



**Ipsos MORI**  
Social Research Institute

January 2018

# VAT Partial Exemption

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Ipsos MORI Social Research Institute

HMRC Report Number 485

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Published by HM Revenue and Customs, January 2018

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# Glossary

<b>Input costs</b>	Costs for purchases and expenses incurred by the business, excluding wages, VAT, and money taken out of the business.
<b>Input tax</b>	Input tax is the VAT incurred on the purchases of the business, which are used for its business purposes.
<b>Pots (sometimes referred to as overheads)</b>	A special method must have one or more 'pots'. These are separate calculations for the different parts of the business.
<b>Standard method</b>	The standard method is a type of partial exemption calculation. It is used to calculate how much of a partially-exempt business' input tax is attributable to taxable supplies, and therefore, recoverable. Businesses must use the standard method unless HMRC has given approval for them to operate a special method (see below).
<b>Special method</b>	If the standard method of partial exemption calculation is considered not to give a fair result (see above), businesses can apply to HMRC to use a special method for the calculation. A special method is any calculation, other than the standard method, that enables a business to calculate how much of their input tax they may recover. A special method is bespoke to each business.
<b>Turnover</b>	The total amount of money generated in the business from all sales of goods and services before any deductions.
<b>Value Added Tax (VAT)</b>	Value Added Tax (VAT) is a tax levied on the majority of goods and services provided by VAT registered businesses in the UK. The standard VAT rate in the UK is 20%. Some goods and services have a reduced rate of 5% (such as domestic fuel and children's car seats) or 0% (including most food items and children's clothing), and some are exempt from VAT, such as medical and dental care, social services, education, financial and insurance services, and certain supplies of land and buildings.
<b>VAT partial exemption</b>	Businesses can usually reclaim the VAT paid on goods and services purchased for use in their business to make taxable supplies. However, VAT incurred on goods and services used by a business to make VAT exempt supplies cannot be recovered. Where a business makes both taxable and exempt supplies, they are described as 'partially exempt', and need to calculate the proportion of VAT incurred that is recoverable.
<b>VAT recovery rate</b>	The percentage of VAT incurred on purchases and expenses that a business can recover.

# Executive Summary

This report presents findings from a telephone survey of 1,932 VAT registered businesses in 17 industry sectors of the economy.

## Background and research aims

Value Added Tax (VAT) is a tax levied on the majority of goods and services provided by registered businesses in the UK. It is the third largest source of government revenue, after income tax and National Insurance contributions. The standard VAT rate in the UK is 20%. Some goods and services have a reduced rate of 5% or 0%, and some are exempt from VAT.<sup>1</sup> Businesses can usually reclaim the VAT paid on goods and services purchased for use in their business. However, VAT incurred on goods and services used by a business to make exempt supplies cannot be recovered. Where a business makes both taxable and exempt supplies, they are described as 'partially-exempt', and need to calculate the proportion of VAT they incur that is recoverable.

There are different methods that partially exempt businesses can use to work out how much input tax they can recover. The default is the standard method, which applies to most businesses, and is based on the value of supplies the business makes. Alternatively, businesses can apply to HMRC to use a special method, which is bespoke to each business and can only be used with HMRC's permission.

The aim of this research was to explore business knowledge and use of VAT partial exemption, and gather information on VAT recovery rates in 17 industry sectors.

## Awareness and knowledge of VAT partial exemption

**Awareness of VAT partial exemption was high though detailed knowledge was more limited.** Among businesses that did not have full VAT recovery (71% of the sample), 86% reported that they had heard of VAT partial exemption compared with 12% who have not. One in seven (14%) professed to know a great deal and 32% a fair amount.

Among businesses who were aware of VAT partial exemption, half (51%) reported that they knew at least a fair amount about *how it is calculated* and 32% about *different partial exemption methods* (i.e. special or standard). Businesses most commonly obtained information and advice on VAT partial exemption from their accountants or tax agents (43%) and HMRC (29%).

**Larger businesses, in terms of employee number and turnover, were more knowledgeable than smaller businesses on VAT partial exemption**, partly because they were more likely to be using a partial exemption method. There was also considerable variation in overall knowledge of VAT partial exemption by industry sector, which reflects differences in use of partial exemption. Businesses in financial service activities, education, and activities auxiliary to finance were most knowledgeable, as these sectors had relatively high use of partial exemption. In contrast, businesses in postal courier activities, retail, and construction were least knowledgeable; these businesses were also least likely to report using a partial exemption method.

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<sup>1</sup> The main difference between zero rate and exempt supplies is that the suppliers of zero-rated goods and services can still reclaim all their input VAT, but the suppliers of exempt goods are either not registered for VAT or if they are, they cannot reclaim their input VAT.

## Application of VAT partial exemption

A quarter (24%) of businesses in the sample reported that they were using the standard method and 13% the special method. Use of a partial exemption method was most common in social work without accommodation, and financial service activities (56% in both), and least common in postal and courier activities, retail, and construction (8%, 15% and 23% respectively).

The most common special method used was single overhead or pot, and the principle calculation was most commonly a mixture of different calculations. Businesses reported similar reasons for using the standard method and the special method – it was the most appropriate method for the sector or business activities, and works for the business

The highest VAT recovery rates, that is the total VAT claimed back as a percentage of total VAT incurred, were in retail (74%) and public administration (86%). The lowest VAT recovery rates were in social work activities without accommodation (22%) and education (23%).

Businesses who were aware of VAT partial exemption most commonly reviewed their calculation method annually (29%), though a similar proportion reported that they have never reviewed their method. Around one in ten (8%) do it more than once a year, although twice as many do it less than once a year (15%). One in ten (9%) do it ad-hoc (e.g. when their circumstances change or when requested by HMRC).

Two thirds of businesses (68%) who were using, or have used in the past, a partial exemption method reported that they incurred costs in complying with VAT partial exemption. The most common costs reported relates to staff time and accountant/adviser fees, especially among businesses using a special method.

Businesses using a special method were more likely to report incurring costs across the board. However, across both groups, the large majority reported that they would still use an accountant/tax agent in the absence of VAT partial exemption (78% of those using a special method and 74% of those using the standard method).

# 1 Introduction

## 1.1 Background and research aims

Value Added Tax (VAT) is a charge levied on the majority of goods and services provided by VAT registered businesses in the UK. It is the third largest source of government revenue, after income tax and National Insurance. For 2015/16, the VAT receipts for the UK Government were £116 billion.<sup>2</sup>

The standard VAT rate in the UK has been 20% since January 2011, and some goods and services have a reduced rate of 5% (such as domestic fuel and children's car seats) or 0% (including most food items and children's clothing). Some supplies made by businesses are exempt from VAT, including medical and dental care, social services, education, financial and insurance services, and certain supplies of land and buildings.<sup>3</sup> Businesses can usually reclaim the VAT paid on goods and services purchased for making taxable business supplies. The amount of VAT recoverable by businesses can be affected by many factors, including the extent to which they undertake non-business activities and any special schemes, such as those that apply to Local Authorities and Government Departments. VAT incurred on goods and services used by a business to make exempt supplies cannot be recovered. Where a business makes both taxable and exempt supplies, they are described as '*partially-exempt*' and need to calculate the proportion of VAT they incur that is recoverable.

There are different methods that partially-exempt businesses can use to work out how much input tax can be recovered. The default is the *standard method*. It calculates recovery based upon the proportion of taxable and exempt turnover in the business. If the standard method is considered not to give a fair and reasonable attribution of input tax to taxable supplies, businesses can apply to HMRC to use a *special method* for the calculation (for example, apportionments based upon numbers of transactions or one that subdivides the business into its different activities). HMRC can also direct businesses to use a special method. A special method is bespoke to each business, and can only be used with HMRC's permission.

