

Response to HMRC's

# Call for evidence: simplification of partial exemption and the Capital Goods Scheme

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## Abbreviations

BUFDG	British Universities Finance Directors Group
CGS	Capital Goods Scheme
HE	Higher Education
HEI	Higher Education Institution
OTT	Option To Tax
PE	Partial Exemption
PESM	Partial Exemption Special Method

## The British Universities Finance Directors Group

The [British Universities Finance Directors Group](#) ('BUFDG') is the representative body for higher education finance staff in the United Kingdom. BUFDG aims to be the recognised channel for the provision, analysis, and dissemination of information, advice and support across the HE Finance sector, helping institutions deliver value, enhance their finance capabilities and work together. BUFDG's members are the Directors of Finance and Chief Financial Officers of almost all UK higher education institutions, as well as their finance staff.

### Partial Exemption

#### **1. Does your business use a PESM? If so, what was your experience in getting the PESM approved?**

Almost all universities/HEIs/BUFDG members use a PESM, other than the very smallest of institutions who may not be VAT registered given the minimal taxable income they receive.

Our members' experiences of getting a PESM approved vary, but actually there are very few good news stories – generally the difference is between the approval process only taking a long time as opposed to a very long time.

Some have told us that the process of agreement was time consuming and the PESM was expensive to implement.

One university told us, however, that one of HMRC's suggestions during the discussions resulted in improved input tax recovery, suggesting they were focused more on fairness than reducing cost, which is encouraging.

#### **2. How long did the approval process take?**

This varies for our members, however, most say it usually takes quite a long time. Responses we received varied from one response stating it took three-five months (but with a lot of work being put in before contacting HMRC), up to two years, with many seeming to be around the one year-eighteen months mark.

For some, it's a lengthy process even when only a small part of the method is being renegotiated – one university told us 'We added one sector to our PESM and it took a year for HMRC to approve it.' Another told us 'it took 18-24 months to add a sector for a building'.

#### **3. Do you find the administration involved with PESMs challenging?**

Universities responses to this question were varied but none thought it was simple and quick. One large university who didn't find it 'challenging', because their method is fairly straightforward and has been in place for a few years, still said it was time-consuming, even with a specific VAT administration employee to undertake the work.

Even those with many years of experience of VAT in Higher Education find it challenging/time consuming.

**4. Would allowing businesses to apply PESMs without seeking approval improve the system?  
Please give reasons for your answer.**

Although on the face of it this sounds like an excellent way to reduce administration and what is perceived as wasted time during lengthy negotiations, it actually caused concern for most of our members, who felt that if HMRC had extensive powers to challenge the method at a later date then taxpayers would never have certainty and this would certainly not improve the current situation.

Our preference would be for HMRC to have sufficient resource, expertise and pragmatism to negotiate/approve all methods quickly and efficiently. This would give a much greater degree of certainty to both sides.

However, if that can't be the case, and it continues to take between one and two years to agree a method or a change to an existing method, then we would welcome the introduction of 'minor' changes to a method to be allowed without having to seek further agreement. We would envisage that these would be specific changes, within certain parameters agreed in the original method or set out in law (or a mixture) such as allowing an additional sector in specific circumstances. One of the current problems is the requirement to re-agree the entire method for changes such as this. If this became the position, then taxpayers should advise HMRC of the changes, giving HMRC an opportunity to review these within a certain timescale.

Perhaps having a notification process but removing the approval aspect could be explored. HMRC could then undertake a risk management approach to verifying methods from the notifications using various factors re type of business, risk rating etc.

**5. Would there be issues created by removing the requirement to seek approval of a PESM?**

The main concern for universities would be that this would remove certainty and increase the risk of HMRC challenge later (along with a retrospective exposure).

If this approach were to be introduced, then there would still need to be a notification to HMRC so that HMRC can then undertake a risk management approach to verifying methods from the notifications and other factors e.g. type of business, risk rating etc. Thus, if any challenges are raised, this would hopefully happen quickly before a large retrospective exposure has built up. As part of this, HMRC would need to be given guidelines and make them public on when they would challenge unapproved methods.

But again, our preference would be for HMRC to have sufficient resource, expertise and pragmatism to negotiate/approve all methods quickly and efficiently. This would give a much greater degree of certainty to both sides.

**6. Would an increased focus on the use of sectoral frameworks be of benefit, particularly if approvals were removed?**

Possibly. There is a framework for the higher education sector, as well as other sectors, however, some analysis of a) how well the frameworks are used within the sectors that already have one, as well as b) how long it takes to agree a PESM under the framework vs. PESMs agreed outside of the frameworks should be undertaken before expanding their use. Are the current frameworks actually achieving their aim? This should be properly explored before expanding their use.

