

## Update – VAT Partial Exemption in Law Firms - February 2026

### “Protect and plan”

#### Preface

This briefing note is aimed at helping firms plan their approach to the partial exemption issue considering existing HMRC views now understood by most law firms and advisors to the legal sector.

We also have a call to action in conjunction with an experienced barrister to help the legal sector gain better traction with HMRC on this issue and remove the uncertainty the sector is currently suffering.

Advisors relying on past wins with HMRC on partial exemption cannot rely on those successes. We have had Partial Exemption Special Methods (PESMs) approved pre 2008 for law firms, along with winning various disputes on partial exemption but what we are dealing with here is a new opinion and approach from HMRC e.g. basing calculations on gross rather than net interest earned after payments in lieu of interest to clients and not entertaining reasonable PESMs along with new arguments on where interest income is ancillary.

We still disagree that interest in is not ancillary - but that's not the point. The point here is advising law firms on protecting their positions in the event of ultimate success by HMRC on an issue where they currently have clear views.

Penalties from HMRC can be based on their reasonably expected knowledge for a law firm (with an advisor in place). It is probable the bar here for expected knowledge, being a law firm, will be higher than for the general public particularly given they will almost always have informed advisors in place that are aware of HMRCs view from sector forums.

#### 1. Overview

The issue of VAT surrounding interest income from client accounts in law firms continues to be a topical issue in 2026. The recent MoJ consultation which proposes to sweep up large elements of client interest receipts as additional funding for the justice system has further fuelled this issue.

In this paper we provide an update on evolving public understanding of HMRC's stance on this issue along with actions for law firms to consider in respect of their own position, particularly in relation to protection against future potential penalties arising.

#### 2. What have we seen over the last few months?

We have seen increasing instances where HMRC are confirming that they do not accept interest income is incidental (ancillary) and that they do not accept the standard method for calculating partial exemption recoupments is unfair, suggesting they may not entertain PESH applications in this area.

We have also seen increasing volumes of advisors confirming they have seen being the same approach taken by HMRC and at the same time those advisors appear to be softening their stance on whether they believe that interest income is “ancillary” and presenting a more confused position of what their overarching advice on the matter is.

Whilst HMRC has not made any formal public statement on the subject our expectation is that this position may well change by spring.

In broad terms, regardless of whether we all agree with HMRC's views, there is growing evidence of HMRC's stance on this subject area. As this position evolves further this will increase the risk of future penalties levels for law firms who are not applying the legislation in the way in which it is now popularly understood HMRC concludes.

### 3. What is different in 2026 for law firms?

Let's start with what is not different – we remain of the view that we do not accept HMRC's opinion that interest income is not ancillary in a law firm business model. We also maintain that it is unreasonable that law firms should suffer a restriction of their input VAT because HMRC are unable to accept a fair PESM.

However, we must be cognisant that the popular understanding of HMRC's views on this subject have evolved and to ignore this may well increase risks for law firms in the future if ultimately HMRC's interpretation is upheld.

Interest charges arising from unpaid VAT, given current interest rates, can be significant, but this cost of course is mitigated for law firms by them retaining the cash in the interim. Penalties which HMRC may raise in contrast are a **subjective view of a taxpayer's behaviour** and consequently they are unpredictable.

The point here is that with there being a growing body of evidence that HMRC's view on this subject has changed (i.e. that interest income is not ancillary) it is increasingly likely that to protect themselves against penalties firms may want to consider undertaking partial exemption calculations and accounting to VAT for amounts due.

### 4. What actions should law firms consider?

Whilst law firms should consider their own specific circumstances, we would recommend that law firms should assess their potential liabilities for input VAT recovery under the standard method.

They should then look to apply this method for future VAT calculations and make an adjustment to prior years (up to 4 years) to account to HMRC for VAT payable under the partial exemption standard method.

