Framework for HEI Partial Exemption Special Methods

2013

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Annexes

Introduction

1. This Framework provides guidance on formulating Partial Exemption (PE) special methods for Higher Education Institutions (HEIs) in particular:

- How to determine a fair 'value' for supplies of grant-supported education;
- When to add 'sectors' to a PE method; and,
- How to identify and deal with 'distorting supplies'.

2. This Framework is not mandatory and does not replace the content of VAT Notice 706 (Partial Exemption), but adopting its principles will enable HMRC more readily to give approval for a PE special method for which a Statutory Declaration has been made. HMRC recognises that some HEIs may choose to adopt the standard method, while others may choose to adopt an income-values based method which is only a special method because it includes the use of multiple sectors. The Framework has been prepared by working with the British Universities Finance Directors' Group (BUFDG), the representative body for the tax affairs of universities, and the university funding councils via the Higher Education Funding Council for England (HEFCE). It takes full account of the findings of the KPMG Review of Partial Exemption in the Higher Education Sector (KPMG Review) that was commissioned by BUFDG, HEFCE and HMRC and which was published in June 2007.

3. This Framework is intended to improve fairness and consistency and reduce administrative burden by:

- Giving HEIs and their advisers clear guidelines on what constitutes a fair and reasonable, but simple to operate, PE method; and,
- Enabling HMRC to give speedy approval with the minimum of additional enquiry.

For these benefits to be realised, both HEIs and HMRC officers must embrace the spirit of fairness and reasonableness which underpins this Framework. HMRC will take robust action against HEIs that exploit PE flexibility.

4. This Framework has been prepared after lengthy and detailed discussions between HMRC and BUFDG. Consequently, it should not be viewed as the starting point for discussions over points of principle. An HEI adopting one of the options set out in the Framework should adhere to the basic principles of that option. HMRC will

only consider changes of detail to an option set out in the Framework, and such changes of detail are normally expected to be required solely to tailor the HEI's chosen option to its specific circumstances.

This Framework will be updated regularly adding detail and further topics as needed. Readers wishing to suggest improvements and new topics should write to Deductions and Financial Services Policy Team, 100 Parliament Street, London SW1A 2BQ.

Overview

5. This Framework is based on the following tenets arising from the KPMG Review:

- Grant-supported education:
  a) Failure to adjust for the receipt of grants prevents a fair PE method for any HEI.
  b) Inclusion of teaching support grant can be a fair adjustment for teaching-orientated HEIs.
  c) Teaching support grant means the grants received which are provided for the purpose of supporting the supply of teaching including, but not limited to, grants provided by the four British funding councils, the European Social Fund and the Training and Development Agency for Schools. If the purpose of a grant is unclear, it shall be included as teaching support grant unless it is specifically identified as being provided for non-education purposes. Examples of grant received for non-education purposes include research (R) grant, capital grants and grants such as HEIF that are provided for third mission activities.
  d) TRAC is a good alternative especially for research-intensive HEIs.
- Sectors:
  e) Many HEIs currently find it unnecessary to have additional sectors in their PE methods.
  f) Sectors improve accuracy but increase complexity.
  g) Sectors tend to benefit HEIs because they are in a low-recovery environment.
  h) But, sectors must be even-handed and not 'cherry picked'.
- Distorting supplies:
  i) Some supplies provided by HEIs distort PE results.
  j) But, distorting supplies can be taxable or exempt and still consume some costs.

k) There are no hard and fast rules on what is distorting but there are good indicators.

- Agreeing methods:
  l) HEIs are free to choose their PE method to meet their own circumstances.
  m) And, HMRC will approve any fair method irrespective of its recovery rate.
  n) But, HEIs should help HMRC validate methods by disclosing options considered.
  o) All new partial exemption method proposals, regardless of whether they are based on one of the Framework options, must be accompanied by a PE Declaration.

6. Notwithstanding HMRC's duty to consistently apply the same fair PE rules to all businesses, the close working with BUFDG and HEFCE has enabled HMRC to develop the following helpful policies that reflect the unique circumstances of HEIs:

- Allowing the TRAC cost of teaching (including the costs of teaching overseas students) to be substituted for the value of fees plus teaching support grant, on the understanding that HEIs make supplies of teaching 'break-even' without an intention to report overall profits or losses;
- Allowing the netting-off of bursaries paid under an Access Agreement with the Office of Fair Access because statute requires them to be paid to students;
- Allowing TRAC to be used for PE purposes on the condition that its use meets HEFCE rules and that its controls are subject to routine assurance by the HEI;
- Allowing in-year provisional recovery rates and deferral of the annual adjustment and Capital Goods Scheme adjustments for HEIs adopting TRAC options; and
- Allowing limited use of figures from an HEI's annual accounts as estimates of the value of supplies made, predominantly in the denominator of an output values based calculation.

VAT and HEIs

7. HEIs are complex, dynamic organisations affected by a wide range of VAT matters. They have charitable status and often have trading subsidiaries; they receive grants, donations and subsidies; some have large investment and property portfolios; and most deal regularly with domestic, European and overseas customers. Some HEIs are the size of FTSE companies with annual income of £hundreds of millions. HEIs make both VAT taxable and exempt supplies (such as conferencing and education respectively) and undertake non-business activities (such as publicly-

funded research). Despite their complexity, most HEIs can safely adopt relatively simple PE methods, provided the methods are sensibly designed, discussed openly with HMRC, and periodically reviewed and updated as needed. This is the approach to PE anticipated by this Framework.

8. An HEI, like any VAT registered businesses, can recover VAT on costs and expenses that are 'used or to be used' for making taxable supplies (supplies that carry a right to deduct). VAT on costs relating to exempt supplies (sales that are exempt from VAT) is normally irrecoverable, and VAT on costs for non-business purposes is never recoverable. Most HEI costs are used for a mix of taxable, exempt and non-business purposes and the VAT incurred must be apportioned; this requires the following two calculations:

- First, a business / non-business calculation (B/NB) to determine the amount of VAT that relates to their business supplies (such VAT is known as input tax); and,
- Second, a PE calculation (PE method) to calculate the proportion of input tax that can be recovered as relating to taxable supplies.

From 1 January 2011 HMRC can approve a method covering B/NB calculations. All HEIs also, of course, have to carry out partial exemption calculations. All HEIs have the option to ask HMRC to approve one single agreement covering both B/NB and partial exemption calculations. This is known as the combined method.

HMRC will not approve separate B/NB and partial exemption methods after 1 January 2011. Where approval for a B/NB calculation is sought it must also cover partial exemption calculations. This is to save the cost of seeking approval of two separate methods and also helps to make sure a fair recovery of VAT overall as the calculations can be considered in their entirety. However, HEIs are still able to carry on using their own B/NB (without prior approval) and seek approval for a PESM.

An important point to note with the new combined method is that the legislation does not allow taxpayers to benefit from the partial exemption de minimis rules if they use a combined method. This is because the de minimis rules might require taxpayers to unpick their B/NB and partial exemption calculations, which goes against the objective of the combined method to cut down on the number of calculations and reduce compliance costs. There is of course no de minimis limit for non-business VAT.

Although any current B/NB agreements remain valid, HMRC will not approve separate B/NB and partial exemption methods after 1 January 2011. HMRC advises HEIs to seek approval for a combined method when they next routinely update their existing B/NB agreement. This has the advantage of providing certainty to both sides. However, HEIs should note that it is not compulsory to have a combined method and they may wish to retain the flexibility of a separate unapproved B/NB method. In this case, the HEI can apply section 24(5) of the VAT Act, but without any certainty that HMRC will definitely accept the result of the calculation

Further details on what is meant by 'used or to be used' (often called the principle of use), and on the interaction of B/NB and PE calculations are provided in Annex A.

Background to this Framework

9. This Framework deals mainly with PE (although it makes reference to other relevant topics such as B/NB) and it must be read in conjunction with published PE guidance (V1-15) and PE Public Notices (706 & 706/2). This Framework focuses on:

- Values-based PE methods. Paragraphs 10 and 11 explain how subsidies can frustrate the values-based methods that most HEIs use to calculate their recoverable input tax.
- Values and costs. Paragraphs 12 to 14 describe the important policy facilitation allowing HEIs to replace the 'value' of their grant-supported education with 'cost'.
- TRAC system for costing. Paragraphs 15 to 22 consider the suitability of the Transparent Approach to Costing system (TRAC) as a means to further simplify PE for HEIs.
- The Capital Goods Scheme (CGS). Paragraph 23 discusses the impact of a new PE method on existing CGS items.
- KPMG Review. Paragraphs 24 to 40 explore the options recommended in the KPMG Review and outline the conditions when HMRC are likely to grant approval.
- Accounts. Paragraphs 41 to 46 deal with the practical issues of using figures derived from annual accounts.
- Sectors. Paragraphs 47 to 57 provide guidance on when it might be sensible to sub-divide a PE method into sectors.
- Distorting supplies. Paragraphs 58 to 70 discuss events that typically distort PE methods for HEIs and for which additional sectors or adjustments may be required.

- Other matters. Finally, paragraphs 71 to 74 consider the impact of this Framework on the PE Declaration, changes to methods, retrospective approval of methods and dispute resolution.

Values-based PE methods

10. Most HEIs operate values-based PE methods to determine their recoverable input tax. Values-based methods are generally reliable because they:

- Respond to changing circumstances (receipts vary with levels of activity);
- Rely on readily available records (such as income and sales); and,
- Figures are objectively determined, tightly controlled and easily verified.

11. Values-based methods work on the premise that each £ of taxable supply and each £ of exempt supply consumes the same amount of input tax bearing overhead cost; in other words, the higher the value the more costly its supply. But, this premise fails badly for supplies of grant-supported education because the 'value' for VAT purposes is net of grants received; so, unless a correction is made, the PE method will under-apportion input tax to education. This is unacceptable to HMRC and has often led to disputes in the past.

Values and costs

12. If a PE method is to work fairly it must compare 'like-with-like'. A method based on the arms-length value of supplies would normally work just as well as a method based on the full cost of the supplies; whereas, a method in which some supplies were reported at value whilst others were at cost would be unfair.
The challenge for HEIs is to determine a fair, arms-length equivalent value for supplies of grant-supported education so as to compare like-with-like with the values of other supplies included in their values-based method.

13. Historically, HMRC often suggested HEIs include the amount of education subsidy 'as if' it were part of the value of their supply of education. Some HEIs considered this unfair, maintaining that grants might be used for purposes other than education such as research activities; however, there were seldom reliable records to evidence how teaching (T) and research (R) grants were actually used, making this a difficult issue to resolve amicably.

14. During the development of this Framework, it emerged that HEIs typically provide education on a 'break-even' basis without an intention for overall reportable

profits or losses. Tightly controlled state-funding coupled with the pressure to compete for the best students means that HEIs are unable to routinely over or under-spend on their core supplies of education with the result that break-even becomes the norm. Provided that education is supplied at break-even without an intention for overall profits or losses, then its value in a values-based PE method can be replaced with its full cost. This option could help HEIs that routinely utilise their T and R grants other than strictly in the way suggested by the funding formula, so long as they have in place reliable costing systems, such as TRAC. If an HEI supplies education with an intention to report profits or losses then it cannot substitute cost in its values-based PE method.

TRAC System for Costing

15. This section provides a brief introduction to TRAC and considers its suitability as a costing tool for PE purposes. Further details on TRAC are available from the BUFDG and HEFCE websites.

16. TRAC is an activity based costing system used by HEIs to allocate their total costs between the following five categories:

- Publicly Funded Teaching (PFT). This includes tuition of domestic and EU students.
- Non-Publicly Funded Teaching (NPFT). This includes tuition of overseas students and closed courses.
- Publicly Funded Research (PFR). This includes own-funded research as well as that funded by Research Councils or funded by the EU.
- Non-Publicly Funded Research (NPFR). This includes research undertaken on behalf of UK industry, commerce and public organisations, UK based charities, the EU government, and other overseas organisations.
- Other. This includes accommodation, catering, conferences and business consultancy.

