

HMRC ABI

**Partial Exemption Guidance
for the Insurance Sector**

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1. Introduction

1.1 This guidance has been written and compiled jointly by the Association of British Insurers (ABI) and HM Revenue and Customs (HMRC). The guidance is relevant to those dealing with partial exemption for insurers, including business and HMRC when discussing how partial exemption applies in practice for an insurer. The guidance is intended to help insurers gain approval for a fair and reasonable partial exemption special method (PESM) with the minimum of cost and delay. The guidance is neither mandatory nor binding and HMRC will consider whether to approve any PESM that an insurer declares as being fair and reasonable. HMRC cannot approve a PESM unless accompanied by a declaration. Further information on what is meant by fair and reasonable is provided in Annex A.

1.2 This guidance will be updated regularly by ABI and HMRC jointly to reflect new issues arising and to help ensure consistency of treatment across the insurance industry.

1.3 This guidance covers;

- Insurance definitions and activities
- Attribution of Input Tax to Taxable Supplies and Exempt Supplies
- Sectors
- Allocation of Residual Input Tax to Sectors of Business
- Pro Rata calculations
- Run-off
- Annex 1 - The basic Principles of Partial Exemption
- Annex 2 - Why a Partial Exemption Special Method is usually suitable for an Insurance business.
- Annex 3 - Partial Exemption Special Method Templates for the Insurance sector

2. Insurance definitions and activities.

2.1 Basic definitions

2.1.1 Insurance:

The following are extracts from the FSA's Perimeter Guidance Manual (PERG) 6 Guidance on the Identification of Contracts of Insurance

PERG 6.3.3 01/07/2005

The courts have not fully defined the common law meaning of 'insurance' and 'insurance business', since they have, on the whole, confined their decisions to the facts before them. They have, however, given useful guidance in the form of descriptions of contracts of insurance.

PERG 6.3.4 01/07/2005

The best established of these descriptions appears in the case of Prudential v. Commissioners of Inland Revenue [1904] 2 KB 658. This case, read with a number of later cases, treats as insurance any enforceable contract under which a 'provider' undertakes:

- (1) in consideration of one or more payments;*
- (2) to pay money or provide a corresponding benefit (including in some cases services to be paid for by the provider) to a 'recipient';*
- (3) in response to a defined event the occurrence of which is uncertain (either as to when it will occur or as to whether it will occur at all) and adverse to the interests of the recipient.*

For the purposes of VAT "corresponding benefit" includes goods as well as services.

2.1.2 Premium

Consideration paid for a contract of insurance.

Gross Premium income is

- 1) The amount of the premium payable to the insurer or reinsurer for the supply of insurance,
- 2) The total sums payable represents the value of outputs for VAT purposes. These are not reduced by;
 - (a) brokerage or commission retained by the broker or agent for placing the business with insurer or reinsurer;
 - (b) Claim payments;
 - (c) Taxes (but see para 6.4 below);
 - (d) Reinsurance payments to reinsurance.

The gross premium can be reduced by discounts or refunds provided for in the contract.

For reinsurance only, the gross premium must be reduced by;

- a) Reinsurance commission (known as treaty, ceding or overriding commission) which is agreed between the reinsurer and reinsured to cover the cost of obtaining the original business and is, therefore, regarded as a discount.
- b) Profit commissions, which is a contingent discount reducing the amount the reinsured pays for reinsurance.

2.1.3 Brokers

These are insurance intermediaries who advise their clients (the insured) and arrange their insurance. They are expected to find the best policy at the best price. Although the broker acts as the agent of his client, he is typically remunerated by a commission or set fee from the insurer. However, it is possible that as a consequence of the Retail Distribution Review ("RDR") fees received from the insured will become common in the Life insurance business.

2.1.4 Insurer

2.4 Person permitted (by Law) to carry on insurance business in the UK under the FSMA 2000. The Act is presently administered by the Insurance Division of the Financial Services Authority (FSA), however this administration is under review.

2.2 Insurance activities

This section describes the business units and activities of a typical large insurer. This information is helpful when determining the sectors that might be needed in a fair and reasonable PESM.

All insurers are different, their business units will differ, the scale and type of their activities will differ, their costs and charging arrangements will differ, and so will their plans for the future. The insurance market is dynamic and competitive and as a result many insurers have diversified in their activities and the insurance products they provide continue to evolve. Some insurers have been subject to mergers and acquisitions further widening their range of activities. A good understanding of the insurer's business is a prerequisite to formulating a fair and reasonable PESM.

2.2.1 General Insurance

General insurance includes any insurance which is not life assurance. Many insurers ring fence certain specific types of general insurance separately from their wider "general insurance" business, e.g. Marine, Aviation and Transport (MAT) insurance. General Insurance is also typically subdivided between retail insurance, aimed at consumers, and commercial, or corporate, insurance, aimed at businesses and other institutions and will often be subdivided by the different types of distribution channel and product.

For consumers, general insurance companies principally provide:

- Property and home insurance to protect buildings and their contents, separately or together.
- Motor insurance, compulsory if you want to drive a vehicle in the UK.
- Travel insurance, protecting belongings and paying compensation if travel arrangements are disrupted.
- Payment protection insurance, for example, repaying your loan if you are ill or become unemployed.
- Pet insurance.
- Medical insurance (although this can sometimes be linked with the life and pensions business).

For commercial customers, Insurers principally provide the following types of insurance:

- Public, employers' and product liability insurance, which pays compensation when someone or something has been held legally liable for an adverse event such as an industrial injury.
- Professional indemnity insurance, to protect against claims of negligence in business, for example doctors, lawyers or other professionals.
- Business interruption insurance, to enable commercial enterprises to protect their income at times when they are unable to trade.
- Commercial property insurance - buildings and contents insurance for business and industrial premises.
- Commercial vehicles insurance - motor insurance for fleets of vehicles.

2.2.2 Life and Pensions

This concerns insurance products where the risk is linked to the life of an individual and also provides services of administering pensions. It is often referred to as "long term" business.

Principle types of product include:

- Life assurance policies [life cover] - these provide a lump sum of money, or a monthly income in the event of death before an agreed date.
- Income protection policies - these can be taken out to ensure an income is maintained in the event of a loss of income due to long term illness, injury or disability.
- Investment products – these are products where the premium is invested in some form of collective investment product or fund. Therefore, as well as a payout in the event of death, the customer will get an investment return depending on the performance of the product or fund. .
- Pensions, providing the services of administering pensions, normally either for an individual, or for a commercial institution on behalf of its employees.

- Annuities – this provides a stream of income to the customer, normally until death, in exchange for a lump sum. Most commonly the lump sum is the result of the funds administered as part of a pension scheme, thus generating an income stream commonly referred to as “a pension”.

2.2.3 Reinsurance

Frequently, the scale of risks underwritten is too great for one insurer to carry safely. In these circumstances, companies use reinsurance to mitigate their own risk exposure. Accordingly the reinsurance business deals with insuring the risks underwritten by the ‘primary’ insurers. Specialist reinsurance companies take on part of the risk that the primary insurers assume from their personal or commercial clients. Reinsurers can do this by sharing the losses among several carriers in the event of a claim. For this service, the reinsurer is paid a share of the insurance premium in accordance with its level of participation in the risks.

2.2.4 Block Insurance

The term ‘block policy’ was used by the ECJ to define the policy held by Card Protection Plan Ltd (CPP) (case- C-349/96). The term can be used within the insurance industry to mean other types of policy. Similarly, terms (such as ‘master policy’) can be used to describe the type of policy held by CPP. It is important therefore to be clear what is meant by the term ‘block policy’ when used with reference to the ECJ decision in CPP and its wider implications for the insurance exemption in this area.

The key characteristics of a block policy are that:

- there is a contract between the block policyholder and the insurer which allows the block policyholder to effect insurance cover subject to certain conditions;
- the block policyholder, acting in their own name, procures insurance cover for third parties from the insurer;
- there is a contractual relationship between the block policyholder and third parties under which the insurance is procured; and
- the block policyholder stands in place of the insurer in effecting the supply of insurance to the third parties.

This type of policy is commonly used within the industry. It is often taken out by a supplier of goods or services to cover a number of small transactions over a set period.

The decision of the ECJ in CPP also has implications for supplies made by holders of block insurance policies. CPP were holders of a block insurance policy and, as such, were given authority by the insurer to arrange for their customers to become insured under the policy. The ECJ found that CPP were making supplies of insurance transactions to their customers even though they were not themselves insurers.

Following the ECJ decision, HMRC regard supplies made by block policyholders as being insurance transactions for the purposes of the VAT exemption.

This means that block policyholders are acting as principals when they are effecting insurance transactions rather than as intermediaries arranging supplies of insurance

2.2.5 Warranties and Guaranties

- **Guarantee or warranty arrangement** - the purchase price of the goods includes an amount in consideration of which the manufacturer or retailer undertakes to replace or repair defective goods within a specified period; and
- **Extended warranty arrangement** - the provider enters into a distinct contract under which they undertake, for a consideration, to be subject to the same (and possibly some additional) obligations as covered in the original warranty. If it is sold as a separate product; for a separate consideration; and under terms consistent with insurance, it will constitute an exempt supply of insurance even though it is agreed in the context of a sale.

