

Foreword

This notice cancels and replaces Notice 706 (June 2006). Details of any changes to the previous version can be found in paragraph 1.2 of this notice.

Further help and advice

If you need general advice or more copies of HM Revenue & Customs notices, please ring the **National Advice Service** on **0845 010 9000**. **You can call between 8.00 am and 8.00 pm, Monday to Friday.**

If you have **hearing difficulties**, please ring the **Textphone** service on **0845 000 0200**.

If you would like to speak to someone in **Welsh**, please ring **0845 010 0300**, **between 8.00 am and 6.00 pm, Monday to Friday.**

All calls are charged at the local rate within the UK. Charges may differ for mobile phones.

Other notices on this or related subjects

[706/2 Capital goods scheme](#)

[700/57 Administrative agreements entered into with trade bodies](#)

1. Introduction

1.1 What is this notice about?

You need to read this notice if your business is partly exempt. A business is partly exempt if it incurs input tax that relates to taxable supplies and input tax that relates to exempt supplies.

If your business is partly exempt, you may not be able to recover all your input tax. You will have to use a partial exemption method to work out how much input tax you can recover. This notice explains:

- what partial exemption is;
- the partial exemption methods available to you; and
- the calculations and input tax adjustments you must make.

It also explains when you can recover all of your input tax even though part of it relates to exempt supplies. The impact of partial exemption on some specific business situations is also explained.

1.2 What's changed?

You can access details of any changes to this notice since December 2006 either on our Internet website at www.hmrc.gov.uk or by telephoning the National Advice Service on 0845 010 9000.

This notice and others mentioned are available both on paper and on our website.

This notice replaces the June 2006 edition. Changes have been made to improve readability but the content remains the same including the following changes to the October 2004 edition which were made as a result of the 2005 budget

- a new requirement that in future all special methods must be approved or directed in writing (**paragraph 6.3**)
- new rules to deal with “gaps” in special methods (**paragraph 6.13**)
- new restrictions on rounding up in the standard method for very large businesses (**paragraph 4.3**), and for new special methods (**paragraph 6.8**).

Changes were also made to reflect policy changes following the ECJ decisions in **Kretztechnik (section 8.7 and Business Brief 21/05)** and **P Charles, TS Charles Tijmens (paragraph 2.2 and Business Brief 15/05)**.

1.3 Where can I find the legislation?

The primary UK VAT law concerned with the right to deduct (recover) input tax and partial exemption is contained in sections 24 to 26 of the Value Added Tax Act 1994. This is supplemented by more detailed rules in Regulations 99 -110 of the Value Added Tax Regulations 1995.

2. Partial exemption in general

2.1 What is partial exemption?

The basic rules of VAT are set out in Notice 700 The VAT Guide. The notice explains that taxable supplies are supplies of goods or services that:

- are made in the United Kingdom (UK) or the Isle of Man;
- are made by a taxable person;
- are made in the course or furtherance of business; and
- are not specifically exempted.

Most taxable supplies require VAT to be charged at the standard rate, but some taxable charges will be at the reduced or zero-rate.

As a VAT registered business, you can recover the VAT on your purchases, which relates to taxable supplies that you make, or intend to make (but see **paragraph 2.5** regarding 'blocked' input tax). In principle, you cannot recover VAT that relates to any exempt supplies, although you may be able to if the VAT is below certain limits. See **section 9**, which explains this in more detail.

If you make, or intend to make, both taxable and exempt supplies and incur input tax that relates to both kinds of supply, you are classified as 'partly exempt'. Partly exempt businesses must undertake a calculation, which works out how much input tax they may recover, each time they complete their VAT return.

If you...	read...	before you read...
have non-business activities	paragraph 2.2	paragraph 2.3
make supplies outside the UK	paragraph 2.4	paragraph 2.3.

2.2 What about VAT on non-business activities?

VAT you incur on goods and services that are used exclusively for non-business purposes is not input tax and you **cannot** recover it.

VAT on goods and services that you use partly for business purposes and partly for non-business purposes must be apportioned between business and non-business use **before** dealing with partial exemption.

Notice 700 The VAT Guide explains the difference between business and non-business activities and contains guidance on working out how much of the VAT you incur is input tax. These methods are referred to as 'business/non-business methods' and are wholly separate from partial exemption methods.

As an alternative to the business/non-business apportionment, you can apply the Lennartz mechanism to certain received supplies. This means that you will be able to treat those supplies as business ones for input tax purposes, but will have to account for output tax on subsequent non-business use (Business Brief 15/05 explains this in more detail).

2.3 What are the basic rules?

You can normally recover input tax that relates to:

- taxable supplies;

- supplies made outside the UK that would be taxable supplies if made in the UK, known as 'out of country supplies' (**paragraph 8.1**); and
- certain supplies specified by Treasury Order, known as 'specified' supplies (**paragraph 8.1**).

For the purposes of this notice, input tax relating to these supplies will be called 'taxable input tax'.

Similarly, input tax relating to the following supplies will be known as 'exempt input tax' and cannot normally be recovered:

- exempt supplies; or
- supplies made outside the UK that would be exempt supplies if made in the UK, but which are not specified by Treasury Order. These are known as 'non-specified exempt supplies'.

2.4 What about supplies made outside the UK?

'Out of country' supplies and 'specified' exempt supplies cannot be included in the partial exemption standard method (see **section 4**) nor can they normally be included within a special method (see **section 6**). Calculations for determining recovery of input tax relating to these supplies must be carried out **before** any partial exemption method calculations.

Your local VAT Business Centre may, however, be willing to agree a single calculation in which a special method is combined with an agreed basis for recovering input tax relating to 'out of country' and 'specified' supplies - see also **section 8**.

2.5 What about 'blocked' input tax?

If you incur input tax on certain items, the input tax is always non-recoverable. Examples include certain cars and business entertainment. This input tax is commonly known as 'blocked' input tax. You can find out more about this in Notice 700 The VAT Guide.

2.6 When can I recover input tax?

The normal rules governing the evidence you need to recover input tax and the time when you can make your claim can be found in Notice 700 The VAT Guide. Usually, you have the right to claim recovery of input tax in the VAT return for the accounting period in which the tax was charged to you, subject to holding the necessary evidence. If for any reason you need to make a belated claim to input tax you should refer to **paragraph 11.17**.

2.7 What records and accounts do I need to keep?

When you are registered for VAT you are required by law to keep the records and accounts specified in Notice 700 The VAT Guide. For partial exemption purposes your records must also enable you to work out the amount of input tax you can recover in each tax period and in each tax year (**paragraph 10.2**). Any other records that are used in calculating your recoverable input tax must also be kept.

2.8 What are the main terms in partial exemption?

If you are new to partial exemption you may find the glossary of main terms in **section 13** useful.

3. How to calculate how much input tax you can recover

3.1 What are the main steps in recovering input tax?

There are three main steps to calculating how much input tax you can recover. These are:

Step	Description
1	Direct attribution of input tax
2	Apportionment of residual input tax
3	Completion of an annual adjustment

Steps one and two must be carried out for each VAT return and step three at the end of each tax year.

3.2 What is direct attribution of input tax?

Direct attribution of input tax is the identification of those goods and services received by you that you use, or intend to use:

- exclusively in making taxable supplies; or
- exclusively in making exempt supplies.

This process should be carried out on the basis of the use you make, or intend to make of those goods and services. Attribution is undertaken at the time you receive the goods or services.

3.3 What directly attributed input tax can I recover?

You can recover, in full, input tax on supplies of goods and services that are used, or to be used, exclusively in making taxable supplies or other supplies that carry the right to deduct.

In principle you cannot recover any of the input tax on supplies of goods and services used, or to be used, exclusively in making exempt supplies or other supplies in respect of which input tax is non-recoverable.

3.4 What is residual input tax?

Residual input tax is VAT that cannot be directly attributed to either taxable supplies or to exempt supplies, because it relates to both, for example, telephone bills and accountancy fees. It is also known as 'non-attributable' input tax.