17. TRAC allocates costs between categories by reference to the appropriate cost drivers as set out in the published TRAC Manuals. The major staff related costs for HEIs are allocated between categories by reference to a time allocation survey that is updated on a rolling-basis over a three year cycle. Accommodation overhead costs are allocated by floor areas weighted for type (low weighting for offices but high for fully maintained laboratories).

18. TRAC is good for PE purposes because it allocates all costs and reconciles with audited financial statements, and because some of its five categories closely match the non-business, exempt and taxable definitions of VAT. For example, PFR is normally a non-business activity, whereas PFT is normally exempt for VAT purposes; in both cases the VAT incurred on costs is in principle irrecoverable. However, some further apportionment of research income between business and non-business will be necessary - although NPFR is often a business activity, this TRAC category includes UK Charities' funded activity, so the status of research income must be determined on a project by project basis.

19. To use TRAC for PE purposes an HEI must be satisfied that its TRAC system is sufficiently developed and the following conditions can be met:

- It has fully implemented TRAC in accordance with published guidance;
- Its own TRAC guidance is either publicly available or made available to HMRC on request;
- The declaration on its TRAC return has been signed by its Vice-Chancellor;
- Its TRAC return has been accepted through the benchmarking process; and,
- Full account has been taken of the results of Internal Audits and Quality Assurance Reviews of the TRAC process.

20. Although there is no requirement in law for a formal business/non-business apportionment method to be approved, an HEI's activities should have the same weight in both its business/non-business calculation and its partial exemption method. As stated in Annex A, HMRC expects that an HEI applying a TRAC variant partial exemption method will also use TRAC, or an alternative basis that can be shown to give the same weight to each major activity in both calculations, as the basis of its business/non-business apportionment.

The option of agreeing a combined method, covering both B/NB and partial exemption calculations, explained in paragraph 8 above, may help HEIs to meet this requirement for both calculations.

21. Some HEIs that use TRAC based partial exemption methods have agreed to use business/non-business apportionment calculations that are not TRAC based. Where this has happened, HMRC will review those agreements. If the HEI cannot

demonstrate that both calculations give equal weight to the same activities, HMRC will discuss alternatives with the HEI.

If a suitable alternative cannot be agreed, HMRC may resile from the existing business-non/business agreement. If HMRC does resile from an existing agreement it will be from an agreed and notified future date.

22. TRAC simplifications

HMRC offers the following simplifications to help HEIs adopting TRAC options:

- Provisional in-year recovery using the prior year's rate, corrected annually when the full TRAC calculations are finalised;
- Delay of the longer period adjustment to the January accounting period as TRAC returns are not prepared until December/January; and,
- Delay of the Capital Goods Scheme calculations to the April accounting period for HEIs with a significant number of Capital Goods Scheme items.

PE methods and the Capital Goods Scheme (CGS)

23. HEIs should be aware of the impact of a new PE method on existing CGS items. Specifically CGS adjustments will be required where a new method results in a recovery rate that is higher or lower than that allowed under the previous method.

More information on how the principles of CGS affect HEIs is given at Annex B. Examples of how HEIs using TRAC variant based PE methods might make CGS adjustments are given at
Annex C.

KPMG Review

24. The KPMG Review outlined some lead options to deal with grant-supported education for PE purposes. The options include both 'value' and 'cost' options on the premise that education is supplied on a break-even basis. HEIs should think carefully before choosing an option, as the most appropriate methodology will depend on their own circumstances. Some HEIs may prefer to develop a methodology not in this Framework. HEIs will not be given approval for a PE method unless they first declare that it is fair and reasonable for their circumstances and it helps HMRC give rapid approval if HEIs explain the options considered and why other options were rejected.

25. The lead options outlined in the KPMG Review as likely to be suitable for most HEIs are:

- **Teaching Support Grant plus VTFs less Bursaries**. This option uses the teaching support grant plus the net amount of Variable Tuition Fees (VTFs) as a value for grant-supported education.
- **Modified Teaching Support Grant plus VTFs less Bursaries**. This option adjusts the above value to remove certain amounts of teaching support grant clearly anticipated as not for education purposes.
- **TRAC**. This option relies on TRAC to determine the full cost of education (PFT and NPFT) which is then substituted in an otherwise values-based PE method where cost equals values.
- **TRAC Variant**. This option relies on TRAC to determine the full cost of all HEI activities and supplies so as to enable an essentially cost-based PE method.

26. HMRC fully supports these options as likely to be suitable for most HEIs. HMRC also agrees that the options should give very similar PE results and thus any large variances between them should be carefully examined before a method is declared as fair. Illustrative examples of the lead options are provided in Annexes D to F, with examples illustrating where sectorisation may be appropriate, and whether a supply is distorting, at Annexes G and H.

Teaching support grant plus VTFs less bursaries

27. Teaching support grant plus VTF less bursaries is arguably the simplest option. It is available to all HEIs and currently used by many of them. This option is acceptable to HMRC because the teaching support grant is independently determined by the funding councils in accordance with published rules so that HEIs deliver state supported education in a resource-constrained and value-for-money environment.

28. This option, which was discussed in HMRC Business Brief 11/2006, assumes the total money received for exempt education (which is the proxy value for PE purposes) equals the teaching support grant from the Funding Councils, plus VTFs charged to students, less amounts of VTF returned to students as a statutory bursary under the HEI's Access Agreement with the Office of Fair Access (OFFA). Other bursaries cannot be netted-off because they are not paid on a statutory basis. VTFs were introduced in England and Northern Ireland from 1 August 2006 and in Wales

from 1 August 2007. There are currently no VTFs in Scotland. This option is used by many HEIs although some view it as a 'blunt tool'.

29. This option is likely to be most suitable for HEIs that:

- Predominantly teach as opposed to undertake research so that education is the main driver for their expenditure;
- Typically spend the full amount of the teaching support grant on delivering education; and,
- Feel their use of TRAC is less developed or currently unsuitable as a basis for a PE method that must be legally declared as fair and reasonable.

Modified teaching support grant plus VTFs less bursaries

30. Modified teaching support grant plus VTFs less Bursaries is a refinement to the first option which is also available to all HEIs. This option is acceptable to HMRC because all amounts are independently determined and easily verified.

31. This option recognises that the funding councils are gradually reducing their levels of 'special funding' by incorporating amounts into a single teaching allocation. This option allows HEIs to exclude certain amounts of the teaching allocation as not to be used to support VAT exempt supplies of education. The exclusions are expected to be relatively minor and the impact on overall recovery rates minimal. HEIs may therefore decide that, given the work involved in making the adjustments, this option is not worthwhile. HMRC and BUFDG have agreed that the following teaching support grant elements do not support the cost of teaching and that it is appropriate to exclude them in a modified teaching support grant method.

- The element of Widening Participation grant used for outreach activities (valued either by reference to the grant element award or by the relevant costs of an HEI's outreach office);
- The element of additional pension scheme employer funding that relates to non-teaching staff (this can be calculated on a headcount or pro-rata T to R grant basis);
- The element of Rewarding and Developing Staff scheme funding that relates to non-teaching staff (this can be calculated on a headcount or pro-rata T to R grant basis);
- The value of any subvention to a Student Union that is required by the University Charter.

32. This option is likely to be most suitable for HEIs that:

- Wish to operate a teaching support grant based method but receive amounts of 'special funding', the inclusion of which they feel would materially affect their VAT recovery; or,
- Wish to refine their teaching support grant based method as a precursor to adopting a TRAC based method.

TRAC

33. The TRAC option is acceptable to HMRC because if TRAC is fully implemented and operated in accordance with HEFCE guidelines it provides a robust and reliable system for evidencing 'use of costs' in making supplies. TRAC results are subject to independent scrutiny and HEIs must evidence corrective action for any problems found. Furthermore, the TRAC principles are subject to regular review and refinement and their application is becoming more consistent across the sector.

34. The TRAC option is best described as a part-cost option. It uses TRAC to provide a full cost of education (including non-VAT bearing costs such as salaries and employer payroll taxes, and amounts of irrecoverable VAT), which can then be used as a substitute for education value in the otherwise values-based PE method. HMRC would normally refuse as unfair any PE method that mixed costs with values. However, this option relies on the HMRC policy of allowing 'cost' instead of 'value' for grant-supported education on the proviso the HEI makes these supplies on a break-even basis.

35. HEIs adopting this option should exclude certain costs. These include:

- Return for Investment (RFI) and Infrastructure Adjustment (IA) which are both accounting adjustments not related to actual expenditure; and,
- OFFA related bursaries which are included in TRAC cost of teaching but are not spent by the HEI in delivering education.

Because this option relies on determining the full cost of education, HEIs must ensure that they include all costs confirmed by TRAC guidance as a cost of teaching, whether VAT bearing or not.

36. This option is likely to be most suitable for HEIs that:

- Major on research and routinely spend less on grant-supported education than the sum of their T grant and student fee income; and
- Are confident that the information derived from TRAC can be used as a basis for a PE method that must be legally declared as fair and reasonable.

TRAC Variant

37. The TRAC Variant is based entirely on costs rather than values and whilst it is arguably the most accurate, it is also the most complex. There are two sub-options:

- TRAC Variant 1. Under this option residual VAT is allocated amongst the five TRAC categories in the same proportion as the total costs (after certain adjustments) are allocated to these categories by TRAC. VAT relating to non-business activities is identified and deducted from the total. (In practice this will normally be VAT incurred on certain research activities.) The residual input tax for each TRAC category is then apportioned between taxable and exempt supplies using a pro-rata that is suitable for the particular TRAC category. Often the pro-rata will be income based.

- TRAC Variant 2. This option is a simplification of TRAC Variant 1. The advantage of this method is that rather than looking at all five TRAC categories for the B/NB apportionment calculation it concentrates on just the three main categories likely to have B/NB activities i.e. PFR, NPFR and Other. The remaining two categories, PFT and NPFT, are put to one side on the basis that their activities are predominantly by way of business and exempt for VAT purposes. The remaining TRAC categories (PFR, NPFT and Other) are then combined into a single PE calculation. Since PFR, NPFR and Other TRAC category activities might use residual input tax in quite different ways care should be taken to ensure that no distorting supplies affect the single non-attributable cost pool. The normal considerations given elsewhere in this Framework for determining whether a supply is distorting should be applied.

38. As with the TRAC option, the TRAC Variant sub-options require adjustments to be made to exclude RFI, IA and OFFA related statutory bursaries. Where costs or income are recorded in TRAC that do not relate to a member of the HEI's VAT group these should be excluded from the calculations. Under TRAC variant VAT is allocated between the TRAC categories in accordance with costs. We consider that

HEIs should adjust for non VAT bearing salary costs, unless these are either not easily identifiable, or relatively small and would therefore have a minimal impact on the allocation (e.g. salary costs in central support functions).

39. It is important to remember that in a TRAC variant PESM the allocation of costs within the TRAC return and the allocation of VAT within the PE calculation should be done on a like for like basis. This is to ensure that the residual VAT that is allocated to the TRAC calculation was incurred on the costs that have been assigned to the TRAC categories. Any VAT that can be directly allocated to a particular activity may be taken out of the residual VAT figure in the TRAC calculation and put directly to the relevant activity. If you do this, remember to take the costs associated with the reallocated VAT out of your TRAC calculations.

If you reallocate residual VAT from the TRAC variant calculation to a particular activity and the allocation process significantly alters your overall recovery of input tax (e.g. by more £50,000 over a VAT year or a change in the overall PE recovery ratio of more than 1 percentage point) you should consider whether the overall result of your TRAC variant calculation remains fair and reasonable. The total amount of input VAT being recovered for the specified activity by direct allocation outside the TRAC variant calculation plus any amount recovered indirectly via it should be checked for fairness against other available accounting information. Where the result after reallocation appears to be unfair or not reasonable after the change an HEI may prefer either (i) to remove all directly allocated residual VAT from the TRAC variant calculation across all the TRAC categories, or (ii) not to directly allocate the residual VAT relating to the particular activity or activities that caused the result to become unfair. Where systems or accounting issues prevent an HEI from removing directly allocated residual VAT across all TRAC categories it is suggested that the HEI considers adopting option (ii) and not make any direct allocations, or perhaps consider a different basis for its PE calculations than a TRAC variant approach.

