

Background

About this document

The information contained here applies to taxable persons who undertake both business and non-business activities and who are also partly exempt for VAT purposes – which is referred to as ‘partly exempt persons’.

This information doesn’t replace published Partial Exemption legislation and guidance – this aims to support NHS bodies who are partly exempt persons. For further information about Partial Exemption (PE), please refer to [VAT Public Notice 706](#) or [HMRC’s Partial Exemption Manual](#).

Combined methods

Where the partly exempt person uses costs in carrying out both business and non-business activities they are required, under Section 24(5) VAT Act 1994, to apportion VAT incurred on these costs between those activities. VAT that is apportioned to business activity under this process is input tax. If that input tax is used in making both taxable and exempt supplies the taxpayer is partially exempt and is required to apply the PE methods set out in regulations to apportion that input tax.

Any partly exempt person who falls within these criteria may apply for a ‘combined method’ - a method that combines the Business / Non-Business apportionment with a Partial Exemption calculation.

Approval for the use of a combined method is given under Regulation 102ZA of the VAT Regulations 1995, with the start date of the method being either:

- A current or future date as requested within the written proposal
- Backdated to the start of the tax year in which the ‘fair and reasonable’ declaration to the proposal was received by HMRC - for NHS bodies this will be 1 April of the relevant year

For the avoidance of doubt, a combined method cannot be operated without written approval from HMRC.

In-year provisional recovery

In-year provisional recovery is where the recovery rate established by the previous year’s Longer Period Adjustment, is used as a ‘best estimate’ recovery rate in each period of the ‘current year’. Where the method has a number of separate sectors, the relevant provisional recovery rate will apply to each sector.

In-year provisional recovery is the default, and least burdensome, option for completing calculations, whether a partly exempt person uses an approved combined / special method or the Partial Exemption standard method. The alternative option is that partly exempt persons must carry out full calculations in each return period.

The use of in-year provisional recovery will be written into the approval letter. Once approved, a partly exempt person cannot change to full period-by-period calculations, without written approval from HMRC. Similarly, if a partly exempt person is using the Partial Exemption standard method, they cannot alternate between in-year provisional recovery and full period-by-period calculations.

The amount of input tax recovered provisionally will be adjusted based upon the actual recovery rate for the year, when the longer period adjustment is calculated.

Longer Period Adjustments

Partly exempt persons who operate a Partial Exemption method or combined method are required, by law, to carry out a Longer Period Adjustment (“LPA”) also known as the Annual Adjustment. This requirement is set out in Regulation 107 of the VAT Regulations 1995.

The legislative purpose of the LPA in relation to non-combined methods, is to allow a partly exempt person to reconsider the use of goods and services over the longer period, as well as to re-evaluate exempt input tax under the de-minimis provisions, thereby establishing a final recovery rate.

The legislative purpose of the LPA in relation to combined methods, is solely to allow a partly exempt person to reconsider the use of goods and services over the longer period, thereby establishing a final recovery rate.

In either scenario, the LPA cannot be used to correct a failure to apply a method properly in provisional periods. Further information regarding the legislative purpose of the LPA can be found in [HMRC’s PE Guidance, at PE37600](#).

That same guidance explains, with reference to the Tribunal case of *Greenpeace Ltd (LON/99/532)*, that the LPA cannot be used to correct errors that are discovered during the longer period - any errors must be corrected separately, and in the correct period, under the legal provisions that exist in regulations 34 and 35.

The LPA must be declared as part of the VAT Return for the last period of the longer period, or the first period following the end of the longer period, except where the Commissioners allow another period to be used.

For the avoidance of doubt, the combined method approval letter sets out the period in which the LPA must be made.

If the LPA is made in the correct period it should be included as part of the appropriate VAT Return, regardless of the value of the adjustment - there is no need to separately notify HMRC.

Although the LPA is not an error itself, and it cannot be used to correct errors, if it’s not made in the correct period then the error correction limits set out in VAT Public Notice 700/45 should be followed - the LPA must be declared to HMRC using the appropriate method.

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Confirmation of correct processes

Correct operation of provisional recovery / restriction

Historically, HMRC has not objected to NHS bodies only carrying out a provisional restriction in relation to residual COS VAT, with residual non-COS or mixed-use VAT being dealt with on an annual basis.

HMRC recognises this practice is not in line with Partial Exemption guidance and legislation. Therefore, from 1 April 2024 this practice will no longer be accepted.

Where a partly exempt person opts to use provisional recovery, rather than full period-by-period calculations, and regardless of whether they are operating a combined / special method or the Partial Exemption standard method, they must carry out both:

- Provisional recovery for non-COS / mixed-use VAT
- Provisional restriction for residual COS VAT

A partly exempt person who uses a combined / special method will have an 'approval letter' from HMRC. If provisional recovery has been proposed and agreed, it will be stated in the approval letter. For the avoidance of doubt, the relevant statement has, historically, not distinguished between residual COS and residual non-COS / mixed-use VAT. That is to say, the approved method requires the partly exempt person to carry out provisional recovery fully and correctly.