For more information on warranties and guaranties see [Public Notice 701/36](#) paragraph 3.7

2.2.6 Run-off

This is business that has been closed to new business but still settling claims. See section 6.1

2.2.7 International written insurance

Insurers may treat General and Life insurance business provided to overseas customers as distinct business streams to keep them separate from domestic business.

2.2.8 Investments in securities

Insurers may invest in securities to meet solvency requirements in respect of future liabilities. Such investments will include liquid (cash or near-cash) and illiquid holdings in securities. The most common illiquid investment used for longer term investment is land and property. The majority of insurers' portfolios will be in low risk items, however, they may also invest smaller sums on ring fenced developing areas.

2.2.9 Investment management

Whilst some insurers buy in investment management services from third party providers, many have business units (including separate companies) within the group structure that provide these services. Often these will also provide similar services to third parties as well. It is common for different types of investments to be handled by different teams.

More information regarding types of insurance policy used for investment can be found within HMRC's Insurance Policyholder Taxation Manual [IMPTM1400](#)

2.2.10 Engineering inspections

These inspections are carried out on high value pieces of equipment (aircraft, industrial machinery, lifts etc) to ensure they meet health and safety requirements which may be a prerequisite for any insurance. Some insurers provide this service externally to their clients. Other inspections may be carried out to assess the value for internal risk assessment purposes before committing to providing insurance cover, or to meet health and safety requirements.

2.2.11 Support and Head Office functions

Regulated insurance companies can only provide insurance and closely related activities. That is why the insurance group will often have separate support and service functions. These will carry out the day to day running of the group. Examples of these functions will be pension administration, HR, IT and infrastructure and legal services (at business level). These will likely incur the majority of costs for the group.

The Head Office is concerned with the setting of strategy for the group and driving the business forward. Examples of Head Office activities may include strategy, Tax & Finance, Risk & compliance, Legal services (for the group as a whole) Marketing (the whole group brand.)

2.2.12 Branches and Subsidiaries

Like most multi nationals, large insurers may organise themselves into branches and subsidiaries across the territories they operate in.

A branch is part of the same legal entity/company. A subsidiary is a different legal entity/company that is controlled by its parent.

2.2.13 Types of insurance companies

Insurance companies can be broken down into 3 types: -

- Life - those companies authorized to write long-term business.
- General - those companies authorized to write short-term business.
- Composite - those companies authorised for both long term and general business. This type of company was prohibited further to the Insurance Companies Act 1982. The risk being that funds accumulated from long-term business would be used to pay general claims. Existing composites were allowed to continue trading after 1982 and since 1 July 1995 composites have been allowed in a limited format (health). Some large groups of companies are referred to as Composites because they have Life and General insurance companies in the group

2.2.14 Captives - These are insurance companies set up to insure all or part of the risks of their parent company.

2.2.15 Loss adjuster - Provides the specialist service of investigating and valuing a claim. The adjuster acts for the insurer.

2.2.17 Loss assessor - Provides the same service as the adjuster but acts for the insured.

2.3 The Corporation of Lloyd's

Lloyd's is not an insurance company. It is a society of members, both corporate and individual, who underwrite insurance in syndicates. It is a market where policyholders are insured "at Lloyd's" by members of Lloyd's and not by Lloyd's itself. However, the market has a common brand and identity.

Members, whether individuals or corporate, group together to form syndicates in order to accept insurance risk.

Risks at Lloyd's are placed through brokers who shop around for insurance on behalf of their clients, and the types of insurance that can be purchased have widened out from just marine insurance to virtually all types of general insurance and reinsurance and some life insurance.

Each syndicate has a "Managing Agent", who is appointed to manage its affairs. Employees of the Managing Agent carry out the underwriting and other functions in relation to the insurance risks.

Individual members and most smaller corporate members, including Scottish Limited Partnerships (SLPs), have to appoint a "Members' Agent".

The Corporation of Lloyd's carries out the functions of advancing and protecting the interests of Lloyd's members in connection with their Lloyd's business.

Further guidance regarding Lloyds can be found in HMRC Insurance guidance [VATINS4000](#)

There are specific administrative arrangements for operating VAT within the Lloyd's market which include rules for PE. These can be found within HMRC Partial Exemption guidance [PE5700](#). It was drawn up following an extensive review of the previous Lloyd's VAT Arrangements, which dated back to 1985 and a period of review and consultation with the Lloyd's market

2.4 An insurance group may also have additional activities, including;

2.4.1 Consulting

An example is the provision of advice and risk identification / mitigation strategies in order for a client to reduce their insurance costs.

2.4.2 Claims Handling

Claims professionals work on behalf of insurance policyholders and the insurance companies, investigating claims, determining their extent and validity, and negotiating the claim on behalf of the insured. This service may also be provided to third parties outside of the Insurer's VAT group.

2.4.3 Loss adjusting

A service company may operate independently of insurance companies, its function being to mitigate loss and get businesses back up and running with the minimum amount of disruption. Such activities may also include looking into the circumstances surrounding a claim - establishing the cause of a fire, for example - before negotiating a fair sum to replace the loss or repair the damage

2.5 Specified supplies

SI 1999/3121, the Specified Supplies Order, allows for recovery of input tax on financial, insurance and insurance related services when

- the recipient of the supply of finance, insurance or related services belongs outside of the EC; or

- related services are supplied in connection with a contract under which the insured party belongs outside the EC (even if the insured party is not the recipient of the supply of related services); or
- the insurance being supplied is directly linked to the export of goods to a place outside the EC; or
- related services are supplied in connection with insurance directly linked to the export of goods outside the EC.

Supplies that meet the above conditions are usually referred to as “specified supplies.”

3. Attribution of Input Tax

3.1 In the insurance sector, relatively few costs are either used wholly to make exempt supplies, or used wholly to make taxable supplies. The main exceptions where direct attribution is possible is for example where cost are incurred on property and some specific projects of one VAT liability. Claims-related costs are also regarded as directly attributable to the related supply of insurance (see 3.4 below).

3.2 As set out, regulations require direct attribution to be carried out before cost allocation to sectors. However, direct attribution at this stage can cause difficulties where tax departments are unaware of how particular costs are used and have a large number of such costs to review.

3.3 It has been agreed by HMRC and the ABI that whilst direct attribution must still take place, it need not always be the first step, and could, for some costs, follow the allocation stage. In other words, methods could refer to direct attribution both pre and post allocation, so that costs are dealt with as most appropriate. The underlying principle is that the method must be both fair and reasonable.

3.4 Deutsche Rück - concerned a contract of reinsurance. The taxpayer received a supply of legal services in order to quantify a claim made under that contract. The High Court decided that the expense concerned was a cost component of the reinsurance service. When applying the Deutsche Rück principles to the supply of insurance, HMRC consider the expenses incurred settling a contract of insurance to be a cost component of the supply even though they are incurred long after the premium has been paid.

4. Sectors

4.1 Sectors are used within partial exemption to sub-divide a special method calculation into different business areas. Rather than having a single calculation, a sectorised method enables each different parts of a business to adopt a separate calculation appropriate to its circumstances. These individual calculations are then combined to determine the recoverable VAT for the business as a whole. The use of sectors improves accuracy and lessens the risk of distortion. However, adding sectors increases complexity and compliance cost. Furthermore, unless sectors are chosen objectively they risk undermining fairness and certainty.

4.2 HMRC encourages the use of sectors in large partly exempt businesses to lessen the risk of unfair VAT recovery (either too much or too little). Sectors are particularly important for diverse businesses, such as large insurers that undertake a range of activities for which different sets of costs are incurred. HMRC consider that such businesses should benefit from sectorising their special methods based on the operational sub-divisions within their organisation (such as business units for which separate accounts are prepared), and then allocating costs between these sectors in line with their internal cost accounting procedures.

4.3 Sectors should arise naturally out of the way a business is organised and should not be an artificial creation just for the purposes of PE. As stated above, sectors ideally should be aligned to the business divisions. If separate records have to be created in order to operate a sector, it suggests that the sector is not a 'natural' one, but is being created solely for PE. Sectors should ideally follow the existing commercial divisions in the business. In many cases this is likely to mean sectors based on either individual companies or collective groups of companies with similar activities, although a business (and thus its natural sectors) can also be organised along the lines of:

- Specific function
- Geographic area
- Product
- Project

These are just illustrative examples. Regulatory requirements might create another natural division, particularly for insurance businesses.

4.4 In a few situations, where HMRC feel that a distortion could result, HMRC will use the provisions set out in articles 173 2 (b) and (c) of the EC VAT directive which allow for the creation of separate sectors for distortive transactions, such as sales of securities, or supplies from overseas branches.