The restriction of VAT recovery through partial exemption has a significant impact on UK VAT receipts by the Treasury. The aim of this study was to better understand business knowledge and use of partial exemption, as well as gaining an estimate of the proportion VAT businesses are recovering in 17 key industry sectors.

## 1.2 Methodology

The research comprised a random probability sample of 1,932 VAT registered businesses in 17 sectors of the economy. Businesses were sampled from HMRC VAT records. A telephone survey was carried out between February and March 2017. The number of interviews achieved in each sector are shown in Table 1.1 on the following page.

The sample was designed to provide **sector estimates** on VAT recovery rates. A minimum sample size of 100 interviews was set for each sector, increasing to 200 for sectors with a very high number of businesses such as construction, retail, real estate, and education. In a number of sectors, the target number of interviews was lowered because there were insufficient sample with valid telephone numbers even after telephone matching was undertaken.

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<sup>2</sup> HM Revenue & Customs' Trust Statements 2011-12 to 2015-16.

<sup>3</sup> The main difference between zero rate and exempt supplies is that the suppliers of zero rated goods and services can still reclaim all their input VAT, but the suppliers of exempt goods are either not registered for VAT, or if they are, they cannot reclaim their input VAT.

**Table 1.1: Total number of interviews by industry sector**

Industry sector	Number of interviews
Construction of buildings	212
Retail	233
Postal and courier activities	79
Financial service activities, except insurance and pension funding	88
Insurance, reinsurance and pension funding, except compulsory social security	49
Activities auxiliary to financial services and insurance activities	87
Real estate activities	184
Public administration and defence compulsory social security	136
Education	207
Human health activities	121
Residential care activities	47
Social work activities without accommodation	87
Libraries, archives, museums and other cultural activities	93
Gambling and betting activities	13
Sports activities and amusement and recreation activities	129
Activities of membership organisations	126
Funeral and related activities	41
<b>Total</b>	<b>1,932</b>

Within sectors, businesses were sampled proportional to turnover, which means businesses with higher turnover had a greater chance of being selected for the sample. This was done because businesses with higher turnover have a bigger contribution to VAT receipts and overall sector VAT recovery rate, so it is important that the survey was able to capture these responses. Weights were used to correct for unequal selection and non-response in each sector, so that the findings are representative of the true population. Weights were calculated as the total population divided by the total number of businesses responding in each turnover cells. More details on the weighting approach can be found in the Appendix.

Weighting was not used to correct for sector size. Therefore, findings based on overall data (i.e. those presented in chapters 2, 3, and 4) are not representative of the general population, but over-represent the views from larger businesses and businesses in some sectors. This is because larger businesses and businesses in the certain sectors are more likely to have experience of partial exemption, and insights into their knowledge and use of partial exemption are of particular interest to HMRC.

### 1.3 Interpretation of findings

Sector level estimates for average turnover, input costs, and recovery rates are based on weighted data (this applies to all of chapter 5, as well as Figure 2.2 and Table 2.1 in chapter 2). All other data is unweighted and reflects only the views of those businesses in the sample.

VAT recovery rates reported here are sector estimates, i.e. the estimated proportion of VAT incurred that is being claimed back in the sector as a whole. VAT recovery rates varied widely within sectors, and do not necessarily correlate with the size of a business (turnover) or use of specific partial exemption method. **Therefore, the figures presented here are not**



intended as a guide to how much individual businesses in each sector should be recovering, as each will have its own circumstances that will determine how much VAT they could recover.

Outliers (i.e. extreme high and extreme low values) were sense checked, and either capped or excluded from the analysis. Where mean estimates are presented, upper and lower estimates are also presented – shown in the relevant tables as “95% confidence intervals”. This means that if we use the same sampling method to select different samples and computed an interval estimate for each sample, we would expect the true population parameter to fall within the interval estimates 95% of the time.

As can be seen in Table 1.1, fewer than 50 interviews were conducted in four sectors: insurance, reinsurance and pension funding (except compulsory social security); residential care activities; funeral and related activities; and gambling and betting activities. Findings for these sectors will not be reported further in this report due to the small bases sizes. Findings based on 51-100 interviews should be treated with caution; these are indicated by an asterisk\* throughout the report.

## 2 Profile of VAT registered businesses

This chapter presents the key characteristics of businesses to provide context for the rest of the report. Data presented in this chapter is unweighted unless specified otherwise. Unweighted data reflects only the views of those businesses in the sample. The survey focused on businesses in 17 industry sectors, chosen because they were more likely to have businesses that were VAT partially exempt.

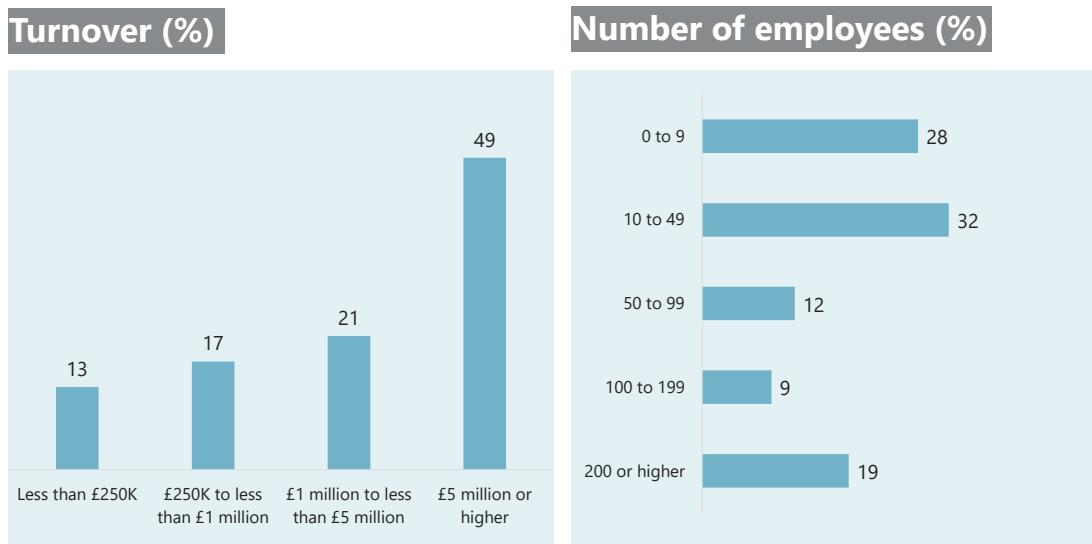
### 2.1 Legal status and use of tax advisers

Three in five (59%) businesses in the sample were incorporated companies. One in ten (12%) classified themselves as a charity, 8% a public sector body and 7% a partnership. Half (52%) were using an accountant or tax adviser for their VAT, either on a paid or unpaid basis, and a similar proportion were not (48%). Use of an accountant for VAT was higher among businesses with *below £1 million turnover* compared to those with *£1 million or higher* (55% compared with 50%). There was no variation in use of accountants by industry sector.

