

Solicitors – VAT and client accounts

Do you earn interest on your client accounts? If so, you may have a VAT issue

What's the issue?

Interest is exempt from VAT - exempt income means that there may be restrictions on VAT recovery under the partial exemption rules.

There is an ability under partial exemption rules to ignore some exempt income where it is considered incidental to the main activity and this is the case for most businesses – as long as there is no active management of funds to earn interest it can be ignored as incidental.

However, HMRC have a different view of interest earned by solicitors on their client accounts – in their view, the income is not incidental and cannot be ignored. For solicitor client accounts, HMRC advises that:

- Where an account is designated for a particular client and any interest is passed on to the client, this is a through flow of funds which can be ignored for VAT purposes.
- Where there is a general client account, whether any interest is passed on to the client or not, the total income must be considered for the purposes of any partial exemption calculations.

HMRC's historic approach to this has not been consistent – it may not have even been picked up or may also have thought to be incidental (or too small to be concerned with) but we understand that, more recently, HMRC have been taking an interest in solicitors and issuing assessments for overclaimed VAT under the partial exemption provisions. It could happen to you.

Could you be affected?

HMRC's view has not changed but the position for solicitors may have. From 2016 to early 2022, the bank base rate remained fairly low (between 0.25% and 0.75%) and as such the amounts of interest earned by solicitors have been low and, even if considered to be part of any partial exemption calculations, may have been so small as to be de minimis. However, since 2022, the bank base rate has increased (up to 5.25% in May 24) meaning that significantly more interest may have been earned which will have an impact on any partial exemption calculations. Taxpayers (and HMRC) must go back 4 years – when these interest rates were at their highest.

In simple terms, if more than 1% of your income is exempt, there is a need to consider the VAT impact - if 10% of your income is exempt, in rough terms 10% of the VAT incurred on your costs may not be recoverable – can you afford this over 4 years?

Action required

If you do nothing and HMRC challenge the position, as well as any tax that might be due, there is a risk of penalties. If you earn significant interest from your client accounts it is worth a discussion – doing nothing is not an option.

For more information or an informal chat, contact your team at Galloways

Just call us on 0800 012 9190 or email us

Disclaimer: The information provided is for general guidance only, does not constitute professional advice, and is not a substitute for consulting a qualified accountant or other professional for specific circumstances.