4.5 It is good practice to include a sector to deal with input tax that is not dealt with elsewhere in the method. This catch-all sector may also be used to deal with a new business organisation or activity that has yet to be addressed in the method. It is good practice to include a use-based sector to include major projects such as corporate re-branding, major relocation of business, mergers and acquisitions that need to be notified to the Stock Exchange (restructuring or acquisition or disposal costs of businesses) and anything outside the usual run of business. The use basis also enables the insurer to contact HMRC to discuss and agree a suitable basis for apportionment, as and when the need arises.

4.6 It is good practice to define a sector in terms of the activity it covers, rather than the legal entity which carries it out. Another area where PESMs and the business organisations may not be fully aligned is the names given to PESH sectors. A PESH is usually in place for a number of years, and as highlighted above, the business may reorganise, merge etc. Although convenient for the business, the business name may change over time, or activities within it may change or be discontinued. Therefore HMRC consider it best practice to identify sectors by their activities.

4.7 The most common sectors within insurance businesses can include;

- General insurance (retail / commercial / Lloyd's)
(This may also include Claims handling and policy administration as part of insurance underwriting)
- Life and Pensions and other long term insurance

- Reinsurance
- Run-off
- Writing international insurance business
- Investments in securities
- Investment property (own property portfolio)
- Investment management
- Consulting
- Fund management (may be carried out internally or out-sourced)
- Investment products (OEICs, AUTs etc)
- Brokerage
- Engineering inspections
- Head office, typically including:
 - Marketing (brand)
 - Legal services
 - Strategy
 - Risk & compliance
 - Tax & Finance
 - Treasury
- Support
 - Pension Administration
 - HR
 - IT and Infrastructure
 - Legal services (at business level)

4.8 For a small insurance company, a basic split would be:

- (a) Between underwriting premiums and commission income.
- (b) The premium business sub-divided into three: general insurance, life/other long-term business and reinsurance.
- (c) General insurance premium business subdivided into three: commercial business, retail business and Lloyd's business.
- (d) Investment business sub-divided between property and securities, with each of these sub-divided between insurance company's own investments and investments made for clients.

5. Allocation of Residual Input Tax to Sectors of Business

5.1 Partial exemption seeks to identify VAT on costs that are 'used or intended to be used' for making taxable supplies (and supplies that give a right of VAT recovery). 'Use' means 'economic use', which is the business' rationale for incurring a cost. A business may decide to allocate costs by reliance on its 'internal cost accounting systems', which are systems designed by the business to provide it with reliable information on its cost base. A business is encouraged to rely on its internal cost accounting systems for partial exemption purposes because this is likely to represent the business' best view on the economic use of its costs.

5.2 The benefits of using a cost accounting methodology can be;

- The business does not have to use a separate allocation system for its PE method;
- The allocation methodology will tend to follow the changing circumstances of the business without the need to amend the method;
- The cost allocation system will be underpinned by accounting principles, and audited, possibly independently; and,
- The business has other motivations aside from VAT to ensure that the allocation method reflects the use of costs.

5.3 It is not HMRC's intention to bind the business to a PESM that uses its cost accounting method where the result proves to be distortive or too complex. There has to be a degree of trade-off between accuracy and practicality, but HMRC would generally expect departures from the internal business model of apportioning costs to be for good reasons. HMRC believes that the internal business organisation and cost accounting methodology usually provide a strong foundation from which to build a special method. However the overriding principle must be simplicity and that any methodology should be fair and reasonable.

5.4 A typical special method that links to a cost accounting methodology usually involves three steps; the principle, the detail and the appropriateness; for example:

- Principle. Input tax is to be allocated between sectors on the basis of the management cost accounting system.
- Detail. Input tax on costs relating to two or more business units is to be allocated between them in proportions determined by the management cost accounting system.
- Appropriateness. The cost accounting methodology shall be determined by internal management and cost accountants in accordance with generally accepted accounting principles, and it should ideally be judged on the extent it is used and relied upon for purposes other than just PE and tax, and how effectively it is managed.

5.5 There are however many different types of cost allocation and there are no widely recognised set of standards. To summarise, they can be based on;

- Budget basis
- Re-charging basis
- Pre-agreed sharing basis
- Year-end agreed sharing basis
- Overall corporate recovery
- Headcount

5.6 In identifying a suitable allocation methodology, it is important to consider whether sectors are cost centres, profit centres or a combination of both. It is also important to understand the basis, and the extent to which, central costs (such as head office, IT and infrastructure costs) are reallocated to profit centres as these costs may represent significant expenditure which needs to be allocated to the income-earning sectors within the PE method. Head office departments may also make some supplies, e.g. within treasury, IT, catering, or from within the insurance company's own property portfolio.

5.7 A cost allocation method based on marginal costs (which might be more relevant for decision making purposes) should be treated with caution. This is because PE is concerned with full cost allocation; both variable and fixed costs. Marginal costing can result in unfair recovery within the PE method and is a relatively common source of dispute when businesses introduce new (typically exempt) activities the marginal cost of which is minimal.

5.8 There may be instances where a allocation methodology is insufficient or unsuitable to form the basis for a PE method as it stands. In these instances, the insurer will need to suitably adapt the methodology for PE.

The most common methodologies are those based on headcount or floor space

5.9 Headcount allocation

Headcount is often used as the underlining bases for cost accounting methodology. However, headcount can also be used independently of a cost accounting methodology as a proxy for use based allocation. To ensure a consistent approach is taken when addressing full and part-time working many organisations will apply FT methodology. Also the definition needs to clearly state which staff are to be included and which staff are to be excluded. Income generating staff should be included. This should include front office, middle office and back office who are closely connected with generating the income.

The key issue is to ensure that there is a degree of parity between the staff included within the calculation. This may have to be achieved by the use of weighting. In addition, the system used within the calculation must be robust and verifiable.

5.10 Floor space allocation

This is usually appropriate where costs are related predominately to one building with business sectors occupying specific floor areas with communal areas being excluded.

6. Pro Rata calculations

6.1 Generally, output values is normally the starting point for a PESM, however if output values is unsuitable other calculations will need to be considered. Common pro-rata methods are;

- **General insurance (retail / commercial)**
- Output values (usually based on premiums)
- **Life and long term insurance**
- Output values or volumes by location of insured(Excludes income arising on assets and sale proceeds of assets)

- **Run-off**

This will normally be a set rate based on the last three full underwriting years. Normally the PESM will state how the fixed rate is calculated

- **Writing international insurance business**
- Output values or volumes by location of insured (usually premiums)

- **Investments in securities**

Transactions (number or value)

- **Investment property**

Output values (usually based on property rental income from opted and non opted properties excluding value of capital sale of properties)

- **Investment management**

Output values (usually fees)

- **Consulting**

Output values

- **Fund management**

Output values (fees & commissions)

- **Brokerage**

Output values

- **Engineering inspections**

Internal/output fee values

- **Head office costs**

Reallocation to income generating areas of business. Failing that aggregate output value of the whole group. Due to the complexity of agreeing a suitable calculation for this sector, some insurers have a use based apportionment for this sector.

- **Inputs-Based Method**

Reallocation on the basis of directly attributable costs e.g. if 70% of directly attributable costs relate to taxable supplies, so the same % of non-attributable costs may be regarded as attributable to taxable supplies.

Support functions may have a pro-rata based on values for example;

- **Marketing**
- Reallocation to income generating areas of business. Failing that aggregate output value of the whole group
- **IT and Infrastructure**
- Reallocation to income generating areas of business. Failing that aggregate output value of the whole group
- **Pensions Administration**
- Output values

6.2 Overseas branches and/or head offices

Regulation 103 allows recovery of input tax incurred by UK insurers in connection with their overseas branches and/or their overseas head offices. However, the process of identifying supplies made by overseas branches and head offices to EU and Non-EU counterparties where there are various branches and subsidiaries and the amount of input tax the UK insurers can recover may be difficult. Notice 700/57 ("Administrative agreements entered into with trade bodies") contains agreed

methodologies for recovery of such input tax that insurers can apply for overseas branches. Insurers have also treated input tax used in relation to supplies made by non-EU branches as fully recoverable and treated input tax used in relation to supplies made by EU branches as fully irrecoverable, Insurers may still apply this easement. If they want to move away from this methodology and other methodologies contained in Notice 700/5, they can propose other methodologies to identify recovery rates that determine the use of input tax in relation to the branch activities and also for their head office activities if applicable.

6.3 It should be noted that the above are examples and are in no way to be treated as prescriptive. Each sector needs to be looked at individually and treated as such accordingly.

6.4 With regard to Insurance Premium Tax (IPT) businesses can choose to either include or exclude the value of IPT within their calculation. If they chose to include the value of UK IPT in sector and/or sub-sector allocations or apportionment calculations, they should include equivalent foreign taxes and any other duties or taxes charged or chargeable on insurance premiums. If they chose to exclude the value of UK IPT then equivalent foreign taxes and any other duties or taxes charged or chargeable on insurance premiums should be excluded.

