

REDUCED RATE OF VAT ON HEAT PUMPS

The purpose of this technical bulletin is to advise members of where they can apply the reduced VAT rate of 5% to heat pump installations under the energy saving materials and heating equipment scheme. Members have repeatedly reported instances of unregulated competitors continuing to apply a 5% VAT rate despite all advice suggesting they can no longer legally do so.

1. BACKGROUND

In July 2014 HMRC introduced a scheme for applying a reduced rate of VAT of 5% on energy saving materials and heating equipment. It followed on from the enhanced capital allowances list of previous years whereby heating equipment which featured on that list could have a 5% VAT rate applied when the products were installed in domestic situations. The move was designed to encourage the uptake of energy efficient heating systems such as heat pumps in retrofit applications.

In October 2019 the rules were subtly changed to incorporate a “60% test” that must be applied for the reduced rate to be used if certain social policy conditions are not met.

2. SOCIAL POLICY CONDITIONS & THE 60% TEST¹

The installation of energy-saving materials in residential accommodation is reduced rated when any one of the social policy conditions is satisfied.

The first condition is that the supply of the installation is to a ‘qualifying person’ in the qualifying person’s sole or main residence. A qualifying person is defined in legislation as a person who is aged 60 or over, or is in receipt of one of the following benefits:

- Child Tax Credit (other than the family element)
- Council Tax Benefit
- Disability Living Allowance

¹ <https://www.gov.uk/guidance/vat-on-energy-saving-materials-and-heating-equipment-notice-7086>

- Disablement Pension
- Housing Benefit
- Income-based Jobseeker's Allowance
- Income Support
- War Disablement Pension
- Working Tax Credit

The second condition is that the supply of the installation is to a 'relevant housing association' as defined in legislation which includes a registered social landlord and registered housing association.

The third condition is where the residential accommodation is a building or part of a building used solely for a 'relevant residential purpose' as defined in legislation. This includes children's homes, care homes and accommodation for the armed forces.

Where the social policy conditions are not met, it is necessary to apply the 60% test to a supply of installing energy-saving materials. The business, which provides the services of installation, has to calculate the VAT to charge.

It must first establish the price that it paid to purchase the materials (excluding VAT) used in the installation and calculate this as a percentage of the total value of its supply (excluding VAT) to its customer. The materials that must be included in this calculation are all of the goods supplied to the customer as part of the installation which remain in place once the job has been completed.

For example, a business installs insulation in a residential property. It pays £400 (excluding VAT) for the insulation material and charges its customer £1,000 (excluding VAT) for the installation. Since the cost of the materials to the business is only 40% of the value of the supply that the business makes to its customer, the business can charge the reduced rate of 5% on the total supply, that is 5% of £1,000 = £50.

However, where the 60% threshold is exceeded (that is, where the percentage is 61% or more using normal rounding conventions), the business will need to carry out an apportionment. This requires the business to apportion the value of the total supply that it makes to its customer, between materials (which will be standard rated) and labour (which will be reduced rated).

For example, a business carries out an installation of solar panels combined with a battery. It pays £5,000 for the solar panels and battery (excluding VAT) and charges its customer £7,500 (excluding

VAT) for the installation. Since the cost of the materials to the business is 67% of the value of the supply the business makes to its customer, the 60% threshold is exceeded. This means that the business will need to separately identify the value of the materials supplied to its customer and charge VAT at the standard rate on the supply of those materials. The labour element of the supply will continue to qualify for the reduced rate.

3. VAT NOTICE 708/6 – CONFUSION OVER DEFINITIONS²

In February 2021 an amendment to clause 2.17 Air source heat pumps was made to correct a mistake where air source heat pumps of the split air conditioning type had been specifically ruled out from the scheme.

The new text reads (as of 5th July 2021):

2.17 Air source heat pumps

Air source heat pumps use the air as a source of heat. They absorb heat from the outside air which can be used for radiators, underfloor heating, and hot water within the home.

Some air source heat pumps can be reversed so that they draw heat from inside a building, thus providing cooling during the summer as well as indoor heating for colder periods of the year.

While the legislation for energy-saving materials (Note 1 of Group 2 of Schedule 7A of the VAT Act 1994) includes air source heat pumps within the meaning of energy-saving materials, it does not refer to air conditioning units. Deciding whether any particular product is to be treated as an air source heat pump will depend on the facts of the case.

Thus it can be seen that there is still confusion over the definitions and applicability of air conditioning systems used for heating homes and residential premises.

² <https://www.gov.uk/guidance/vat-on-energy-saving-materials-and-heating-equipment-notice-7086#:~:text=2.17%20Air%20source,of%20the%20case.>

4. SOLUTION AND RESPONSE FROM HMRC

Clause 2.9³ of the VAT Notice 708/6 states:

Subject to one of the social policy conditions being satisfied or the 60% threshold not being exceeded, the reduced rate applies to the installation of the following energy-saving materials:

- controls for central heating and hot water systems ([paragraph 2.10](#))
- draught stripping ([paragraph 2.11](#))
- insulation ([paragraph 2.12](#))
- solar panels ([paragraph 2.13](#))
- wind turbines (withdrawn on 1 October 2019, [paragraph 2.14](#))
- water turbines (withdrawn on 1 October 2019, [paragraph 2.15](#))
- ground source heat pumps ([paragraph 2.16](#))
- air source heat pumps ([paragraph 2.17](#))
- micro combined heat and power units ([paragraph 2.18](#))
- wood-fuelled boilers ([paragraph 2.19](#))

The defining factor for VAT relief to apply in paragraph 2.17 is that the air source heat pump can be used to *heat* the home.

An air conditioning unit that only functions to cool the home would not be within the scheme. However, a heat pump that can be used to heat, and if wanted, cool the home will qualify.

In summary, provided the heat pump uses air as the heat source to heat the home, and one of the social policy conditions has been met or the 60% threshold has not been exceeded, it will qualify as an energy saving material, irrespective of whether it can also cool or not.

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³ [https://www.gov.uk/guidance/vat-on-energy-saving-materials-and-heating-equipment-notice-7086#:~:text=2.9%20Energy-saving,boilers%20\(paragraph%202.19\)](https://www.gov.uk/guidance/vat-on-energy-saving-materials-and-heating-equipment-notice-7086#:~:text=2.9%20Energy-saving,boilers%20(paragraph%202.19))