the value of exempt supplies is no more than 50 per cent of the value of all supplies
- 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 per cent of the value of all supplies

For further information see [VAT Information Sheet 04/10](#).

There are no de minimis limits for VAT incurred before registration.

If a business is approved to operate a combined method to carry out its business/non-business calculation as well as its partial exemption calculation, the normal de minimis limit does not apply and no exempt input tax can be recovered.

When applying the de minimis limit a business should disregard any adjustments to input tax that result from the Capital Goods Scheme.

For further guidance on de minimis see [PE4050](#).

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## The annual adjustment

### 10. Has the annual adjustment been calculated correctly?

#### Risk

The input tax which a partly exempt business calculates and claims in each monthly or quarterly VAT period is provisional and must be finalised through a longer period calculation and adjustment. The longer period adjustment is commonly known as the 'annual adjustment' and normally covers a partial exemption tax year, although in some circumstances it may be shorter or longer.

If a newly registered or newly partly exempt business has made provisional calculations on the basis of 'use' (see [Q7](#)), the annual adjustment calculation must also be made on this basis. Otherwise the standard method annual adjustment calculation must apportion residual input tax using the value of supplies - see [Q7](#).

#### Mitigation

Confirm that an annual adjustment calculation has been carried out at the end of the partial exemption tax year and that any necessary adjustment has been declared on an appropriate VAT Return. Review the calculation to ensure that:

- the attribution of input tax has been adjusted to reflect any change in use or intended use
- the amount of residual input tax that can be claimed over the course of the longer period has been recalculated using the value of supplies for the whole period
- the de minimis test has been reapplied to see whether the business can be treated as fully taxable over the longer period

Compare the result of the annual adjustment calculation to the cumulative total of the provisional period calculations. Any difference is the annual adjustment and can be declared on either the final VAT Return of the longer period itself or on the VAT Return for the first period following it.

#### Explanation

The annual adjustment repeats the attribution and apportionment process using the values for the whole of the period in question. In doing so, it eliminates any seasonal fluctuations in the value and mix of supplies and in levels of residual input tax. For example, a business may have

been treated as de minimis in one or more individual return periods but then establish that it is not de minimis for the longer period as a whole - or vice versa.

A longer period calculation must be carried out at the end of the business's partial exemption tax year, which is a calendar year normally ending on 31 March, 30 April or 31 May depending on the business's normal VAT Return periods. If a business makes monthly returns their tax year ends on 31 March. An alternative tax year (and longer period) can be agreed with HMRC (for example to tie in with a business's financial year end).

For further guidance on the longer period see [PE4100](#).

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## 11. Has the need to apply the standard method override been considered?

### Risk

The standard method override only applies to larger businesses with annual residual input tax exceeding £50,000 (or £25,000 for group undertakings which are not members of the same VAT group). For such businesses, an override applies if the standard method does not produce a fair and reasonable apportionment of residual input tax - see explanation below. A business may fail to consider the application of the override when appropriate.

### Mitigation

The application of the standard method override normally should normally be considered alongside the longer period calculation. If total residual input tax exceeds £50,000 (or £25,000 for group undertakings which are not members of the same VAT group), consider whether the standard method provides a fair apportionment of residual input tax. If it does not, the standard method override must be applied.

### Explanation

A standard method apportionment does not produce a fair apportionment of residual input tax if the result it produces is substantially different from the amount that would be recovered if a 'use' based apportionment were applied. A difference is substantial if it exceeds the lower of

- £50,000
- £25,000 and 50 per cent of the total residual input tax incurred

For further guidance on the standard method override see [PE1450](#).

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## 12. Where there has been a change of use or intended use, has the initial attribution been adjusted to reflect this?

### Risk

If input tax is initially attributed on the basis of intended rather than actual use and that intention changes after the end of the annual adjustment period in which it is incurred but before actual use occurs, the attribution must be adjusted. Such an adjustment is known as 'clawback' if input tax must be wholly or partly repaid to HMRC and 'payback' if additional input tax may be claimed. In addition to situations where intention changes from taxable to exempt use (or vice versa), clawback and payback also apply when there is a change from a mixed use intention to an intention to make wholly taxable or wholly exempt supplies or vice versa.

For VAT incurred on or after 1 January 2011, the clawback and payback rules have been extended to cover changes in intended non-business or private use as well as changes in intended taxable and exempt use. For more information see [Revenue & Customs Brief 53/10](#).