### 2.2 Size and turnover

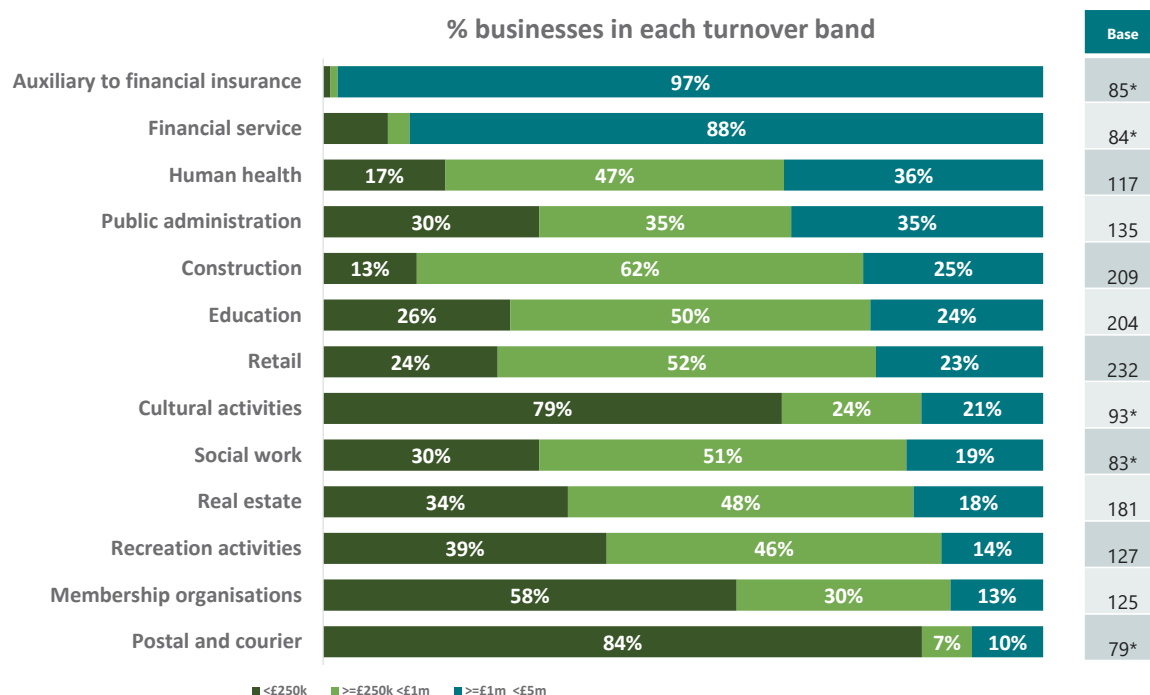
There was a high proportion of larger businesses in the sample: 19% of businesses had 200+ employees and 70% had a turnover of £1 million or higher. This is the result of the sample design, which intentionally over-sampled businesses with high turnover because of their greater significance as an indicator of the revenue impact on VAT recovery rates.

**Figure 2.1: Turnover and employee size**



Base: All businesses (1,932)

There were considerable variations in turnover across industry sectors (Figure 2.2). The large majority of businesses in activities auxiliary to financial services, and financial service activities except insurance and pension funding, reported turnover of *£1 million or higher* (97% and 88% of businesses respectively). Subsequently these sectors recorded relatively high average turnover. The majority of businesses in postal and courier activities and membership organisations reported turnover of *below £250,000* (84% and 58% of businesses respectively). These sectors recorded the lowest average turnover of the 17 industry sectors.

**Figure 2.2: Turnover by industry sector (weighted data); ranked by % with turnover £1 million or higher**

\* Small base of less than 100 interviews. Figures should be treated as indicative. Base: Businesses that were able to provide estimated turnover for their business  
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**Table 2.1: Estimated mean turnover by industry sector (weighted data); ranked by mean turnover**

Industry sector	Estimated mean turnover	Base	Confidence interval	
			Lower £	Upper £
Financial service activities, except insurance and pension funding	£50,400,000	84*	£33,900,000	£67,000,000
Activities auxiliary to financial services and insurance activities	£23,400,000	85*	£14,000,000	£32,800,000
Public administration and defence compulsory social security	£14,600,000	135	£8,600,000	£20,600,000
Education	£4,900,000	204	£2,900,000	£7,000,000
Retail	£4,300,000	232	£2,800,000	£5,700,000
Construction of buildings	£3,700,000	209	£2,100,000	£5,200,000
Human health activities	£3,100,000	117	£1,700,000	£4,600,000
Real estate activities	£3,000,000	181	£1,900,000	£4,200,000
Social work activities without accommodation	£2,600,000	83*	£1,500,000	£3,800,000
Libraries, archives, museums and other cultural activities	£1,900,000	93*	£700,000	£3,200,000
Sports activities and amusement and recreation activities	£1,600,000	127	£700,000	£2,500,000
Activities of membership organisations	£1,200,000	125	£800,000	£1,600,000
Postal and courier activities	£1,000,000	79*	£100,000	£1,900,000

\*Small base of less than 100 interviews. Mid-points were used for businesses that gave a banded response. Data have been weighted to reflect the turnover of the businesses in each sector.

# 3 Knowledge of VAT partial exemption

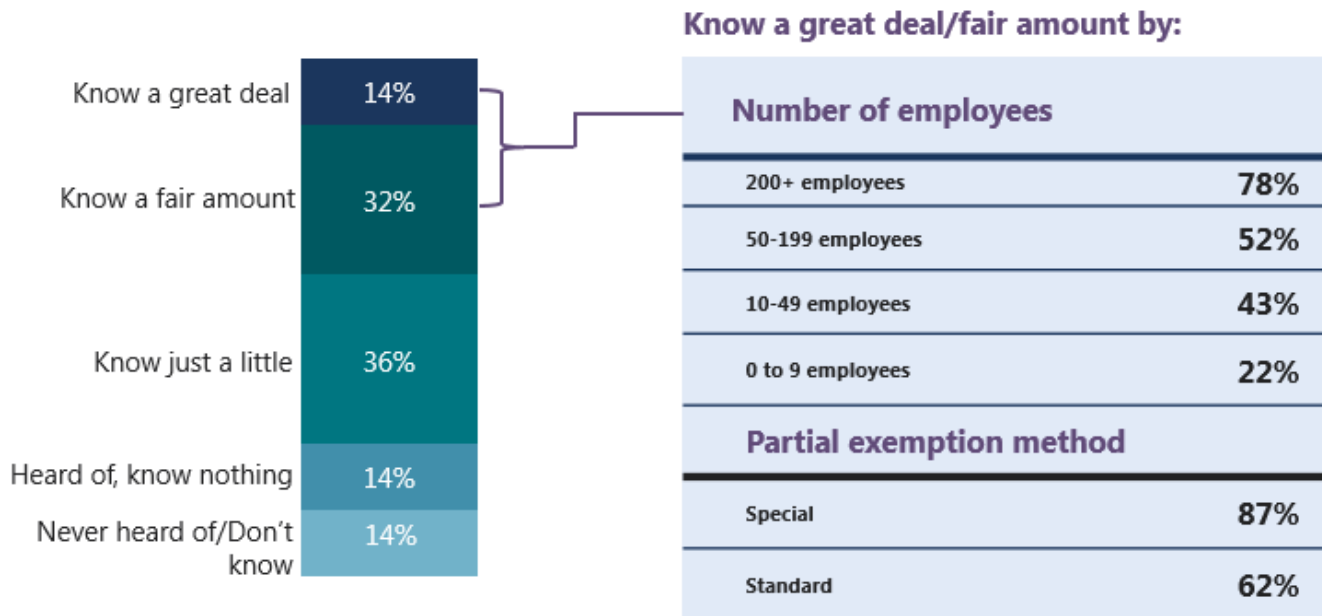
This chapter examines business knowledge of VAT partial exemption, and sources information and advice in relation to it. Data presented in this chapter is unweighted. Unweighted data reflects only the views of those businesses in the sample.

## 3.1 Level of knowledge of partial exemption

Businesses who did not have full VAT recovery comprised 71% of the sample. Among this group, awareness of VAT partial exemption was high, with 86% reporting that they had heard of it (Figure 3.1). However, detailed knowledge was more limited, with 14% claiming to know a great deal about it and 32% claiming to know a fair amount. Around one in ten (12%) had never heard of VAT partial exemption.