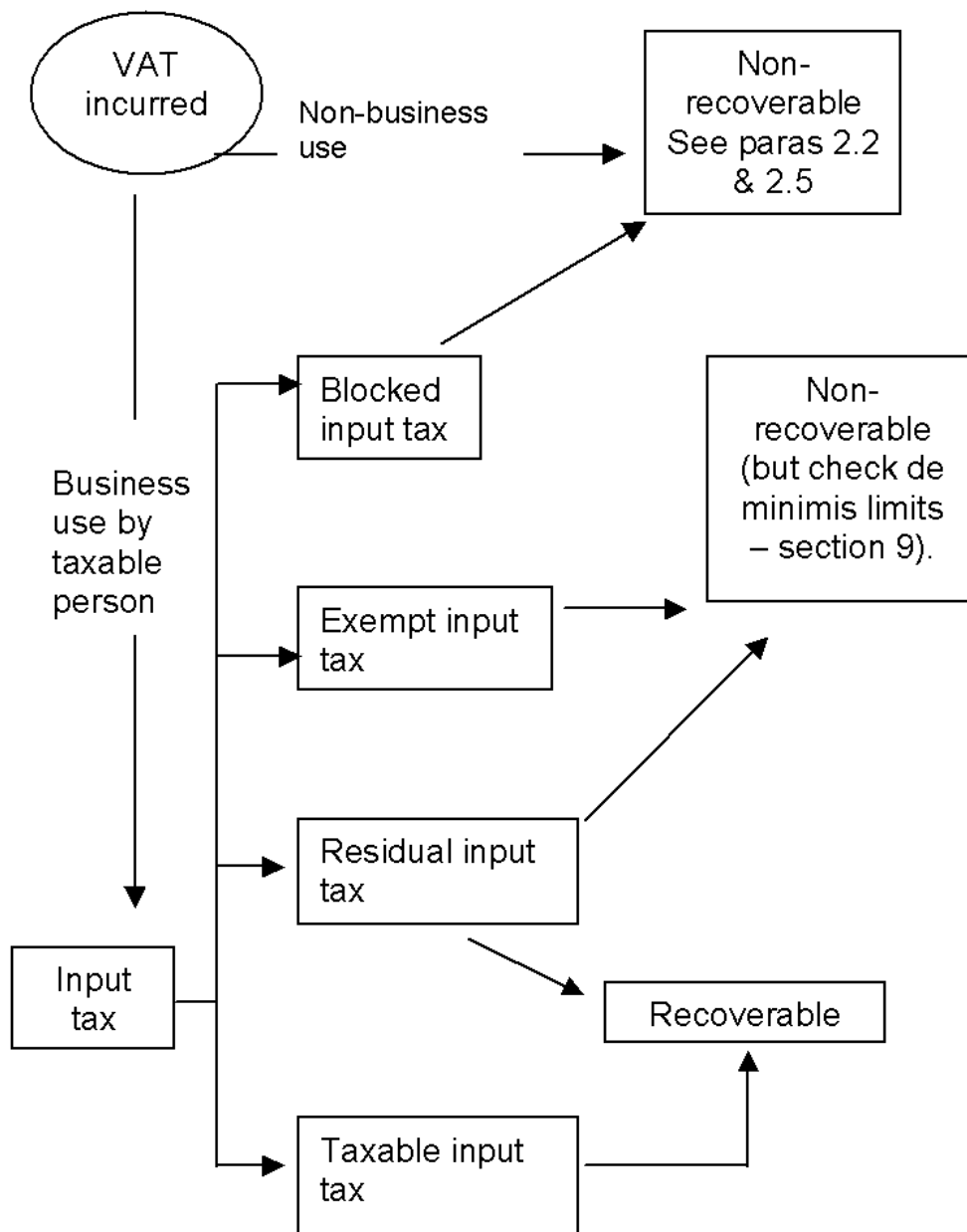
3.5 What residual input tax can I recover?

You can recover the amount of your residual input tax that relates to your taxable supplies. This amount is determined by a partial exemption calculation details of which are explained in **section 4, if you use the standard method** or **section 6, if you use a special method**. If you make supplies outside the UK that carry the right to deduct, you should also read **section 8**.

3.6 What is the total amount of input tax that I can recover?

You can recover the directly attributable taxable input tax (see **paragraph 3.3**) and the recoverable portion of residual input tax (see **paragraph 3.5**).

You may also find the following flowchart useful.



3.7 What input tax can I not recover?

You normally cannot recover the directly attributable exempt input tax or the irrecoverable portion of residual input tax. However, if you incur only small amounts of exempt input tax you may be able to recover them under the de minimis rules, see **section 9**.

3.8 What is an annual adjustment?

An annual adjustment is a calculation carried out at the end of a longer period, usually your partial exemption tax year. It will take into account any differences in the percentage of recoverable residual input tax that may occur between VAT periods in the same longer period. This is explained in **section 10**.

3.9 What partial exemption methods are there?

There are two types of partial exemption method that you can use:

- the standard method (see **section 4**) which is specified in the law and is suitable for most smaller businesses; or
- a special method (see **section 6**) which is devised by you to reflect your unique business circumstances.

You do not need our approval to use the standard method unless you currently operate a special method, but you must obtain our approval to use or stop using a special method.

3.10 When is a partial exemption method acceptable?

A partial exemption method is acceptable if it produces a result which is 'fair and reasonable', this means:

- it reflects all your business activities, apart from certain exceptions (see **paragraph 4.4**);
- you can apply it;
- we can check it without undue difficulty; and
- it enables you to recover the proportion of input tax which is incurred on goods and services that are used or will be used to make taxable supplies (and other supplies with a right to deduct).

If a method allows you to recover more or less input tax than that proportion, then it will not be 'fair and reasonable'.

3.11 What happens if my partial exemption method is not 'fair and reasonable'?

If you are using...	then you should consider...
the standard method	<ul style="list-style-type: none">• whether you should apply to your local VAT Business Centre to use an alternative method (section 6); or• whether the standard method override is applicable - see section 5.
a special method	<ul style="list-style-type: none">• whether you should apply to your local VAT Business Centre to use an alternative method (section 6); or• whether a special method override notice is

	required - see section 7 .
--	-----------------------------------

Paragraph 6.10 explains when we have the power to make you change your method (our directing powers).

4. The standard method

4.1 What is the standard method?

The standard method is the calculation that you must use unless we have given you approval to use a special method. The rules of the standard method calculation are fixed and you must not vary them. These rules are designed to allow you to recover the input tax you incur on your purchases to the extent that you use them to make taxable supplies that take place in the UK now or in the future.

Note: You do not need our approval to use this method unless you currently use a special method.

4.2 When is the standard method acceptable?

The standard method is acceptable to us provided the result it produces is fair and reasonable (**see paragraphs 3.10 and 3.11**). Generally its use is acceptable in most partly exempt businesses, particularly the smaller sized ones.

4.3 What does the standard method do?

The standard method enables you to calculate the proportion of your residual input tax that you can attribute to your taxable supplies and thus recover. It works by attributing the residual input tax according to the value of your taxable and exempt supplies made in the tax period in which the residual input tax is incurred.

The standard method calculation is:

$$\frac{\text{Value of taxable supplies in the period (excluding VAT)}}{\text{Total value of supplies in the period (excluding VAT)}} \times 100 = \text{Recoverable percentage of residual input tax}$$

Please note that:

For VAT periods.....	If the resulting percentage of your standard method calculation is not a whole number.....
Up to 31 March 2005	You should round up to the next whole percentage.
Commencing 1 April 2005.	<ul style="list-style-type: none"> you should round up to the next whole percentage only if your business incurs no more than £400,000 residual input tax per month on average; but

- | | |
|--|--|
| | <ul style="list-style-type: none">• you must round up to two decimal places for all other cases. |
|--|--|

Note: If you do not consider that the standard method provides a fair and reasonable result, you should apply to use a special method (section 6).

4.4 Does the standard method include the value of all business supplies?

The value of some supplies must not be included in your standard method calculation.

You should exclude from your calculation the value of all supplies you make in the following categories, whether they are taxable or exempt:

- supplies of capital goods you have used for the purposes of your business;
- incidental real-estate transactions;
- incidental financial transactions; and
- self-supplies.

You exclude the value of these supplies from your calculation to prevent them from distorting the result. However, any related input tax can still be recovered provided the supply is taxable.

You should also exclude from your calculation (where applicable):

- the value of any goods and services that you provide as a business transaction but which is neither a taxable nor an exempt supply - such as where you transfer a business as a going concern;
- the value of imported services (**paragraph 12.6**);
- the value of supplies made outside the UK that carry the right to deduct input tax (see **paragraph 8.1**). All other supplies made outside the UK on which there is no right of recovery must be included.