40. The TRAC Variant sub-options are likely to be most suitable for HEIs that:

- Major on research activities and routinely transfer monies between T and R grant headings; and
- Operate comprehensive financial management systems and have full confidence that their use of TRAC is sufficiently developed so as to enable a PE method to be declared fair.

Annual Accounts

41. This guidance applies when an HEI uses income values derived from annual published Financial Statements in any part of its PE method and should seek approval as outlined in paragraphs 45 and 46.

42. Ordinarily the value of supplies, recognised at the tax point, should be used when making a values-based PE apportionment calculation. Income figures derived from annual accounts are recorded under accounting rules that can recognise income at a different point. Using the annual accounts figures to approximate value of supplies may produce a timing difference affecting the PE recovery rate.

However, after representations from BUFDG, HMRC has agreed that for some HEIs the possible loss of accuracy arising from the use of income figures from annual accounts as compared to using income figures from values of supplies with precise tax points is outweighed by the additional work required to produce exactly precise information.

43. HEIs should have systems to ensure that output tax is accounted for by reference to the actual time of supply for all business income. HEIs must maintain systems to produce accurate information for taxable income at the standard rate to produce their VAT return. HEIs may not have systems that identify the relevant time of supply for other business income such as exempt income or taxable income at the zero rate.

Where an HEI has systems that provide values of supplies allocated to accounting periods by the actual time of supply, this information should be used in the PE apportionment calculation. HMRC may accept estimation of zero rated income in the numerator and exempt income in the denominator. The use of annual accounts income figures will therefore predominately be in the denominator of the PE apportionment.

44. There are a number of practical reasons why HMRC considers the use of figures derived from annual accounts to be acceptable if the approach outlined in the previous paragraph is adopted:-

- HEIs have low PE recovery rates. This means that taxable income is a low proportion of the total business income. Using values of positive-rated supplies based upon the relevant time of supply in the numerator of an

apportionment fraction and annual accounts income figures in the denominator will mean any potential variance in PE rate should be minimal.

- HEIs have diverse business activities and also diverse accounting systems resulting in undue administrative burden if HMRC were to reject a proposed method solely because it made use of aggregate data derived from annual accounts.
- The identification of tax points is required principally for tax accounting on positive-rated supplies and extension of this requirement to determination of values of outputs for exempt and zero-rated business supplies would serve no purpose other than for PE.
- Exempt business income may be paid on account rather than through an invoicing system making the determination of the relevant time of supply more complicated.
- Published annual accounts are subject to careful preparation with associated internal audit procedures and are also subject to audit by external professional auditors.

Seeking approval for an annual accounts-based PESM

45. HMRC appreciates that HEIs may legitimately choose different methods of compiling annual accounts within business and accounting conventions. HMRC do not expect that a single prescriptive approach would be applicable to all institutions but, nevertheless, need certainty that any PE methodology that makes use of data derived from annual published Financial Statements is clearly understood by both sides.

Therefore, HMRC requires an HEI proposing to use figures derived from annual accounts to outline the principles of its methodology. HMRC will require a worked example showing the source of figures from typical annual accounts documentation when a PE method is proposed for discussion, or is formally lodged with a statutory Declaration. Where additional analysis is required of any income line in the annual accounts to identify supplies with different liabilities then a supporting schedule should be attached to the worked example.

In so far as discussions leading up to the making of a statutory declaration and HMRC giving statutory approval for the proposed PE method HMRC and the HEI will be bound by the worked example that the HEI provides. (An HEI may choose to

follow a similar approach if it also wishes to agree a business/non-business apportionment calculation with HMRC that relies on the use of figures drawn from its annual accounts).

46. However, an HEI would, of course, have the opportunity to amend the details of how the values were estimated in any worked example that had been provided to HMRC before the stage of making a statutory Declaration, or subsequently if HMRC declines to give approval for a method for which a Declaration had been made and the HEI submits a revised proposal.

Sectors

47. The overall recovery rate of an HEI should reflect the mix of all its activities. Using a single calculation will give a broad brush result that for many HEIs will reflect its mix of supplies and how its costs are used in making them. However, where an HEI has a particular activity that uses costs very differently, the PE method may no longer give a fair and reasonable result. In this situation the use of a sectorised method may be appropriate. By using sectors an HEI will divide its PE calculation into a number of sub-calculations, the results from which are added together to provide an amount of recoverable input tax.

48. The HEI must first consider whether a single calculation gives a result that fairly reflects how it uses its costs. If they decide that the proportion of VAT bearing costs actually used in making a given supply varies from that implied by the pro-rata calculation, then the HEI should consider:

- How much of my overhead cost is used in making this supply?
- How does this compare with the result of a single pot calculation? and,
- Is the difference material?

49. If the conclusion is that a single calculation does not properly reflect the overall use of costs then a sectorised method may be appropriate. The HEI's own business model should be the starting point for how this could be structured. Businesses are generally organised so that the income generated from each activity and the internal allocation of costs can be recognised. A business should look first to this internal management and allocation of its costs and income as the logical structure for its PE method, as this is likely to show non-standard activities for which a sector may be appropriate.

50. The HEI should consider the use of costs in the various parts of its business. Supplies can be brigaded together into a single sector if the costs of making several different supplies are used in a similar way. However, where the HEI has an activity that uses costs very differently, and including this supply in a single calculation will lead to a result that is no longer fair or reasonable, the income and costs should be put into a separate sector.

51. If additional sectors are required they must be chosen objectively and consistently. It is not acceptable to create sectors which increase recovery while ignoring equally valid sectors which depress recovery; in other words, it is unacceptable to cherry pick.

52. Common-sense dictates that, given the additional work involved, sectors should only be created when the impact on VAT recovery is material. Generally there is no point to creating a sector unless the recoverable proportion is materially different from that used elsewhere in the PE method. You could have a sector where recovery is 50% different from the general pot, but if VAT for the sector is only £5,000 overall is this really material?

53. When creating a sector, an HEI should take the following into account:

- Have they balanced the change in the overall recoverable percentage with the costs involved in creating and maintaining the sector?
- Does the sector reflect the organisation of the business, or does it create an artificial split of costs or activities?
- Has the business allocated both costs and income to the sector? and
- Does the institution have a sufficiently robust cost centre structure to properly implement the sector?

54. The paragraphs below set out indicators, rather than hard and fast rules, for when an HEI may consider that a difference is material and a sector is warranted.

55. During the work with KPMG it was suggested that a reasonable indicator of the need to create a sector is if the supply makes at least a 1% difference to the recoverable rate achieved by the PE method, or 10% difference to the prevailing rate. For example, if a method gives a recoverable rate of 15% a 10% difference will be 1.5% either side. Any supply that moves the result of the PE method outside the

range of between 13.5% and 16.5% should be considered for possible sectorisation. However, if a method gives a recoverable rate of 5%, a 10% difference will be 0.5%. In that scenario the higher fixed tolerance of 1% applies and any supply that moves the result of the PE method outside the range of between 4% and 6% should be considered.

56. Another indicative level would be when sectorisation makes a difference of £50,000 a year (or £25,000 and 50% of the residual input tax incurred in the year) to the amount of input tax recovered or restricted by the HEI. When calculating the difference, the comparison must be made between a method without sectors and a sectorised method based on objective criteria, i.e. one that contains no element of "cherry picking".

57. When one of the indicative levels is exceeded, an institution should consider whether the impact on the PE method is material or not. A further £60,000 recovery might be material to some HEIs but not to others when weighed against the costs involved in creating a separate sector for the supply (and any others that have a similar impact on input tax recovery).

Distorting Supplies

58. Values-based methods work on the premise that each £ value of output supply uses the same amount of VAT-bearing residual cost. In reality most output supplies will use proportionately more or less VAT-bearing residual cost than the average, but provided the ups and downs are small, the variances will cancel out and the PE method will still be fair. However, occasionally a supply will use a disproportionate amount of residual cost thereby distorting the entire PE method.

59. The general characteristics of a distorting supply are:

- The value of the income received bears little link to the VAT bearing expenditure incurred;
- It can be taxable or exempt; and,
- The supply may be non-core or one off.

60. The concept of a distorting supply is not unique to the UK and has been covered in part by European case law under the heading of 'incidental'. This requires that certain supplies (incidental ones) are excluded from the partial exemption pro-rata calculation so as not to distort the outcome. The European Court of Justice has

steered clear of defining a numerical test of incidental and has put great emphasis on the distorting nature of the transaction and the very limited or excessive use of VAT bearing residual costs.

61. Whether or not a supply is distortive is to some extent a subjective question which requires the exercise of sensible judgement. The partial exemption pro-rata calculation is a broad brush one and can deal with unexceptional ups and downs from an average. What creates a distortion for one HEI will not necessarily create a distortion at another. It should also be noted that a distortive supply may still use some input tax and therefore total exclusion may not be fair and reasonable.

62. When considering whether a supply is distortive it helps to ask the following questions:

1. What increase (or decrease) to the recoverable rate does this supply's value make?
2. How much extra input tax does that imply should be recovered or restricted?
3. Is that proportionate to the tax that is actually incurred on the taxed cost components of that supply?

63. Once a distorting supply has been identified, the HEI must consider how it should be treated in the PE method. The income generated by the distorting supply should either be excluded, or its impact limited through the creation of a separate sector. All supplies will make some use of overhead costs, even if it is very little. However where a distorting supply makes very minimal use of these costs, excluding the income will lead to a fair and reasonable recovery of residual input tax.

Alternatively, if the use of the overhead costs in making the distorting supply is significant, but different to other supplies, a more sophisticated solution is needed. The impact of the distorting supply should be limited to those costs which are cost components of that supply.

This can be achieved by creating a sector that deals solely with the distorting supply and the costs incurred. Whether or not creating a separate sector will properly address the distortion will depend heavily on how accurately the HEI allocates the costs of the distorting supply. Annex G explores this point in greater detail.

64. There can be many reasons why the structure and mix of supplies can change. Where change happens organically, we would expect the partial exemption method to respond appropriately so that any change in the use of overhead costs is reflected by a corresponding change in the recovery of input tax.

65. There is more chance of a distortion arising where an HEI restructures its business so that intra group (but not intra VAT group) supplies are made; often but not only where a subsidiary company is involved in the supply chain. One reason is because when supplies made under the new structure are fed into the existing partial exemption method the result implies that overhead costs are used significantly in making the new supplies while in fact the underlying use of overhead costs is unchanged.

This is particularly the case when the restructuring results in staff and other non VATable expenditure being recharged to the subsidiary by way of taxable supply. Another reason may be because normal commercial pressures do not apply to set pricing levels. Following a restructure an HEI should review its existing method and consider whether the result is still fair and reasonable.

66. If following a restructure an activity changes from being an exempt supply by an HEI to being a taxable supply undertaken by a subsidiary a significant distortion leading to a partial exemption benefit may arise. The HEI must carefully consider the impact of the value of these supplies on the overall recovery of input tax by the institution. Annex H considers this point in more detail.

67. Under direct tax rules, HEIs often separate their Primary and Non-Primary Purpose activities by hiving-off the latter into trading subsidiary companies. (Details are available in The BUFDG Corporation Tax Treatment of UK Universities Guidance Note). Where an HEI changes its corporate structure merely to hive-off already taxable Non-Primary Purpose activities, an increase in VAT recovery would not normally be expected unless there had been a genuine change in the way costs are used. However it may be that if the liability of services hived off for CT reasons changes, for example because of the loss of eligible body status, an unexpected increase in recovery is produced. In this case the HEI would need to review its method to ensure that it still gives a fair and reasonable input tax recovery.