**Figure 3.1: Knowledge about VAT partial exemption**

*How much do you know about VAT partial exemption?*



Base: Businesses that were not recovering 100% of their VAT (1,372)/using a special (260) or standard method (459)

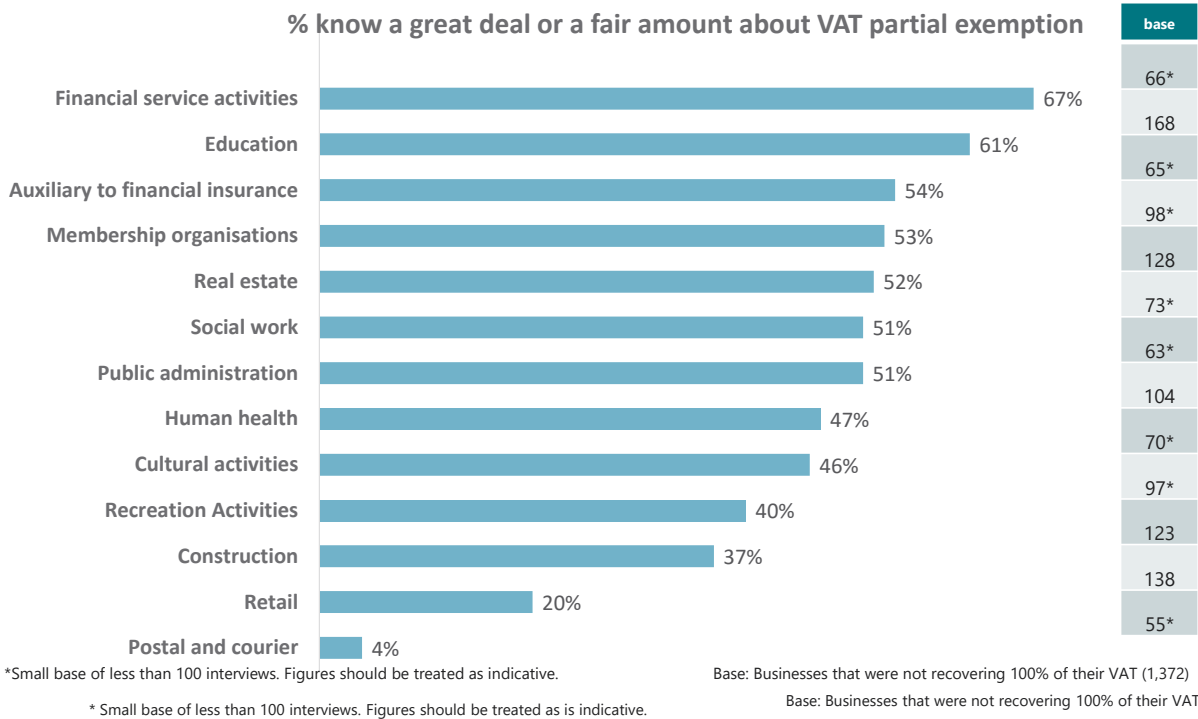
Knowledge was positively related to business size as shown in Figure 3.1; firms with higher turnover and number of employees reported much higher levels of knowledge. For example, 78% of businesses with 200+ employees reported that they knew at least a fair amount about VAT partial exemption, compared with 22% of businesses with 0-9 employees. Similarly, 61% of businesses with a turnover of more than £5 million declared they knew at least a fair amount, compared with 16% of businesses with less than £250k turnover.

Businesses that were using a special partial exemption method were more likely than those businesses using a standard method to report being knowledgeable<sup>4</sup>; 87% of businesses using a special method reported to knowing at least a fair amount about VAT partial exemption compared with 62% of businesses using a standard method and 27% using neither.

<sup>4</sup> Larger businesses were more likely to be using a special method hence both characteristics are related to knowledge about partial exemption.

As can be seen in Figure 3.2, knowledge about partial exemption was greatest among businesses in financial service activities and education. Businesses in these sectors reported relatively high use of partial exemption (Section 4.1). Conversely, knowledge was lowest in sectors least likely to report using partial exemption, namely postal and courier activities, followed by retail, and construction businesses.

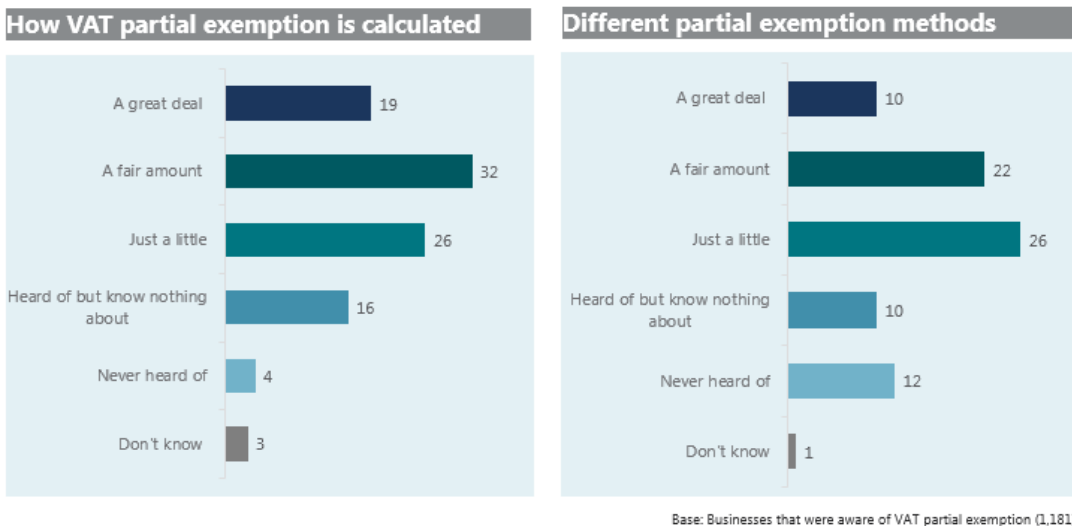
**Figure 3.2: Variation in knowledge about VAT partial exemption by industry sector**



Focusing on specific aspects of VAT partial exemption, 77% of businesses who were aware of VAT partial exemption reported they knew at least a little about *how it is calculated*, and 58% knew at least a little about the *different partial exemption methods* (Figure 3.3). Those claiming to know a great deal were in the minority (19% and 10% respectively).

**Figure 3.3: Awareness of VAT partial exemption calculations and methods (Figures are in %)**

*How much, if anything, do you know about . . . ?*



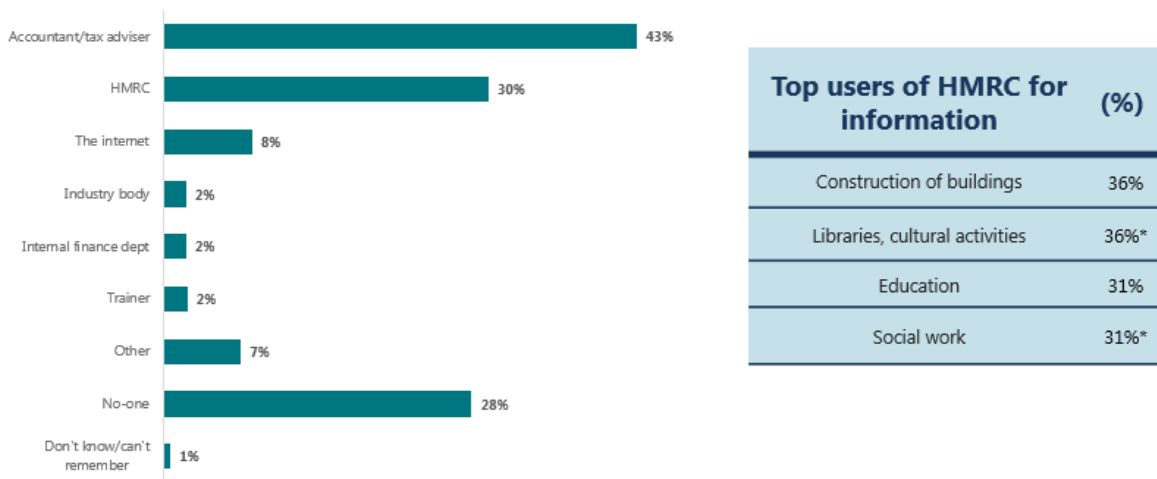
### 3.2 Information sources used on VAT partial exemption

The majority of businesses reported getting information and advice about VAT partial exemption from accountants/tax advisers (43%) and HMRC (29%) (Figure 3.4). Other sources were much less commonly used and included the internet (8%), internal finance department, industry bodies and trainers (each used by 2% of businesses).