4.5 How do I calculate the input tax I can recover using the standard method?

To calculate the input tax you can recover using the standard method you will need to follow the following seven steps:

Step	Action
------	--------

1	Identify how much of your input tax is directly attributable to your exempt supplies.
2	Identify how much of your input tax is directly attributable to your taxable supplies.
3	Calculate how much of your input tax is residual. (This will be the total value of input tax less the input tax directly attributed in steps 1 and 2).
4	Calculate the recoverable percentage as described in paragraph 4.3 .
5	Apply the percentage at step 4 to your residual input tax. The value produced is the amount of your residual input tax that can be recovered.
6	Add together your directly attributable taxable input tax at step 2 and the amount of recoverable residual input tax at step 5. This is your total taxable input tax and can be recovered in full.
7	Add together your directly attributable exempt input tax at step 1 and the amount of residual input tax that was not attributed to taxable supplies at step 5. This is your total exempt input tax and cannot normally be recovered at all.

You may find the example at **paragraph 4.8** useful to see how these calculations work.

4.6 When can I recover my exempt input tax?

You cannot normally recover any exempt input tax. However, if your exempt input tax, calculated at step 7 of paragraph 4.5 is below the de minimis limits you can be treated as fully taxable and recover all your exempt input tax (see **section 9** regarding the de minimis limits).

4.7 Do I have to carry out any further calculations when using the standard method?

Yes, you will have to carry out an annual adjustment (as detailed in **section 10**) as the input tax you recover in each VAT period is provisional and you must re-work your calculation at the end of your partial exemption year (longer period).

4.8 Can you show me an example of a calculation using the standard method?

Yes, this example follows the steps given at paragraph 4.5 and uses the value of the supplies made by the business as the basis of the formula, although some supplies are excluded.

Example		
(a)	Total input tax.	£35,500
(b)	Input tax that relates exclusively to taxable supplies.	£12,500
(c)	Input tax that relates exclusively to exempt supplies.	£7,500
(d)	Input tax on business entertainment. Input tax incurred in relation to business entertainment is blocked (paragraph 2.5).	£500
(e)	Residual input tax.	£15,000
(f)	Value (excluding VAT) of all taxable supplies.	£135,000
(g)	Value of exempt supplies.	£55,000
(h)	Value (excluding VAT) of a machine used in the business and subsequently sold. Capital items are excluded because their inclusion would distort the calculation (paragraph 4.4)	£20,000

The recoverable percentage of residual input tax is:

$$\frac{(f) - (h)}{(f) + (g) - (h)} = \frac{135,000 - 20,000}{135,000 + 55,000 - 20,000} = \frac{115,000}{170,000} \times 100 = 67.65\%$$

This should be rounded up to 68%, as stated in paragraph 4.3.

(i) The recoverable amount of residual input tax is therefore:

$$£15,000 \times 68\% = £10,200$$

(j) Taxable input tax (recoverable)	=	(b)	£12,500	(directly attributable to taxable supplies)
	+	(i)	£10,200	(recoverable amount of residual)
			<hr/>	
			£22,700	
			<hr/>	
(k) Exempt input tax (non-recoverable)	=	(c)	£7,500	(directly attributable to exempt supplies)
	+		£4,800	(exempt amount of residual – that is (e) £15,000-(i) £10,200)
			<hr/>	
			£12,300	
			<hr/>	

5. The Standard Method Override

5.1 What is the standard method override?

The standard method override deals with circumstances where the standard method does not produce a fair and reasonable deduction of input tax.

The override requires you to make an adjustment when the input tax deducted during the tax year using the standard method differs **substantially** (see **paragraph 5.2**) from a deduction based on the use or intended use of the goods and services received by you in making your taxable supplies.

The annual adjustment (**section 10**) will normally have to be carried out in order for you to establish whether the difference is substantial or not.

This new rule applies to input tax incurred on or after 18th April 2002.

Further guidance is contained in VAT Information Sheet 04/2002.

5.2 What does substantial mean?

A difference is **substantial** if it exceeds:

- £50,000; or
- 50% of the residual input tax incurred and £25,000.

5.3 In what circumstances will the override apply?

The override will only apply where the standard method fails to produce a fair and reasonable deduction of input tax. This can happen when purchases are:

- incurred in one tax year but used in a different tax year in which the proportion of deductible VAT is very different; or
- not used in proportion to the values of taxable and exempt supplies made.

5.4 Will I be affected by the override?

You will only be subject to the override if:

- you are partly exempt and apply the **standard method**; and
- your residual input tax is more than £50,000 per year (£25,000 per year for group undertakings not members of the same VAT group) or adjusted in proportion for periods of less than a year; **and**
- the **standard method** does not give a fair and reasonable reflection of use.

Even then, you will only have to make an adjustment if there is a **substantial** difference between the input tax deducted and the amount deductible on the basis of use.

5.5 Could you give me some examples of when the override may apply?

Yes, some examples of where the standard method breaks down and the override may apply are when:

- purchases are made in one period or tax year in setting up a new line of business which will significantly affect the relative values of taxable and exempt supplies in future tax years when the purchases are to be used;
- exceptionally high value transactions are undertaken which do not consume inputs to an extent significantly greater than transactions of lower value;
- the pattern of business is such that inputs are simply not consumed in proportion to the values of outputs; and

- the values of outputs may give a distortive pattern for the residual percentage.

5.6 How do I apply the override?

To apply the override you must....	and...
calculate the difference between the input tax deductible under the standard method and that deductible according to use	account for this amount in the same VAT period as your annual adjustment (see section 10).

However when a...	any override adjustment must be accounted for on the...
business does not carry out an annual adjustment (because it first becomes partly exempt in the last period of a tax year)	next VAT return.
registration is cancelled	final VAT return.

5.7 How do I calculate the extent of use?

Any calculation will be acceptable if it produces a fair and reasonable attribution of input tax according to the use, or intended use, of your purchases in making taxable supplies. The easiest way to prepare a fair and reasonable calculation is to consider why the standard method breaks down and to correct for it.

Provided your residual costs (those relating to both taxable and exempt supplies) are used in proportion to the values of taxable and exempt supplies made in the period in which they are incurred, the standard method will give a deduction that reflects use. However, any costs that are not used in proportion to the values of supplies made can be dealt with separately from the standard method calculation.

5.8 Do the de minimis rules mentioned in section 9 apply to the override?

Yes, the existing de minimis provisions continue to apply. If after an override adjustment the input tax attributed to exempt supplies is within the current de minimis limits, then you can deduct all of your input tax for that period.

However, if you have deducted all of your input tax under the de minimis rules, but after applying the override you are not entitled to do so, you must make an adjustment and pay back the amount of input tax originally deducted.

5.9 Is the override based on a 'fair and reasonable' interpretation of use?

Yes, the override does incorporate the concept of 'fair and reasonable' even though the new regulations do not say so explicitly. All UK partial exemption is based on section 26 of the VAT Act, which requires that regulations exist to provide a fair and reasonable deduction of input tax.

5.10 What about the standard method rounding provision?

The override is not triggered by the rounding provision in the standard method.

5.11 What should I do where a period spans 18th April 2002?

The override only applies to input tax incurred on or after 18th April 2002. For a tax year or longer period that spans this date you should:

- calculate the annual adjustment for the whole tax year or longer period in the normal way;
- determine the amount of residual input tax incurred between 18th April 2002 and the end of the tax year;
- compare this to the override threshold of £50,000 (£25,000 for group undertakings) per annum, pro rata for the period 18th April to the end of the tax year;
- if this residual input tax exceeds the threshold, compare the standard method attribution of this tax (using the percentage applied by the annual adjustment calculation) with an attribution based on use or intended use; and
- if the difference is substantial, include both the annual adjustment amount for the whole period, and the override amount for the period from 18th April 2002 in the VAT account and VAT return for the annual adjustment period.

Where no longer period applies, the override threshold should be applied pro rata to the residual input tax incurred between 18th April 2002 and the end of the prescribed accounting period. If there is a substantial difference between the attribution of this tax using the standard method and one based on use, this is to be entered as an override adjustment on the return for the next accounting period.

5.12 Should I keep evidence of my use-based calculation?

You must keep evidence in support of an override adjustment. Where an adjustment is not required details of the calculations carried out that support this should also be kept.

5.13 What if I overlook the override adjustment?

You should inform your local VAT business centre. A voluntary disclosure must be made in the normal way, because the value of any adjustment using the override will be at least £25,000.