Changes in intended use often occur in property development where projects can take several years from planning to completion and the final VAT liability may be subject to change.

## Mitigation

Consider any changes or planned changes in business activities. Identify expenditure to which clawback or payback may apply and ensure that any necessary adjustments are made using the partial exemption method and values for the longer period in which the input tax was originally incurred.

Clawback and payback adjustments must be considered for a period of six years commencing on the first day of the VAT Return period in which the input tax was incurred.

A proposed payback claim must be submitted to HMRC for approval.

If a project is wholly abortive and the related goods and services are not used to make any supply, there is no requirement to adjust the initial input tax attribution.

## Example

A property developer initially attributes the costs of constructing a new office block to taxable use on the grounds that it is his intention to make a taxable freehold sale of a new building. Two years into the project he concludes that market conditions now favour him retaining ownership of the block to rent out without exercising an option to tax. He has now changed the intended use of the input tax he has incurred to exempt supplies and a clawback adjustment is required.

House builders intending to make wholly taxable (zero rated) freehold sales of new dwellings may find themselves forced by unfavourable market conditions to make temporary short term lets of the properties in question while retaining the underlying intention to make taxable sales.

For further information on partial exemption in this scenario see [VAT Information Sheet 7/08](#) and [Revenue & Customs brief 101/09](#).

For further guidance on clawback and payback see [Partial Exemption Manual - PE4200](#).

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## 13. If credit notes have been issued or received, have any necessary partial exemption adjustments been made?

### Risk

If a sales credit note (taxable or exempt) is issued in the same VAT Return period or partial exemption longer period as the sales invoice to which it relates, the effect of the credit note will be accurately reflected. However, if the credit note is issued after the end of the longer period in which the original supply occurred, the outputs ratio used to apportion residual input tax may be distorted.

Similarly, if a purchase credit note carrying VAT is received and/or posted after the end of partial exemption longer period in which the purchase invoice to which it relates was received, it may be subject to a higher (or lower) residual recovery rate than that applying to the original purchase invoice.

### Mitigation

Review records for credit notes issued or received by the business which adjust a supply made or received in an earlier longer period. If appropriate, rework the partial exemption calculation for the period in which the underlying supply occurred, including the credit note, and adjust input tax accordingly, reviewing the application of the de minimis test if appropriate.

### Explanation

For further guidance see [PE4375](#).

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## 14. If input tax has been claimed late, have any necessary partial exemption adjustments been made?

### Risk

If a business makes a late claim for input tax, it is only recoverable to the extent that it would have been recoverable had it been claimed in the period in which it was incurred. The annual adjustment for the tax year in question may consequently need to be recalculated and the de minimis test reapplied. For example, a business which was previously below the de minimis limits for a tax year may in some circumstances exceed them when the belated input tax claim is taken into account - in such circumstances all exempt input tax for the year in question becomes irrecoverable.

### Mitigation

Review records for late input tax claims. Review the partial exemption calculation for the period in which the entitlement to input tax arose and ensure that input tax is adjusted accordingly. If the business was originally found to be de minimis for the longer period in question, confirm that this still applies.

### Explanation

For further guidance see [PE4425](#).

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## 15. Have bad debt relief adjustments been correctly treated?

### Risk

If a partly exempt business claims bad debt relief in respect of unpaid sales, it should not reduce the value of turnover used to apportion residual input tax. The non-payment of the invoices in question does not alter the use to which the related expenditure was put.

If a partly exempt business is required to repay input tax claimed on expenditure which remains unpaid after six months, the amount to be added back should reflect the proportion originally claimed. For example, if an unpaid item of expenditure was attributed to exempt use and no input tax was claimed, there is no requirement to add back any input tax.

### Mitigation

Review VAT Return calculations for bad debt relief adjustments and ensure that they have been treated correctly.

For further guidance see [PE4500](#).

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## Capital Goods Scheme

## 16. Has the need for Capital Goods Scheme adjustments been considered?

### Risk

Certain land and computer assets are subject to the Capital Goods Scheme (CGS) and the extent of taxable use must be monitored over a specified period. With effect from 1 January 2011 the CGS has been extended to apply to purchases of aircraft, ships, boats and other vessels over a specified value. For items subject to the CGS where the input tax is incurred on or after 1 January 2011, a CGS adjustment is also required to reflect any change in the level of non-business or private use.