68. It may be that no single supply causes the distorting effect – it could be the result of the cumulative impact of a number of smaller supplies. What is important is that the method overall gives a fair and reasonable result. If the cumulative impact exceeds the criteria set out in paragraphs 55 and 56, an HEI should consider whether it needs to sectorise the supplies that cumulatively lead to the distorting effect.

69. Examples of potentially distorting supplies within the HE sector are:

- Income from Property
- Largely non-VAT bearing management services or salary recharges supplied to a separately VAT registered subsidiary company

This list is not exhaustive.

70. Supplies made under lease and leaseback agreements can undermine values-based methods because they can result in substantial supply values in relation to which little, if any, overhead cost is used. It therefore makes sense to exclude these supplies. Equally, transactions with connected parties can be troublesome when amounts charged do not reflect 'open market values' (OMV).

Other Matters

71. Framework methods and the PE Declaration

HEIs must obtain written approval before adopting a PE special method, even if the method mirrors an option in this Framework. Furthermore, in common with all businesses since 1 April 2007, HMRC cannot approve a PE method unless the HEI first declares that the proposed method is to the best of its knowledge and belief fair and reasonable. HMRC believes that if HEIs follow this Framework and act fairly they should be confident in providing a declaration, and furthermore, whilst HMRC must still make reasonable enquiries HEIs should still benefit from speedier approval. Annex I sets out in detail the steps that an HEI should reasonably take to ensure that their proposal is fair and reasonable.

72. Changes to methods

An HEI may need to change its PE special method if new circumstances arise. Even if the change involves amendment to an existing method such changes will normally require formal approval by HMRC of a new PE special method. A declaration is required for any new method.

If the mechanism for attributing tax incurred against an activity cannot be agreed immediately it is possible to sectorise that activity in a new PE method and apply the principle of use to it. The principle of use is explained in Annex A, paragraph A5.

Subsequent discussion between HMRC and HEI can take place to agree how use should be measured, and this measurement can then be applied from the date on which the new PE method starts.

73. Retrospection of new PE methods

Established policy is to offer retrospection for newly approved PE methods to the start of the current tax year. In exceptional circumstances retrospection can extend further although adjustments to input tax deductions are limited by the cap (4 years). HMRC's offer of exceptional retrospection for PE method proposals submitted by 30 April 2008 has expired and established policy applies.

74. Resolving disputes about PE

This Framework is intended to lessen the risk of PE disputes with HEIs. In addition to the normal procedures for resolving disputes, such as an independent review or appeal to a VAT and Duties Tribunal, HEIs may seek the involvement of the technical and policy specialists that comprise the National PE Network. These specialists advise local officers and meet regularly with policy colleagues to consider generic issues. Furthermore, as part of the development of this Framework, PE policy meets regularly with BUFDG and HEFCE to monitor progress in implementing fair methods for all HEIs and to agree improvements to this Framework. These meetings never discuss individual cases.

Annex A

Background to Partial Exemption for HEIs

A1. VAT on costs that are wholly used for taxable, exempt or non-business purposes is directly attributed, whereas VAT on mixed-use costs (such as overheads) must be apportioned. This is completed by firstly carrying out a business/non-business (B/NB) split to identify an amount of input tax (VAT on business-use costs) and then a PE method to determine the recoverable input tax relating to taxable supplies. If a partial exemption special method was approved prior to 1 January 2011, then two separate calculations are still required under VAT legislation. However, with effect from 1 January 2011, HMRC are now able to approve a combined method to cover both calculations.

A2. Both the B/NB split and PE method, in both separate and combined methods, must be fair and reasonable, namely:

- Provide for recovery in accordance with the 'use or intended use' of goods and services in making taxable supplies (this is known as the 'principle of use');
- Readily auditable by HMRC and not overly burdensome on the business; and,
- Unambiguous whilst providing sufficient flexibility to accommodate changes in circumstance that a responsible business could be expected to foresee.

A3. There can be any number of fair and reasonable B/NB splits and PE special methods all of which would be acceptable. A business must always obtain prior written approval from HMRC before changing its PE method, and whilst HMRC will approve any PE method that is judged fair and reasonable, HMRC will not approve an apparently fair PE method that relies on an unfair B/NB split. Furthermore, since 1 April 2007, HMRC will only approve a PE method that is accompanied by a Declaration on which the business states that to the best of its knowledge and belief the method produces a fair and reasonable input tax recovery.

A4. Both calculations should compare like with like. For example where an HEI wishes to use income based methods for both steps, what is considered to be business income for one calculation should also be treated as business income for the other. Likewise if an HEI substitutes the TRAC costs of teaching for the total of fees received (less any OFFA related bursaries) plus teaching support grant in its PESM, it should do so in its business/non-business apportionment.

This is equally true for full TRAC based calculations as TRAC analyses costs over the whole range of university activities: non-business supplies, taxable supplies and exempt supplies. HMRC expects that an HEI applying a TRAC variant partial exemption method will also use TRAC as the basis of its business/non-business apportionment unless it can clearly demonstrate that an alternative basis gives equal weight to the HEI's major activities in both calculations.

A5. PE guidance provides in-depth discussion on the 'principle of use' in terms of the EU-law concepts of 'direct and immediate link' and 'cost component' – input tax is recoverable insofar as the costs have a direct and immediate link so as to form cost components of the price of taxable supplies. In practice, the principle of use means:

- Identify the main categories of VAT-bearing cost and expenditure;
- Determine what 'drives the cost'; and,
- Apply the 'cost driver' to apportion the input tax incurred to taxable supplies.
- Costs sharing the same cost driver can be dealt with either in a single calculation or a single sector.

Annex B

HEIs and the Capital Goods Scheme (CGS)

B1. The CGS is a mechanism for adjusting the initial attribution of input tax on certain property and computer assets when the use changes after they have been brought into use by the HEI.

Major changes to the CGS took place [for expenditure incurred] on or after 1 January 2011. The change most likely to affect HEIs is that the CGS has been widened to include non-business activities. This requires an adjustment mechanism for the non-business VAT incurred on a CGS asset to be revisited. The same principles outlined in paragraphs B2 to B7 will apply but care should be taken to ensure adjustments reflect the date of the change and expenditure to be included in the CGS. Full details of the changes can be found in Notice 706/2 and Partial Exemption Guidance PE 4800.

B2. It has no effect in the first year as the degree of use in the first interval is set under normal PE rules (i.e. by the PE method you have agreed, normally under this Framework).

B3. The CGS runs for ten years – which means up to nine adjustments. The years are technically known as intervals because in certain specific situations they can run for periods other than twelve calendar months.

B4. In subsequent years an HEI needs to consider whether an adjustment is due. It must calculate whether and what adjustment is due using the following formula:-

One tenth of the total input tax on the asset multiplied by the adjustment percentage.

B5. The adjustment percentage is the difference between how much input tax was deductible originally, expressed as a percentage, and the taxable use percentage for the year in question.

B6. The standard way of ascertaining the taxable use percentage in a subsequent year is to imagine that the input tax being considered for adjustment was incurred in

that year and work out how much would have been recoverable under the current PE method.

B7. When the use has not changed and the PE method has not changed there will be no adjustment. Where, after a change of method, the CGS generates adjustments but there has been no change of use, please discuss with your HMRC officer.

B8. Prior to 1 January 2011, where HEIs have non-business use of property related assets then theoretically the non-business apportionment that is made initially cannot be revisited and adjustments will take only the relative mix of taxed and exempt business supplies into account. The amount of tax calculated as related to non-business use in the first year is discarded and never revisited while the amount considered as input tax can be adjusted for changes in the relative levels of taxable and exempt use.

B9. However this can lead to unfair results. Also it is difficult to comply with where there was a combined PE and non-business method in place when the tax was incurred because the amount of non-business VAT incurred will be unclear.

B10. Some HEIs, prior to 1 January 2011, had used de facto approved methods that combined the business/non-business and partial exemption stages of the calculation of recoverable input tax. Some HEIs have replaced an existing combined calculation with a Framework PE method that follows an initial business/non-business split. Where this has happened HMRC is prepared to agree to recovery percentages for CGS items, that have unexpired intervals at the date of implementation of the new PE method, being aggregated from both the new method and the business/non-business split. This will provide a comparable recovery percentage to the combined calculation that was used when the baseline recovery was set.

EXAMPLE CALCULATION

For simplicity, it is assumed that the rate of VAT is 20% throughout this example. The results of the business/non-business, partial exemption special method and combined method are assumed to be global across the whole HEI and are therefore applied to the CGS item in this example.

B11. An HEI takes a new building into use on 1 August 2011. The building costs £1 million. VAT of £200,000 is paid on those costs, of which £150,000 is incurred before 1 January 2011 and £50,000 after 1 January 2011.

At the time of first use, which is the first interval under the CGS, the building is used 60% for business and 40% for non-business purposes. The business use is 20% for the making of taxable supplies and 80% for the making of exempt supplies.

On 1 August 2012 the HEI stops undertaking non-business activities in the building but the level of taxable use stays at 20%. On 1 August 2013 the use of the building changes so that only 10% of the buildings is used for taxable business purposes.

B12. In 2011 the HEI has a separate business/non-business (B/NB) agreement with HMRC and operates a modified teaching grant based partial exemption special method (PESM). On 1 August 2012 HMRC approves a combined B/NB and PESM (again based on modified teaching grant) for the HEI.

B13. Initially the HEI needs to calculate how much of the VAT incurred on the building was deductible following its B/NB and PESM. As the building was originally used for 60% business purposes, 60% of the £150,000 VAT incurred before 1 January 2011 can be treated as Input Tax (£150,000 x 60% is £90,000). As the business activities were 20% taxable, 20% of this Input Tax, (£18,000), is deductible.

All of the £50,000 VAT incurred after 1 January 2011 falls within the CGS. Taxable business activity forms 12% (60% business and 20% taxable) of the HEI's total activity, and so 12% of £50,000 or £6,000 is recoverable.

The HEI therefore recovers £24,000 in total out of £200,000 VAT incurred, of which £140,000 (£90,000 from before 1 January 2011 and £50,000 from after 1 January 2011) falls to be considered by the CGS.

B14. Prior to 1 January 2011 only the expenditure allocated to business activities and related input tax falls within the scope of the CGS. The baseline recovery percentage is determined by reference to the amount of deductible input tax expressed as a percentage of total input tax, which is 20% in this example.

B15. In each subsequent interval the HEI is then required to imagine that it has incurred all of the Input Tax (£90,000) again and review the extent to which it had been used to make taxable supplies. In this case, the input tax is used until 31 July 2013 to make 20% taxable supplies in each subsequent interval and so no adjustments are required under the old CGS rules, even though business use of the building had increased on 1 August 2012.

B16. However, from 1 August 2013, the input tax is used to make 10% taxable supplies. This means that, if there were no more changes to the use of the building, the HEI would have to repay (10% - 20%) x £90,000/10 = £900 as a CGS adjustment at the end of each of the remaining intervals.

B17. With effect from 1 January 2011, all of the expenditure on the building falls within the CGS. The baseline recovery percentage needs to be determined by

reference to the amount of deductible input tax on the asset expressed as a percentage of the total VAT on the asset: in this case £6,000/£50,000 = 12%.

B18. The HEI is then required to imagine that it has incurred all of the VAT (£50,000) again and apply its B/NB and PESM calculation. For the time up until 31 July 2012 this means applying the separate B/NB and PESM – from 1 August 2012 it means applying its combined method.

B19. As the building has been used entirely for business purposes from 1 August 2012 the CGS recovery percentage is 20% (since there is 20% taxable business use) in the intervals after 1 January 2011 and up until 31 July 2013. This recovery percentage drops to 10% from 1 August 2013 when the taxable use of the building drops to 10%.

B20. This means that the HEI claims (20% - 12%) x £50,000/10 = £400 at the end of each interval up to 31 July 2013. It then means that the HEI repays (12% -10%) x £50,000/10 = £100 for the subsequent intervals after the drop in taxable use on 1 August 2013. Under the wider CGS the adjustments reflect the increased business use of the building as well as the decrease in taxable use since the building was first used and apply the result to tax incurred after 1 January 2011.