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Use of combined methods for bringing 'old years' up-to-date

Historically, HMRC has not objected to NHS bodies using a newly approved combined method to complete the LPA for years prior to the start date of the method, where the adjustment had not yet been carried out and where an existing method was not already in use.

HMRC recognises this practice is not in line with Partial Exemption guidance and legislation. Therefore, from 1 April 2024 this practice will not be accepted for any currently outstanding or future outstanding periods.

For the periods prior to the start date of an approved combined method, partly exempt persons must carry out a two-step process Business / Non-Business apportionment (under Section 24(5), VAT Act 1994) **followed by** a Partial Exemption standard method calculation. Once those calculations have been carried out, partly exempt persons are required to consider the Standard Method Override ("SMO").

The SMO applies if annual residual input tax is more than £50,000.00 **and** the Partial Exemption standard method does not give a fair and reasonable result. The calculation can be carried out using any method that is fair and reasonable, which might be based on a PE calculation that is set out in their approved combined method. Please note that the SMO 'trigger' amount stated here is residual input tax, which does not include residual COS VAT.

If the SMO limits are triggered, an adjustment only needs to be made if the 'substantial difference test' is met. That is to say, if the difference between the input tax deducted using the standard method and the amount deductible using the SMO calculation is more than either:

- £50,000.00
- 50% of the total residual input tax incurred **and** at least £25,000.00

In this situation, partly exempt persons must declare the result of the standard method calculation and the adjustment amount of the SMO in the same VAT Return - it is not enough to declare a 'total' amount based on both calculations.

Note, the above is limited to situations where an NHS body does not already have an approved combined method. If an NHS body already has an approved combined method, that method should be used to carry out LPAs until such time as HMRC approve or direct its termination.

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Correcting periods where a previous Longer Period Adjustment has not been carried out

Historically, HMRC has not objected to NHS bodies completing LPAs for older years, i.e. those years prior to the most recently ended longer period, with no action to correct individual periods.

HMRC recognises this practice is not in line with Partial Exemption guidance and legislation. Therefore, from 1 April 2024 this practice will not be accepted for any currently outstanding or future outstanding periods.

Where the LPA has not been completed for an older year, partly exempt persons must correct each individual period using the most recently completed LPA, to establish a 'correct' provisional recovery for the year. This process must be followed by carrying out the LPA for that year, to establish the actual recovery rate. The process is then repeated for subsequent years, until all years are up-to-date.

For example, if, during the 2022-2023 year, it is discovered that the 2019-2020 (and onwards) LPA was not completed, the correct action is to:

- Complete the LPA for 2019-2020 - assuming in-year provisional recovery was correctly carried out during the year
- Use the recovery rate established by the 2019-2020 LPA to correct the provisional recovery for each period of 2020-2021
- Complete the LPA for 2020-2021
- Use the recovery rate established by the 2020-2021 LPA to correct the provisional recovery for each period of 2021-2022
- Complete the LPA for 2021-2022
- Use the recovery rate established by the 2021-2022 LPA as the provisional recovery rate for 2022-2023

In this situation, partly exempt persons must declare the in-year adjustments and LPAs for each year as separate values, at the same time - it is not enough to declare a 'total' amount based on both the in-year and LPA calculations.

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Partial Exemption and behavioural penalties

Partial Exemption calculations are given to HMRC either by virtue of inclusion in the appropriate VAT Return, or by submission of an error correction notice.

It is the responsibility of a partly exempt person to take all reasonable care in ensuring the accuracy of the Partial Exemption calculations they give to HMRC, whether that is for in-year provisional recovery or LPAs.

By correctly following the Partial Exemption legislation and guidance, partly exempt persons can help to mitigate the possibility of making errors.

If a Partial Exemption error is made, HMRC must consider the error in line with the 'behavioural penalties' legislation, as set out in Schedule 24 of the Finance Act 2007, which states:

1(1) A penalty is payable by a person (P) where-

- (a) P gives HMRC a document of a kind listed in the Table below, and*
- (b) Conditions 1 and 2 are satisfied.*

1(2) Condition 1 is that the document contains an inaccuracy which amounts to, or leads to-

- (a) an understatement of a liability to tax,*
- (b) a false or inflated statement of a loss, or*
- (c) a false or inflated claim to repayment of tax.*

1(3) Condition 2 is that the inaccuracy was careless (within the meaning of paragraph 3) or deliberate on P's part.

1(4) Where a document contains more than one inaccuracy, a penalty is payable for each inaccuracy.

For awareness a 'document of a kind listed in the Table below' includes VAT Returns, as well as 'other returns, statements or declarations in connection with a claim' - this includes documents submitted under the error notification arrangements contained in Regulations 34 and 35, of the VAT Regulations 1995.

Further information about behavioural penalties can be found in [HMRC's Compliance Handbook, starting at reference CH80000](#).