As set out in Figure 3.4, businesses in construction, libraries and cultural activities, education and social work were most likely to report that they obtained information and advice about VAT partial exemption from HMRC. Linked to this, it is businesses with between 50-199 employees who were most likely to have obtained information and advice from HMRC (35% compared with 29% overall). Larger businesses (200+ employees) were most likely to have used an accountant or tax adviser for information and advice (55% compared with 43% overall).

**Figure 3.4: Sources of information and advice about VAT partial exemption**

***Over the past 12 months, where have you tended to get any required information or advice about VAT partial exemption?***



Base: Businesses that were aware of partial exemption (1,178); in Construction (109); Libraries and cultural activities (55)\*; Education (154); and Social work (67)\*  
 \* Small base of less than 100 interviews. Figures should be treated as indicative.

■

## 4 Application of VAT partial exemption

This chapter explores VAT partial exemption methods used by businesses. Data presented in this chapter is unweighted. Unweighted data reflects only the views of those businesses in the sample.

### 4.1 Type of partial exemption method

There are two different methods that partially exempt businesses can use to work out how much input tax can be recovered:

- The standard method calculates recovery based upon the proportion of taxable and exempt turnover in the business. Businesses must use the standard method unless HMRC has given approval for them to operate a special method.
- If the standard method is considered not to give a fair result, businesses can apply to HMRC to use a special method for the calculation. HMRC can also direct businesses to use a special method. A special method is any calculation, other than the standard method, that enables a business to calculate how much of their input tax they may recover. A special method is bespoke to each business.

A quarter (24%) of businesses in the sample reported that they were using the standard method, 13% a special method, and 8% did not know which method their business was using (Figure 4.1). One in six (16%) reported that they were not using partial exemption and 39% had not heard of it. Among the 55% of businesses who were not using partial exemption, 29% were making full VAT recovery, hence, not subject to the partial exemption rules.

**Figure 4.1: Partial exemption method**

***Which VAT partial exemption method does the business currently use? Do you use a standard or special method?***

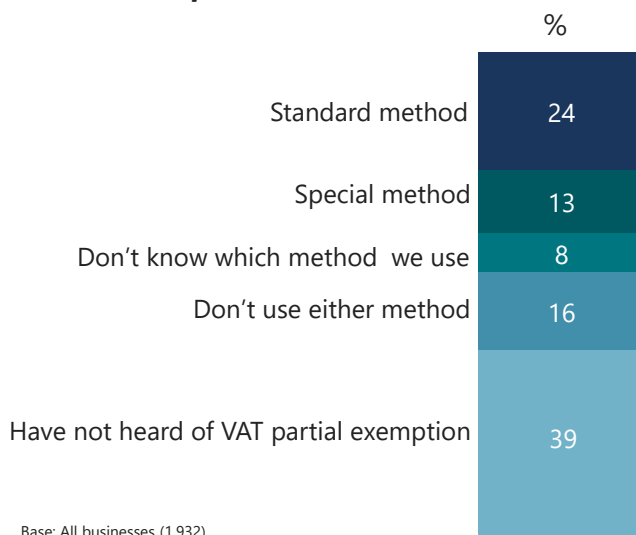


Table 4.2 shows that use of special and standard methods was *most common* in social work without accommodation (56%), financial services and human health activities (55% each). In contrast, use of these method was *least common* in postal and courier activities, retail and construction (8%, 15% and 23% respectively). As highlighted in section 3.1, sectors with high use of partial exemption were more knowledgeable, whilst the reverse was true of sectors where few businesses were partially exempt.

Table 4.2: VAT partial exemption methods by industry

Industry sector	Standard	Special	Do not use partial exemption	Don't know/not heard of partial exemption	Base
Human health activities	41%	14%	7%	38%	121
Social work activities without accommodation	38%	18%	13%	31%	87*
Activities auxiliary to financial services and insurance activities	32%	18%	10%	39%	87*
Education	28%	26%	14%	33%	207
Sports activities and amusement and recreation activities	26%	12%	18%	44%	129
Activities of membership organisations	26%	15%	16%	43%	126
Libraries, archives, museums and other cultural activities	26%	14%	12%	48%	93*
Real estate activities	20%	12%	23%	45%	184
Construction of buildings	20%	3%	25%	52%	212
Financial service activities, except insurance and pension funding	17%	38%	13%	31%	88*
Public administration and defence compulsory social security	16%	12%	7%	65%	136
Retail	13%	2%	18%	67%	233
Postal and courier activities	8%	0%	20%	72%	79*

\*Small base size of <100 interviews. Data is unweighted.

Businesses who were aware of VAT partial exemption most commonly reported that they review the calculation method annually (cited by 29%) (Table 4.3). One in seven (15%) do it less regularly than once a year, and around one in ten (8%) only do it when their circumstances change or when they are requested to by HMRC. Three in ten (29%) had **never** reviewed their VAT partial recovery calculation method; this practice was more common among businesses using the standard method compared with special method (20% compared with 9%).

Table 4.3: Frequency of review of VAT partial recovery calculation methods

	And using a standard method	And using a special method	All aware of VAT partial exemption
<b>Base: All aware of VAT partial exemption</b>	457	260	1,164
<b>More than once a year</b>	9%	13%	8%
<b>Annually</b>	39%	34%	29%
<b>Less regularly than once a year</b>	14%	29%	15%
<b>Never</b>	20%	9%	29%
<b>When circumstances change</b>	7%	10%	7%
<b>When requested by HMRC</b>	3%	4%	2%



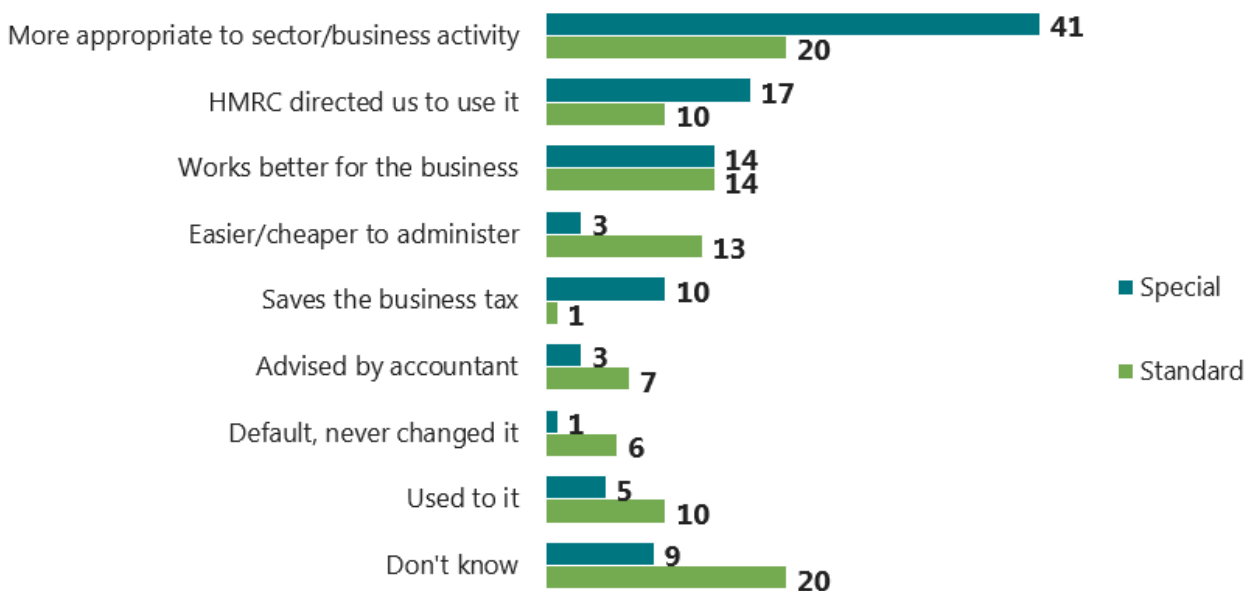
## 4.2 Reasons for using standard and special methods

The primary reason given by businesses for using the standard and special methods were similar: it was considered to be the most appropriate method for the sector or business activities, and works for the business (Figure 4.4). A minority reported that they were directed to use the method by HMRC; this was more commonly reported by businesses using the special method (17% compared with 10% using the standard method).