7. Run-off

7.1 Run-off describes the situation where an insurer wishes to close either the whole of its business, or a particular book of business.

7.2 The nature of insurance means that an insurer cannot close immediately; it has to remain open until it has settled its liabilities, especially with reference to claims. These may arise even after the policy has lapsed, e.g. an industrial disease may only become apparent many years after the period covered by the insurance policy has ended, but nonetheless the claim may still be made under that policy.

7.3 Therefore, the first stage of run-off is normally the closure to new business. This means that the insurer can now concentrate on the insurance policies that are extant but it also means that the premium income drops immediately as the only premium being received is any additional premium (AP), arising from changes to the extant policies leading in an increase to the original premium charged. Furthermore, premium may also be returned to the insured, known as return premium (RP), in respect of cancelled policies or changes in circumstance leading to a reduction to the original premium charged.

7.4 As AP and RP is the only premium to be accounted for by the insurer, a values-based method can become, at the least distorted and at the worst unworkable, especially when negative percentages are calculated. Therefore the normal practice is for an insurer to apply to use a fixed percentage recovery based on the last three years of business. This can be rather more subjective than representative, e.g. in cases where the book has not be open for three years; or the book has changed in a short period of time. Here best judgment might be employed, to assist in arriving at a fair and reasonable method.

8. Annual Adjustment

An annual adjustment is a review carried out at the end of at the end of the business' tax year (the longer period) revisiting the provisional quarterly attribution of input tax within a PE method, taking into account any changes in use. It allows business to reconsider the use of goods and services in the tax year and for some, to reevaluate the exempt input tax under the de minimis regime. Guidance for annual adjustments can be found within [HMRC PE Guidance - PE4100](#)

The key points to keep in mind are;

- Apportionment calculations should be reworked using figures for the whole adjustment period using the method as prescribed by the PE method used in the year.
- Exempt input tax must be reconsidered in relation to the de minimis rules
- The Commissioners have powers to allow businesses to account for the adjustment in a later prescribed accounting period where businesses can show that they have difficulty in using the first prescribed accounting period after the end of the tax year. Application and approval should be in writing.
- If during a longer period a business discovers that it has made an error in the completion of its returns (other than an input tax allocation or attribution error), it cannot use the annual adjustment to correct this retrospectively. All errors must be calculated in their correct periods and only those that are not capped can be posted.

9. Capital Goods Scheme

Generally the Capital Goods Scheme (CGS) applies to the acquisition of

- computers (in excess of £50,000)
- buildings, and the refurbishment of buildings (with a capital value in excess of £250,000)

made by a partially exempt business.

Input tax is claimed on the purchase of the capital items as per the PE method in place for the business at the time of acquisition. Adjustments are made over a period of time (5 or 10 intervals depending on the capital item.). If the extent to which the capital item is used in making taxable supplies increases or decreases when compared to the initial use, a CGS adjustment is required.

Further guidance on the mechanics of the CGS can be found within [HMRC PE Guidance - PE4800](#)

An example where the CGS can have implications is when an insurer undertakes a major refurbishment of its head office or other large building in its possession. If the refurbishment is over £250,000 it will fall within the remit of the CGS.

HMRC's preference is for CGS adjustments to be carried out at sector level where the input tax was incurred. In some instance this may not be applicable, so a negotiated bespoke methodology may be required.

It is best practice to include within the PESM a catch-all appendix to deal with any Capital Goods item which cannot be assigned to a sector, and apportion on the basis of use.

Annex 1- The basic principles of Partial Exemption

a1.1 PE is the set of rules for determining recoverable input tax (VAT on business costs) insofar as the costs are 'used or intended to be used' in making taxable supplies and supplies that carry a right of deduction (collectively termed taxed supplies). HMRC see 'use' as 'economic use' meaning the business purpose, planning and source of funding for the cost. ECJ cases provide an alternative description, namely that costs must have a 'direct and immediate link, so as to be a cost component, of the price'.

a1.2 In accordance with PE guidance, a special method typically involves:

- i. Direct attribution to taxed supplies. Identify input tax on costs used wholly for making taxable supplies. This input tax is normally recoverable in full.
- ii. Direct attribution to exempt supplies. Identify input tax on costs used wholly for making exempt supplies. This input tax is normally irrecoverable.
- iii. Direct allocation to PE 'sectors' (business sub-units described in the special method). Identify input tax on costs used wholly within a sector making both taxable and exempt supplies. This input tax is apportioned between taxable and exempt supplies by application of a pro-rata.
- iv. Allocation re shared costs. Identify input tax on costs used in two or more sectors making both taxable and exempt supplies. Allocate input tax to the sectors in line with cost-usage, and apportion between taxable and exempt supplies in each sector.
- v. Allocation re overhead costs. Identify input tax on costs used across all sectors of the business making both taxable and exempt supplies. Allocate input tax to sectors in line with cost-usage and apportion between taxable and exempt supplies in each sector..
- vi. Re-allocation re internal customers. Identify input tax on costs used in providing services between sectors. Allocate input tax in line with cost-usage and apportion between taxable and exempt supplies in the sector(s) using the costs concerned.

a1.3 In most but not all cases, the first stage in PE is direct attribution (see section 3). It deals with a category of cost described in management accounting as direct cost, namely costs economically identified with (caused by) a specific output unit (or supply for VAT purposes). The second stage in PE is allocation. Allocation deals with common costs that relate to various outputs or parts of the business. Allocation also deals with central costs (or overheads) that relate to the business as a whole, and to internal services between business units. Apportionment, which is the final stage in PE, divides input tax between taxed and exempt supplies by way of a pro-rata calculation, based for example on methods illustrated at para 6.1 above..

a1.4 It is important to note that VAT regulations and PE methodology require input tax to be identified on invoices, normally at the invoice coding stage by posting invoices net with VAT taken to a separate VAT account. It is normally unacceptable to post invoices gross and then 'calculate' input tax for VAT recovery purposes; even if the same calculations are then used to assign input tax to taxed and exempt outputs.

a1.5 Allocation and apportionment is an approximation and it is meaningless to refer to a correct methodology although for PE purposes, some methodologies are preferred whilst others are unsuitable. A special method need only be 'fair and reasonable', namely:

- Robust, in that it can cope with reasonably foreseeable changes in business;
- Unambiguous, in that it can deal, definitively with all input tax likely to be incurred;
- Operable, in that the business can apply it without undue difficulty;
- Auditable, in that HMRC can check it without undue difficulty; and,
- Fair, in that it reflects the economic use of costs in making taxable and exempt supplies.

a1.6 HMRC will only approve the use of a special method if the business 'declares' that it has taken reasonable steps to ensure the method is fair and reasonable. HMRC cannot confirm that a special method is fair and reasonable, but will make enquiries based on an assessment of risk, and will never knowingly approve an unfair or unreasonable special method.

Annex 2 Why a Partial Exemption Special Method is usually suitable for an Insurance business.

a2.1 As we have seen, insurance businesses make a mixture of exempt and taxable supplies, and may also provide specified services to customers located outside of the EU which incur a right to recover input tax. When determining how to calculate the recoverable elements of input tax, the starting point is with the Standard Partial Exemption Method, as defined within regulation 101 of the VAT Regulations 1995, but this will rarely be suitable.

a2.2 The reason is that insurance companies make disposals of investments in securities and supplies from overseas branches which are both excluded from the standard method calculation based on values, with recovery being determined on the basis of use under regulation 101(8) of the VAT Regulations 1995 (as amended). In addition, they often make disposals of investment property which may lead to an over-ride calculation under regulation 107A to F.

a2.3 Moreover, many insurance businesses are complex organisations that provide many different services of differing liabilities to customers, often in different countries, using costs from suppliers around the world in different proportions. Added to this certain costs may have little relation to the value of the supplies for which they are incurred. For a business that carries out a number of different business activities, a one pot method is too simplistic and will not reflect the reality of the activities carried out or measure, with any accuracy, how the costs incurred are to be used. As a result, the standard method rarely produces a fair and reasonable result for insurance businesses.

a2.4 Therefore, most insurance businesses will need to apply to HMRC for approval to use a Partial Exemption Special Method (PESM.)

a2.5 As larger and more complex organisations have very different activities that use costs in different ways, HMRC encourages them to propose sectorised methods because it is considered that they are more likely to be fair and reasonable than a simple method.

Annex 3 Partial Exemption Special Method Examples for the Insurance sector

These templates and the accompanying aide memoir are used by HMRC officers when drafting PESMs that have been proposed by customers.

This template is a suggested format for a PESM and is in no way binding

a3.1 Example 1 – Single pot Values Method

Dear

**VAT REGISTRATION NO.
PARTIAL EXEMPTION SPECIAL METHOD FOR THE RECOVERY OF INPUT TAX**

1. Approval

Consideration has been given to your request dated _____ in which you seek approval for the use of a partial exemption special method to determine recoverable input tax and your declaration dated _____ that to the best of your knowledge and belief your proposals are fair and reasonable. The method is set out in this letter and the Commissioners approve that method (and hereby record their approval of it) subject to the conditions below.

