

# VAT: Partial Exemption – changes to the de minimis rules

VAT Information Sheet 04/10

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## 1. Introduction

### 1.1 Who should read this information sheet?

Smaller-sized businesses that currently benefit, or think they may benefit, from the partial exemption de minimis rules. This information sheet assumes you have an existing knowledge of the current partial exemption rules. Further information about partial exemption can be found in Public Notice 706 Partial Exemption.

### 1.2 What is this information sheet about?

It provides guidance on two changes to simplify the de minimis rules that affect VAT periods commencing on or after 1 April 2010. The changes are optional and can be adopted by businesses without approval from us. The two changes are referred to as:

- simplified tests (section 2)
- annual test (section 3)

### 1.3 Why are these changes being introduced?

The current de minimis rules require businesses to carry out detailed partial exemption calculations. These changes are being introduced to allow the vast majority of businesses to confirm their de minimis status using far simpler calculations that rely on information that a business has readily to hand.

The changes follow a consultation on ideas to simplify the partial exemption rules, which confirmed strong support for their implementation. They build on changes made last year to simplify the standard method by further reducing administrative burdens on businesses.

## 2. Simplified tests

### 2.1 How does the current de minimis test work?

The current test requires a business to calculate how much input tax it has incurred on costs relating to exempt supplies in accordance with its partial exemption method. Provided this input tax is no more than £625 per month on average and no more than 50 per cent of its total input tax, the business is said to be 'de minimis' (or to have 'passed the de minimis test') and can provisionally recover input tax relating to exempt supplies. The test is then re-applied at the end of the partial exemption year (also known as a 'longer period') to establish the de minimis status of the business and any under/over recovery of input tax is accounted for in the annual adjustment.

### 2.2 What are the simplified tests?

The simplified tests save some businesses the need to carry out a full partial exemption calculation to confirm their de minimis status. If, in a VAT period, a business passes Test one or Test two (set out below) it may treat itself as de minimis and provisionally recover input tax relating to exempt supplies. The business is still required to review its de minimis status at year-end as before and account for any under/over recovery of input tax as part of its annual adjustment (see 2.5). The simplified tests are:

- Test one: total input tax incurred is no more than £625 per month on average and the value of exempt supplies is no more than 50 per cent of the value of all supplies
- Test two: total input tax incurred less input tax directly attributable to taxable supplies is no more than £625 per month on average and the value of exempt supplies is no more than 50 per cent of the value of all supplies

**Note one:** 'Total input tax' excludes blocked input tax (such as VAT on the cost of business entertainment) which is irrecoverable.

**Note two:** 'The value of all supplies' includes taxable supplies made in the UK, supplies made outside the UK which confer the right of recovery (known as 'regulation 103 supplies') and exempt supplies.

**Note three:** 'input tax directly attributable to taxable supplies' is input tax on costs that are used or to be used exclusively in making taxable supplies. For example, input tax on the cost of goods for resale.

Example one: a business has a VAT period running from 1 April to 30 June 2010. During that period it incurs total input tax of £1,800 which it uses making taxable supplies of £30,000 and exempt supplies of £20,000. For the quarter ending June 2010, the business incurs total input tax of no more than £1,875 (£625 x 3 months) and the value of its exempt supplies is no more than 50 per cent of its total supplies ( $20,000/50,000 \times 100 = 40\%$ ). Therefore, the business is de minimis for this period as it passes Test one and can provisionally recover £1,800 input tax on its VAT return without the need to carry out a full partial exemption calculation. This will be subject to review at year-end in accordance with paragraph.2.5.

Example two: a business has a partial exemption year running from 1 May 2010 to 30 April 2011. During that period it incurs total input tax of £30,000, of which £25,000 is on goods for resale which are directly attributable to taxable supplies. It makes taxable supplies of £75,000 and exempt supplies of £60,000. Its total input tax less input tax directly attributable to taxable supplies is £5,000 ( $30,000 - 25,000$ ) which is less than £7,500 (£625 x 12), and the value of its exempt supplies is no more than 50 per cent of its total supplies ( $60,000/135,000 \times 100 = 44\%$ ). Therefore, the business has finalised its de minimis status for the year and is entitled to recover £30,000. There is no need for any further partial exemption calculation for that year.