If such analysis proves that most taxpayers within the sectors where PE frameworks have been agreed use a framework compliant method, and that the agreement process was significantly quicker than not using a framework PESM, more frameworks could be considered.

However, frameworks are unlikely to work for partially exempt businesses outside of industry sectors which are all partially exempt. And even some partially exempt sectors may find it difficult to come up with a framework which works for the majority of businesses within it as in some sectors there is much more complexity, difference in how the businesses operate, and a large international element.

A big concern, however, is that existing sector-based partial exemption frameworks could be removed in favour of a generic one-size-fits-all/none framework – such an approach would certainly not improve matters and we would definitely resist this.

**7. Do you have other suggestions to improve or simplify the application of the PE regime?**

Firstly we would question whether it is the right time to be overhauling the PE regime – with the introduction of Making Tax Digital, taxpayers may end up with better quality data (through improved use of software, coding and data analytics) in the medium to long term which may be helpful to support different approaches, but this will take time to develop as MTD develops so can't be used in the near future.

In addition, with Brexit on the horizon, is it better to wait until there is clarity on the UK's interaction with EU VAT rules before delving into this, as it may be possible to improve the PE regime in a much more fundamental way (or it may become clear that this won't be possible)?

Also, many taxpayers involved in partial exemption also have to deal with business/non-business apportionments and this is certainly the case for universities and the wider charity sector. We think it would be sensible to consider both business/non-business apportionments and partial exemption together, so HMRC should reframe some of this call for evidence to include both. It is very difficult to consider one without the other in sectors affected by both.

That said, we would make the following comments about potential improvements/simplifications to the existing PE regime:

- a. Make it easier to both add and remove sectors. Perhaps this could be done without advance approval, even if the method itself needs formal sign-off.

- b. Encourage use of diagrams, and agree how to practically apply a method (in light of available systems etc).
- c. More dedicated resource within HMRC to deal with PESMs/Partial Exemption in general,
- d. Regs 108 and 109 (clawback and payback as HMRC call them) apply where there's a change of intention or use, before any actual use (whereas the CGS is about cases where a change follows actual use). They pre-date the CGS, which was developed separately, and there's probably a case for looking at how they interact, whether they take account of each other. Also, though, these regs are the mirror image of each other, except that if you owe money to HMRC you just have to adjust on your VAT return and pay it, whereas if they owe you money you have to ask them nicely for it. They should be genuinely reciprocal – you shouldn't have to ask. This was actually one of the proposals in (and prompted my recollection of) 'making input tax recovery fairer', but it should be revisited.

**8. Do you have other suggestions on how the way in which HMRC interacts with partly exempt businesses could be improved?**

Most of our members agree that more dedicated resource in HMRC in this area would be helpful. Optional post-implementation reviews of the first PE calculation after a method has been agreed would be helpful, but can't be done with the current levels of resource within HMRC.

We received several comments from members that HMRC enter negotiations on PESMs with an assumption that the taxpayer is trying to gain an advantage, or that HMRC simply don't have an open mind when entering negotiations.

The levels of VAT recovery in the HE sector are generally very low (normally between 1% and less than 20%, with most being under 10%), so quibbling over small details within the PESH makes very little difference to the overall amounts of recoverable VAT at stake, and universities find this frustrating. Many would prefer to see a more pragmatic approach from HMRC – firstly acknowledging that, certainly within the HE sector, the use of PESMs to gain an unfair tax advantage is rare but that HEIs are just looking for a fair method that is easy to apply, and, if the taxpayer is looking for a simple method, recognition that the simplicity of a method (and its ease of application and review) is important, even if there is a small detriment to perceived accuracy. (Given the small change this would make to amounts of VAT recovered).

One member raised an objection to Partial Exemption being combined with Tax Avoidance in the TAPE team at HMRC, giving the perception (at least) that HMRC consider partial exemption must equal tax avoidance.

On a more general note, the point was also raised that in a complex sector for VAT, such as Higher Education, where partial exemption is only one of many tax issues that the taxpayers have to deal with, there seems to be little consideration for the proportionality of other requests from HMRC sent to all taxpayers in the sector, given the workload the businesses have with day-to-day tax complexity, on top of wider changes that HMRC are implementing such as Making Tax Digital.

In terms of 'fair and reasonable' declarations, we think it would be appropriate for HMRC to undertake some analysis to assess (and demonstrate to taxpayers/the public) whether the declarations are serving their original stated purpose of speeding up approvals. If the analysis shows that this is not the case, then the requirement to submit declarations should be removed.

## De Minimis

### Increasing the De Minimis Limit

#### **9. What is your experience of carrying out the de minimis test?**

No comments as this is rarely, if ever, relevant in the higher education sector.

#### **10. What would the advantages and disadvantages of increasing the de minimis threshold be to business?**

No comments as this is rarely, if ever, relevant in the higher education sector.