5.14 What is the effect of the override on the Capital Goods Scheme?

If you incur input tax on an item subject to the Capital Goods Scheme (CGS) - see Notice 706/2 Capital goods scheme - within a period covered by the override, you must include that input tax when considering whether the override applies and, if so, consider the use or intended use of the capital item in determining if there is a substantial difference.

CGS adjustments must not be counted as input tax when determining whether the override applies. However, where the override does apply to a tax year or longer period which is also a subsequent CGS interval, the CGS adjustment will be affected if the standard method is used as the basis of adjustment for the scheme.

5.15 What is the effect of the override on transfers of a going concern?

In order to counter avoidance schemes, which may seek to circumvent the rules by transferring all or part of a business as a going concern, the use of purchases by transferees or "successors" must be considered in certain circumstances. If, at the time input tax is incurred by a business, it is intended that the purchases will be used in whole or part by a successor, the intended use by the successor is to be taken into account in determining whether input tax is exempt input tax and to what extent.

Successor in this context includes a reference to a successor's successor through any number of transfers.

Transfer in this context means transfer of a business as a going concern, where the sale is treated as neither a supply of goods nor a supply of services by reference to an order under VAT Act 1994 s 5(3).

5.16 What if I find that I have to use the override on a regular basis?

If this is the case you may decide that it would be better to apply for approval to use a special method - see **section 6**.

6. Special methods

6.1 What is a special method?

A special method is any calculation, other than the standard method, that enables you to calculate how much of your input tax you may recover. It must only allow you to recover the input tax on your purchases to the extent that you use these purchases to make taxable supplies now or in the future.

A special method is unique to your business, and you can develop it to deal with your particular business circumstances. However, you must not use a special method, nor change a special method that you are already using, **without our approval**.

6.2 What special methods will you approve?

We will approve your special method provided we consider that it is fair and reasonable (**paragraph 3.10**). If your existing partial exemption method is not fair and reasonable you should contact your local VAT Business Centre with your proposals to obtain our approval to use the new method.

You may also seek approval to change your existing partial exemption method if you feel it is no longer suitable for your business even though it may still be fair and reasonable. This might happen if you change your accounting system, re-organise your business, or plan to make significant changes in the future.

6.3 How do I obtain approval for a special method?

You can obtain approval for a special method by writing to your local VAT Business Centre, with details of your proposals. You must explain clearly how your proposed method will work and when you want it to come into effect. You should explain what your business does, the types of supplies it makes or plans to make, and the nature of the costs that relate to these supplies.

It will help us to approve your method quickly if you show us why it is fair and reasonable. You can do this by showing how your method will work using actual figures from your business; this will also help you ensure that it works as you intend.

From 1 April 2005 all approvals and directions of special methods must be in writing. Oral approvals will no longer have any effect.

If we decide to approve your method, we will write to you explaining how your method is to be applied, and will ask you to sign a copy of our letter to confirm that you agree to it. You may find it useful to discuss your proposals with us before making a written proposal.

If we decide not to approve your method we will write to you explaining the reasons why it is considered that the proposals do not provide a fair and reasonable attribution of input tax to taxable supplies and invite you to make further or modified proposals.

6.4 What does a special method contain?

A special method is unique to your business and can contain any calculations or stages that are needed to ensure it is fair and reasonable. All special methods should:

- reflect all your business activities;
- provide for direct attribution of input tax to taxable supplies;
- provide for direct attribution of input tax to exempt supplies;
- identify residual input tax;
- calculate the element of residual input tax that relates to taxable supplies;
- calculate the element of residual input tax that relates to exempt supplies; and
- allow you to determine the total input tax that you can recover.

6.5 Can I divide my business into sectors?

If you wish you can divide your business into sectors and determine the input tax to be recovered in each sector. This may help ensure your special method is fair and reasonable if, for example, your business has discrete areas, activities, or even accounting centres, in which you 'use' your input tax differently. This can happen, for example, if your business consists of a VAT group of separate businesses.

If you divide your business into sectors, your special method must enable you to allocate your input tax between the sectors in a way that reflects each sector's use of the costs that bear the input tax being allocated. This may vary for different types of cost and so you may wish to consider allocating input tax differently according to the nature of the cost concerned. Once you have done this, you may then carry out a separate calculation to deal with the residual input tax in each sector.

If your method calculates a separate recovery rate for each sector it is commonly referred to as a 'sectorised' method.

6.6 How do I determine the recovery rate for residual input tax?

When you use the standard method the percentage recovery rate for residual input tax is calculated using the values of supplies made by your business. When you use a special method you can determine your percentage recovery rate using other allocations and apportionments. You can even use a different type of calculation for each sector if you have a 'sectorised' method.

6.7 Could you show me examples of allocations and apportionments?

Yes, here are some examples:

- outputs;
- numbers of transactions;
- staff time or numbers;
- inputs or input tax;
- floor area;
- costs allocations; and
- management accounts.

This list is not exhaustive and if you use any of the above you **must** ensure that the resulting calculation produces a result that is a true reflection of the use to which your input tax is put.

6.8 What percentage recovery rate should I use?

You should calculate the percentage recovery rate produced in your special method to **two decimal places**. Previously the only exception to this was a special method based on a single outputs calculation - where you could round up to the next whole percentage-because it closely resembled the standard method which allows you to round up to the next whole percentage. For all new special methods approved or directed after 1 April 2005 HMRC will only allow rounding to two or more decimal places. HMRC will also apply this policy as and when existing special methods are reviewed or updated.

6.9 What about changes in circumstances?

If you operate a special method and there is any change in your business circumstances, or if you are a VAT group and there is any change in the group membership that may have a significant impact on the amount of input tax you can claim, it is important that you advise your local VAT Business Centre immediately. This will enable us to review your method to see whether you can continue to use it. If it is decided that your method is no longer suitable for your business, you will be invited to propose an alternative method. If you fail to propose a method that is fair and reasonable, we may direct you to use a specified method. In some circumstances a Special Method Override Notice (see **section 7**) may be required.

6.10 What are directing powers?

We have the power to direct a taxpayer to use a particular method or to stop using an existing special method. These powers are only used in circumstances where we are unable to negotiate a mutually satisfactory method, or where the VAT system is being abused. Directions are made in writing and apply from the date they are given, or from a specified future date. If a taxpayer disagrees with the issue of a direction it can be appealed to the VAT Tribunal. Further information on appeals can be found in Notice 700 The VAT Guide.

6.11 Can I change my method?

You cannot change your method without the prior approval of your local VAT Business Centre. If you are using an approved special method, you must continue to use it until the VAT Business Centre approves or directs the use of another method or directs termination of its use. If you want to change from an approved special method to the standard method, you can only do so if the VAT Business Centre agrees. Any new method can start only from a current or future date. However, you will usually be allowed to use the new method from the start of the tax year in which the written application (being the approved application) is received.

6.12 What about annual adjustments when using special methods?

You have to follow a similar procedure, as you do for the standard method, to calculate the annual adjustment for a special method (see **section 10**).

6.13 Gaps in special methods

A special method is said to have a “gap” whenever it fails to specify how to deal with an amount of residual input tax. Gaps can arise in poorly constructed methods or when business circumstances change after methods have been approved. Gaps can result in unfair VAT recovery for businesses.

Up to 31 March 2005, the law did not specify how such gaps should be 'closed'. HMRC's interpretation of how recovery should be worked out was to use the calculation which was used for the standard method to address the gap.

From 1 April 2005, residual input tax falling into a 'gap' is to be recovered to the extent that the goods and services on which the input tax is incurred are used in making taxable supplies. Where the treatment of input tax on goods and services is only partly covered by the method – that is, part of the input tax falls into the 'gap' – only that part of the input tax not covered by the method comes under the new rules.

This does not mean that HMRC think that methods with 'gaps' are acceptable but merely sets out how to cope with gaps if they arise in future. Once a gap has arisen, HMRC expect that in due course businesses will make suitable proposals for a new method that takes account of the gap and any other known faults in the current method.

7. Special Method Override Notices

7.1 When does the special method override apply?

The Special Method Override Notice (Notice) allows HMRC or the business to correct the results of an unfair special method until a replacement method is implemented.

The override affects only partly exempt businesses that operate a **partial exemption special method** and where HMRC have:

- served a Notice on the business; or
- approved a Notice served by the business.

No other businesses are affected.