This method has been approved under Regulation 102 of the Value Added Tax Regulations 1995. It incorporates input tax attributable to foreign and specified supplies as defined in Regulation 103 Value Added Tax Regulations 1995.

2. Use of the method

You must use this method to calculate your recoverable input tax for all periods with effect from _____ and must continue to use it until such time as the Commissioners approve or direct the termination of its use.

You should make proposals to this office for a new method if this one no longer results in a fair and reasonable recovery of input tax.

3. Change in business/trading patterns

WORDING FOR NON VAT GROUPS

This approval is given in the context of your current business structure and trading patterns as advised by you to this office. Should there be any changes in the structure of your business and/or trading patterns, which prevent this method from giving a fair and reasonable recovery of input tax, you must notify this office in writing at once. Planned changes in the above mentioned matters should, wherever practicable, be notified to this office at least 30 days in advance of implementation and in any event, no later than upon implementation.

WORDING FOR VAT GROUPS

This approval is given in the context of your current business structure and trading patterns as and is based on information [name of VAT group] has provided to the Commissioners. Should there be any changes in the structure of your business and/or trading patterns, which prevent this method from giving a fair and reasonable recovery of input tax, you must notify this office in writing promptly. I would ask you to inform this office of the change or changes in writing should:

- there be any material change in the structure of your business;
- any member of XXX VAT group cease, commence, or re-commence trading, or commence a new type of business activity;
- there be any changes in the trading patterns of any member of the VAT group, or any other changes affecting the VAT group, that might reasonably be considered to create a risk that the approved method will no longer produce a fair and reasonable recovery of input tax.;
- any group undertaking commence or recommence trading with the VAT group. For the purpose of this letter group undertakings shall have the same meaning as in section 1161, companies Act 2006.

Planned changes in the above mentioned matters should, wherever practicable, be notified to this office at least 30 days in advance of implementation and in any event, within 30 days of implementation.

4. Definitions

For the purpose of this method the words used shall have the meanings defined in this letter, or if not defined here, their meaning as defined in the VAT Act 1994, or if not defined there, their normal everyday meaning.

Where this method refers to **taxable supplies** it should also be taken to include:

- a) any supply made outside the UK that would be a taxable supply if made within the UK; and
- b) any supply specified in an Order made under section 26(2)(c) of the Value Added Tax Act 1994.

Where this method refers to **exempt supplies** it should also be taken to include:

- a) any supply made outside the UK which would be exempt if made in the UK, other than any supply specified in an Order made under section 26(2)(c) of the Value Added Tax Act 1994.

5. Tax year

Your tax year begins on _____ and ends on _____ .

6. Attribution

In each prescribed accounting period you shall:

- a) identify all supplies, acquisitions and imports you receive which are used, or to be used, in whole by you exclusively in making taxable supplies; the input tax thereon is recoverable;
- b) identify all supplies, acquisitions and imports you receive which are used, or to be used, in whole by you exclusively in making exempt supplies or in carrying on any activity other than the making of taxable supplies; the input tax thereon is not recoverable;
- c) determine the recoverable amount of any remaining, non-attributable input tax by multiplying that input tax by the formula below:

$$\frac{\text{Value of taxable supplies in the period}}{\text{Value of total supplies in the period}}$$

7. Exclusions

You must exclude from the calculations the value of any supplies specifically excluded by regulation 101(3) of the VAT Regulations 1995. You must also exclude the value of supplies in the following categories:

- a) any supply made from branches situated outside the UK;
- b) any supply of any goods or services sold on in the same state connected to the making of an advance or the granting of any credit, including for example, goods sold on by a finance house under a hire purchase agreement;
- c) any supply of goods or services made to connected persons, where the supply is acquired for the purposes of your business and supplied to the connected person without material alteration or further processing;
- d) supplies made where it is intended that the same, or equivalent, goods or services will be subsequently used by the business including for example, goods or services forming part of a sale and leaseback transaction.

[Amend, exclude or add any other supplies that are likely to cause a distortion to the calculation as appropriate to the particular business]

8. Supplies to connected persons

Where the value of a supply made to a connected person is either significantly less than, or significantly greater than, its open market value, then the value of the supply shall be taken to be its open market value for the purposes of this method.

Any question as to whether a person is connected shall be determined in accordance with Section 1122 of the Corporation Tax Act 2010.

9. Percentages to be used

All ratios are to be expressed as percentages. They shall be rounded up to two decimal places in each tax period and in the longer period adjustment.

10. Annual adjustments

A longer period adjustment must be carried out and declared in accordance with regulation 107, Value Added Tax Regulations 1995. This adjustment should be included in the first period following the end of your tax year.

11. Requirements

- a) You are required to keep records to show how you have calculated your deductible input tax and enable an Officer of HM Revenue and Customs to verify the amount claimed.
- b) When you have calculated the value of your non-recoverable input tax refer to the “de minimis” limits currently in force.

12. Contact officer

Should you wish to discuss this letter please contact _____ at the above address.

Yours

a.3.2 Example 2 Single Pot Transactions Method

This Example a suggested format for a PESM and is in no way binding

Dear

VAT REGISTRATION NO. PARTIAL EXEMPTION SPECIAL METHOD FOR THE RECOVERY OF INPUT TAX

13. Approval

Consideration has been given to your request dated _____ in which you seek approval for the use of a partial exemption special method to determine recoverable input tax and your declaration dated _____ that to the best of your knowledge and belief your proposals are fair and reasonable. The method is set out in this letter and the Commissioners approve that method (and hereby record their approval of it) subject to the conditions below.

This method has been approved under Regulation 102 of the Value Added Tax Regulations 1995. It incorporates input tax attributable to foreign and specified supplies as defined in Regulation 103 Value Added Tax Regulations 1995.

14. Use of the method

You must use this method to calculate your recoverable input tax for all periods with effect from _____ and must continue to use it until such time as the Commissioners approve or direct the termination of its use.

You should make proposals to this office for a new method if this one no longer results in a fair and reasonable recovery of input tax.

15. Change in business/trading patterns

WORDING FOR NON VAT GROUPS

This approval is given in the context of your current business structure and trading patterns as advised by you to this office. Should there be any changes in the structure of your business and/or trading patterns, which prevent this method from giving a fair and reasonable recovery of input tax, you must notify this office in writing at once. Planned changes in the above mentioned matters should, wherever practicable, be notified to this office at least 30 days in advance of implementation and in any event, no later than upon implementation.

WORDING FOR VAT GROUPS

This approval is given in the context of your current business structure and trading patterns as and is based on information [name of VAT group] has provided to the Commissioners. Should there be any changes in the structure of your business and/or trading patterns, which prevent this method from giving a fair and reasonable recovery of input tax, you must notify this office in writing promptly. I would ask you to inform this office of the change or changes in writing should:

- there be any material change in the structure of your business;
- any member of XXX VAT group cease, commence, or re-commence trading, or commence a new type of business activity;
- there be any changes in the trading patterns of any member of the VAT group, or any other changes affecting the VAT group, that might reasonably be considered to create a risk that the approved method will no longer produce a fair and reasonable recovery of input tax.;
- any group undertaking commence or recommence trading with the VAT group. For the purpose of this letter group undertakings shall have the same meaning as in section 1161, companies Act 2006.

Planned changes in the above mentioned matters should, wherever practicable, be notified to this office at least 30 days in advance of implementation and in any event, within 30 days of implementation.

16. Definitions

For the purpose of this method the words used shall have the meanings defined in this letter, or if not defined here, their meaning as defined in the VAT Act 1994, or if not defined there, their normal everyday meaning.

Where this method refers to **taxable supplies** it should also be taken to include:

- a) any supply made outside the UK that would be a taxable supply if made within the UK; and
- b) any supply specified in an Order made under section 26(2)(c) of the Value Added Tax Act 1994.

Where this method refers to **exempt supplies** it should also be taken to include:

- a) any supply made outside the UK which would be exempt if made in the UK, other than any supply specified in an Order made under section 26(2)(c) of the Value Added Tax Act 1994.

A **transaction** is the issue of a document calling for payment for services or goods supplied or, in the absence of such a document, the receipt of any such payment.

[Or other such definition that is appropriate to the business and the method]

17. Tax year

Your tax year begins on _____ and ends on _____ .

18. Attribution

In each prescribed accounting period you shall:

- d) identify all supplies, acquisitions and imports you receive which are used, or to be used, in whole by you exclusively in making taxable supplies; the input tax thereon is recoverable;
- e) identify all supplies, acquisitions and imports you receive which are used, or to be used, in whole by you exclusively in making exempt supplies or in carrying on any activity other than the making of taxable supplies; the input tax thereon is not recoverable;
- f) determine the recoverable amount of any remaining, non-attributable input tax by multiplying that input tax by the formula below:

$$\frac{\text{Number of taxable transactions in the period}}{\text{Total number of transactions in the period}}$$

19. Exclusions

You must exclude from the calculations:

[insert any transactions that are likely to cause a distortion to the calculation as appropriate to the particular business]

8. Percentages to be used

All ratios are to be expressed as percentages. They shall be rounded up to two decimal places in each tax period and in the longer period adjustment.