B21. To summarise, the HEI initially recovers £24,000, representing 20% taxable use of 60% business use of VAT incurred prior to 1 January 2011 of £150,000 and 20% taxable use of 60% business use of VAT incurred after 1 January of £50,000.

The baseline for the Input Tax incurred prior to 1 January 2011 is 20% and is derived solely from the partial exemption calculation. The baseline for the VAT incurred after 1 January 2011 is 12% (20% taxable use of 60% business use) and is derived from both the B/NB and PESM.

The tax considered by the CGS is £140,000. This is made up of £90,000 (60% of the £150,000 incurred prior to 1 January 2011) and all £50,000 of the VAT incurred after 1 January 2011.

For the £90,000 incurred prior to 1 January 2011, only changes in the result of the PESM will affect the recover rate. For the £50,000 incurred after 1 January 2011, changes in both the B/NB and the PESM recovery rate will impact upon the CGS calculation.

In this example, non-business use of the tax stops on 1 August 2012. The extent to which the tax is put to business use drops from 20% to 10% on 1 August 2013.

So far as the £90,000 incurred prior to 1 January 2011 is concerned, the 10% drop in taxable use has to be reflected in all intervals after 1 August 2013. The adjustment is £900 in favour of HMRC each interval.

So far as the £50,000 incurred after 1 January 2011 is concerned, the fully business use of the tax has to be reflected from 1 August 2012 and the drop in taxable use has to be reflected from 1 August 2013. This means an adjustment of £400 in favour of the HEI up until 31 July 2013, and an adjustment of £100 after 1 August 2013.

The adjustments the HEI makes are therefore:

Until 31 July 2012 – none

From 1 August 2012 to 31 July 2013 - £400 in favour of the HEI (to reflect more business use of tax incurred after 1 January 2011)

From 1 August 2013 to the end of the CGS - £1,000 in favour of HMRC (£900 to reflect less taxable use of the input tax incurred before 1 January 2011 and £100 to reflect less taxable business use of the VAT incurred after 1 January 2011).

Annex C

Capital Goods Scheme (CGS) items and TRAC variant based methods

TRAC variant 1

C1. The University is using a TRAC variant 1 partial exemption method. It has two CGS items to consider – one is a building used across the whole university, the other is used only for research activities. All the expenditure on the CGS items was incurred prior to 1 January 2011.

C2. The University has residual VAT of £1m which it is unable to assign directly to any of the TRAC categories. It assigns this tax across the five categories in direct proportion to the level of VAT bearing expenditure incurred in each category. The VAT on the CGS items is included in the business/non-business and PE method as normal and is included in the appropriate amounts below.

C3. The result of these allocations is shown below.

	Total VAT Bearing Expenditure	Residual VAT
PFT	30,500,000	£586,500
NPFT	1,500,000	£28,800
PFR	10,100,000	£194,200
NPFR	2,200,000	£42,300
Other	7,700,000	£148,200
Total	52,000,000	£1,000,000

C4. Analysis of the income in each category shows that 17% of the income generated by PFR activities derives from business supplies and 91% of the income generated by NPFR activities comes from business supplies. (100% of the income generated from the remaining three categories is from wholly business supplies).

C5. Applying this analysis to its residual VAT allocation, the University finds that it has residual input tax in each category as follows:

	Residual Input Tax
PFT	£586,500
NPFT	£28,800
PFR	£33,014
NPFR	£38,493
Other	£148,200
Total	£835,007

C6. Residual input tax for the whole university is £835,007 out of £1,000,000 residual VAT. Therefore it has applied a business percentage of 83.50% to the CGS item that is used across the whole university.

C7. Residual input tax for the university's research activities is £71,507 (£33,014 + £38,493) out of £236,500 residual VAT (£194,200 + £42,300). Therefore it applied a business percentage of 30.24% to the CGS item that is used only for research activity.

C8. The University has calculated its recoverable input tax is as follows:

	Residual Input Tax	Taxable Income	Total Business Income	Recoverable Rate	Input Tax Recovered
PFT	£586,500	600,000	60,200,000	1.00	£5,865
NPFT	£28,800	200,000	3,300,000	6.06	£1,745
PFR	£33,014	3,400,000	3,400,000	100.00	£33,014
NPFR	£38,493	6,900,000	8,000,000	86.25	£33,200
Other Activities	£148,200	3,360,000	35,100,000	9.57	£14,183
Total	£835,007	14,460,000	110,000,000	10.54	£88,007

C9. The University has calculated that it has a 10.54% overall recoverable rate under its partial exemption method. It therefore applied this rate to the CGS item that is used across the whole university and this would be the baseline recovery for this item. (10.54% of the 83.50% (the percentage determined to apply to business use above) of total VAT incurred on the CGS item).

C10. The University has a research recoverable rate of £66,214 recoverable input tax (£33,014 + £33,200) out of £71,507 input tax incurred (£33,014 + £38,493) or 92.60%. It therefore applied this rate under its partial exemption method to the CGS item that is used only for research activities and this would be the baseline recovery for this item. (92.60%
{the percentage determined to apply to business use above} of the 30.24% of total VAT incurred on the CGS item).

C11.The University needs to calculate a combined rate for both business/non-business and partial exemption because it previously had a combined method and it has taken up one of the CGS simplification options offered by HMRC in 2009. For the CGS item used across the whole university the combined rate will be 8.80% (83.50 x 10.54%). For the CGS item used only for research activities the combined rate will be 28.00% (30.24 x 92.60%).

TRAC variant 2

C12. The University is using a TRAC variant 2 partial exemption method. It has two CGS items to consider – one is a building used across the whole university, the other is used only for non-publicly funded research activities and falls within a capital items sector of the partial exemption method. All the expenditure on the CGS items was incurred after 1 January 2011.

C13. The University has residual VAT of £1m which it is unable to assign directly to any of the TRAC categories. It assigns this tax across the five categories in direct proportion to the level of VAT bearing expenditure incurred in each category. The VAT on the CGS items is included in the business/non-business and PE method as normal and is included in the appropriate amounts below.

C14. The result of these allocations is as follows:

	Total VAT Bearing Expenditure	Residual VAT
PFT	30,500,000	£586,500
NPFT	1,500,000	£28,800
PFR	10,100,000	£194,200
NPFR	2,200,000	£42,300
Other	7,700,000	£148,200
Total	52,000,000	£1,000,000

Analysis of the income in each category shows that 17% of the income generated by PFR activities derives from business supplies and 91% of the income generated by NPFR activities comes from business supplies. (100% of the income generated from the remaining three categories is from wholly business supplies).

C15. Applying this analysis to its residual VAT allocation, the University finds that it has residual input tax in each category as follows:

	Residual Input Tax
PFT	£586,500
NPFT	£28,800
PFR	£33,014
NPFR	£38,493
Other	£148,200
Total	£835,007

C16. Residual input tax for the whole university is £835,007 out of £1,000,000 residual VAT. Therefore it applied a business percentage of 83.50% to the CGS item that is used across the whole university.

C17. For the CGS item that is used only for non-publicly funded research activity a proxy has been agreed as part of the capital items sector in the partial exemption method. That proxy is the proportion of taxable to total income generated by research activities undertaken in the building.

Income is felt to be a good proxy for the extent of taxable business use, and there are no reasons to suggest that income is not a fair measure of non-business use of the building. Therefore it is sensible to adopt the same approach in the business/non-business calculation that is adopted in the partial exemption method.

The resulting analysis of business to total income generated by research undertaken in the building tells the University that 88.72% of the use of the building is for business purposes.

C18. The University has calculated its recoverable input tax as follows:

	Residual Input Tax	Taxable Income	Total Business Income	Recoverable Rate	Input Tax Recovered
Teaching	£615,300	800,000	63,500,000	1.26	£7,753
Research and Other	£219,707	13,660,000	46,500,000	29.38	£64,550
Total	£835,007	14,460,000	110,000,000	8.66	£72,303

C19. The University has calculated that it has an 8.66% overall recoverable rate under its partial exemption method. It therefore applied this rate to the CGS item that is used across the whole university. The baseline recovery for this asset is therefore 7.23% (83.50 x 8.66%) being the deductible input tax expressed as a percentage of the total VAT on the asset, in this instance input tax and non-business VAT.

C20. The University has a recoverable rate of 29.38% in the sector of its partial exemption method into which the CGS item that is used only for non-publicly funded research falls. It therefore applied this rate under its partial exemption method to that item. The baseline recovery for this asset is therefore 26.07% (88.72 x 29.38%) being the deductible input tax expressed as a percentage of the total VAT on the asset, in this instance input tax and non-business VAT.

Annex D

Examples of Teaching support grant and TRAC methods

The following examples illustrate how certain PE methods might work in practice and to help HEIs to decide which approach is suitable. They should not be taken as indications of acceptable recovery rates or deductible tax amounts.

The examples also demonstrate the effect of the university's chosen method of valuing education on the overall rate of VAT recovery. In each example there is consistency between the income treated as business income in the partial exemption calculation and that treated as business income in the business/non-business calculation.

Example of a method using 'Teaching support grant plus VTF less Bursaries'

D1. In its latest year, which is typical, an HEI VAT group uses the following information in order to review its PE method:

Income		Income / £millions		
Taxable consultancy		0.8		
Taxable commercial income		9.2		
Total taxable income			10.0	
Variable Tuition Fees (VTFs)		15.0		
Exempt income (student residences etc)		55.0		
Total exempt income			70.0	
Total business income				80.0
Teaching support grant		45.0		
Non-business income (research)		16.0		
Total Income				141.0
Expenditure	£k	Expenditure / £millions		
Residual VAT		1.1		
Residual input tax; academic departments	146			
Residual input tax; commercial activities	243			
Residual input tax; general overheads	584			
Total residual input tax		0.973		
OFFA bursaries			2.5	
TRAC cost of teaching (assume net of adjustments)			56.0	

D2. The business / non-business calculation should always be carried out before the PE calculation. Because the HEI is using 'Teaching support grant plus VTF less Bursaries' to value the supplies of education in the PESM, it should treat this value as business income in the business/non-business calculation.

$$\frac{\text{Total business income*}}{\text{Total income **}} = \frac{122.5}{138.5} = 88.45\%$$

*Plus Teaching support grant less OFFA bursaries.

** Less OFFA bursaries

Applying this calculation to the residual VAT identified of £1.1m results in £973k of residual input tax being carried forward to the PE calculation.

Its current method is a single-sector method using 'Teaching support grant plus VTF less Bursaries' which is calculated as follows:

$$\frac{\text{Total taxable income}}{\text{Total business income + Teaching support grant – OFFA Bursaries}} = \frac{10.0}{122.5} = 8.16\%$$

Using this calculation the HEI will recover residual input tax of £79,397.

Points to note:

- Residual input tax; academic departments relates to taxable short courses and exempt education
- Residual input tax; commercial activities relates to taxable supplies such as conferencing and holiday lets, and exempt supplies such as research for eligible bodies etc
- Residual input tax; general overheads relates to general fabric of buildings and admin
- PE recoverable percentages are calculated to two decimal places

D3. Although the current method is likely to be within the range of fair and reasonable, the HEI reviews its method and recognises the following issues:

- Less than 1% of the supplies of the academic departments are taxable (such as short courses) and yet 8.16% of the academic departments' input tax is recovered.
- However, an estimated 15% of commercial activities are taxable and yet only 8.16% of the residual input tax is recovered.

- The general overheads will be used to support all the activities of the institution, in this case 8.16%.

D4. To address these issues, the university could add further sectors. In deciding whether this is appropriate it should take the following into account:

- The aim of a sectorised method is greater accuracy – to achieve this, the university must clearly identify which activities are supported by which costs and allocate these to sectors in a way that makes consistent use of its accounting information and systems.
- A sectorised approach that fails to assign costs to sectors in a sensible way can lead to a result that is neither fair nor reasonable.
- The added burden of identifying the costs to be allocated to sectors - especially if the university's cost centres do not analyse expenditure at this level; and
- Whether the difference in recovery warrants the extra work.

