

## Framework for HEI Partial Exemption Special Methods

October 2008

### Introduction

1. This Framework provides guidance on formulating Partial Exemption (PE) special methods for 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 but is strongly recommended. It 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.

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

### Summary

4. 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 UK higher education funding bodies, 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.

5. 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

- Establishing a regular meeting with BUFDG and HEFCE to monitor progress on implementing fair PE methods and to agree improvements to this Framework.

## **VAT and HEIs**

6. 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.

7. 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 (sales that are subject to VAT). 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.

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**

8. 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 9 & 10 explain how subsidies can frustrate the values-based methods that most HEIs use to calculate their recoverable input tax.
- Values and costs. Paragraphs 11 to 13 describe the important policy facilitation allowing HEIs to replace the ‘value’ of their grant-supported education with ‘cost’.
- TRAC system for costing. Paragraphs 14 to 19 consider the suitability of the Transparent Approach to Costing system (TRAC) as a means to further simplify PE for HEIs.

- KPMG Review. Paragraphs 20 to 35 explore the options recommended in the KPMG Review and outline the conditions when HMRC are likely to grant approval.
- Sectors. Paragraphs 36 to 46 provide guidance on when it might be sensible to sub-divide a PE method into sectors.
- Distorting supplies. Paragraphs 47 to 59 discuss events that typically distort PE methods for HEIs and for which additional sectors or adjustments may be required.
- Other matters. Finally, paragraphs 60 to 62 consider the impact of this Framework on the PE Declaration.

### **Values-based PE methods**

9. 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.

10. 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**

11. 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.

12. 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.

13. 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**

14. 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.

15. 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.

16. 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).

17. 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.

18. 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. If not, HMRC consider that the HEI will not be in a position to make a declaration that the method is fair and reasonable.

- 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.

19. 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.

### **KPMG Review**

20. 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 for their circumstances and it helps HMRC give rapid approval if HEIs explain the options considered and why other options were rejected.

21. 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.

22. 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 B to D, with examples illustrating where sectorisation may be appropriate, and whether a supply is distorting, at annexes E and F.

### **Teaching support grant plus VTFs less bursaries**

23. 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 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.

24. This option, which was discussed in HMRC Business Brief 11/2006, assumes the total money received for exempt education (which is the 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'.

25. 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**

26. 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.

27. This option recognises that the funding councils are gradually reducing their levels of 'special funding', including 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 Access 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.

28 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**

29. 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.

30. 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.

31. 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.

32. 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**

33. 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 non-attributable VAT is apportioned between the five TRAC categories in proportion to the total costs (after certain adjustments) 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 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 attaching a value to the educational activity, it looks at and excludes the proportion of an HEI's costs consumed by educational activity. It combines all the remaining activities of the HEI in the PFR, NPFR and Other TRAC categories 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.

34. 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 apportioned between the TRAC categories in accordance with costs. We consider that it will be preferable to 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).

35. 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.

## **Sectors**

36. 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.

37. 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?

38. 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.

39. 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.

40. 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.

41. Commonsense 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?

42. 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?

43. 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.

44. 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%, any supply that gives a result 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%, any supply that gives a result outside the range of between 4% and 6% should be considered.

45. 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”.

46. 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**

47. 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.

48. The general characteristics of a distorting supply are:

- The value of the income received bears little link to the VAT bearing expenditure incurred;
- It may however use some input tax and therefore total exclusion may not be fair and reasonable;
- It can be taxable or exempt; and,
- The supply may be non-core or one off.

49. 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.

50. 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.

51. 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?

52. 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 still 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 E explores this point in greater detail.

53. There can be many reasons why the structure and mix of supplies can change. Where change happens organically, it is reasonable to expect that while the value of the costs incurred will change, the use of costs in making that supply will remain constant. Such organic growth will not necessarily introduce a distortion into the partial exemption calculations.

54. There is more chance of creating a distortion 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 in a different way, 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.

55. 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.

56. 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 CVCP 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.

57. 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 45-47, an HEI should consider whether it needs to sectorise the supplies that cumulatively lead to the distorting effect.

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

- Supplies made by or to a nurse training company;
- Supplies made to subsidiary companies, e.g., library companies; and
- Property portfolios

This list is not exhaustive.

59. 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**

60. 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 G sets out in detail the steps that an HEI should reasonably take to ensure that their proposal is fair and reasonable.

61. Framework methods and the CGS. HEIs should be aware of the impact of a new PE method on existing capital goods scheme 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.

62. Retrospection of new PE methods. Established policy is to offer retrospection for newly approved PE methods to the start of the current tax year, unless there are exceptional circumstances in which retrospection can extend to the limit of the three-year cap. HMRC offered exceptional retrospection for PE method proposals submitted by 30 April 2008. This period has now expired and the policy outlined above will apply.