One in five businesses (20%) using the standard method was unable to recall their reason for using it. Recall was higher among businesses using the special method because the process was more involved for them compared to the standard method.

**Figure 4.4: Reasons for using the standard and special methods** (responses of <5% for both are not shown, all figures are in %)

### *What are the main reasons for the business using a special / standard method?*



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Base: Businesses using a special (260)/standard method (459)

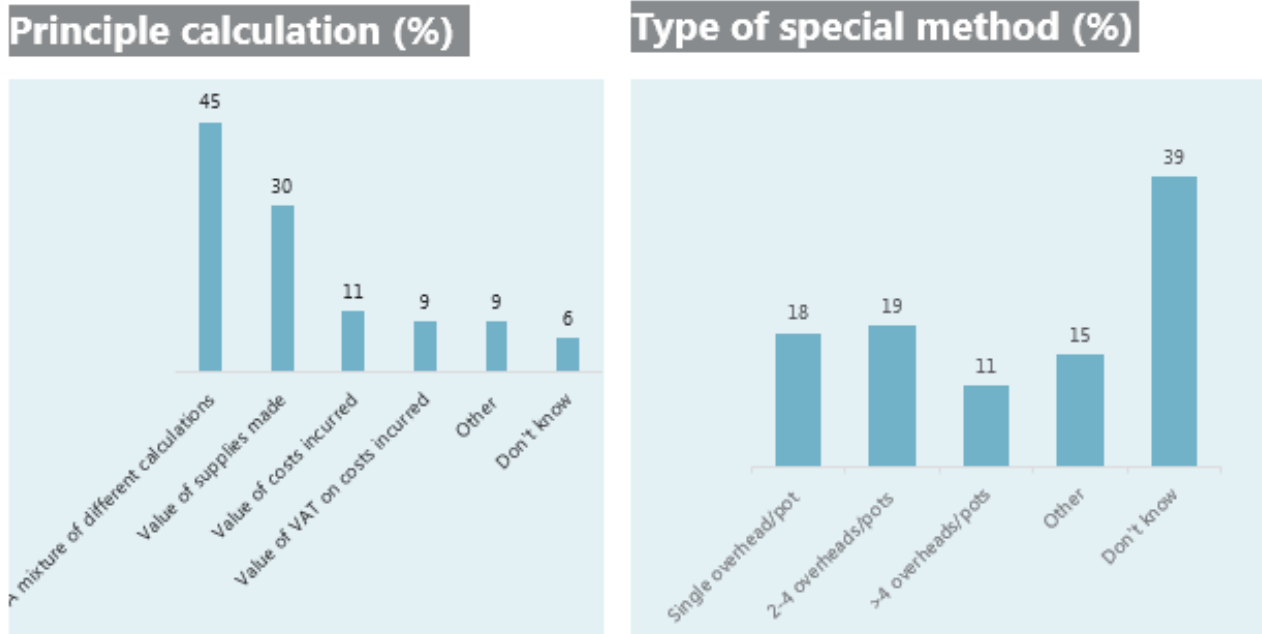
## 4.3 Special method

When businesses use the standard method the percentage recovery rate for residual input tax is calculated using the values of supplies made by the business. When businesses use a special method they can determine their percentage recovery rate using other allocations and apportionments or, for more complex businesses, by dividing the business up into its different activities. The most common apportionment methods are output values and number of transactions, although some of the others can work in some circumstances.

The majority of businesses who were using the special method were able to describe the special method they used (62%). Single overhead or pot (18%) and 2-4 overheads or pots (19%) were most common (Figure 4.5). One in ten (11%) reported that they used more than 4 overheads or pots, and 15% cited another special method. However, as many as two in five (39%) did not know which special method they were using.

Businesses were more knowledgeable about the principle calculation used in their special method. The most common answer was a mixture of different calculations (45%), followed by value of supplies made (30%). Other principle calculations were less common and included value of costs incurred (11%) and value of VAT on costs incurred (9%).

**Figure 4.5: Type of special method and principle calculation used for the special method**



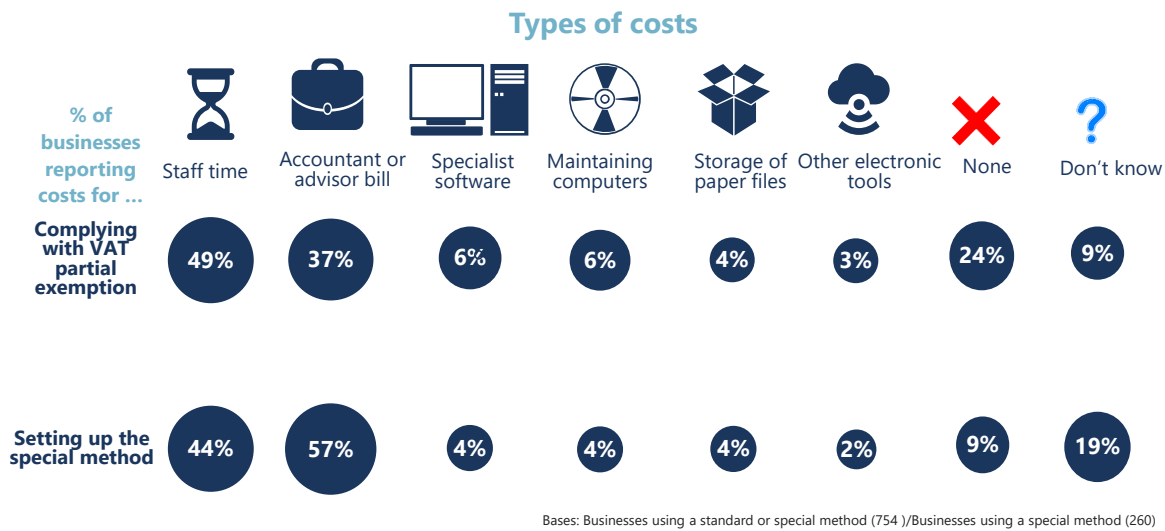
Base: Businesses using a special method (260)

Two thirds of businesses have been using a special method for more than five years, with half of these businesses reporting using a special method for over 10 years. Among businesses who were aware of VAT partial exemption, 9% reported that their business had used another special method in the past. The main reasons for changing the special method were so that it was more appropriate to their business activity (25%) and because their business activity had changed (13%). One in five (18%) reported that they were told to change by HMRC.

#### 4.4 Costs of compliance

Two thirds of businesses (68%) that were currently using, or had used in the past, a standard or special method reported that they incurred costs in complying with partial exemption. Figure 4.6 presents firstly, costs associated with complying with VAT partial exemption and secondly, costs incurred in setting up the special method. The most common costs reported were staff time and accountant/adviser bills. This was true for both on-going compliance costs and the cost of setting up the special method, though accountant/adviser bill was a more common cost incurred by businesses in setting up the special method.