Example of a method using TRAC cost of teaching

D5. The University then considers whether the TRAC cost of teaching option could be used as an alternative.

Because the University proposes using the TRAC cost of teaching to value the education, it should use this figure as business income in the business/non-business calculation.

$$\frac{\text{Total business income*}}{\text{Total income**}} = \frac{121.0}{137.0} = 88.32\%$$

* Less VTF plus TRAC cost of teaching

** Less VTF and T grant plus TRAC cost of teaching

Applying this calculation to the residual VAT of £1.1m gives £971,520 residual input tax.

A single sector option using the pro-rata calculation:

$$\frac{\text{Total taxable income}}{\text{Total business income less tuition fees plus TRAC cost of teaching}} = \frac{10.0}{121.0} = 8.26\%$$

The University would recover £80,248 of the residual input tax of £971,520

D6. Points to note:

- The difference in total VAT recovery using either the T-grant option or the TRAC cost of teaching option is minimal. It is unlikely that the university will base its decision on the difference in recovery but on which option is administratively easier
- Although TRAC is being used to determine the cost of teaching, this method is not a full TRAC variant and so the University's normal accounting system also has a key role to play in the operation of the method.
- As with the Teaching support grant approach the university should look at whether the method should be refined by adding further sectors.

Annex E

Example of a modified teaching support grant method

This example illustrates how the modified teaching support grant method might work in practice and to help HEIs to decide which approach is suitable. It should not be taken as an indication of an acceptable recovery rate or deductible tax amount.

The example also demonstrates the effect of the university's chosen method of valuing education on the overall rate of VAT recovery. In the example there is consistency between the income treated as business income in the partial exemption calculation and that treated as business income in the business/non-business calculation.

In its latest year, which is typical, an HEI VAT group determines the following information in order to review its PE method:

Income		Income / £millions		
Taxable consultancy		0.8		
Taxable commercial income		9.2		
Total taxable income			10.0	
Variable Tuition Fees (VTFs)		15.0		
Exempt income (student residences etc)		55.0		
Total exempt income			70.0	
Total business income				80.0
Teaching support grant		45.0		
Non Business income (research)		16.0		
Expenditure	£k	Expenditure / £millions		
Residual input tax; academic departments	150			
Residual input tax; commercial activities	250			
Residual input tax; general overheads	600			
Total residual input tax		1.0		
OFFA bursaries			2.5	
TRAC cost of teaching			56.0	

E1. The HEI wants to use a modified teaching support grant, single pot method. For the purposes of this example it has been assumed that the following apply:

- The University pays a Student Union subvention under its Charter of £950k. This money does not support the University's teaching activity.
- The University receives Rewarding and Developing Staff grant of £2.5M. 60% of the staff time of the University is spent delivering teaching, and it is assumed that £1.5M of this grant supports teaching activity. The balance of £1M should be excluded as a modification to the Teaching support grant.

E2. So, the modified Teaching support grant figure is:

Teaching support grant (£M)			45
Less	Student Union Subvention	0.95	
	RDS Grant	1.00	
			1.95
Modified Teaching support grant			43.05

E3. For the purposes of the business/non-business calculation the numerator should include the same proxy value for supplies of education as the denominator in the PE method.

$$\frac{\text{Total business income*}}{\text{Total income *}} = \frac{120.55}{136.55} = 88.28\%$$

* Plus modified Teaching support grant – OFFA Bursaries

E4. The University's pro-rata calculation would therefore be:

$$\frac{\text{Taxable income}}{\text{Total business income + modified Teaching support grant – OFFA bursaries}} = \frac{10.00}{120.55} = 8.30\%$$

E5. Points to note:

- Use of the modified teaching support grant figure gives the University a slightly increased overall recovery compared with use of the full teaching support grant (7.33% compared to 7.22% (88.45% x 8.16% from annex D)). The University may therefore wish to consider whether the administrative costs of compiling the modified teaching support grant figure are warranted.
- The HEI should be prepared to demonstrate that any adjustments to the teaching support grant are sensible.
- The University will need to agree with HMRC which payments should be excluded from the teaching support grant.

Annex F

Example of TRAC variant methods

The following examples illustrate how TRAC variant PE methods might work in practice and may help HEIs to decide which approach is suitable. They should not be taken as indications of acceptable recovery rates or deductible tax amounts.

The examples also demonstrate the effect of the university's chosen method of valuing education on the overall rate of VAT recovery. In each example there is consistency between the income treated as business income in the partial exemption calculation and that treated as business income in the business/non-business calculation.

1) Example of a TRAC variant 1 method

F1. The HEI is a research intensive institution. Its TRAC system has been in place for some time, and the University is confident that it is a robust and reliable tool for allocating costs to the various categories. It wishes to adopt a full TRAC variant methodology, with sub-sectors to take account of its publicly funded teaching, its research activities and its commercial activities.

F2. The University should first:

- Refer to the total cost shown on the submitted annual TRAC return for the partial exemption year concerned for each TRAC activity;
- Exclude the non-transaction based adjustments added into the cost figure such as the Return for Investment addition and the Infrastructure addition;
- Make sensible adjustments to remove significant non-VAT bearing expenditure from the TRAC costs - these may include costs such as salaries, insurance, rates/taxes, OFFA-related bursaries and charges from associate colleges;
- If possible, exclude the costs associated with any input VAT that has already been directly allocated to a particular activity outside the pool of residual VAT to which the TRAC-based apportionment method is to be applied.

F3. TRAC variant 1 works on the premise that tax follows cost. So, if a cost is significant but non-VAT bearing, it should be taken out of its pool before comparison is made across the pools. This improves the allocation of tax to the TRAC categories

but does not address the attribution of tax within a pool between taxable and exempt supplies. For this attribution the normal rules apply for creating an appropriate proxy for the extent to which the cost is used to make taxable supplies or other supplies with a right of recovery of tax.

For example, the cost of engaging associate colleges is non-VAT bearing and should be taken out of the Publicly Funded Teaching pool when allocating costs to the TRAC categories. When the overall pool of VAT is allocated to the TRAC categories in proportion to the total adjusted cost in each category, none of the VAT in the teaching pool will be recovered as all the outputs in this category are exempt.

The Research and Other categories will require a suitable proxy by which the proportion of VAT allocated pro rata to these categories can be attributed to relevant outputs. Ideally these proxies should relate to the costs within the TRAC pools of carrying out activities that have a right of recovery of tax, but where cost data is not available, the proxies chosen might need to be based upon the turnover values at the different VAT treatments applicable to the income generated within the Research and Other TRAC categories.

F4. The University incurs £9M VAT, £1m of which it is able to directly attribute to either taxable or exempt supplies leaving an overall pool of £8M. First it must consider whether the proportion of residual input VAT within the total VAT incurred could compromise the result of a TRAC variant 1 calculation if it is not possible to exclude the costs associated with any input VAT has been directly allocated to a particular activity outside the pool of VAT as mentioned in F2 above.

This is because all of the VAT bearing costs on which the £9M VAT is incurred would be included in the TRAC return cost heads per category but only £8M of that VAT is to be allocated by reference to those costs. In this instance, 89% of the VAT incurred is to be allocated by reference to the VAT bearing costs assigned using TRAC and since this is the greater majority of the VAT it is unlikely that a significant distortion to the allocation could result if it is not possible to exclude the costs related to directly-attributed VAT.

If a significant distortion were likely to arise the University must either find away of identifying the costs relating to directly-attributed VAT or it might want to consider adopting one of the alternative bases for a PESM set out in this Framework.

F5. The University has VAT of £8M which it cannot attribute to taxable or exempt supplies. It intends to assign this tax across the five TRAC categories in direct proportion to the level of VAT-bearing expenditure reflected by the adjusted cost pools for each category.

F6. The result of these allocations is shown below:

	Total VAT bearing Expenditure	Percentage of VAT bearing expenditure in TRAC category	Allocated VAT
PFT	30,500,000	58.65%	£4,692,000
NPFT	1,500,000	2.88%	£230,400
PFR	10,100,000	19.43%	£1,553,600
NPFR	2,200,000	4.23%	£338,400
Other	7,700,000	14.81%	£1,185,600
Total	52,000,000	100.00%	£8,000,000

F7. The University must now undertake a business/non-business calculation per TRAC category in which any non-business activity arose. This is likely to apply to the categories of PFR, NPFR and Other. Analysis of the income in each category shows that 17% of the income generated by PFR activities comes from business supplies, 91% of the income generated by NPFR activities comes from business supplies and 80% of the income generated by Other activities comes from business supplies.

	Total VAT bearing Expenditure	Allocated VAT	B/NB	Residual Input Tax
PFT	30,500,000	£4,692,000	100%	£4,692,000
NPFT	1,500,000	£230,400	100%	£230,400
PFR	10,100,000	£1,553,600	17%	£264,112
NPFR	2,200,000	£338,400	91%	£307,944
Other	7,700,000	£1,185,600	80%	£948,480
Total	52,000,000	£8,000,000		£6,442,936

Therefore the University has residual input tax as shown above to carry forward into its PESM; for example £264,112 for the PFR sector, £307,944 for the NPFR sector and £948,480 for the Other sector.

F8. Next the University analyses the use of costs in the Other category. By referring to the TRAC data, TRAC drivers, financial statements and its normal accounting records, the University finds the information set out below.

	Total VAT bearing Expenditure	Residual Input VAT
Conferences	1,900,000	£234,041
Catering	1,100,000	£135,497
Residences	1,000,000	£123,179
Business Park	3,200,000	£394,174
Theatre	300,000	£36,954
Miscellaneous	200,000	£24,636
Total	7,700,000	£948,480

However, the University finds that the only non-business activity in the Other sector is restricted to the Business Park and wants to consider whether this has a material impact on the recovery of tax given that the remaining activities in the TRAC category are entirely business activities. It is estimated that 53% of the costs in the Business Park relate to business activities so that a targeted business/non-business calculation may be made in the Other category in place of the overall 80% business proportion adopted initially in F7. The allocated VAT of £1,185,600 from F6 for the Other category might then be the starting point as follows:

	Total VAT bearing Expenditure	Allocated VAT	B/NB	Residual Input Tax
Conferences	1,900,000	£285,000	100%	£285,000
Catering	1,100,000	£165,000	100%	£165,000
Residences	1,000,000	£160,000	100%	£160,000
Business Park	3,200,000	£500,600	53%	£265,318
Theatre	300,000	£45,000	100%	£45,000
Miscellaneous	200,000	£30,000	100%	£30,000
Total	7,700,000	£1,185,600		£950,318

F9. The University is now in a position to consider how its proposal might look in practice.

- The University must consider whether any further sub-sectors on the Other Category might be suitable. In doing so it should consider how the costs are used and whether separating out costs with a single pool still gives a result that is fair and reasonable.
- Part of this process should be weighing up the administrative costs of further sectorisation against increased accuracy.
- In particular it looks at the activities included in the TRAC Other sector. These are diverse and it is suspected that those which generate the most output tax tend to use little by way of VAT-bearing costs whereas those which incur large amounts of input tax tend to generate little in the way of output tax.
- Although splitting the Other TRAC category into the Business Park and the remainder as a single sector might lead to a distortive result, the University considers that it is only the Conferences sub-sector that uses input tax on business activities significantly differently to the other sub-sectors and so decides to divide the Other TRAC Category into three sub-sectors of Conferences, Business Park, and Other-Other.
- The University is not able to analyse the costs within the TRAC pools of carrying out activities that have a right of recovery of tax, and those that do not, and decides that the partial exemption proxies for attribution of residual input VAT to use for activities that have a right of recovery of tax need to be based upon the turnover values at the different VAT treatments applicable to the income generated within the Research and Other TRAC categories.