Firms may then wish to consider making an **immediate reclaim** (a process known as “error or mistake” claims) to effectively tell HMRC they disagree that the standard method being applied and that they believe interest income is ancillary.

The benefits of this course of action are: -

- a. It puts the law firm in a strong position to mitigate penalties (“good behaviour by the taxpayer)
- b. Stops interest accruing in the interim
- c. Ensures the law firm have registered the reclaim of VAT to preserve their position with HMRC.

There is another route firms might consider where their annual potential liability for partial exemption restriction exceeds £50,000. This is known as the Standard Method Override (SMO) and enables firms to apply an alternative calculation approach where the firm believes the standard method is not fair and reasonable. However, this approach can only be applied for the current year (not retrospectively) and in our opinion the adoption needs to be notified to HMRC. It might however be an approach that is worth considering in certain circumstances.

## 5. What have firms done to date?

In our experience the response by law firms has been mixed. A small minority to date has calculated amounts of input VAT repayable and accounted to HMRC for those amounts. A larger proportion of law firms have taken no action, and a similar proportion of firms have made a provision for VAT potentially payable of between 50% and 100% of the possible liability. Some firms are assessing their liability based on the gross interest received, some based on net amounts after payments to clients.

A provision in financial accounts (just like, for example, providing for an excess on a PII claim) is not an assertion that there is certainty a liability is due. It is a recognition that it is possible and with this issue developing in the sector it is reasonable to form a view that it is probable without being certain until the matter is clarified.

With the groundswell of opinion more recently becoming clearer around HMRC's views on this subject it will be harder for law firms to ignore these views in determining their future actions in this area – both for VAT, audit, and income tax purposes – this is the position firms face irrespective of what actions they have taken to date. Indeed, in our experience the position has shifted notably since November 2025, when most firms had approved their 2025 financial statements.

As outlined in 4) above, overall, our advice to firms, to protect against future penalties, where they believe they have VAT at risk from partial exemption calculations that they should either be:

- a. Calculating and repaying the VAT to HMRC (potentially with an immediate Error and Omission claim as set out in 4 above) or;
- b. Approaching HMRC for a decision specific to their firm surrounding partial exemption or;
- c. Making a protective disclosure to HMRC

## 6. Our call to action

We remain keen to support the legal sector on this issue. We have therefore independently commissioned an opinion from an experienced barrister that specialises in VAT cases of this nature, Stephen Morse from Temple Tax Chambers.

We are organising an online session during which we will further explain our comments in this paper and more importantly Stephen Morse will outline his opinion on this technical issue, the legal arguments that exist and how they interact with case law beyond the scope of the commonly quoted ECJ decision in *Regie Dauphinoise*.

The intended outcome from this online session is both to inform law firms and hopefully arrange a “call to action” to facilitate the matter being progressed with HMRC with law firm participation.

Overall, we felt this was a more practical and constructive thing to organise to help the legal sector on this issue rather than following the popular trend of simply reiterating that we believe interest income is ancillary!

Stephen's details can be found at: [www.templetax.com/barristers/stephen-morse](http://www.templetax.com/barristers/stephen-morse)

If you would like to take part in the online session, please let me know – the session will take place between **11am and 12:30pm on Friday 27 February 2026**

## **How can we help?**

If you would like any help in assessing your firms position for partial exemption, calculating amounts potentially payable, managing aspects such as error and omission claims with HMRC or maybe even considering an SMO then please get in touch.

We have prepared a guidance sheet for law firms who are looking to make an error and omission application to HMRC, and we have also prepared a spreadsheet to help firms calculate partial exemption adjustments. If you would like access to these support items, please get in touch.

So, overall, our message to law firms here is that they need to consider whether, given the evolution of general knowledge on HMRCs views, their best approach to now mitigate the risk of penalties on this issue is to account to HMRC for the VAT and register their disagreement with HMRC's stance whilst the matter concludes.

**.....Time to “Protect and plan”.**

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