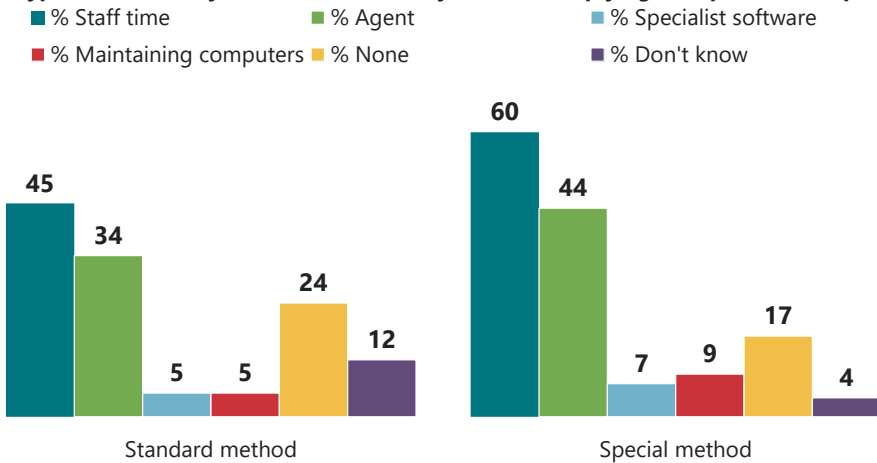
**Figure 4.6: Types of compliance costs incurred**



Overall, businesses using the special method were more likely to report incurring costs across board (Figure 4.7). However, across both groups, the large majority reported that they would still use an accountant in the absence of VAT partial exemption (78% of those using the special method and 74% of those using the standard method).

**Figure 4.7: Variation in compliance costs incurred for standard and special methods** (responses of <5% for both are not shown)

*What type of costs does your business currently incur in complying with partial exemption.?*



Base: Businesses currently using a standard (459) or special method (260)

## 5 VAT supply and recovery rates

This chapter provides details on the VAT incurred and recovered by businesses, and the implied VAT recovery rates. Weighted data is presented in this chapter<sup>5</sup>.

### 5.1 VAT rates on goods and services supplied

The standard VAT rate in the UK is 20%, and 95% of businesses had supplied standard rated products. In contrast, only one in seven (15%) businesses reported that they supplied goods and services at the reduced VAT rate of 5%. The same proportions reported that they supplied goods and services with zero VAT and exempt from VAT (35% each).

Sectors with particularly *high proportions* of businesses supplying VAT exempt goods and services included public administration (70% of businesses in this sector), human health activities (68%), and financial service activities excluding insurance and pension funding (65%) – Table 5.1. Conversely, businesses in real estate activities, retail and sports and recreations were least likely to report supplying VAT exempt goods and services (27%, 34% and 35%, respectively).

**Table 5.1: Proportion of businesses in each sector reporting they apply particular VAT rates to goods and services they supply**

Industry sector	20% VAT (standard rate)	5% VAT (reduced rate)	0% VAT (zero rate)	Exempt from VAT	Base
Public administration and defence compulsory social security	95%	30%	56%	70%	136
Human health activities	93%	28%	46%	68%	121
Financial service activities, except insurance and pension funding	85%	5%	33%	65%	88*
Activities auxiliary to financial services and insurance activities	79%	5%	32%	59%	87*
Libraries, archives, museums and other cultural activities	99%	22%	42%	49%	93*
Social work activities without accommodation	92%	24%	44%	48%	87*
Education	94%	10%	37%	47%	207
Activities of membership organisations	95%	3%	28%	35%	126
Sports activities and amusement and recreation activities	98%	7%	34%	34%	129
Retail	94%	22%	41%	27%	233
Real estate activities	96%	9%	20%	24%	184
Construction of buildings	96%	24%	39%	14%	212
Postal and courier activities	100%	7%	13%	7%	79*

\*Small base size of less than 100 interviews.

Data have been weighted to reflect the turnover of the businesses: i.e. for each business in the sector, multiply their exempt percentage by their total turnover, then add up all these exempt amounts across businesses in the sector and divide this by the sum of all turnovers in the sector.

Table 5.2 below looks at what proportion of business sales were from VAT exempt goods and services. Sectors with the highest *average percentage of business sales exempt from VAT* were education (72% of sales), activities auxiliary to financial services and insurance activities (58%) and social work activities without accommodation (51%) – Table 5.2.

<sup>5</sup> Data for each sector have been weighted by turnover.

Table 5.2: Average percentage of the business sales that were exempt from VAT

Industry sector	Estimated average percentage	Base	95% Confidence interval	
			Lower %	Upper %
Education	72%	198	59%	84%
Activities auxiliary to financial services and insurance activities	58%*	82	52%	63%
Social work activities without accommodation	51%*	80	37%	65%
Financial service activities, except insurance and pension funding	34%*	82	28%	39%
Human health activities	33%	107	22%	43%
Libraries, archives, museums and other cultural activities	32%*	93	25%	39%
Real estate activities	27%	181	18%	36%
Activities of membership organisations	26%	124	11%	40%
Public administration and defence; compulsory social security	14%	128	6%	22%
Sports activities and amusement and recreation activities	14%	123	2%	26%
Construction of buildings	9%	208	3%	15%
Retail	5%	229	0%	9%
Postal and courier activities	1%*	79	0%	2%

\*Small base size of less than 100 interviews.  
Mid-points were used for businesses that gave a banded response.  
Data have been weighted to reflect the turnover of the businesses

## 5.2 Input costs

Business input costs are costs for purchases and expenses incurred by the business (excluding wages, VAT, and money taken out of the business). Businesses can reclaim input VAT on goods and services purchased to make business supplies that are **not** VAT exempt. Thus input costs provide an indication of how much input tax businesses incur and recover.

Sectors with the *highest* average input costs were Financial service activities and public administration (Table 5.3). These sectors were also in the top three in terms of reported average turnover (Figure 2.2 in section 2). The *lowest* average input costs reported were in postal and courier services, membership organisations, and recreation activities. These sectors also reported the lowest average turnover.

**Table 5.3: Mean input costs in the last financial year**

Industry sector	Estimated mean input costs	Base	Confidence interval	
			Lower £	Upper £
Financial service activities, except insurance and pension funding	£27,700,000*	86	£8,600,000	£46,900,000
Public administration and defence compulsory social security	£19,700,000	136	£9,700,000	£29,700,000
Activities auxiliary to financial services and insurance activities	£7,600,000*	87	£4,600,000	£10,700,000
Construction of buildings	£4,300,000	212	£2,000,000	£6,500,000
Retail	£2,700,000	233	£1,800,000	£3,600,000
Education	£2,400,000	206	£1,300,000	£3,600,000
Real estate activities	£1,900,000	184	£1,000,000	£2,800,000
Libraries, archives, museums and other cultural activities	£1,300,000*	93	£500,000	£2,200,000
Social work activities without accommodation	£1,300,000*	87	£600,000	£2,000,000
Human health activities	£1,300,000	121	£600,000	£2,000,000
Sports activities and amusement and recreation activities	£800,000	129	£500,000	£1,000,000
Activities of membership organisations	£700,000	126	£500,000	£900,000
Postal and courier activities	£600,000*	79	£200,000	£1,000,000

\*Small base size of less than 100 interviews. Mid-points were used for those businesses that gave a banded response.

### 5.3 VAT recovery rate

VAT recovery rates reported here are sector estimates, i.e. the estimated proportion of VAT incurred that is being claimed back in the sector as a whole. VAT recovery rates varied widely within sectors, and do not necessarily correlate with the size of a business (turnover) or use of specific partial exemption method. Therefore, the figures presented here are **not** intended as a guide to how much individual businesses in each sector should be recovering, as each will have its own circumstances that will determine how much VAT they could recover.

The highest VAT recovery rate, that is the total VAT claimed back as a percentage of total VAT incurred, was highest in public administration and defence; compulsory social security; retail; and financial service activities (Table 5.4). These sectors had relatively low percentage of sales that were exempt from VAT (to a lesser extent in financial service activities) (Table 5.2). In contrast, the VAT recovery rate was lowest in social work activities and education which had the highest (in the top 3) average percentage of sales exempt from VAT.