#### **11. Are you aware of the existing simplification, and do you make use of it?**

No comments as this is rarely, if ever, relevant in the higher education sector.

### Removal of the de minimis limit

#### **12. What would be the advantages and disadvantages of removing the de minimis test?**

No comments as this is rarely, if ever, relevant in the higher education sector.

#### **13. Do you have other suggestions to improve or simplify the application of the de minimis regime?**

No comments as this is rarely, if ever, relevant in the higher education sector.

#### **14. Do you have any suggestions on how to determine what can be considered as 'insignificant' that would be different to the current de minimis tests?**

No comments as this is rarely, if ever, relevant in the higher education sector.

## The Capital Goods Scheme

### CGS Thresholds

#### **15. What is your experience of the CGS?**

The CGS is complicated and time-consuming for the Higher Education sector. Many universities have extensive CGS registers (around, or even well in excess of, 100 items is not uncommon) and the majority of these, where there isn't any particular capital sector for that building or refurbishment within the PESM, are adjusted by very small amounts each year related solely to minor fluctuations in the university's underlying partial exemption recovery rate. (And the fluctuations will swing towards more taxable and then towards more exempt etc. so overall there is practically zero change in the VAT amount recovered). In these circumstances the CGS seems to be, frankly, an entirely pointless yet very time-consuming administrative exercise.

Given the fact that the threshold has never increased, more and more items are being included in the CGS within the HE sector, many being alterations, extensions and refurbishments, with no real monetary impact at all.

One university said that it has 86 CGS items to calculate each year, and only 20% of those are new build construction projects, with the rest being alterations, extensions or refurbishments. The impact is minimal as it mirrors the minor fluctuations in the underlying partial exemption recovery rate, and yet the CGS process five to six full days to complete.

#### **16. How much time and resource do you allocate to carrying out CGS calculations? Does this have an impact on your business?**

Responses ranged from one to two weeks depending on the number of items on the university's CGS register e.g. one university has 180 CGS items and it takes two weeks to complete the CGS process, again, for very little financial impact.

Another has 86 CGS items to calculate with over 80% of them being alterations, extensions or refurbishments. The whole CGS process takes them 5 - 6 days.

#### **17. To what extent does the CGS help to prevent cases of tax avoidance and unfair competition?**

Whilst it may prevent full or high recovery based on initial intended taxable use which then falls away, it is unclear that this approach would be widespread without the CGS as this in itself would be complicated to undertake and would have its own costs associated with it.

#### **18. What would be the advantages and disadvantages of increasing the threshold for land and property for businesses?**

This is a difficult question. It is certainly true that the current CGS threshold pulls in far too many projects – it is impossible to construct any commercial building for under £250,000, and the problem

is that more and more 'small' projects such as refurbishments are now included, making CGS registers ridiculously long and making CGS calculations very time-consuming.

Universities are generally attracted to the idea of increasing the CGS threshold, as it would remove the need to 'include every single bit of work around the campus' as one university put it. The effect of the current low threshold vs. increasing it is well illustrated by an example that one university provided:

*'If the threshold is increased to £500k that would remove 30% of our CGS which had an adjustment of £794.20 last year, and if it was £1m it would remove 51% of our CGS which had a total adjustment figure of £974.88 !! Our total CGS was £6,610.'*

However, increasing the threshold, while initially an attractive idea, would bring numerous additional complications and difficulties of its own regarding transitioning to a new threshold in relation to a ten-year scheme. So, any time the threshold is changes it will take over ten years to fully transition to it (as items already in the CGS will be under the old threshold), unless an option of simply ending old CGS calculations for any existing items under the new threshold could be entertained, but this may not be what all taxpayers want.

There would be major complications for projects that were ongoing at the time of the change – how would you determine which threshold to use for a construction project that takes more than 12 months, as many do? This would be a problem for property owners, but also those dealing with TOGCs and trying to determine whether a property is within the CGS.

Also, while an increase to £1m might remove an awful lot of refurbishment projects etc. it would not remove any new build construction.

Universities are usually owner-occupiers of properties, and their use of the buildings rarely changes significantly over the course of the CGS (one research project may replace another for example, but the VAT implications are the same; or a lecture theatre may be used for a different course, but as a lecture theatre it will still be used for exempt education etc.). This is that results in such minimal change in the amount of VAT recovered over the course of the CGS. For pure 'owners' of property they are much more likely to have larger fluctuations in the use of the building between fully exempt and fully taxable – this makes the calculations more meaningful in terms of the amount of VAT adjusted, as well as much simpler than they are for occupiers/owner-occupiers. This seems perverse. Therefore, perhaps the answer is to remove the CGS altogether for occupiers/owner-occupiers and leave the threshold as it is for owners who do not occupy the building themselves.