A business which owns a CGS item and is partly exempt, or becomes partly exempt during the specified period, may omit to make the necessary adjustments to reflect any increase or

decrease in the extent of taxable business use of the asset in question. A CGS adjustment may also be required if a CGS item is sold or partly sold during the specified period - see [Q18](#).

### **Mitigation**

Identify assets which are subject to CGS adjustments. Ensure that the need for a CGS adjustment is reviewed annually at the correct time - any necessary CGS adjustment must be declared on the return for the second VAT period after the end of the annual adjustment period to which it relates. For example, if a business on quarterly VAT Returns has an annual adjustment period ending 31 March, any necessary CGS adjustments are due on the return for the period ending 30 September.

### **Explanation**

Assets subject to the CGS are referred to as 'capital items'. Only items used in the business are subject to the CGS - items for resale are excluded.

The CGS applies to capital expenditure on land and buildings with a value of £250,000 or more (exclusive of VAT) which was subject to VAT at the standard or reduced rate. The purchases in question are:

- an interest supplied to an owner in land, a building or part of a building or a civil engineering work
- expenditure incurred in the construction of a building, part of a building or a civil engineering work
- alterations, extensions and annexes to buildings which increase the existing floor space by 10 per cent or more (for input tax incurred on or after 1 January 2011 the CGS definitions relating to such expenditure have been simplified to remove the floor space element of the applicable definitions)
- for input tax incurred on or after 1 January 2011, the CGS has been extended to include alterations, extensions and annexes to civil engineering works
- capital expenditure on services and goods affixed to the building in the course of refurbishing or fitting out a building (for input tax incurred on or after 1 January 2011 it no longer matters whether goods are affixed to a structure or not, only whether the expenditure has been capitalised)
- for input tax incurred on or after 1 January 2011 the CGS has been extended to include refurbishments of civil engineering works
- an interest supplied to the owner, or expenditure incurred, in constructing a civil engineering work

The CGS also applies to any computer with a VAT exclusive value of £50,000 or more. 'Computer' means a single item of equipment rather than a complete network. Computer software and computerised equipment are not included.

With effect from 1 January 2011 the CGS has been extended to apply to capital expenditure on aircraft, ships, boats and other vessels with a VAT exclusive value of £50,000 or more. As well as VAT incurred in respect of the purchase of such assets, the scheme also includes VAT incurred in the course of their manufacture, refurbishment, fitting out or alteration.

From 1 January 2011 the value threshold for determining whether an asset is subject to the CGS is the total expenditure on the asset in question, not the business related expenditure alone.

If an asset purchased on or after 1 January 2011 is wholly or partly excluded from the business's assets and treated wholly or partly as a private asset with no related VAT being claimed (sometimes referred to as 'the Armbrrecht option'), only the value of the business element of the asset is taken into consideration in deciding whether a CGS item exists. For such

assets which are subject to the CGS, there is no subsequent input tax adjustment required in respect of the element of the asset kept outside the business.

A business does not have to be partly exempt or (for items purchased after 1 January 2011) have non-business activities when it purchases an item for the CGS to apply. For example, a company may use a building purchased for £300,000 plus VAT for wholly taxable purposes for six years. In year seven it diversifies into an exempt activity - for example insurance - and bases its new insurance team in this building. The building remains subject to the CGS and CGS adjustments may now be required.

For further information see sections 3 and 4 of **Public Notice 706/2 Capital Goods Scheme**.

For more information on the changes to the CGS from 1 January 2011 see **Revenue & Customs Brief 53/10**.

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## 17. Have Capital Goods Scheme adjustments been calculated correctly?

### Risk

While a business may recognise that it owns assets subject to the Capital Goods Scheme (CGS), it may carry out the necessary calculation incorrectly. Calculation errors can include:

- wrongly identifying the baseline recovery rate for the asset in question
- applying the wrong adjustment period to the asset in question
- wrongly calculating the adjustment percentage to apply for the period in question

For further information on the CGS calculation and a worked example see sections 5 and 6 of **Public Notice 706/2 Capital Goods Scheme**.

### Mitigation

Review CGS calculations to ensure they have been correctly performed.

### Explanation

The period over which a person is required to review the extent of taxable use (and/or non-business use for input tax incurred on or after 1 January 2011) of an item under the CGS is called the adjustment period. The adjustment period is split into a number of intervals - these are normally years and aligned with the business's partial exemption tax years. The adjustment period for land, buildings and civil engineering works is normally ten intervals. For an interest in land, buildings and civil engineering works which has less than ten years to run, and for computers, aircraft, ships, boats and other vessels, the adjustment period is normally five intervals.

