AFB Practice Workshop

How to deal with Partial Exemption Special Methods for VAT

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AFB practice workshop.

How to deal with Partial Exemption Special Methods for VAT.

Agenda

Why is PESM important?

Terminology

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Summary

Introductions

BDO Financial Services VAT Practice - key people

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Why is PESM important?

VAT is a cost

Banks typically carry our VAT exempt activities and so cannot recover all its VAT.

VAT recovery

The level of VAT recovered depends on the partial exemption method.

Standard method not reflective

A turnover based method may not always provide a fair and reasonable reflection of the use of costs by the business (e.g. large value transactions could be distortive).

PESM like a contract

This is an agreement with HMRC, and so both sides must adhere to terms of the PESM.

Terminology

Direct attribution

Input tax wholly attributable to either taxable supplies or (100% recovery) or wholly exempt supplies (0% recovery).

Residual

Input tax used for both taxable and exempt supplies.

Direct allocation

For sectorised method, input tax wholly attributable to a sector.

Specified supplies

Certain financial services provided to customers based outside the UK are treated as ‘taxable’ for partial exemption purposes.

A quick poll



https://forms.office.com/e/tzjMgq03Qf

Case study 1



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Case study 1

(1 of 4)

A Hong Kong Bank (HKB) has set up a UK branch to provide banking services.

Its key activities are lending and payment services. The branch has an office in London for its banking operations and sublets one floor.

The business currently does not have a PESM.

Income description	UK income/Exempt	Non-UK income/Taxable
Loan Interest	£0.6m	£1.4m
Payment services	£0.8m	£0.2m
Sublet one floor (option to tax)		£0.1m



Case study 1
(2 of 4)

Input tax on business' costs can be summarised below:

Input tax description	£
Legal fees for UK loans	50,000
Legal fees for non-UK loans	20,000
Software for payment services	100,000
Rent & Property costs (5 floors)	100,000
Other overheads	200,000

Case Study 1: Questions

1	2	3
What is the standard method recovery?	Is it suitable or should it consider a special method?	What more information could the business obtain to help it decide an appropriate PESM?

Case study 1
(3 of 4)

More data:

Income description	Office space sqm	Headcount	No of customer accounts	Transaction count
Loan interest	1,000	30	200 (UK: 80, non-UK: 120)	2,400 (UK: 1,440: non-UK: 960)
Payment services	500	20	150 (UK: 100, non-UK: 50)	6,000 (UK: 3000, non-UK: 3000)
Sublet one floor (option to tax)	1,000	-	1	4
Back office/support/ communal	3,000	50	-	-

Case Study 1: Questions

4

What are the key costs and how are they used by the business?

5

Which of the above metrics could drive the cost of purchases?

6

Can we sectorise the business?

Can we create sub-sectors?

7

What other metrics can be considered?

8

Which metrics should be discarded?

9

Which method would you propose to HMRC and why?

Case study 1
(4 of 4)

Application done online: https://www.gov.uk/guidance/apply-for-a-partial-exemption-special-method

With the application, you need to submit:

- A proposal document. You will need to explain details of the business activities and its VAT treatment, reasons why standard method or existing PESM is no longer suitable and why propose method is better
- A worked example of your proposal – HMRC will ask for the proposal to be calculated based on the prior year's. They will also want to see your main costs of the business
- Fair and Reasonable declaration
- Latest annual adjustment calculation
- Annual Accounts
- If the business is planning to incur expenditure within the Capital Goods Scheme, HMRC will want details
- Other supporting information (e.g. floor plans if floor space is used).



Break

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Case study 2



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Case study 2

(1 of 3)

HKB set up a UK subsidiary to service the UK retail market:

- UKCo incorporated and VAT grouped with the UK branch
- Retail business is transferred to UKCo, the commercial business remains with UK branch
- Businesses are also offering FX services
- HK head office has a software to optimise pricing for FX transactions which are used by both UK branch and the UKCo
- The group also receives management services from the head office
- The UKCo also has incurred software development costs from Bulgaria for its mobile app.

Case study 2

(2 of 3)

Case Study 2 Questions:

1	2	3	4	5
Can we use UK branch's single VAT registration PESM?	If the VAT group needs to apply for a new PESM, can it use the same one as before? Why not?	What modifications from previous PESM, if any?	Bulgarian supplier did not charge VAT – does that mean we ignore it?	Supplies from the head office, what are the considerations?

Case study 2
(3 of 3)

HMRC PESM review

HMRC are carrying out a review of the PESM. In addition to checking the correct numbers are used, they ask more questions:

- Does the PESM cover all activities?
- Has there been a change of business, was HMRC notified?
- Has the business revisited a modelling exercise

Case Study 2: Questions

6	7
How would you defend the current PESM?	What if there was a change of business activities or where the bank incurs costs not covered in the PESM?



Summary

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Key Takeaways

- Standard method vs PESM in the banking sector – PESM more suitable
- What drives costs
- Suitable allocation and recovery drivers
- How to support your decision
- Changes to the business
- Other issues in the foreign banking sector, including cross border matters



When to apply for PESM?

- On standard method but PESM provides a better recovery
- Values do not reflect use of costs
- Recurrent Standard Method Override
- Existing PESM out of date
- Multiple business activities
- Changes to the VAT group
- Acquisitions/disposals
- Overseas branches
- Ringfence certain business activities

HMRC expect business currently operating a PESM to review their position every few years that the method is still fair and reasonable.





Questions

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