7.2 When might a Notice be served?

A Notice might be served when the method in use is no longer fair and reasonable. This might be because there has been a change in business circumstances (see **paragraph 6.9**) or there are weaknesses in the method that may lead to an unfair recovery of input tax.

Preparing a new method can take time, especially for a large and complex business. As this could result in either HMRC or the business losing out, the Notice gives the ability to correct the results of the special method in place until a replacement method can be agreed and implemented.

7.3 When will Customs serve or approve a Notice?

HMRC will only serve or approve a Notice if they have clear evidence that the current special method does not fairly and reasonably reflect the principle of use (see **paragraph 7.7**). They will also need to be satisfied that preparing a replacement will not be agreed quickly and the direction of a special method (**paragraph 6.10**) is not appropriate.

7.4 What details should a Notice contain?

A Notice must specify:

- that it is a special method override notice;
- the current or future date from which it takes effect;
- the reasons why the result of the current special method does not fairly and reasonably reflect the use of goods and services in making taxable supplies; and
- the effect of the Notice (only Notices served by HMRC).

An example of a Notice showing the minimum details you should include is shown at **paragraph 7.8**.

When HMRC approve a Notice served by a business this will usually be done in writing.

7.5 What must I do once a Notice has been served?

Once a Notice has been served you must, for each VAT return period beginning on or after the date specified in the Notice, carry out the following calculation:

- determine the amount of deductible VAT using your current special method;
- determine the amount of deductible VAT in accordance with the principle of use (see **paragraph 7.7**); and
- account for any difference between these amounts.

You must also do this in your year-end adjustment. If the date specified in the Notice falls part way through your tax year or longer period, you must carry out this calculation at the year-end in relation to the part of the year falling after the date specified in the Notice.

7.6 When does a Notice expire?

A Notice will expire when a new special method has been approved or directed, or HMRC allow or direct a business to use the standard method.

7.7 What do we mean by the 'principle of use'?

Paragraph 2.3 explains that you can normally only recover VAT incurred on your purchases which relates to taxable supplies that you make or intend to make. This means that the amount of VAT deducted in a VAT period fairly and reasonably reflects the extent that costs and purchases are used or will be used in making taxable supplies. This is referred to as the 'principle of use'.

In determining whether or not you have used a particular cost or purchase to make a specific taxable supply you must establish whether or not there is a direct and immediate link between the cost and the supply. Only where a direct and immediate link exists between an input and a taxable output is there a right to deduct VAT incurred on that input. A direct and immediate link will exist if the cost incurred directly forms a component of the price of a supply or supplies being made. If a cost or purchase wholly forms a component of the price of an exempt supply or supplies, the input tax cannot be recovered.

General overheads of a business do not have a direct and immediate link with any specific supplies made by that business. However, because they are set against income in calculating overall net profit or loss, they do have a direct and immediate link to the business as a whole. This gives them a direct and immediate link to all of the businesses supplies and means that the input tax incurred on them will always be residual.

In determining what costs are wholly or partly cost components of what supplies made it may be useful to look at how expenditure is treated within your accounts. However accounting treatment should not be taken as the definitive test and other relevant factors may need to be considered.

7.8 What does a Notice look like?

Below is an example of a Notice; it shows the minimum details that are required to be included.

Name, address and VAT registration number of business

Special Method Override Notice

Date of service: [day, month, year]

Reasons for serving the Notice:

[State detailed reasons why the method is not fair and reasonable, for example distortions, changes in circumstances etc.]

This Notice takes effect from [state current or future date in day, month, year format]

8. Input tax relating to 'out of country' and 'specified' supplies

8.1 General position

Paragraph 2.3 of this notice explains that, in addition to taxable supplies made in the UK, you can recover input tax relating to certain other supplies known as 'out of country' and 'specified' supplies. These are supplies referred to as "supplies that carry the right to deduct".

This section explains what we mean by 'out of country' and 'specified' supplies and the extent to which you can recover related input tax.

8.2 What are the supplies that allow me to recover input tax?

In addition to taxable supplies made in the UK, you can recover input tax relating to:

(a) supplies made outside the UK that would be taxable if made in the UK - 'out of country' supplies; and

(b) 'specified' supplies as defined in the VAT (Input Tax)(Specified Supplies) Order 1999. These are:

- supplies made to a person who belongs outside the European Union (EU);
- supplies directly linked to the export of goods to a place outside the EU; or
- the making of arrangements for these specified supplies,

where those supplies are exempt or would have been exempt if made in the UK by virtue of any item of Group 2 (Insurance) or any of items 1 to 6 and 8 of Group 5 (Finance) of Schedule 9 to the VAT Act 1994.

You can find out more concerning when supplies of services are made outside the UK in Notice 741 VAT: Place of supply services.

Certain supplies of investment gold are also included in the Specified Supplies Order. The method for recovery of any related input tax is dealt with in Notice 701/21 Gold.

8.3 How do I work out how much input tax I can recover?

Where you incur input tax on goods and services that are **exclusively** used (or to be used) in making 'out of country' or 'specified' supplies (or both), you can recover the input tax in full.

However, if the goods and services are only partly used in making these supplies, you will need to apportion the input tax.

8.4 How do I apportion the input tax?

To apportion the input tax on 'out of country' and 'specified' supplies, you must determine the recoverable element according to use of the relevant goods and services in making these supplies as a proportion of the whole use of the relevant goods and services.

8.5 Can I use the standard method as an apportionment?

No, you cannot use the standard method to apportion this tax. The standard method can only be used to apportion input tax relating to supplies made in the UK. However, if an output values calculation fairly and reasonably represents the use of the relevant goods and services this can be used. Any calculation that achieves that aim may be used, though you will need to consider which calculation or calculations are appropriate for each period.

8.6 When do I make this calculation?

See paragraph 2.4.

8.7 Can I recover input tax relating to share sales?

The issue of new shares is not normally a supply for VAT purposes (see Business brief 21/05).

If the issue is made for the purposes of a fully taxable business then any input tax will be recoverable under the normal rules. If you are partly exempt you should seek advice from your VAT Business Centre as the treatment will depend on the exact circumstances.

If you sell existing shares or securities, the input tax on the related costs is recoverable if the purchaser belongs outside the EU and the sale is made by way of business.

9. The de minimis limit

9.1 What do you mean by the de minimis limit?

The de minimis limit allows you to treat exempt input tax as if it were taxable input tax and recover it in full if the total value (directly attributable plus the exempt proportion of any residual input tax) is less than a prescribed amount.

You must first carry out the steps described in **section 3** to work out the amount of your exempt input tax before you can apply the rules in this section.

9.2 What are the de minimis limits?

You can be treated as fully taxable in any tax period or longer period (**section 10**) if your exempt input tax is not more than:

- £625 per month on average; **and**
- half of your total input tax in the relevant period.

Note: 'On average' normally means the average over the tax period or longer period.

9.3 What if my exempt input tax is below the de minimis limits?

If your exempt input tax is below the de minimis limit you can treat all your exempt input tax as taxable input tax and recover it all. If, however, your exempt input tax exceeds the de minimis limit, then **none** of your exempt input tax can be treated as taxable input tax and you cannot recover it.

If you have a group registration for VAT, the limit applies to the group as a whole. For treatment of divisional registrations see **paragraph 12.3**.

9.4 Are there any items I should include or exclude?

When applying the de minimis limit you should ignore any input tax due to you or from you as adjustments under the Capital Goods Scheme (**paragraph 11.16**).

9.5 When do I apply the de minimis limit?

Every time you prepare the figures for your VAT return you must check if your exempt input tax exceeds the de minimis limit.

You will need to reconsider the de minimis limit when you carry out your annual adjustment (**section 10**). Your adjustment calculation will need to include all exempt input tax incurred in the tax year, regardless of whether it was recovered under the de minimis rule during the tax year.

9.6 Can you show me an example of a de minimis calculation?

Yes, this example shows how to apply the de minimis test in an annual adjustment.

Input tax directly attributable to exempt supplies	£7,500
Exempt proportion of the residual input tax	<u>£4,800</u>
	£12,300
Total input tax incurred	£35,500
$\frac{£12,300}{12} = £1,025$ per month (on average) $\frac{£12,300}{£35,500} \times 100 = 34.65\%$	

The exempt input tax is more than £625 on average, and so is not recoverable. This is the case even though it is less than 50% of all input tax incurred, because **both** conditions must be met to pass the de minimis test.