## **19. Would there be any other issues involved with increasing the land and property threshold?**

Transition etc. as covered in question 18 above.

**20. If the threshold for land and property is increased, do you think we should consider having a different threshold for alterations, extensions, annexes and refurbishments, (i.e. retain the current threshold) or would this increase complexity?**

In some ways different thresholds would be helpful, but overall this will just increase complexity and we are all looking for ways to simplify the CGS.

**21. Are there other ways in which the CGS can be improved?**

*Recommendations:*

**A. Remove the CGS for occupiers/owner-occupiers altogether.**

We would highly recommend that serious consideration is given to removing the CGS altogether for occupiers/owner-occupiers who have the most complex calculations but the smallest fluctuations in 'use' of the buildings and therefore minimal VAT adjustments (which usually fluctuate between payments and repayments anyway).

**B. Introduce a minimum adjustment threshold**

Alternatively, our other suggestion is to introduce a minimum adjustment threshold. This was mooted in the OTS recommendations as well.

In order to save the work that would go into calculating the adjustment amount (which defeats the object of introducing the criteria) we would recommend that the minimum adjustment relates to the percentage change in the taxable use e.g. a CGS adjustment only needs to be carried out if the percentage of taxable use in the building increases or decreases by e.g. 10% or more. As many occupiers/owner-occupiers' CGS adjustments are based on the overall partial exemption recovery rate, they will know what the percentage change is without starting the CGS calculation work. This is, again, helpfully illustrated by an example provided by one university, who explained that their partial exemption recovery rate:

*'movement is normally within 1%-2% and all it produces for 86 items is £6k on £23m recovered input tax!'*

So, a minimum adjustment threshold of a 10% change in the recovery rate (or even 5%) would **eliminate the need to undertake the one-two weeks of work altogether, all for the sake of a £6,000 adjustment on a £23m original VAT recovery (a 0.03% value adjustment!)**, which over the ten year CGS period will fluctuate between payment and repayment anyway!

**C. Remove refurbishments from the CGS**

These are what tend to clutter up a CGS register, and many don't even last 10 years, but are refurbished before the CGS intervals are complete and another refurbishment takes place.

#### ***D. Reduce the frequency of CGS calculations***

While we would prefer options A. or B. above, if these cannot be implemented, perhaps CGS calculations could be carried out less frequently if the recovery percentage fluctuates minimally, up to a set percentage e.g. if it changes by less than 5% or 10% either way, then a CGS calculation is not required for 3 intervals – this would need to apply to a taxpayer's CGS register as a whole though, rather than individual CGS items (unless those items are under separate recovery/PESM sectors), so that the timing remains the same for all.

#### Categories

##### **22. Do you have experience of computers being included in the CGS?**

This is extremely uncommon, though not entirely unheard of, even within the Higher Education sector with a lot of computer research etc.

##### **23. Would removing computers from the CGS be a simplification for business?**

Yes, computers should be removed as this would simplify the scheme. However, the OTS recommended that the other non-land and property categories should be removed as well. And we would also support removing boats and aircraft from the CGS in order to simplify it further.

#### Intervals

##### **24. What do you think of the current interval length?**

Most universities felt it was fine.

##### **25. Would a change in the number of intervals help businesses with their administration of VAT? Why?**

Given the lifespan of buildings, ten years seems an acceptable number of intervals for buildings. Perhaps not so for refurbishments (especially given the low £250k threshold), which are often refurbished again within the ten year period.

Other possible areas to review

**26. Do you have other suggestions to improve and simplify the application of the PE and CGS regime?**

Consideration should be given to allowing those with a partial exemption recovery rate under a certain level, e.g. 15%, an option to apply the partial recovery rate to all input tax, rather than attributing input tax to taxable or exempt supplies (and fully recovering or not recovering those amounts at all) before applying the partial recovery rate to the remaining residual VAT. This would remove one stage of the process and could simplify matters for many partially exempt taxpayers. One further point is that there is a discrepancy between the record keeping requirements for VAT in general (must be kept for six years) and the CGS which lasts for ten years. The record keeping requirements should be amended to show that for records relevant to the CGS (only) must be kept for the full CGS period.

**27. Do you have any experience of the operation of PE and the CGS in other countries?  
How does the UK compare?**

No.

**28. Do you have any other comments?**

It should be noted that while there are many similarities between universities/HEIs in terms of their activities and their partial exemption/CGS position, and this response represents the majority of universities, there are some whose operations differ enough to affect their partial exemption. These are usually specialist institutions. For example, while the vast majority of universities have combined business/non-business partial exemption recovery rates of less than 18%, we are aware of outliers and at least one that reclaims 40-45% of its residual VAT, due to the specific nature of its business activities.