F10. The recoverable input tax is as follows:

	Residual Input Tax	Taxable Income	Total Business Income	Recoverable Rate	Input Tax Recovered
PFT	£4,692,000	0	60,200,000	0.00%	£0
NPFT	£230,400	0	3,300,000	0.00%	£0
PFR	£264,112	3,060,000	3,400,000	90.00%	£237,701
NPFR	£307,944	6,900,000	8,000,000	86.25%	£265,602
Conferences	£285,000	2,150,000	3,000,000	71.67%	£204,260
Business Park	£265,318	4,250,000	4,250,000	100.00%	£265,318
Other Activities	£400,000	1,210,000	32,100,000	3.77%	£15,080
Total	£6,444,774	17,570,000	114,250,000	15.38%	£987,961

F11. The recoverable VAT total of £987,961 is 15.33% of the residual input tax amount of £6,444,774 and is 12.35% of the £8m total VAT incurred. The University performs a reasonableness test against a single pot, output values based calculation under the "Teaching Support plus VTF's less bursaries" PE model. In that approach the HEFCE teaching grant was £50M making the total business income up to £164,250,000 so that the taxable income of £17,570,000 would give an overall recovery rate of 10.7% based on the ratio of taxable to total business income. The University therefore concludes that the TRAC variant 1 method gives a reasonable result.

F12. Conclusions

- Using a full TRAC method with 7 sectors and breaking down the allocation of residual VAT by outputs-based attribution proxies, the University achieves an effective recoverable rate of 15.33%
- The University could use a single pot outputs-based method under the "Teaching Support plus VTF's less bursaries" PE model and get a recoverable rate of 10.70%, which would give a recoverable amount of £689,591.
- It is for the University to decide whether it would be happy with the simpler Teaching Support plus VTF's less bursaries" PE model or to invest in the higher level of administrative burden and complexity of the TRAC Variant 1 method to gain the slightly higher degree of VAT recovery.

F13. A proposal using these principles should give a fair and reasonable result because a number of key issues have been addressed. These include:

- The proposal allows for similarly based business/non-business and partial exemption calculations, especially in the Research TRAC categories;
- Sectors for the smaller commercial activities have been considered and some rejected because the input tax incurred on them is not significant;
- The adoption of an even-handed approach with the application of consistent principles to the selection of sectors; and
- Reasonableness tests have been applied to the allocation of tax to sectors and to the overall result.

2) Example of a TRAC variant 2 method

F14. The HEI is a research intensive institution. Its TRAC system has been in place for some time and the University is confident that it is a robust and reliable tool for

allocating costs to the various categories. It considers adopting a TRAC variant 2 methodology with a single PE calculation enabling input tax recovery against all non-teaching activities of the HEI.

F15. The University should first:

- Refer to the total cost shown on the submitted annual TRAC return for the partial exemption year concerned for each TRAC activity;
- Exclude the non-transaction based adjustments added into the cost figure such as the Return for Investment Adjustment and the Infrastructure Adjustment.;
- Make sensible adjustments to remove significant non-VAT bearing expenditure from the TRAC costs - these may include costs such as salaries, insurance, rates/taxes, OFFA-related bursaries and charges from associate colleges;
- If possible, exclude the costs associated with any input VAT that has already been directly allocated to a particular activity outside the pool of residual VAT to which the TRAC-based apportionment method is to be applied.

F16. TRAC variant 2 works on the premise that tax follows cost. So, if a cost is significant but non-VAT bearing, it should be taken out of its pool before comparison is made across the pools. The same principles outlined in paragraph F3 will also apply to allocation. This improves the allocation of tax to the TRAC category but does not address the attribution of tax within a pool between taxable and exempt supplies. For attribution the normal rules of creating a proxy for the value for state supported education apply. The cost of engaging associate colleges is a cost of teaching and must be included in the denominator of any proxy calculation that works out how much tax is attributed to taxable activities.

F17. The University incurs £9M VAT that it cannot directly allocate to a TRAC category, £7m of which it is however able to directly attribute to either taxable or exempt supplies. The University incurs costs of £160M, of which it has removed £102M for salaries, accounting adjustments etc. It has also removed £6M of costs where the VAT on them will be directly allocated to activities that fall within the TRAC Other category. This leaves total VAT bearing expenditure of £52M.

F18. The University must now consider whether the proportion of residual VAT to total VAT incurred could compromise the result of a TRAC variant 2 calculation. This

is because the VAT bearing costs on which the £9M VAT is incurred would be considered by the TRAC variant approach but only £2M of that VAT is residual and is to be allocated by reference to those costs. In this instance, although only 22% (£2m/£9m) of the VAT incurred is to be allocated by reference to the VAT bearing costs assigned using TRAC, this tax is incurred mainly on estates and IT expenditure. Since the costs of the estate and IT systems are residual across the whole of the University, and represent about 70% of all of the VAT bearing costs, the University considers that the assignment of VAT by reference to an analysis of TRAC costs is a fair representation of the allocation of those costs to activities.

F19. The University looks at its TRAC report and finds that the adjusted TRAC cost figures are as shown below:

	Total VAT Bearing Expenditure
PFT	30,500,000
NPFT	1,500,000
PFR	10,100,000
NPFR	2,200,000
Other	7,700,000
Total	52,000,000

It therefore assigns residual VAT to the TRAC categories as follows:

	Allocated VAT
PFT	£1,173,076
NPFT	£57,692
PFR	£388,462
NPFR	£84,616
Other	£296,154
Total	£2,000,000

F20. The University must now undertake a business/non-business calculation. This will apply to the categories of PFR and NPFR.

Analysis of the income in each category shows that 17% of the income generated by PFR activities comes from business supplies and 91% of the income generated by NPFR activities comes from business supplies. 100% of the income generated from the remaining three categories is directly attributable to wholly business activities.

Therefore the University has residual input tax to carry forward into its PESM of £66,039 for the PFR sector and £77,001 for the NPFR sector, including the residual input tax for the PFT, NPFT and Other TRAC categories as shown below.

	Allocated VAT	B/NB	Residual Input Tax
PFT	£1,173,076	100%	£1,173,076
NPFT	£57,692	100%	£57,692
PFR	£388,462	17%	£66,039
NPFR	£84,616	91%	£77,001
Other	£296,154	100%	£296,154
Total	£2,000,000		£1,669,961

Of which	Residual VAT	Business percentage	Carried forward to partial exemption method
Attributable to teaching:	£1,230,768	100%	£1,230,768
Attributable to non-teaching	£769,232	57.09%	£439,193

F21. It then assigns a proportion of the residual VAT to teaching. This calculation is based on the total VAT incurred, not the residual VAT. This is because the TRAC calculation has worked out what proportion of total activity (including business and non-business) is education. It is therefore necessary, to compare like with like, to apply that proportion to the total (business and non-business) VAT incurred by the HEI.

F22. The proportion of residual input VAT assigned to teaching is £1,173,076 (assigned to PFT) plus £57,692 (assigned to NPFT) or £1,230,768. This tax is regarded as attributable to the exempt supply of teaching.

F23. The HEI is in effect making a second stage of direct attribution of input tax to the exempt activity of teaching when using TRAC variant 2. Unless the HEI wishes to agree a proxy value for education with HMRC this method precludes the recovery of any input tax incurred on costs recorded in the PFT and NPFT TRAC categories. The University has a small element of taxable teaching and, using an output values based calculation, could recover 0.75% of this input tax, or £9,231. It wants to consider

whether the administrative cost of making this calculation outweighs the tax that could be recovered before deciding whether to apply a proxy to this sector.

F24. The residual VAT not attributable to teaching is £2,000,000 less £1,230,768, which is £769,232. The residual input tax not attributable to teaching is £66,039 (PFR) plus £77,001 (NPFR) plus £296,154 (Other), which totals £439,194.

F25. The University has taxable business income derived from research and other activities of £12.5M and total business income from the same sources of £40.5M. The taxable income is 30.86% of the total business income.

F26. The HEI would therefore recover £439,194 x 30.86% or £135,535. This one calculation covers the three TRAC categories of PFR, NPFR and Other.

F27. In order to work out its overall partial exemption recoverable percentage for use in Capital Goods Scheme (CGS) adjustments the HEI calculates the total residual input tax reclaimed as a proportion of total input tax incurred. The HEI has not applied a proxy calculation to the teaching sector, so the overall recovery ratio for the CGS would be £135,535/£1,669,962 (the total residual input tax) = 8.12% if the CGS base VAT cost amounts are recorded after a business/non-business apportionment calculation. If the CGS base VAT cost amounts are recorded as the actual VAT incurred, then the overall recovery ratio for the CGS would be £135,535/£2,000,000 = 6.78%.

F28. In some cases it will be possible to demonstrate the reasonableness of the proposed method by looking at a single pot output values based calculation. In this case, it has taxable income of £12.5M and total income (including teaching fees, teaching grants and non-teaching activities) of £160.5M. It would therefore recover 7.79% of its residual VAT of £1,669,691 or £130, 090 using such a method.

From this test, in this instance, the HEI can demonstrate that the adoption of the TRAC variant 2 approach is reasonable. However, if there was a significant variance between the result of the proposed method and the comparator single pot outputs based method, it would suggest that one or other methodology would not be producing a result that would pass the ‘fair and reasonable’ test. Consideration should then be given to the identification of the factors responsible for producing the variation, and addressing them within the method proposal.

F29. The HEI is able to readily isolate the costs and income from its conferencing activity. It knows conferencing has 71.62% taxable income (£5.3M out of £7.4M) and residual input tax of £142,500, which it has confirmed is reasonable by reference to the known VAT bearing costs shown in the financial statements for the HEI's conferencing subsidiary company.
It proposes to sectorise this activity because of the dampening effect on recovery caused by the other, predominantly exempt activities considered by the single TRAC variant 2 calculation.

F30. Sectorisation of this activity would give the HEI 21.75% recovery on a smaller general input tax pool of £296,694 (without the conferencing income this sector has £7.2M taxable income out of a business income total of £33.1M).
The £439,193 residual input tax less the £142,500, allocated to conferencing, totals £296,694 with the recoverable percentage of 21.75% applied to this the result is recoverable input tax of £64,531.

There will be a 71.62% recovery on the conferencing residual input tax pool of £142,500 (£142,500 x 71.62% = £102,059). This would give total recovery of £64,531 + £102,059, or £166,590, which is 9.98% overall recovery of input tax.

F31. Had the £6M of costs where the VAT on them was directly allocated to activities that fall within the TRAC Other category been left in the allocation of residual VAT would have been as follows:

	Total VAT bearing Expenditure	Allocated VAT	B/NB	Residual Input Tax
PFT	30,500,000	£1,051,724	100%	£1,051,724
NPFT	1,500,000	£51,724	100%	£51,724
PFR	10,100,000	£348,276	17%	£59,207
NPFR	2,200,000	£75,862	91%	£69,034
Other	13,700,000	£472,414	100%	£472,414
Total	58,000,000	£2,000,000		£1,704,103

Of which	Residual VAT	Recovery Rate	Recovery
Attributable to teaching:	£1,103,448	0.00%	£0
Attributable to conferences:	£142,500	71.62%	£102,059
Attributable to non-teaching excluding conferences:	£458,155	21.75%	£99,649
Total	£1,704,103	11.84%	£201,707

The proportion of residual VAT assigned to teaching is £1,051,724 (assigned to PFT) plus £51,724 (assigned to NPFT) or £1,103,448. This input tax is regarded as attributable to the exempt supply of teaching.

After the business/non-business calculation, the input tax assigned to PFR is £59,207 and to NPFR is £69,034. Total non-teaching input tax is therefore £600,655.

£102,059 of the non-teaching input tax would still be recovered on conferencing costs as apportioned in section F30 above. This leaves a recovery of 21.75% on the remaining pot of £458,155, or £99,649. The HEI's total recovery would therefore be £201,708 out of residual input tax of £1,704,103, or 11.84%. This is 1.86% or £35,118 in excess of what would be recovered under the proposed method and confirms that it would not be reasonable for the HEI to ignore the impact of directly allocated costs when preparing TRAC variant calculations.

F32. Although at first sight the proposed method might appear to include an element of cherry-picking HMRC recognises that sectorisation can be appropriate where the resulting overall recovery percentage is underpinned by sensible logic. Any sectorised version of the TRAC 2 variant should strike an acceptable balance between the administrative burden PE imposes upon an HEI and the calculation of a fair and reasonable recovery of input tax.