10. Annual adjustments

10.1 What are annual adjustments?

The input tax you claim in each tax period is provisional. It is reviewed at the end of your longer period (which is normally a tax year), because each tax period can be affected by factors such as seasonal variations either in the value of supplies you make or in the amount of input tax you incur. This is called the annual adjustment.

The adjustment has two further purposes:

- it allows you to reconsider your use of goods and services over the longer period; and
- it allows you to re-evaluate your exempt input tax under the de minimis rules.

10.2 What is a 'tax year'?

The tax year is a period of 12 calendar months. It normally ends on 31 March, 30 April or 31 May depending on your tax periods (that is, the periods covered by your VAT returns). If you make monthly returns, your tax year ends on 31 March.

You may find it more convenient to have your tax year correspond with your financial year. If you wish to change your tax year, you should write to your local VAT Business Centre for approval. Your longer period must always finish on the last day of a tax period.

10.3 What are 'longer periods'?

The tax year is the normal longer period for adjustment purposes, although in some circumstances the annual adjustment may cover a period shorter than a tax year. Your first longer period runs from the first day of the tax period in which you first incur exempt input tax to the last day of that tax year. If that tax period is the final period of the tax year, no longer period is applied to that tax year. There are also rules to deal with special circumstances where the longer period does not comprise a period of 12 months. These include:

- newly registered traders (see **paragraph 10.7**);
- belated registration (see **paragraph 10.8**); and
- deregistering traders (see **paragraph 10.9**).

10.4 How do I calculate annual adjustments?

At the end of your longer period, you should revisit the attribution made during the year and determine whether the goods and services have been used in the same way as was anticipated when each return was made. Where use in the longer period differs from the use in the tax period in which you claimed the input tax, you must re-attribute the input tax to reflect the use in the longer period. An example to illustrate this appears at **paragraph 10.5**.

Having reconsidered your use of goods and services as above, you will need to recalculate the amount of residual input tax you can claim using the figures for the whole of the longer period. The method of calculation should be identical to that used in the earlier tax periods.

Using this figure of residual input tax, you must then re-apply the de minimis test outlined in **section 9** using figures for the whole longer period to review the results produced for the individual VAT returns. This will produce a value of recoverable input tax for the longer period.

Any difference between the amount of recoverable input tax as a result of the longer period calculation and the total amount you have provisionally claimed on your VAT returns during the longer period is your annual adjustment.

10.5 Do you have an example of re-attribution?

Yes, a finance company buys a computer system to lease to another company. It claims the input tax in full because it only intends to make a taxable supply of the computer. However, after the company submits its quarterly VAT return, but before the end of the tax year, the lease is terminated and the computer is used in its own partly exempt business for the remainder of the year. This means, in the longer period, the computer was used to make both taxable and exempt supplies and should be re-attributed from directly attributable taxable input tax, to residual input tax.

10.6 How do I declare annual adjustments?

You must normally enter your annual adjustment amount in your VAT account for the first tax period **after** the end of the longer period (not the final period of the longer period). However, if your registration is cancelled, you enter this amount in your VAT account for the final period ending on the effective date of deregistration.

If the recalculation shows that your exempt input tax is within the de minimis limit set out in **section 9** you are treated as fully taxable for the longer period. Any input tax you did not claim on a VAT return during this period because you were above the de minimis limit for that individual accounting period, is an underclaim of VAT.

Partial exemption annual adjustments that are correctly carried out and entered in your VAT account for the correct period, are not errors and do not have to be notified to your local VAT Business Centre under the voluntary disclosure procedure. However, you should remember that you cannot use the annual adjustment to correct actual errors, such as input tax incorrectly treated as exempt when in fact the goods or services were used to make taxable supplies from the outset. Errors such as these should be corrected in accordance with the guidance in Notice 700/45 How to correct VAT errors and make adjustments and claims.

10.7 What if I am a newly registered trader?

If you are newly registered and immediately incur exempt input tax, your initial longer period for adjustment purposes runs from your effective date of registration to the day before the start of your first tax year. This is called your registration period for partial exemption purposes. If you do not incur exempt input tax until later in your registration period, your longer period will run from the first date you incur exempt input tax to the day before the start of your first tax year.

10.8 What about belated registration?

If you are registered retrospectively, your first VAT return may cover a period that is longer than a tax year. You will need to break this period down and carry out a separate longer period adjustment in respect of the registration period and each of the subsequent tax years. You calculate the total amount of input tax you are entitled to recover and put this figure on your VAT return.

10.9 What if I become deregistered?

If your registration is cancelled, your last period for adjustment purposes (your 'deregistration period') runs from the day after the end of your previous tax year to the effective date of deregistration.

11. Intended use of supplies received and changes of intention

11.1 What does this section cover?

Paragraph 3.2 explains that attribution of input tax should be carried out at the time you receive the goods or services you acquire on the basis of the use you make, or intend to make, of them.

It is important that you establish the use or intended use at this time so that the input tax incurred can be accurately attributed to the onward supplies to which it relates. This section covers how to establish what your intention is.

However, there may be occasions when intentions are not clear or where you change your intention **before** you use, or when you actually use, these goods and services. There may also be occasions where your use changes over a period of time.

This section gives advice on procedures to follow and explains when an input tax adjustment is required.

11.2 How do I establish what my intentions are when I receive supplies?

At the time that you receive a supply for the purposes of your business, you need to look at the full use you will put that supply to within your business. Even if the use will initially be solely in one way, if you know that you will eventually use the supply in another way you will need to take that into account from the outset.

A supply received will be used in making an onward supply by your business if it is wholly or partly a cost component of your making that onward supply. You need to look at the VAT liabilities of all the supplies you will make using the supply received in order to establish how to attribute the input tax on that supply as either taxable, exempt or residual.

11.3 How will VAT incurred on costs relating to supplies of land or property be affected?

The land and property sector is an area where it can be particularly difficult to establish what your intentions are when you receive supplies.

Supplies of land and property can either be taxable or exempt and VAT on costs incurred should be attributed according to the liability of the supplies or intended supplies that are to be made.

However, a supply that would otherwise be exempt may become taxable if an option to tax is made and notified to HMRC. Even where a supply requires a valid option to be in place **before** it can be taxable, it is possible for you to have a taxable intention before the option is made and notified. This is far more likely in the early stages of any project than when construction has commenced and cannot be the case after supplies have started to be made. HMRC will expect to see a range of evidence consistently indicating that such an intention exists before accepting that this is so. Notice 742A Opting to tax land and buildings gives further guidance on the option to tax generally and on what evidence might lead to the conclusion that a taxable intention exists prior to an option being made.

However, the best evidence of your intention to make taxable supplies where an option will eventually be required remains an effective option to tax.

11.4 How should I deal with speculative supplies of property?

As a person developing property you may incur costs on or related to one or more sites without knowing exactly what supplies you will eventually make, if any. In these cases VAT should be attributed as residual input tax provided that the costs incurred are for business purposes. This is because, as you do not know what supplies may be made, you cannot know what VAT liabilities they may have.

If a project is aborted then a clawback (see **paragraph 11.7** or payback (see **paragraph 11.9**) adjustment may be appropriate unless costs are wasted (see **paragraph 11.14**).

11.5 What happens if I have surplus property and let it out?

There may be instances where you incur VAT on costs relating to a building that you no longer require for your core business. Whilst you have not decided what you will do with the building, this VAT will be residual input tax.

If you have decided to sub-let and have started to take steps to put the property on the market, this is strong evidence that you have an exempt intention unless you have made and notified an option to tax. Input tax you are charged on rent will be attributable to exempt supplies unless there is no doubt that ongoing taxable supplies must be made. If an option is made and notified at a later date, before any supplies have yet been made, any input tax that has been attributed to exempt supplies cannot be adjusted using 'payback' (see **paragraph 11.9**). This is because the costs will not be available to become cost components of subsequent taxable supplies, as they have effectively been 'used-up'.

11.6 When may I be able to adjust my input tax?

There may be occasions where the intended use of goods or services on which you based your claim to input tax changes. Where you change your intention before you use the goods or services, or, where you actually use the goods or services for a different purpose, the 'clawback' (see **paragraph 11.7**) and 'payback' (see **paragraph 11.9**) provisions may apply.

11.7 When does 'clawback' apply?

This applies where:

- (a) you have claimed input tax on goods or services because:
- you intended to use them in making taxable supplies but in the event you use them, or form an intention to use them, in making either exempt supplies or both taxable and exempt supplies; or
- (b) you have claimed input tax on goods or services because:
- you intended to use them in making both taxable and exempt supplies but in the event you use them, or form an intention to use them, in making only exempt supplies.