63. 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 a local reconsideration 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. By law, two apportionments are needed, firstly a 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.

A2. Both the B/NB split and PE method 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 full TRAC partial exemption method will also use TRAC as the basis of its business/non-business apportionment.

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

The examples in Annexes B - F are to 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 in Annexes B & C 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'

B1. In its latest year, which is typical, an HEI VAT group uses the following information in order to review its PE method:

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

B2. 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

B3. 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%.

B4. 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

B5. 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

B6. 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 C

### Example of a modified teaching support grant method

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

<u>Income</u>		Income / £millions
Taxable education income (short courses via subco)		0.8
Taxable commercial income		9.2
Total taxable income		<u>10.0</u>
Variable Tuition Fees (VTFs)		15.0
Exempt income (student residences etc)		55.0
Total exempt income		<u>70.0</u>
Total business income		80.0
Teaching support grant		45.0
Non Business income (research)		16.0
<u>Expenditure</u>	£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		<u>1.0</u>
OFFA bursaries		2.5
TRAC cost of teaching		56.0

C1. 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.

C2. So, the modified Teaching support grant figure is:

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

C3. 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

C4. The University’s pro-rata calculation would therefore be:

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

C5. 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 B)). 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 D

### 1) Example of a TRAC variant 1 method

D1. 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.

D2. The University must first:

- take the Annual TRAC figures (excluding the non-VAT bearing staff costs);
- make further exclusions for non-transaction based adjustments such as Return for Investment and Infrastructure Adjustment; and
- make sensible adjustments to remove significant non-VAT bearing costs such as OFFA related bursaries.

D3. The University has residual non-attributable VAT of £1m which it is unable to assign directly to any of the TRAC categories. It intends to assign this tax across the five categories in direct proportion to the level of VAT bearing expenditure incurred in each category.

D4. 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

D5. 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 derives from business supplies and 91% of the income generated by NPFR activities comes from business supplies. Therefore the University has residual input tax to carry forward into its PESM of £33,469 for the PFR sector and £39,813 for the NPFR sector.

D6. Next the University analyses the use of costs in the “Other” category. By referring to the TRAC data, TRAC drivers and its normal accounting records, the University finds the information set out below.

	Total Expenditure	Residual VAT
Conferences	1,900,000	35,625
Catering	1,100,000	20,625
Residences	3,000,000	82,575
Theatre	300,000	5,625
Miscellaneous	200,000	3,750
Total	5,300,000	148,200

D7. The University is now in a position to consider how its proposal might look in practice.

- The University must decide how many sectors would be suitable. In doing so it should consider how the costs are used, and whether brigading costs together 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; those which generate the most output tax use little by way of VAT bearing costs and those which incur large amounts of input tax generate little in the way of output tax.
- Although putting all the costs into a single sector potentially leads to a distortive result, the University considers that it is only the conferences sector that uses the input tax significantly differently and so decides to brigade catering, residences, theatre and miscellaneous together to form a single, ‘Other Activities’ sector.

D8. The 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
Conferences	35,625	2,150,000	3,000,000	71.67	25,532
Other Activities	112,575	1,210,000	32,100,000	3.77	4,244
Total	835,007	14,460,000	110,000,000	12.41	103,600

## D9. Conclusions

- Using a full TRAC method with 6 sectors and breaking down the allocation of residual VAT by tax rate it achieves a recovery rate of 12.41%.
- The University could use a one pot outputs based method and get a recoverable rate of 13.15%, which would give a recoverable amount of £109,803.
- This tax recovery would be increased by adding further sectors, although the increase should be balanced against the increase in administrative costs.
- It is for the University to decide what level of administrative burden and complexity of method best suits its circumstances.

D10. 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 minimal; and
- the adoption of an even-handed approach with the application of consistent principles to the selection of sectors.

## **2) Example of a TRAC Variant 2 method**

D11. 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.

D12. The University must first:

- take the Annual TRAC figures ;
- make exclusions for non-transaction based adjustments such as Return for Investment and Infrastructure Adjustment; and
- make sensible adjustments to remove significant non-VAT bearing costs such as OFFA related bursaries.

D13. The University has residual non-attributable VAT of £1m. It has business income of £84m and total income of £100m.

D14. It performs a business/non-business calculation using income as a proxy and finds it has 84% business activity. Applying this percentage to the residual non-attributable VAT of £1m shows non-attributable input tax of £840,000.

D15. It looks at its TRAC report and finds that the adjusted 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

D16. The HEI then calculates the proportion of costs attributable to teaching.

$$\frac{\text{PFT costs + NPFT costs}}{\text{Total costs}} = \frac{32,000,000}{52,000,000} = 61.54\%$$

D17. It then assigns a proportion of the non-attributable VAT to teaching. This calculation is based on the total non-attributable VAT incurred, not the input tax post non-business split. 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.

