

CLIENT NEWSLETTER

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Partial Exemption

You will have already received our alert regarding partial exemption calculations. Although the partial exemption rules have been with us for some time, we still come across some very basic errors within partial exemption calculations, so we thought a few handy tips on working out whether you are within your de minimis might be in order right now.

A quick word of warning, however: If you want to use a method of calculating your exempt input tax which is outside either the “standard method” or Customs’ “preferred method”, this will amount to a Special Method which you should agree in writing with Customs.¹

First of all, we will look at apportionments. Do you have to apportion *all* your input tax within a cost centre where exempt supplies are made? The answer to this is “No”. The correct way of determining the amount of VAT which relates to exempt supplies is to first identify VAT which relates *entirely* to your taxable activities. This is fully recoverable (subject to the usual exceptions, such as motor cars, second-hand goods etc) as your input tax. Next quantify the VAT which relates *entirely* to your non-business activities. This is recoverable as section 33 refund tax. Next, quantify the VAT which relates entirely to your exempt supplies. This is exempt input tax and goes straight into the top line of your p/e calculation. Any VAT which is left over is residual, and should be apportioned. Here is an example.

An outdoor leisure facility incurs VAT on the following purchases:

- Bar stock
- Display cabinets for Tourist Information
- Signposting for the nature trail
- Overhead projector for study centre
- Electricity for whole site

The VAT on the bar stock relates entirely to taxable supplies, so is fully recoverable. The VAT on the display cabinets and signposting relates to the free provision of public services

¹ There is some confusion as to what is a standard method and what is a preferred method. The Standard Method set out in the VAT Regulations 1995 is an income-based apportionment of residual input tax which is generally unsuitable for section 33 bodies. Within Notice 749, the method for local authorities, which we describe as Customs’ preferred method, is occasionally referred to as the “local authority standard method”. A Special Method is anything which is not a standard method and for which you have written approval from Customs.
Confused?

(non-business), so is fully recoverable. Assuming that the study centre makes exempt supplies of education, the VAT on the OHP will be exempt input tax. The VAT on electricity relates to both exempt and other activities, so is residual and will have to be apportioned. Doing it this way will probably give a very different result to quantifying the VAT on the whole cost centre's expenditure and trying to carry out a global apportionment, say, according to the ratio of exempt income against total income.

So how should we apportion input tax? The "standard" way is, in local authority circles, by reference to the ratio of exempt income against total income. Other methods might include area of a building used for exempt activity. In the example above, if the study centre is fairly small compared to the rest of the building, this might prove a good way of apportioning energy and other building costs. It would also be fairly accurate, because a small part of a building requires less energy and maintenance than a large part and would result in less exempt input tax going into your calculation, whereas apportioning on an income basis might give an entirely different result. The important thing is that your apportionment method produces a fair and reasonable result. The skill is in choosing the method fairest to you and agreeing with Customs that you may use it.

Finally, we will look at the difficult bit: doing the calculation. How should I do my calculation? Many local authorities devise spreadsheets which contain formulae that reflect the agreed partial exemption method. There are also various bespoke products available – most of them, it has to be said, are Excel-based – which carry out a similar function. Some use the Notice 749 approach of taking a broad view of including all VAT as exempt input tax wherever there is exempt activity and gradually refining the calculation until they are within the de minimis. Some authorities throw a dice and as long as it doesn't show a six, reassure Customs that they are well within the de minimis, so "it's not really worth spending time on this year, is it?" Whichever you use, it should be user friendly and you should be able to run it as often as you need throughout the year to keep an eye on how close you are to the 5% de minimis. Attributing the VAT incurred directly within a cost centre where there are exempt supplies isn't, in itself, too difficult (following the principles set out above). We find the most difficult task is, of course, quantifying the VAT within recharges from central departments.

The Customs' preferred method of calculating VAT in recharges, which seems to have disappeared from their website recently (!) is as good as any and has the benefit of not requiring any pre-agreement. It is reproduced here:

1. Identify each main Budget Heading that makes any recharges and for each Budget Heading:

(a) Calculate percentage of taxable expenditure.

(b) Calculate a weighting figure: total expenditure divided by total expenditure + recharges in

(c) Multiply recharges out by weighting figure.

(d) Multiply result of 1(c) by result of 1(a).

2. Using total figures for all Budget Headings:

(a) *Divide 1(c) by recharges out. {Average factor}*

(b) *Divide 1(d) by 2(a) {Taxable value of recharges}*

(c) *Divide 2(b) by recharges out to give weighted taxable % {Average taxable %}*

3. *The average taxable percentage should then be applied to determine the taxable element of all recharges impacting on exempt activities.*

If you think that this does not produce a fair and reasonable result, then you should try to devise a method which gives a lower proportion of exempt input tax. Preferably something a bit simpler!

But all this is simply wasting your time if you haven't picked up all your exempt activities in the first place, such as property sharing arrangements where the consideration is not monetary (e.g. barter), training activities which are described as "miscellaneous income", and so on. If you miss any of those, you may have exceeded the 5% threshold without knowing it. Time for a partial exemption review?