9. Annual adjustments

A longer period adjustment must be carried out and declared in accordance with regulation 107, Value Added Tax Regulations 1995. This adjustment should be included in the first period following the end of your tax year.

10. Requirements

- a) You are required to keep records to show how you have calculated your deductible input tax and enable an Officer of HM Revenue and Customs to verify the amount claimed.
- b) When you have calculated the value of your non-recoverable input tax refer to the “de minimis” limits currently in force.

11. Contact officer

Should you wish to discuss this letter please contact _____ at the above address.

Yours

a.3.3 Example 3 Single Pot 'other' Method

This Example a suggested format for a PESM and is in no way binding

Dear

**VAT REGISTRATION NO.
PARTIAL EXEMPTION SPECIAL METHOD FOR THE RECOVERY OF INPUT TAX**

20. Approval

Consideration has been given to your request dated _____ in which you seek approval for the use of a partial exemption special method to determine recoverable input tax and your declaration dated _____ that to the best of your knowledge and belief your proposals are fair and reasonable. The method is set out in this letter and the Commissioners approve that method (and hereby record their approval of it) subject to the conditions below.

This method has been approved under Regulation 102 of the Value Added Tax Regulations 1995. It incorporates input tax attributable to foreign and specified supplies as defined in Regulation 103 Value Added Tax Regulations 1995.

21. Use of the method

You must use this method to calculate your recoverable input tax for all periods with effect from _____ and must continue to use it until such time as the Commissioners approve or direct the termination of its use.

You should make proposals to this office for a new method if this one no longer results in a fair and reasonable recovery of input tax.

22. Change in business/trading patterns

WORDING FOR NON VAT GROUPS

This approval is given in the context of your current business structure and trading patterns as advised by you to this office. Should there be any changes in the structure of your business and/or trading patterns, which prevent this method from giving a fair and reasonable recovery of input tax, you must notify this office in writing at once. Planned changes in the above mentioned matters should, wherever practicable, be notified to this office at least 30 days in advance of implementation and in any event, no later than upon implementation.

WORDING FOR VAT GROUPS

This approval is given in the context of your current business structure and trading patterns as and is based on information [name of VAT group] has provided to the Commissioners. Should there be any changes in the structure of your business and/or trading patterns, which prevent this method from giving a fair and reasonable recovery of input tax, you must notify this office in writing promptly. I would ask you to inform this office of the change or changes in writing should:

- there be any material change in the structure of your business;
- any member of XXX VAT group cease, commence, or re-commence trading, or commence a new type of business activity;
- there be any changes in the trading patterns of any member of the VAT group, or any other changes affecting the VAT group, that might reasonably be considered to create a risk that the approved method will no longer produce a fair and reasonable recovery of input tax.;
- any group undertaking commence or recommence trading with the VAT group. For the purpose of this letter group undertakings shall have the same meaning as in section 1161, companies Act 2006.

Planned changes in the above mentioned matters should, wherever practicable, be notified to this office at least 30 days in advance of implementation and in any event, within 30 days of implementation.

23. Definitions

For the purpose of this method the words used shall have the meanings defined in this letter, or if not defined here, their meaning as defined in the VAT Act 1994, or if not defined there, their normal everyday meaning.

Where this method refers to **taxable supplies** it should also be taken to include:

- c) any supply made outside the UK that would be a taxable supply if made within the UK; and
- d) any supply specified in an Order made under section 26(2)(c) of the Value Added Tax Act 1994.

Where this method refers to **exempt supplies** it should also be taken to include:

- a) any supply made outside the UK which would be exempt if made in the UK, other than any supply specified in an Order made under section 26(2)(c) of the Value Added Tax Act 1994.

[Include such definitions that are appropriate to the business and the method]

24. Tax year

Your tax year begins on and ends on .

25. Attribution

In each prescribed accounting period you shall:

- g) identify all supplies, acquisitions and imports you receive which are used, or to be used, in whole by you exclusively in making taxable supplies; the input tax thereon is recoverable;
- h) identify all supplies, acquisitions and imports you receive which are used, or to be used, in whole by you exclusively in making exempt supplies or in carrying on any activity other than the making of taxable supplies; the input tax thereon is not recoverable;
- i) determine the recoverable amount of any remaining, non-attributable input tax by multiplying that input tax by the formula below:

[Insert method of apportionment]

26. Exclusions

You must exclude from the calculations:

[Insert appropriate exclusions, based on the method to be used, that are likely to cause a distortion to the calculation as appropriate to the particular business]

27. Supplies to connected persons

Where the value of a supply made to a connected person is either significantly less than, or significantly greater than, its open market value, then the value of the supply shall be taken to be its open market value for the purposes of this method.

Any question as to whether a person is connected shall be determined in accordance with Section 1122 of the Corporation Tax Act 2010.

28. Percentages to be used

All ratios are to be expressed as percentages. They shall be rounded up to two decimal places in each tax period and in the longer period adjustment.

29. Annual adjustments

A longer period adjustment must be carried out and declared in accordance with regulation 107, Value Added Tax Regulations 1995. This adjustment should be included in the first period following the end of your tax year.

30. Requirements

- a) You are required to keep records to show how you have calculated your deductible input tax and enable an Officer of HM Revenue and Customs to verify the amount claimed.
- b) When you have calculated the value of your non-recoverable input tax refer to the “de minimis” limits currently in force.

31. Contact officer

Should you wish to discuss this letter please contact _____ at the above address.

Yours

a.3.4 Example 4 Multi Pot Method

This Example a suggested format for a PESM and is in no way binding

Dear

**VAT REGISTRATION NO.
PARTIAL EXEMPTION SPECIAL METHOD FOR THE RECOVERY OF INPUT TAX**

32. Approval

Consideration has been given to your request dated _____ in which you seek approval for the use of a partial exemption special method to determine recoverable input tax and your declaration dated _____ that to the best of your knowledge and belief your proposals are fair and reasonable. The method is set out in this letter and the Commissioners approve it (and hereby record their approval of it) subject to the conditions below.

This method has been approved under Regulation 102 of the Value Added Tax Regulations 1995. It incorporates input tax attributable to foreign and specified supplies as defined in Regulation 103 Value Added Tax Regulations 1995.

33. Use of the method

You must use this method to calculate your recoverable input tax for all periods with effect from _____ and must continue to use it until such time as the Commissioners approve or direct the termination of its use.

You should make proposals to this office for a new method if this one no longer results in a fair and reasonable recovery of input tax.

34. Change in business/trading patterns

WORDING FOR NON VAT GROUPS

This approval is given in the context of your current business structure and trading patterns as advised by you to this office. Should there be any changes in the structure of your business and/or trading patterns, which prevent this method from giving a fair and reasonable recovery of input tax, you must notify this office in writing at once. Planned changes in the above mentioned matters should, wherever practicable, be notified to this office at least 30 days in advance of implementation and in any event, no later than upon implementation.

WORDING FOR VAT GROUPS

This approval is given in the context of your current business structure and trading patterns as and is based on information [name of VAT group] has provided to the Commissioners. Should there be any changes in the structure of your business and/or trading patterns, which prevent this method from giving a fair and reasonable recovery of input tax, you must notify this office in writing promptly. I would ask you to inform this office of the change or changes in writing should:

- there be any material change in the structure of your business;
- any member of XXX VAT group cease, commence, or re-commence trading, or commence a new type of business activity;
- there be any changes in the trading patterns of any member of the VAT group, or any other changes affecting the VAT group, that might reasonably be considered to create a risk that the approved method will no longer produce a fair and reasonable recovery of input tax.;
- any group undertaking commence or recommence trading with the VAT group. For the purpose of this letter group undertakings shall have the same meaning as in section 1161, companies Act 2006.

Planned changes in the above mentioned matters should, wherever practicable, be notified to this office at least 30 days in advance of implementation and in any event, within 30 days of implementation.

35. Sectors

Your operations are to be defined as the following sectors: -

[Insert the sectors, which must include a description of the activities undertaken in each area]

As you are authorised to split your business into sectors for the purpose of determining input tax recoverability, you should make a separate calculation for the apportionment of non-attributable tax in each sector which reflects the use of the goods or services on which input tax has been incurred.

36. Definitions

For the purpose of this method the words used shall have the meanings defined in this letter, or if not defined here, their meaning as defined in the VAT Act 1994, or if not defined there, their normal everyday meaning.

Where this method refers to **taxable supplies** it should also be taken to include:

- e) any supply made outside the UK that would be a taxable supply if made within the UK; and
- f) any supply specified in an Order made under section 26(2)(c) of the Value Added Tax Act 1994.

Where this method refers to **exempt supplies** it should also be taken to include:

- a) any supply made outside the UK which would be exempt if made in the UK, other than any supply specified in an Order made under section 26(2)(c) of the Value Added Tax Act 1994.