And for both (a) and (b) above where the change of intention occurs within six years of the beginning of the period covered by the VAT return in which the original intention was formed.

11.8 What happens if 'clawback' applies?

If 'clawback' applies, you will be required to recalculate the input tax you have claimed in past tax periods and to repay to us an amount equal to any over claimed input tax. You must do this on the return for the tax period in which the use occurs or the revised intention is formed. Your recalculation must be carried out using the method you used when making your original claim to input tax.

11.9 When does 'payback' apply?

This applies where:

(a) you have not claimed input tax on goods and services because;

- you intended to use them in making exempt supplies but in the event you use them, or form an intention to use them, in making taxable supplies or both taxable and exempt supplies; or

(b) you have not claimed input tax on goods or services because:

- you intended to use them in making both taxable and exempt supplies but in the event you use them, or form an intention to use them, in making only taxable supplies.

And for both (a) and (b) above where the change of intention occurs within six years of the beginning of the period covered by the VAT return in which the original intention was formed.

11.10 What happens if 'payback' applies?

If 'payback' applies you should write to your local VAT Business Centre applying for a sum equal to any under claimed input tax to be repaid to you. When the local VAT Business Centre has confirmed the amount to be repaid, you can enter this in your VAT account as an under-claim and include it in your next VAT return. When you calculate the amount under claimed, you must use the method you used when making your original claim to input tax.

11.11 What if I am only making an interim use?

If you are making an adjustment under either 'clawback' or 'payback' because you make an interim use of the goods or services which is different from that which you originally intended, and you retain an intention to make that 'original' supply, all such supplies may be taken into account. Any resulting input tax apportionment must be made on a fair and reasonable basis.

11.12 Do you have an example of 'clawback'?

Yes, you may find the following helpful in understanding the principal.

A construction company builds a residential property with the intention of selling the freehold (a zero-rated supply). In the course of the work, it incurs input tax of £15,000. The input tax is directly attributable to an intended taxable supply, so the company claims all the input tax. The property is put on the market, but no buyer is found.

After 6 months the company decides to let the property on an interim short-term lease whilst continuing to search for a buyer. Because the company originally intended to make a taxable supply, but in fact, actually makes an exempt supply of a lease, an amount needs to be repaid under the 'clawback' provisions. In this case, the company still retains an intention to make a taxable sale of the property. The input tax would therefore be apportioned across the two supplies and an amount to reflect the exempt use would be repaid.

If, on the other hand, the company decides to take the property off the market and grant a 15-year lease, the only supply would be exempt and an amount equal to all the input tax would be repaid.

11.13 Will a change in liability affect 'clawback' or 'payback'?

No, the 'clawback' and 'payback' provisions do not apply where the liability of your intended supply has altered because of a change in the law.

11.14 What about abortive supplies?

There may be occasions when an intended supply does not take place because a project is aborted. In such circumstances, when the goods and services are **not** used to make **any** supply, **no adjustment** to the initial claim of input tax is required or allowed.

However, where a project is aborted and the goods and services are used to make a different supply to that originally intended, an input tax adjustment will still usually be appropriate, using the 'clawback' and 'payback' provisions above.

11.15 What about change of use?

There may be occasions where you have correctly claimed input tax because you have actually used an item either wholly or partly in making taxable supplies and, at a later date, the extent to which you use that item in making taxable supplies changes.

If the change occurs before the end of the longer period, the annual adjustment would reflect this (**see section 10**). If the change occurs after the annual adjustment, no further adjustment will normally be required. The exception to this is if the item is a Capital Item under the terms of the Capital Goods Scheme. See the following **paragraph 11.16**.

11.16 What about the Capital Goods Scheme?

The law recognises that certain items of capital expenditure are capable of being used by a taxable person over a period of years and that there can be variations over those years in the extent to which such goods are used in making taxable supplies.

The Capital Goods Scheme provides a mechanism for adjustments to be made to the initial amount of input tax recovered to reflect these variations over a period of up to 10 years. In broad terms the Capital Goods Scheme applies to:

- computers and items of computer equipment of a tax-exclusive value of £50,000 or more; and
- land and buildings, civil engineering works and refurbishments of a tax-exclusive value of £250,000 or more

where you acquire these as capital items for use in your business.

For full details of the scheme see Notice 706/2 Capital goods scheme.

11.17 What about belated claims to input tax?

If you have failed to claim input tax in any tax period then you can claim it in a later period as long as that does not lead to a claim being made more than three years from the due date of the return for the prescribed accounting period in which the input tax was charged to you.

Alternatively you can correct the error by the normal procedures set out in Notice 700/45 How to correct VAT errors and make adjustments or claims. In either case, however, you can only claim the input tax to the extent that you would have been able to had you included it in the period in which it was charged to you.

11.18 What are the capping provisions?

In most circumstances we will not assess for errors found more than 3 years after the end of the accounting period in which the error was made. Similarly you can only rectify errors involving under claimed input tax within 3 years of the end of the period in which the input tax should have been claimed. This is known as capping.

If the capping rules apply to you, you should carry out your partial exemption calculations in the normal way, as if you were going to recover or repay the input tax. You should identify where the capping time limit falls and any VAT relating to a tax period more than 3 years old will not be adjusted. VAT relating to tax periods less than 3 years old should be recovered or repaid, as appropriate.

11.19 What if my tax year/longer period spans the 3 years?

If the VAT period in which the longer period or annual adjustment is due is not capped, but the earlier periods making up the longer period are themselves capped, then you can use the annual adjustment to take account of a change of use during the longer period. This is because the annual adjustment is properly used to reconsider any direct attribution made during the year and makes adjustments to reflect the use of goods or services in the longer period (see **paragraph 10.4**).

11.20 What if the error is in a period that is capped?

If you have made an error in a period that is capped, you cannot use the annual adjustment to correct that error (see **paragraph 10.6**). When you recalculate the annual adjustment, it is the corrected figures for the earlier periods that should be used (although you cannot recover or repay the tax relating to the earlier periods).

12. Special circumstances which have a bearing on the partial exemption rules

12.1 Will special circumstances apply to group registration?

Yes, there are **two** important points to remember regarding partial exemption and VAT groups.

Points to remember	
1. A VAT group is treated as a single person trading through its representative member.	Therefore it will have only one partial exemption method for the whole group. However, in deciding whether your VAT group can treat property or financial transactions as incidental for the purposes of the standard method calculation the different business activities of the group should be considered separately. Section 4 explains this in more detail. Remember that it is necessary to look at each of the business activities carried on by a group member, not just its principal enterprise.
2. Supplies between group members are disregarded for VAT purposes.	Therefore, the VAT group should attribute input tax by 'looking through' the transactions between group members to the supplies made to persons outside the group. The example at paragraph 12.2 shows how this will work.

VAT Notice 700/2 Group and divisional registration gives further details on VAT groups.

12.2 Can you show me an example of supplies between group members?

A company rents a building from another company in the same VAT group. The input tax on the upkeep of that building should be claimed in full by the VAT group representative member provided the lessee uses the building exclusively to make taxable supplies. However the input tax would be:

- wholly non-recoverable if the building was used solely to make exempt supplies; or
- treated as 'residual input tax' and would be apportioned in line with the group's partial exemption method if the building was to be used to make both taxable and exempt supplies.

12.3 Will divisional registration be affected?

Notice 700/2 Group and divisional registration explains that a body that is organised in a number of divisions may apply for each division to be separately registered for VAT.

However, divisional registration will not be allowed if the exempt input tax of the body as a whole exceeds the de minimis limit (**section 9**). If, at any time, a corporate body registered in divisions exceeds the de minimis limit, you must advise your local VAT Business Centre immediately and a decision will be made as to whether the divisional registration should be allowed to continue. If the divisional registration is cancelled for the corporate body as a whole then, if it is still liable to be registered, the single VAT registration must cover all the taxable business activities of the body corporate as a whole.

12.4 What about holding companies?

Where a holding company incurs input tax on costs that do not relate to actual taxable or exempt supplies (for example input tax on acquisition costs), this may be treated as part of the general overhead input tax of the VAT registration as a whole.

This means that if the holding company is a member of a VAT group, the costs will be a general business expense of the whole group. Where the registration is partly exempt, this input tax is part of the residual input tax (**paragraph 3.4**).