With effect from 1 January 2011, if a business's interest in an asset is more than one year less than the normal CGS adjustment period (for example a business acquiring a seven year interest in a building falling within the CGS) the CGS adjustment period for that asset is reduced to the number of complete years of the interest held plus one (in the example given the period of adjustment for the building in question will be eight intervals). This change applies to CGS items for which the first period of adjustment has not commenced prior to 1 January 2011. For further information see **Revenue & Customs Brief 53/10**.

The initial level of input tax to be recovered in respect of the CGS item (the 'baseline') is determined by the business/non-business calculation (for assets purchased after 1 January 2011) and the partial exemption annual adjustment calculation for the period in which the item is first used. There is no separate CGS calculation at this time.

If input tax is incurred on a CGS item before the first interval (for example during the early stages of a construction project) see paragraph 6.2 of **Public Notice 706/2: Capital Goods Scheme**.

In each of the subsequent intervals (between two and nine depending on the individual item and when it was acquired) the extent of taxable use (and/or non-business use if the item was purchased after 1 January 2011) determined under the longer period partial exemption calculation (and/or business/non-business calculation if applicable) is compared with the initial level of input tax claimed. The difference is called the 'adjustment percentage'. The actual input tax adjustment (if any) required in a subsequent interval is calculated as:

$$\frac{\text{original input tax incurred}}{\text{number of intervals applying to the item}} \times \text{adjustment percentage}$$

In any subsequent interval where the longer period calculation finds the business to be de minimis any exempt business use in that period is generally ignored for CGS purposes. If, however, the Standard Method Override (see [Q11](#)) would have been triggered had all the input tax on the item been incurred in the year in question and treated as de minimis, this is not the case.

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## 18. If a Capital Goods Scheme item has been sold or otherwise disposed of within its adjustment period, have any necessary adjustments been made?

### Risk

If a business sells or otherwise disposes of a capital item or part of the item before the end of its full adjustment period, the Capital Goods Scheme (CGS) adjustment for the interval in which it sells the item is the final adjustment. The final adjustment must also include a further adjustment to take account of any remaining unused intervals. If the sale of the item is a taxable supply, its use in all the remaining intervals is treated as 100 per cent taxable. If the sale is exempt, its use in all remaining intervals is treated as being 100 per cent exempt.

### Mitigation

Establish whether a CGS item has been sold during the longer period under review. If so, confirm that the necessary CGS adjustment for unused intervals is correctly calculated and declared.

### Example

A partly exempt company purchases an office block for £1 million plus VAT of £200,000. It does not opt to tax the building. The block is used for both taxable and exempt purposes. In its first longer period its residual input tax recovery rate is 50 per cent and the amount of VAT recovered on the building is therefore £100,000. In each of the subsequent four intervals (in practice, years) the residual input tax recovery rate remains constant at 50 per cent and no CGS adjustment is required. Shortly before the end of the last of these intervals (the fifth year of use) the block is sold. In the absence of an option to tax the sale is exempt. In addition to the CGS adjustment required for the fifth period itself (in this case nil because the level of taxable use has remained consistent at 50 per cent) a further CGS adjustment is also required in respect of the five remaining unused intervals. As the sale is exempt the extent of taxable use for these intervals is 0 per cent. The adjustment percentage is therefore 50 per cent, being the difference between the initial recovery rate (50 per cent) and the extent of taxable use for the remaining periods (0 per cent). The amount of input tax which must be repaid to HMRC as a CGS adjustment is therefore:

$$\frac{\pounds 200,000}{10} \times 5 \times 50\% = \pounds 50,000$$

### Explanation

If a CGS item is wholly or partly stolen, lost or destroyed before the end of its adjustment period the final CGS adjustment for the part lost is the one for the period in which this event occurs. No further adjustment is required in respect of remaining unused intervals.

For further information on the disposal of a CGS item see section 8 of **Public Notice 706/2 Capital Goods Scheme**.

For further information on CGS items forming part of a transfer of a going concern (TOGC) see section 9 of **Public Notice 706/2 Capital Goods Scheme**.

For further information on CGS items on hand at deregistration before the adjustment period ends see section 8.6 of **Public Notice 706/2 Capital Goods Scheme**.

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