## **2.3 How do the new tests interact with the current test?**

The new tests supplement the current test. A business is de minimis if it passes Test one, Test two or the current test, and if it passes any one test there is no need for it to consider the other two. Even if a business fails Test one and Test two, the information gathered is still required to carry out a full partial exemption calculation for the current test.

## **2.4 If I pass Test one or Test two in a VAT period do I still need to do a partial exemption calculation?**

No. The tests have been introduced to save the need for partial exemption calculations in these circumstances.

## **2.5 Do I still need to do an annual adjustment?**

At the end of your partial exemption year, you need to apply the de minimis test to the year as a whole.

- If you pass Test one for the year, you can recover all of your input tax relating to exempt supplies and are not required to carry out any further partial exemption calculations.
- When applying Test two, you first need to review how much of the input tax you have incurred over the year is directly attributable to taxable supplies. Then, if you pass Test two for the year, you can recover all of your input tax relating to exempt supplies and are not required to carry out any further partial exemption calculations.

- If you fail Test one and Test two for the year, then you need to carry out a full partial exemption calculation for the year to determine whether you pass the current de minimis test (see 2.1) and account for any under/over recovery of input tax as part of your annual adjustment in the normal way.

## **2.6 When do the new tests take effect?**

The simplified tests may be applied to VAT periods commencing on or after 1 April 2010.

## **2.7 Why is Test one not set out in the legislation?**

A business that passes Test one must, in all cases, pass Test two and so it was unnecessary to set it out in the legislation.

# **3. Annual test**

## **3.1 What are the current rules?**

The current rules require a business to apply the de minimis test in each VAT period. If it passes the test it is de minimis and can provisionally recover input tax relating to exempt supplies in that period. This is subject to an end-of-year partial exemption calculation to review its de minimis status and any under/over recovery of input tax is accounted for in the annual adjustment.

## **3.2 What is the new annual test?**

The annual test gives most businesses the option of applying the de minimis test once a year, instead of four or five times a year (depending on when a business decides to account for its annual adjustment). It allows a business that was de minimis in its previous partial exemption year to treat itself as de minimis in its current partial exemption year. This means it can provisionally recover input tax relating to exempt supplies in each VAT period, saving the need for partial exemption calculations.

## **3.3 Do I need to review my de minimis status at year-end?**

Yes, you are still required to review your de minimis status at year-end in accordance with paragraph 2.5 and if you fail the de minimis test for the year you must repay the input tax relating to exempt supplies that you provisionally recovered in-year. However, there is no need carry out in-year partial exemption calculations.

Example three: A business was de minimis in its partial exemption year ending 31 March 2010. It has the option of applying the annual test and treating itself as de minimis during the year ending 31 March 2011. This means that it can provisionally recover input tax relating to exempt supplies in each VAT period during that year without the need to carry out a partial exemption calculation. The business is then required to review its de minimis status at year-end and, if it fails the de minimis test for the year, repay the input tax it has incurred during the year that relates to exempt supplies.

### **3.4 What are the conditions on using the annual test?**

There are three conditions on using the annual test. The business must:

- pass the de minimis test for its previous partial exemption year
- consistently apply the annual test throughout any given partial exemption year
- have reasonable grounds for not expecting to incur more than £1million input tax in its current partial exemption year

If any of these conditions are not met then the business is required to apply the de minimis test in each VAT period, which remains the default position.

### **3.5 What else do I need to consider?**

The main risk of using the annual test is that a business provisionally recovers input tax relating to exempt supplies in-year, but then fails the test at year-end and is required to repay this input tax to us. If you think you are likely to fail the test at year-end and repaying the input tax would cause you difficulties, then it would not be advisable to take up the option of the annual test.

### **3.6 When does it take effect?**

A business may adopt the annual test for partial exemption years commencing on or after 1 April 2010, if it was de minimis in its previous partial exemption year.