A holding company may also incur input tax that relates to actual supplies (for example the sale of shares in subsidiaries or disposals of property). In these circumstances recovery of input tax will depend on the liability of the supplies made and whether they were made by way of business.

12.5 What if I am involved with the transfer of a going concern?

The transfer of assets of a going concern is neither a supply of goods nor a supply of services for VAT purposes (see Notice 700/9 Transfer of a business as a going concern).

The way you treat input tax incurred in relation to a transfer of a going concern depends on whether you are the transferor (the person disposing of the business), or the transferee (the person acquiring the business).

12.6 What if I am the transferor?

Following the European Court of Justice decision in Abbey National Plc (C-408/98), we now accept that, from 1 August 2001, the input tax on expenses that relate wholly to the transfer (for example legal fees) should be treated as an overhead of that part of the business being transferred. Where that part of the business makes:

- only taxable supplies, the input tax is fully recoverable;
- only exempt supplies, the input tax is wholly non-recoverable; and
- both taxable and exempt supplies, the input tax is residual and recoverable in accordance with the partial exemption method in place.

Prior to the Abbey National Plc decision, our policy was that input tax incurred on expenses which related to the transfer of assets were considered to be residual tax, and the value of input tax recoverable was calculated in accordance with the partial exemption method in place.

If your partial exemption method fails to achieve a fair and reasonable result, we may, exceptionally, be prepared to approve an alternative method, which has retrospective effect.

However, we will seek to ensure that any such method provides for a fair and reasonable recovery of input tax.

12.7 What if I am the transferee?

The input tax on costs that relate wholly to the acquisition of assets acquired for your business, as a result of a transfer of a going concern, will be recoverable to the extent to which they will be used in making taxable supplies. Therefore, where they are be used in making:

- only taxable supplies, the input tax is fully recoverable;

- only exempt supplies, the input tax is wholly non-recoverable; and
- both taxable and exempt supplies, the input tax is residual and recoverable in accordance with the partial exemption method in place.

Please note this applies only to acquisitions of businesses by way of a transfer of a going concern. Any input tax on expenses related to any other form of acquisition, such as the acquisition of shares in a business, should be treated as residual input tax, and recoverable in accordance with the partial exemption method in place.

If you acquire...	and you...	your VAT group may...
a business or its assets as a going concern	are a member of a VAT group registration that is partly exempt; or become partly exempt during the tax year in which the transfer takes place	have to account for VAT on certain assets as a supply both to and by the group. Notice 700/9 Transfer of a business as a going concern gives full details.

12.8 What if I receive services from outside the UK?

As a partly exempt business you may receive services from outside the UK on which you have to account for VAT. You must deal with those services as if you had supplied them yourself in the UK. The services subject to this 'reverse charge' and the procedures to follow are described in Notice 741 Place of supply of services.

The points to remember for partial exemption purposes are:

- an amount equal to the output tax you pay on an imported service is your input tax;
- you can only claim the input tax in full if the imported service is used, or to be used, to make a supply with the right to deduct input tax; and
- you should exclude the value of imported services from your calculation to apportion residual input tax if you use the standard method or a special method based on output values; but
- you should include exempt input tax on imported services with your other exempt input tax in determining whether you are within the de minimis limits or not.

You cannot claim input tax simply by relating it to the chargeable imported service itself.

12.9 Are there agreements with trade bodies?

Yes, we have entered into agreements with a number of trade bodies about how their members may calculate their claimable input tax. Details of these agreements can be found in Notice 700/57 Administrative agreements entered into with trade bodies.

13. Glossary

Below is a list, which is not exhaustive, of some terms commonly used in partial exemption, along with a brief explanation of their meanings. Some terms are complex, and so these explanations should be regarded as general only, and not definitive. If in doubt, please contact our National Advice Service.

Term	Explanation
Allocation	Some special methods have different sectors where the recoverable element of residual tax is different. Allocation is the means by which residual input tax is distributed to specific sectors within a method (see section 6).
Annual adjustment	At the end of the tax year the partial exemption calculation is re-calculated using annual figures. See paragraph 3.8 and section 10 .
Apportionment	Residual input tax must be apportioned to reflect the extent to which the goods and services on which it is incurred are used in making onward taxable supplies. The partial exemption method carries out this role (see paragraph 3.5).
De minimis	A test designed to allow recovery of minimal amounts of exempt input tax - further information is given in section 9 .
Direct attribution	The identification of input tax on supplies that are wholly used, or to be wholly used in making taxable supplies or are wholly used or to be wholly used in making exempt supplies. The tax used in making taxable supplies can be recovered in full, whereas the tax used or to be used in making exempt supplies cannot (subject to de minimis). Any input tax used in making both taxable and exempt supplies

	is termed 'residual' (see paragraph 3.2).
Exempt input tax	Input tax incurred on goods and services purchased which is wholly used or to be wholly used in making exempt supplies. After the partial exemption method has been applied, this value will include the exempt element of residual input tax identified by the partial exemption method (see paragraph 3.7).
Exempt supplies	Supplies made by a business, which are listed in Schedule 9 of the VAT Act 1994. VAT incurred in making exempt supplies is non-recoverable, subject to the de minimis test.
Input tax	VAT incurred by a VAT registered person on goods and services purchased for the purposes of a business.
Longer period	This is usually the tax year for annual adjustment purposes but may in certain circumstances be shorter than a tax year. See paragraph 10.3 .
Out of country supplies	Supplies made by a business which are made outside the UK but which would be taxable if they were made in the UK. See section 8 .
Out of country and specified supplies calculation	Calculation to identify the recoverable element of input tax relating partly to out of country and specified supplies and partly to other supplies. Must be completed before the standard or special method unless a single stage calculation has been agreed. See section 8 .
Residual input tax	Input tax incurred by a business on goods and services used or to be used in making both taxable and exempt supplies. This input tax is apportioned between taxable and exempt supplies by the partial exemption method. See paragraph 3.4 . Residual input tax is commonly referred to as 'non-attributable input tax' or 'the pot'.
Special method	Any partial exemption method, other than the standard method, used to identify the

	taxable element of input tax incurred. Special methods require prior approval from us. See section 6 .
Specified supplies	Supplies specified by Treasury Order which are not taxable supplies, but which carry the right to recover input tax incurred in making them. See section 8 .
Standard method	This partial exemption method is available to all partly exempt businesses without seeking prior approval from us (see section 4).
Taxable input tax	Input tax incurred on purchases of goods and services which is wholly used or to be wholly used in making taxable supplies. After the partial exemption method has been applied, this value will include the taxable element of residual input tax identified by the partial exemption method (see paragraph 3.6).
Taxable supplies	Supplies made by a business, which are either standard, reduced or zero-rated. Input tax incurred in making taxable supplies is deductible.
Tax year	A business is given a tax year. These usually end at the end of March, April and May each year, depending on the business's VAT return periods. See paragraph 10.2 .
VAT Groups	Two or more corporate bodies accounting for VAT under a single VAT registration number. One acts as representative member and any supplies between the members of the group are disregarded for VAT purposes. See Notice 700/2 Group and divisional registration.

Do you have any comments?

We would be pleased to receive any comments or suggestions you may have about this notice. Please write to:

Notice 706 Partial exemption
December 2006

HM Revenue and Customs
Partial Exemption Team
3rd Floor 100 Parliament Street
London
SW1A 2BQ

Please note this address is not for general enquiries. You should ring our National Advice Service about those.

If you have a complaint or suggestion

If you have a complaint please try to resolve it on the spot with our officer. If you are unable to do so, or have a suggestion about how we can improve our service, you should contact one of our Regional Complaints Units. You will find the telephone number under 'Revenue & Customs' or under 'Customs and Excise' in your local telephone book. Ask for a copy of our code of practice 'Complaints and putting things right' (Notice 1000). You will find further information on our website at <http://www.hmrc.gov.uk>.

If we are unable to resolve your complaint to your satisfaction you can ask the Adjudicator to look into it. The Adjudicator, whose services are free, is a fair and unbiased referee whose recommendations are independent of Revenue & Customs.

You can contact the Adjudicator at:

The Adjudicator's Office
Haymarket House
28 Haymarket
LONDON
SW1Y 4SP

Phone: (020) 7930 2292

Fax: (020) 7930 2298

E-mail: adjudicators@gtnet.gov.uk

Internet: <http://www.adjudicatorsoffice.gov.uk/>