Annex G

Example of when a capital sector is appropriate

– also consider any ongoing distortion

In its latest year, which is typical, an HEI determines the following information in order to review its PE method:

Income		Income / £millions	
Taxable consultancy		0.8	
Commercial Income		2.5	
Total taxable income			3.3
Variable Tuition Fees (VTFs)		12.0	
Exempt income (student residences etc)		40.0	
Total exempt income			52.0
Total business income			55.3
Teaching support grant		45.0	
Arts Venue Income (projected taxable)		5.5	
Arts Venue Income (projected exempt)		2.5	
Expenditure			
	£k	Expenditure / £millions	
Residual input tax; academic departments	150		
Residual input tax; commercial activities	250		
Residual input tax; general overheads	600		
Total residual input tax		1,000	
Residual input tax; Arts venue (capital costs)		890	
OFFA bursaries			2.5
TRAC teaching costs (net of adjustments)			52.0

G1. The University is a mainly academic institution. It operates a single sector method based on the TRAC cost of teaching option. The result of this calculation is

$$\frac{\text{Total taxable income}}{\text{Total business income – VTF + TRAC cost of teaching}} = \frac{3.3}{95.3} = 3.46\%$$

G2. In 2007 it commences construction of a new arts centre. This houses the students union, but will also host a wide range of concerts and events. The university estimates that the construction costs will be approximately £5m, with related input tax of £890,000. The arts centre will be used for both taxable and exempt purposes, and the university anticipates that about 70% of the supplies made from the new building will be taxable.

- Because the recoverable rate for the new centre is far higher than the overall rate, it is appropriate that the University considers the creation of a separate sector for this building.
- The University therefore seeks approval for a new partial exemption method with a capital sector that applies the following pro-rata.

$$\frac{\text{Taxable income from Arts Centre}}{\text{Total income from Arts Centre}} = \frac{5.5}{8.0} = 68.75\%$$

G3. This proposal assumes that the new sector only applies to the capital costs and that income generated by the centre will be included in a single calculation covering all supplies made by the University. However, the university must consider the effect of this on the recovery of VAT on overhead costs of the University. The result is as follows:

$$\frac{\text{Total taxable income}}{\text{Total business income – VTF + TRAC cost of teaching}} = \frac{8.8}{103.3} = 8.52\ \%$$

G4. The following points must be considered:

- What difference do the supplies make to the recoverable rate?
- What difference do the supplies make to the amount of input tax recovered by the University?
- Is this difference a reflection of how the input tax bearing costs are used?

- Is the impact on the PE method material?

G5. Inclusion of this income in a single sector calculation will increase the recoverable rate by 5.06%, a 146% increase. However most of the input tax bearing cost of the HEI is not used in making supplies from the Arts Centre, but in the core activity of education. The University should conclude that a single sector is not fair and reasonable, and propose a method that does reflect the use of the costs.

G6. To address the distortion, the University should identify the VAT bearing costs which support the Arts Centre, and consider these in a separate sector. The University incurs residual input tax of £1m (although this may increase slightly once the new centre is opened, the increase is not expected to be material). These costs can be separated into three types – input tax incurred on costs that solely support the new Arts Centre; input tax on costs that indirectly support the Arts Centre such as the general overheads of the University; and input tax on costs that have no connection with the Arts Centre. The University's accounting system makes use of cost centres to identify which costs relate to which schools. By analysing the accounting data, the University is able to determine that £5k residual input tax relates directly to the Arts Centre.

G7. The University must then work out how much of the input tax incurred on general overheads relates to the Arts Centre. It considers applying a simple calculation to its general residual input tax. If it keeps with TRAC cost of teaching to value the education, and includes all the income of the University in the pro-rata, the result implies that 5.06% of the total overhead costs are consumed by the taxable activities of the Arts Centre. The University knows that this is not the case and so can not make a declaration that the method would give a fair and reasonable result. It must look for a more accurate way to determine what proportion of residual input tax on overhead costs relates to the Arts Centre.

G8. It has two options. Either it can use its TRAC data and drivers to work out what proportion of the overheads relate to the Arts Centre or it can use its internal recharging mechanism to determine what part of the central costs should be allocated to the centre.

It chooses the TRAC option and this calculation results in £12k of the £600k residual input tax incurred on general overheads being allocated to the Arts Centre. So, in

total, the University has £17k residual input tax to allocate to the Arts Centre - £5k that was incurred on direct costs and a £12k share of the residual input tax incurred on general overheads.

G9. The university is now in a position to put a two sector method into place because it has made a sensible allocation of cost to the Arts Centre. The two sectors are 'University' and 'Arts Centre' with only the costs incurred on, and the income generated by the Arts Centre included in that sector.

The pro-rata for each sector would be:

University

$$\frac{\text{Total taxable income*}}{\text{Total business income* - VTF + TRAC cost of teaching}} = \frac{3.3}{95.3} = 3.46\%$$

(* excluding Arts Centre Income)

applied to University Input Tax of £983k. This gives a recovery of £34,012.

$$\frac{\text{Taxable income from Arts Centre}}{\text{Total income from Arts Centre}} = \frac{5.5}{8.0} = 68.75\%$$

applied to the input tax of £17k identified as related to the Arts Centre. This gives a recovery of £11,688.

This gives an overall recovery of £45,700 or 4.57% and implies that a more realistic 1.11% of the University's overheads are used to support the taxable activities of the Arts Centre.

G10. Points to consider

- Before proceeding with this proposal, the university should consider whether it has any other capital items with a tax exclusive value of £5 million. If so, these would also have to be the subject of separate sectors.
- This approach is required because it would be inconsistent to select one project for special treatment where the recovery rate is higher than the overall rate, without applying the same principles to other projects of the similar size (or bigger).

Annex H

An example of how to determine whether a supply is distorting

H1. An HEI VAT group has the following income and expenditure

Income	Income / £millions		
Taxable consultancy	0.8		
Taxable commercial income	1.2		
Total taxable income		2.0	
Variable Tuition Fees (VTFs)	12.0		
Exempt income (student residences etc)	20.0		
Total exempt income		32.0	
Total business income			34.0
Teaching support grant	30.0		

Expenditure	£k	Expenditure / £millions
Residual input tax; academic departments	2,400	
Total residual input tax		2.4
OFFA bursaries		2.5

It calculated its recoverable residual input tax using the pro-rata:

$$\frac{\text{Total taxable income}}{\text{Total business income + teaching support grant – OFFA Bursaries}} = \frac{2.0}{61.5} = 3.25\%$$

Applying this to the residual input tax of £2.4m gives a recoverable amount of £78,000.

H2. The university then restructures its activities and establishes a separately VAT registered subsidiary company to provide some of its services. The university provides staff and administrative services to the subsidiary. No input tax is incurred on the staff costs and very little in providing the administrative services. The effect of the restructuring is that £5m exempt income per year is replaced by taxable recharges, of which a significant proportion relate to non VAT bearing staff costs.

H3. The impact of this income on the PE method when the services were exempt was minimal (because it made no material difference to the denominator) and it was not therefore excluded from the calculation.

H4. The university as a whole is still supplying the same services to the end customer, although now through a closely linked subsidiary. The use of the general overhead costs that do not directly support these supplies has not changed materially. However the effect on the PE calculation is as follows:

$$\frac{\text{Total taxable income}}{\text{Total business income + T grant – OFFA Bursaries}} = \frac{7.0}{61.5} = 11.38\%$$

Applying this to the residual input tax of £2.4m gives a recoverable amount of £273,120.

H5. The implication is that an additional £195,120 residual input tax on overhead costs is used to support what is essentially the same activity. We know that this is not a true reflection of how the overhead costs are being used.

H6. The new supply meets the criteria of a distorting supply because the change in the recovery rate is 5% which is greater than both the fixed 1% limit and 10% of the prevailing rate (10% of 2% or 0.2%).

Annex I

Seeking approval for a PE method: taking reasonable steps

When making a statutory Declaration that a proposed PE method would give a fair and reasonable attribution of input tax to the making of supplies that carry a right of deduction, the person who makes the Declaration is required to include a statement that he/she has taken reasonable steps to ensure that he/she is in possession of all relevant information relating to the proposed method.

When deciding whether the steps taken are reasonably sufficient have you**:**

1. Considered more than one method?

- You will need to consider the cost/benefit of several methods, to confirm that the method being requested is not significantly at variance to other methods.

2. Considered whether your method needs sectors?

- You will need to consider whether any of the supplies you propose to refer to in the method might distort the fairness and reasonableness of its attribution.
- You will need to consider if any such distortion might arise, whether you should split out parts of your business into one or more sectors. If so, you will need to determine what parameters you need to set so that any other sectors are split out on a consistent basis. You will also need to ensure that each sector only looks at the cost components of the supplies made in the sector concerned.
- You will need to be able to demonstrate that your accounting system is capable of dealing with the level of allocation of costs to sectors that your proposed method requires.
- If you intend to use TRAC data but your accounting system does not post the relevant VAT along with the cost, you will also need to show that your allocation of tax to sectors is based on an analysis of VAT bearing costs in TRAC (see Annex F).

3. Prepared a worked example of your proposed method?

- If your proposal is based on the use of TRAC data you will need to show that your TRAC figures are robust (see paragraph 19).
- If your proposal uses figures derived from annual accounts in the denominator of an income based apportionment you should show the source of these figures in your worked example.
- HMRC prefers to receive a worked projection of how your proposed method will work in practice, using real figures, and also an explanation why you feel your proposed method gives a fair and reasonable result. HMRC might not be able to give approval for a proposed method if there is uncertainty about its methodology in the absence of any documented projection of the result that the proposed method would generate.

4. Recorded any rejected methods?

- You should keep a record about alternative methods that you considered but rejected when making your choice of a method to propose, to reduce the risk of a subsequent challenge by HMRC that the declaration had been made incorrectly. You do not need to prepare full worked examples for any method you do not wish to adopt.
- If your proposed method for choose gives a result that is materially different from any other options you considered, HMRC may wish to discuss with you why this is so.

5. Designed your method using the framework and HMRC guidance?

- If your proposal is not based on one of the methodologies in the Framework, HMRC will still fully consider it without preconceptions over its acceptability. However, you must expect that more detailed enquiries will be made and the proposal fully tested.
- When you design your partial exemption special method you may wish to use the standard paragraphs set out in HMRC Guidance. These can be found at Section, PE 3500 of the Partial Exemption Guidance Manual available via the HMRC website.

6. Made your declaration?

- You will need to make a statutory Declaration in accordance with PE law (set out in Regulation 102(9), SI 1995/2518). You should be able to do so

if you have taken these reasonable steps to ensure that your proposed method gives a fair and reasonable result.

On receipt of your proposal HMRC will

- Consider your proposal and Declaration.
    - If your proposal is clear, and the method appears to give a fair and reasonable result, it will be approved.
    - If it is unclear, HMRC will discuss with you how the method is intended to operate.
    - If the discussion clarifies the proposal, and the method appears to gives a fair and reasonable result, it will be approved.
- If your proposal does not appear to give a fair and reasonable result, HMRC will write to you refusing the method and outlining the reasons for the rejection. Discussions can then continue so that you can make a new proposal for a method that might then be given approval.
- HMRC will not seek to approve only the method that produces the lowest recovery rate and in principle has no objection to an HEI using a method that produces a higher recovery rate provided that it is an appropriate methodology for that HEI.
- Once your method is approved and implemented it will be subject to audit by HMRC in the normal way. This audit may include a further examination of your reasons for choosing the method for which the HEI made a statutory Declaration. If HMRC disagrees with your reasons it may consider exercising its powers to deem the Declaration to have been incorrect and to declare the method to be invalid retrospectively to the original date of implementation.
- If your method uses TRAC data, it is unlikely that HMRC will make a full audit of your TRAC system. This is because, as part of the approval process, you are likely to have indicated that your figures are robust.