Table 5.4: VAT recovery rate by industry sector

Industry sector	Approximately how much VAT did your business incur in the last financial year (total across all businesses in the sector)?	How much of that VAT did the business claim back (total across all businesses in the sector)?	Implied VAT recovery rate (as a percentage)	Base	Confidence interval	
					Lower %	Upper %
Public administration and defence; compulsory social security	£2,090,800,000	£1,808,500,000	86%	124	78%	95%
Retail	£494,100,000	£364,200,000	74%	186	63%	84%
Financial service activities, except insurance and pension funding	£275,100,000	£198,500,000	72%*	79	67%	77%
Construction of buildings	£712,600,000	£506,000,000	71%	175	61%	81%
Real estate activities	£672,400,000	£475,000,000	71%	160	61%	81%
Postal and courier activities	£34,000,000	£23,800,000	70%*	61	58%	82%
Libraries, archives, museums and other cultural activities	£34,600,000	£23,400,000	68%*	73	60%	75%
Sports activities and amusement and recreation activities	£114,400,000	£69,900,000	61%*	98	42%	80%
Activities auxiliary to financial services and insurance activities	£85,900,000	£42,000,000	49%*	76	43%	55%
Human health activities	£70,400,000	£32,000,000	46%*	90	33%	58%
Activities of membership organisations	£81,500,000	£33,100,000	41%	102	23%	58%
Education	£438,000,000	£101,700,000	23%	173	11%	36%
Social work activities without accommodation	£65,500,000	£14,700,000	22%	75	10%	35%

\*Small base size of less than 100 interviews.

## 6 Conclusion

The research found high levels of awareness about VAT partial exemption among VAT registered businesses in the sample: 86% of businesses who were not making full VAT recovery<sup>6</sup> reported that they had heard of VAT partial exemption, including 46% stating they know at least a fair amount about it. Businesses reported they were more knowledgeable about how VAT partial exemption is calculated and less knowledgeable about the different partial exemption methods. Accountants or tax agents and HMRC are important channels for raising awareness and knowledge about VAT partial exemption; businesses most commonly obtained information and advice about VAT partial exemption from these two sources.

There was significant variation in levels of knowledge of partial exemption by industry sector, and this is a reflection of differences in use of partial exemption. Businesses in financial service activities, education, and activities auxiliary to finance were most knowledgeable; these sectors had relative high use of partial exemption. In contrast, businesses in postal courier activities, retail, and construction were least knowledgeable; these businesses were least likely to report using a partial exemption method. Overall, a quarter (24%) of businesses in the sample reported that they were using the standard VAT partial exemption method and 13% the special method.

VAT partial recovery rates varied widely by sector and within sectors. The **highest** VAT partial recovery rate, that is the total VAT claimed back as a percentage of total VAT incurred, was in public administration (86%), and in retail (74%). In contrast, the **lowest** VAT recovery rates were in social work activities without accommodation (22%) and education (23%).

Two thirds of businesses (68%) who were using, or have used in the past, a special or standard method reported that they incurred costs in complying with VAT partial exemption. The most common costs reported were related to staff time and accountant/adviser, especially among businesses using the special method. Businesses using the special method were more likely to report incurring costs across board. However, across both groups, the large majority reported that they would still use an accountant in the absence of VAT partial exemption (78% of those using the special method and 74% of those using the standard method).

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<sup>6</sup> 71% of businesses in the sample were making full VAT recovery.



# Appendix

## Sample design

A random probability telephone survey was undertaken with 1,932 businesses in 17 industry sectors, chosen because they were more likely to have businesses that were VAT partially exempt.

The sample was designed to be representative of the turnover distribution of the population by industry sector, since high turnover businesses contribute the most to VAT receipts. The sample was selected using random sampling methods. Within sector, businesses were selected with probability proportional to turnover (as recorded on the sample). This means that businesses with high turnover had a greater probability of selection. Businesses that were missing turnover information on the sample were also sampled so that the proportion selected for the sample was the same as the proportion in the population.

## Questionnaire design

In advance of fieldwork, 10 in-depth interviews were undertaken with businesses to cognitively test the survey questionnaire and accompanying datasheet. The datasheet contained questions that businesses may find difficult answering without prior preparation such as their turnover, input costs and amount of VAT recovered in the last financial year. Participants were emailed the datasheet and encouraged to look up the information prior to the cognitive interview. The cognitive interviews were conducted by telephone in November 2016 and each lasted around 45 minutes.

All questions in the survey were tested with 10 businesses which represented a range of industry sectors and turnover. The purpose of the cognitive interviews was to test businesses' understanding of key questions and terminologies, their ability and willingness to provide detailed information about their VAT, and their use of the datasheet.

Overall, the cognitive testing found that businesses' ability to provide detailed information about their VAT depended on how close the respondent was to the VAT process/calculations. Businesses also reported that the data requested would take time/effort to compile. As a result of these findings, both the questionnaire and datasheet were simplified and a number of questions removed. The questionnaire was updated to include more lead-in questions to make it easier to identify businesses that were not required to answer the more detailed questions. The interview script was also updated to pre-populate some of the calculations for businesses based on responses to previous questions. Some terminology was also simplified to improve respondent's understanding. The revised questionnaire was then piloted with 50 businesses in November – December 2016, prior to the survey going live in January 2017.

## Survey fieldwork

Prior to fieldwork, an advance letter was sent to all businesses selected for interview, providing them with information about the survey and an opportunity to opt out.

All businesses were screened at the start of the survey to establish that they were (i) still trading, (ii) were currently registered for VAT and (iii) to confirm their industry sector. The eligibility rate from screening was 93% (i.e. 7% of businesses were screened out because they did not fulfil one or more of these eligibility criteria).

The survey was conducted by telephone, using CATI, between 30 January and 10 March 2017.. The average survey interview length was 13 minutes. The adjusted response rate was 34%, as shown in Table A1.

**Table A.1: Breakdown of sample used and response rates**

	Sample	
	N	%
Complete interviews	1,932	25
Refusals	1,304	17
Screened out	150	2
No outcome	1,844	25
Opted out of the survey	793	10
Bad numbers	1,825	23
<b>Total sample</b>	<b>7,848</b>	<b>100</b>
<b>Total sample excluding bad numbers</b>	<b>6,023</b>	
Ineligible (screen out/complete + screen-out)	422	7
<b>Valid sample</b>	<b>5,296</b>	
<b>Co-operation rate (complete/(complete + refusal))</b>		<b>60</b>
<b>Adjusted response rate (complete/valid sample)</b>		<b>34</b>

### Data edits

In the analysis, outliers were checked and capped; this affected 16 cases in total. Three cases were excluded from the turnover table due to exceptionally high values. A further 46 cases were excluded from the VAT recovery table because the respondent had provided values greater than 100%, which is not possible. Mean figures were imputed for businesses that gave banded figures (e.g. for turnover, input costs and amount of VAT incurred).

### Weighting

In the analysis, weights were generated to correct for the impact of the unequal selection probabilities and non-response (non-contacts and refusals) **in each sector**. Weighting was **not** applied to correct for interviews between sectors. The small sample sizes in some sectors meant a simple approach was used to generate weights, hence cell weighting was used to adjust the distribution of achieved interviews across sector and turnover band to match the population totals. This meant that adjustment for differences in selection and response was undertaken in a single step.

When identifying cells for weighting, sector and turnover were defined using information provided by the respondent rather than the information from the sample frame. This means the weights are not affected by any differences between the information on the sampling frame and the information reported in a survey.

Weights were calculated as the population total divided by the total responding sample per cell. High weighted were checked and trimmed where necessary. Some of the lowest turnover cells had weights that were very high. The weights in these cells were trimmed by combining the cells with the next lowest turnover cell within that sector.

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