Allocated and/or **sub-allocated** will relate to that residual input tax in any cost centre or income generating area after direct attribution has been made and the fully recoverable and non-recoverable amounts of input tax have been extracted.

Allocation is defined as the act of assigning a share of the non-attributed input tax to a sector. **Re-allocation** is defined as the act of assigning a share of the previously allocated, or reallocated, input tax to another sector.

A **transaction** is the issue of a document calling for payment for services or goods supplied or, in the absence of such a document, the receipt of any such payment.

[Or insert other such definition that is appropriate to the business and the method]

[Other definitions to be inserted where appropriate]

37. Tax year

Your tax year begins on and ends on .

38. Attribution

In each prescribed accounting period you shall:

- j) identify all supplies, acquisitions and imports you receive which are used, or to be used, in whole by you exclusively in making taxable supplies; the input tax thereon is recoverable;
- k) identify all supplies, acquisitions and imports you receive which are used, or to be used, in whole by you exclusively in making exempt supplies or in carrying on any activity other than the making of taxable supplies; the input tax thereon is not recoverable;
- l) identify all supplies, acquisitions and imports you receive which are used, or to be used, both in making taxable and exempt supplies and which are used, or to be used, exclusively within a single sector; the input tax thereon shall be allocated to that sector;
- m) identify all supplies, acquisitions and imports you receive which are used, or to be used, both in making taxable and exempt supplies and which are not used, or to be used, exclusively within a single sector; the input tax thereon should be allocated to the fullest extent possible between the sectors on whose behalf the expense was incurred in the following manner:-

[Insert the method to be used]

The input tax allocated under c) and d) above to the nominated sectors shall be recovered in the following manner:-

[Insert the method to be used]

Non-attributable input tax incurred in respect of activities not covered elsewhere in this method is deductible to the extent that it is incurred on goods or services which are used or to be used to make taxable supplies, expressed as a proportion of the whole use or intended use.

39. Exclusions

You must exclude from the calculations.

[Insert appropriate exclusions, based on the method(s) to be used that are likely to cause a distortion to the calculation, as applicable to the particular business].

[Include the following if there are any values based calculations]:

You must exclude from the calculations the value of any supplies specifically excluded by regulation 101(3) of the VAT Regulations 1995. You must also exclude the value of supplies in the following categories:

- a) any supply made from branches situated outside the UK;
- b) any supply of any goods or services sold on in the same state connected to the making of an advance or the granting of any credit, including for example, goods sold on by a finance house under a hire purchase agreement;

- c) any supply of goods or services made to connected persons, where the supply is acquired for the purposes of your business and supplied to the connected person without material alteration or further processing;
- d) supplies made where it is intended that the same, or equivalent, goods or services will be subsequently used by the business including for example, goods or services forming part of a sale and leaseback transaction.]

[Amend, exclude or add any other supplies that are likely to cause a distortion to the calculation as appropriate to the particular business]

40. Supplies to connected persons

Where the value of a supply made to a connected person is either significantly less than, or significantly greater than, its open market value, then the value of the supply shall be taken to be its open market value for the purposes of this method.

Any question as to whether a person is connected shall be determined in accordance with Section 1122 of the Corporation Tax Act 2010.

41. Percentages to be used

All ratios are to be expressed as percentages. They shall be rounded up to two decimal places in each tax period and in the longer period adjustment.

42. Annual adjustments

A longer period adjustment must be carried out and declared in accordance with regulation 107, Value Added Tax Regulations 1995. This adjustment should be included in the first period following the end of your tax year.

43. Requirements

- a) You are required to keep records to show how you have calculated your deductible input tax and enable an Officer of HM Revenue and Customs to verify the amount claimed.
- b) When you have calculated the value of your non-recoverable input tax refer to the “de minimis” limits currently in force.

44. Contact officer

Should you wish to discuss this letter please contact _____ at the above address.

Yours

a.3.5 Example 5 Sectorised Method

This Example a suggested format for a PESM and is in no way binding

Dear

VAT REGISTRATION NO. PARTIAL EXEMPTION SPECIAL METHOD FOR THE RECOVERY OF INPUT TAX

45. Approval

Consideration has been given to your request dated _____ in which you seek approval for the use of a partial exemption special method to determine recoverable input tax and your declaration dated _____ that to the best of your knowledge and belief your proposals are fair and reasonable. The method is set out in this letter and the attached appendices and the Commissioners approve that method (and hereby record their approval of it) subject to the conditions below.

This method has been approved under Regulation 102 of the Value Added Tax Regulations 1995. It incorporates input tax attributable to foreign and specified supplies as defined in Regulation 103 Value Added Tax Regulations 1995.

46. Use of the method

You must use this method to calculate your recoverable input tax for all periods with effect from _____ and must continue to use it until such time as the Commissioners approve or direct the termination of its use.

You should make proposals to this office for a new method if this one no longer results in a fair and reasonable recovery of input tax.

47. Change in business/trading patterns

WORDING FOR NON VAT GROUPS

This approval is given in the context of your current business structure and trading patterns as advised by you to this office. Should there be any changes in the structure of your business and/or trading patterns, which prevent this method from giving a fair and reasonable recovery of input tax, you must notify this office in writing at once. Planned changes in the above mentioned matters should, wherever practicable, be notified to this office at least 30 days in advance of implementation and in any event, no later than upon implementation.

WORDING FOR VAT GROUPS

This approval is given in the context of your current business structure and trading patterns as and is based on information [name of VAT group] has provided to the Commissioners. Should there be any changes in the structure of your business and/or trading patterns, which prevent this method from giving a fair and reasonable recovery of input tax, you must notify this office in writing promptly. I would ask you to inform this office of the change or changes in writing should:

- there be any material change in the structure of your business;
- any member of XXX VAT group cease, commence, or re-commence trading, or commence a new type of business activity;
- there be any changes in the trading patterns of any member of the VAT group, or any other changes affecting the VAT group, that might reasonably be considered to create a risk that the approved method will no longer produce a fair and reasonable recovery of input tax.;
- any group undertaking commence or recommence trading with the VAT group. For the purpose of this letter group undertakings shall have the same meaning as in section 1161, Companies Act 2006.

Planned changes in the above mentioned matters should, wherever practicable, be notified to this office at least 30 days in advance of implementation and in any event, within 30 days of implementation.

48. Definitions

For the purpose of this method the words used shall have the meanings defined in Appendix 1, or if not defined in Appendix 1, their meaning as defined in the VAT Act 1994, or if not defined there, their normal everyday meaning.

49. Tax year

Your tax year begins on and ends on .

50. Attribution

In each prescribed accounting period you shall:

- g) identify all supplies, acquisitions and imports you receive which are used, or to be used, in whole by you exclusively in making taxable supplies; the input tax thereon is recoverable;
- h) identify all supplies, acquisitions and imports you receive which are used, or to be used, in whole by you exclusively in making exempt supplies or in carrying on any activity other than the making of taxable supplies; the input tax thereon is not recoverable;

- i) identify all supplies, acquisitions and imports you receive which are used, or to be used, both in making taxable and exempt supplies and which are used, or to be used, exclusively within a single sector or sub-sector; the input tax thereon shall be allocated in full to that sector or sub-sector;
- j) identify all supplies, acquisitions and imports you receive which are used, or to be used, both in making taxable and exempt supplies and which are not used, or to be used, exclusively within a single sector or sub-sector; the input tax thereon shall be allocated between the sectors on the basis of _____ ;
- k) [reallocate input tax allocated to the sectors and sub-sectors listed in Appendix 2 according to the calculations set out in Appendix 3]; and
- l) attribute to taxable supplies such proportion of the input tax on such of those supplies received as are used, or to be used, by you in making both taxable and exempt supplies as is determined to be the deductible proportion of the non-attributable input tax for each sector and sub-sector by the calculations set out in Appendix 3.

[The following wording can be inserted here or as “catch all” sector:]

Non-attributable input tax incurred in respect of activities not covered elsewhere in this method is deductible to the extent that it is incurred on goods or services which are used or to be used to make taxable supplies, expressed as a proportion of the whole use or intended use.

51. Exclusions

You must exclude from the calculations.

[Insert appropriate exclusions, based on the method(s) to be used that are likely to cause a distortion to the calculation, as applicable to the particular business].

[Include the following if there are any values based calculations]:

You must exclude from the calculations the value of any supplies specifically excluded by regulation 101(3) of the VAT Regulations 1995. You must also exclude the value of supplies in the following categories:

- a) any supply made from branches situated outside the UK;
- b) any supply of any goods or services sold on in the same state connected to the making of an advance or the granting of any credit, including for example, goods sold on by a finance house under a hire purchase agreement;
- c) any supply of goods or services made to connected persons, where the supply is acquired for the purposes of your business and supplied to the connected person without material alteration or further processing;
- d) supplies made where it is intended that the same, or equivalent, goods or services will be subsequently used by the business including for example, goods or services forming part of a sale and leaseback transaction.

