June 2018

Tax alert

Annual Adjustment of VAT Recovery Rate

If your business is only entitled to deduct part of the VAT it incurs on costs, and you have a 31 December accounting year end, it's time to carry out the mandatory annual VAT recovery rate review for 2017. The adjustment should be included in the May/June 2018 VAT return, which must be filed by 23 July, otherwise statutory interest applies.

What is a VAT Recovery Rate?

A VAT Recovery Rate is the portion of VAT incurred that an entity is entitled to deduct. Different entities are entitled to deduct different amounts of VAT depending on the activities they are engaged in.

- **VAT Taxable Activities** - A business involved exclusively in VAT taxable activities is entitled to recover all VAT it incurs, i.e. it can recover VAT incurred on 100% of its costs (except for VAT incurred on a few specifically disallowed items). This entity does not usually need to carry out an annual VAT recovery rate adjustment review.
- **VAT Exempt Activities** - A business involved exclusively in VAT exempt activities cannot deduct any VAT it incurs unless it provides services to non-EU customers or earns income from non-EU investment assets. It can deduct all VAT incurred which directly relates to its non-EU income/assets but only a portion of VAT incurred on costs used for both its EU and non-EU activities.
- **Both VAT Taxable and VAT Exempt Activities** – A business involved in both VAT taxable and VAT exempt activities will be entitled to full VAT recovery on costs directly attributable to its taxable activities. It will not have any VAT recovery entitlement on costs directly attributable to its exempt activities unless it has non-EU income/assets. This entity will be entitled to partial VAT recovery on costs which are used for both its taxable and exempt activities (known as general overheads).

There are a number of different methods an entity can use to calculate its VAT recovery rate; the most common method used is turnover but other commonly used methods include floor area, staff numbers etc. Where turnover is used, a business involved in both taxable and exempt activities will calculate its turnover from taxable activities as a percentage of its total turnover. The resulting percentage is the entity's VAT recovery rate – see the table on the next page for simple examples.

If it is your first time calculating a VAT recovery percentage, we can help you choose the best methodology for your business.

VAT Recovery Rates by Activity

	Business involved in:	*VAT Recovery Rate*
A	**VAT Taxable Activities Only**	100% VAT recovery rate on all costs (except for VAT incurred on a few specifically disallowed items)
B	**VAT Exempt Activities Only**	
	Receives income from customers/assets located in:	
	EU	0% VAT recovery rate on costs used only on EU activity
	Non-EU	100% VAT recovery rate on costs used only on non-EU activity
	Mix of EU and non-EU	Partial VAT recovery rate on costs used for both EU and non-EU activities
	Example: 60% EU income, 40% non-EU income	Example: 40% non-EU income / Total Worldwide Income = 40% VAT recovery rate
C	**Both VAT Taxable and VAT Exempt Activities**	
	VAT Taxable Activities Example: 80% of total income	100% VAT recovery rate
	VAT Exempt Activities Example: 20% of total income of which half comes from non-EU customers	No Recovery unless involved in non-EU activities - see Section B above
	VAT recovery = (Taxable Income + Non-EU Exempt Income) / Total Worldwide Income	Example: (80+10)/100 = 90% recovery rate

What is the Annual Adjustment of a VAT Recovery Rate?

After each year end, it is necessary to review the mix of taxable and non-EU income to total income to see if the VAT recovery rate used needs to be adjusted up or down. This process is known as the annual VAT recovery rate adjustment review. The diagram below sets out the process:

Provisional VAT Recovery Rate Set for 2017

VAT Recovery Rate Review in 2018

Review mix of VAT taxable and VAT exempt activities based on actual 2017 activities

By 23 July 2018, adjust VAT recovery rate for 2017

If VAT Recovery Rate changes from provisional rate set, the difference in VAT recovery taken should be claimed or paid in May/June 2018 VAT return

If changing recovery rate methodology, or dealing with a historic VAT claim or liability, liaise with Revenue

If an annual recovery rate review isn't carried out and the recovery rate decreases, you could have a significant liability as statutory interest applies to any underpayment. The longer that situation continues the more expensive it becomes. On the flip side, if your recovery rate has increased, you should be entitled to a VAT refund from Revenue.

How Can EY Help?

EY can help by:

- Reviewing your VAT recovery rate using your existing methodology
- Assessing if your existing VAT recovery methodology is the best one for your business
- Agreeing a new methodology with Revenue if appropriate
- Dealing with historic underpayments of VAT or VAT refunds as a result of annual recovery rate adjustments not been carried out timely in prior years.

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