D18. The proportion of non-attributable VAT assigned to teaching is £1m x 61.54% or £615,400. This tax is regarded as attributable to the exempt supply of teaching and none of it is reclaimable.

D19. 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.

D20. The residual input tax not attributable to teaching is £840,000 less £615,400, which is £224,600.

D21. The HEI has taxable business income derived from research and other activities of £13.66m and total business income from the same sources of £46.50m. The taxable income is 29.38% of the total business income.

D22. The HEI would therefore recover  $£224,600 \times 29.38\%$  or £65,987.

D23. In order to work out its overall partial exemption recoverable percentage for use in CGS adjustments, the HEI calculates the total non-attributable VAT reclaimed as proportion of total input tax incurred. This would be  $£65,987 \div £840,000 = 7.86\%$ .

D24. As a reasonable step in preparing its proposal, the HEI looks at a TRAC variant 1 method as an alternative. It decides the administrative burden is too great to use TRAC variant 1, although such a method would give recovery of a further £38k residual input tax.

D25. However, 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 £71,250. 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.

D26. Sectorisation of this activity would give the HEI 21.38% recovery on a smaller general input tax pool of £153,350 (without the conferencing income, this sector has £8.36M taxable income out of a business income total of £39.1M) and 71.67% recovery on the conferencing residual input tax pool of £71,250. This would give a total recovery of  $£32,786 + £51,065$ , or £83,851.

D27. Although at first sight this might appear to be 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 Variant 2 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 E

### 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:

<u>Income</u>	Income / £millions
Taxable education income (short courses via subco)	0.8
Commercial Income	<u>2.5</u>
Total taxable income	3.3
Variable Tuition Fees (VTFs)	12.0
Exempt income (student residences etc)	<u>40.0</u>
Total exempt income	<u>52.0</u>
Total business income	55.3
Teaching support grant	45.0
Arts Venue Income (projected taxable)	5.5
Arts Venue Income (projected exempt)	2.5
<u>Expenditure</u>	
	Expenditure / £millions
Residual input tax; academic departments	£k 150
Residual input tax; commercial activities	250
Residual input tax; general overheads	<u>600</u>
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

E1. 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

$$\begin{array}{rclcl} \text{Total taxable income} & = & \underline{3.3} & = & 3.46\% \\ \text{Total business income – VTF + TRAC cost of} & & & & \\ \text{teaching} & & 95.3 & & \end{array}$$

E2. 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.

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

E3. 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:

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

E4. 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?

E5. 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.

E6. 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.

E7. 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.

E8. 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.

E9. 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

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

(\* 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.

E10. 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 F**

**An example of how to determine whether a supply is distorting**

F1. An HEI VAT group has the following income and expenditure

<u>Income</u>	Income / £millions
Taxable education income (short courses)	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

<u>Expenditure</u>	£k	Expenditure / £millions
Residual input tax; academic departments	2,400	
Total residual input tax	2,400	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.

F2. 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.

F3. 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.

F4. 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.

F5. 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.

F6. The new supply meets the criteria of a distorting supply because it is something that has undermined the pro-rata calculation of input tax recovery.

## **Annex G**

### **What reasonable steps should an HEI take when seeking approval for a PE method?**

**Have you:**

- 1. Considered more than one method?**
  - 2. Considered whether your method needs sectors?**
  - 3. Provided a worked example of your proposed method?**
  - 4. Told HMRC about any rejected methods?**
  - 5. Made your declaration?**
- 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.
  - You will need to consider whether any of your supplies are distorting.
  - You will need to consider whether you should split out a sector of your business. 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.
  - 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 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 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 D). You will need to provide a worked example of how your proposed method will work in practice, using real figures, and explain why you feel your proposed method gives a fair and reasonable result.
  - You should tell HMRC about your rejected methods to reduce the risk of a potential challenge to your declaration. You do not need to prepare full worked examples for any method you do not wish to adopt.
  - If your proposed method gives a result that is materially different from any other option you considered, you will need to explain why this is so.
  - 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 12 of Guidance Manual V1-15, available via the HMRC website.
- You will need to make a declaration in accordance with PE law (set out in Regulation 102(9), SI 2007/768). 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 give 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 our concerns. Discussions can then continue so that you can make a new proposal for a method that will be capable of 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 implemented it will be subject to audit by HMRC in the normal way. This audit may include an examination of your reasons for choosing not to sectorise an activity. If we disagree with your reasons HMRC will write to you explaining why.
- 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 have indicated that your figures are robust.