[Amend, exclude or add any other supplies that are likely to cause a distortion to the calculation as appropriate to the particular business]

52. Supplies to connected persons

Where the value of a supply made to a connected person is either significantly less than, or significantly greater than, its open market value, then the value of the supply shall be taken to be its open market value for the purposes of this method.

53. Percentages to be used

All ratios are to be expressed as percentages. They shall be rounded up to two decimal places in each tax period and in the longer period adjustment.

54. Annual adjustments

A longer period adjustment must be carried out and declared in accordance with regulation 107, Value Added Tax Regulations 1995. This adjustment should be included in the first period following the end of your tax year.

55. Requirements

- a) You are required to keep records to show how you have calculated your deductible input tax and enable an Officer of HM Revenue and Customs to verify the amount claimed.
- b) When you have calculated the value of your non-recoverable input tax refer to the “de minimis” limits currently in force.

56. Contact officer

Should you wish to discuss this letter please contact _____ at the above address.

Yours

VAT REGISTRATION No:

(insert name of business)

APPENDIX 1: DEFINITIONS

EFFECTIVE DATE:

Taxable supplies

Where this method refers to **taxable supplies** it should also be taken to include:

- c any supply made outside the UK that would be a taxable supply if made within the UK; and
- c any supply specified in an Order made under section 26(2)(c) of the Value Added Tax Act 1994.

Exempt supplies

Where this method refers to **exempt supplies** it should also be taken to include:

- a) any supply made outside the UK which would be exempt if made in the UK, other than any supply specified in an Order made under section 26(2)(c) of the Value Added Tax Act 1994.

Connected persons

Any question as to whether a person is connected with the VAT Group shall be determined in accordance with Section 1122 of the Corporation Tax Act 2010.

Attribution

The act of determining whether the whole of the supply, acquisition or import is used, or to be used to make either supplies wholly with a right to recover, or supplies wholly without the right to recover, input tax.

Allocation

The act of assigning a share of the non-attributed input-tax to a sector or sub-sector.

Re-allocation

The act of assigning a share of the previously allocated, or reallocated, input tax to another sector, or sub-sector

Apportionment

The calculation of the amount of the non-attributable input tax allocated to each sector, or sub-sector, that shall be attributed to taxable supplies

[Add any other required definitions - e.g. transactions, headcount, full time equivalent etc.]

VAT REGISTRATION No:
business)

(insert name of

APPENDIX 2: LIST OF SECTORS AND SUB-SECTORS

Appendix 3, Annex Number	Name of Sector or Sub-Sector	Effective Date	Date Ceased	Comments

VAT REGISTRATION No:

(insert name of business)

APPENDIX 3 ANNEX

EFFECTIVE DATE:

SECTOR:

This sector is the business of

Detail of calculation to be used in this sector

The deductible element of the non-attributable input tax allocated to this sector shall be determined by multiplying that input tax by the formula below, which shall be expressed as a percentage:

Notes

[If any restrictions, qualifications or explanations are needed]

VAT REGISTRATION No:

(insert name of business)

APPENDIX 3 ANNEX

EFFECTIVE DATE:

SECTOR:

This sector is the business of

This sector is divided into sub-sectors: and

Sub-sector is the business of

Sub-sector is the business of

Detail of allocation of input tax to sub-sectors

Detail of calculation to be used in sub-sector

The deductible element of the non-attributable input tax allocated to this sub-sector shall be quantified by multiplying that input tax by the formula below, which shall be expressed as a percentage:

Notes

[If any restrictions, qualifications or explanations are needed]

Detail of calculation to be used in sub-sector

The deductible element of the non-attributable input tax allocated to this sub-sector shall be quantified by multiplying that input tax by the formula below, which shall be expressed as a percentage:

Notes

[If any restrictions, qualifications or explanations are needed]

VAT REGISTRATION No:
(insert name of business)

APPENDIX 3 ANNEX

EFFECTIVE DATE:

SECTOR:

This sector is the business of

This sector is divided into sub-sectors: and

Sub-sector is the business of

Sub-sector is the business of

Detail of allocation of input tax to sub-sectors

Detail of calculation to be used in sub-sector

The deductible element of the non-attributable input tax allocated to this sub-sector shall be quantified by multiplying that input tax by the formula below, which shall be expressed as a percentage:

Notes

[If any restrictions, qualifications or explanations are needed]

Detail of calculation to be used in sub-sector

The deductible element of the non-attributable input tax allocated to this sub-sector shall be quantified by multiplying that input tax by the formula below, which shall be expressed as a percentage:

Notes

[If any restrictions, qualifications or explanations are needed]

a.3.6 PESH Template Aide Memoir

AIDE MEMOIRE: PARTIAL EXEMPTION SPECIAL METHOD TEMPLATES FOR THE FINANCE AND INSURANCE SECTORS

1) Introduction

This guidance note should be read in conjunction with the special method templates and in drafting partial exemption special methods. These method templates are issued with a health warning and should be tailored to reflect the individual circumstances of the business. If you have any queries regarding the drafting of special methods please consult a member of the TAPE team or one of the local Regional Partial Exemption Specialist Officers (RPESOs). Reference should also be made to V1-15 guidance on Partial Exemption.

2) Supplies and Transactions

Supplies and Transactions should be defined in a single pot method or in each sector in a sectorised method. The suggested definition of 'transactions' comes with a health warning, and the terms "transactions" and "supplies" need to be defined clearly within each special method depending on what supplies are being made.

3) Suggested wording for determining the recovery of non-attributable input tax

The following methods of apportionment can be used to determine input tax recovery in sectors, sub-sectors and in single special methods. The methods of apportionment need to be defined clearly within each sector/sub-sector or within single pot methods and should state any weightings (if applicable), inclusions and/or exclusions.

a) Single pot special methods for other methods of apportionment

Refer to Section 6, paragraph (c) (Attribution) in the 'single pot other' template. The following paragraphs refer to suggested wording based on the method of apportionment other than values or transactions.

i) Headcount

Number of staff generating taxable income in the period
Total number of income generating staff in the period

**Where income generating staff is used as a method of apportionment in special methods, this term must be defined clearly. Exclusions and/or inclusions should also be stated.*

ii) Time Spent

Time spent on taxable transactions in the period
Total time spent on all transactions in the period

** The above apportionments can also be used in sectors for multi pot special methods.*

b) Methods for allocation to sectors for multi pot special methods

Refer to Section 7, paragraph (d) of the 'multi pot' template which can be replaced with the following:

i) Values

identify all supplies, acquisitions and imports you receive which are used, or to be used, both in making taxable and exempt supplies and which are not used, or to be used, exclusively within a single sector; the input tax thereon should be allocated to the fullest extent possible between the sectors on whose

behalf the expense was incurred, in the ratio of the value of transactions in each sector as a percentage of the total value of transactions in the nominated sectors.

ii) Headcount

identify all supplies, acquisitions and imports you receive which are used, or to be used, both in making taxable and exempt supplies and which are not used, or to be used, exclusively within a single sector; the input tax thereon should be allocated to the fullest extent possible between the sectors on whose behalf the expense was incurred, in the ratio of the number of income generating staff employed in each sector as a percentage of the total number of income generating staff employed in the nominated sectors.

iii) Transactions

identify all supplies, acquisitions and imports you receive which are used, or to be used, both in making taxable and exempt supplies and which are not used, or to be used, exclusively within a single sector; the input tax thereon should be allocated to the fullest extent possible between the sectors on whose behalf the expense was incurred, in the ratio of the number of transactions in each sector as a percentage of the total number of transactions in the nominated sectors.

iv) Time Spent

identify all supplies, acquisitions and imports you receive which are used, or to be used, both in making taxable and exempt supplies and which are not used, or to be used, exclusively within a single sector; the input tax thereon should be allocated to the fullest extent possible between the sectors on whose behalf the expense was incurred, in the ratio of time spent on transactions in each sector as a percentage of the total time spent on all transactions in the nominated sectors.

v) Cost Accounting System

identify all supplies, acquisitions and imports you receive which are used, or to be used, both in making taxable and exempt supplies and which are not used, or to be used, exclusively within a single sector; the input tax thereon should be allocated to the fullest extent possible between the sectors on whose behalf the expense was incurred, using the method by which the input is accounted for within your own cost accounting system.

c) Methods for allocation and apportionment for sectorised methods

i) Refer to Section 6, paragraph (d) of the 'multi sector' template for method allocation. You can use some of the suggested wording as listed in (b) above.

ii) Refer to Appendix 3 of the 'multi sector' template for methods of apportionment. You can refer to some of the suggested wording as listed in (a) above.

4) Exclusions

You should insert appropriate exclusions, based on the method(s) to be used, that are likely to cause a distortion to the calculation, as applicable to the particular business.

Refer to the exclusions that relate to values depending on method of apportionment.

5) Contact Officer

This paragraph should only be included where there is an allocated officer for the business.