Framework for Housing Association Partial Exemption Special Methods

2014

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Foreword

1. This Framework has been prepared in conjunction with the National Housing Federation, the Scottish Federation of Housing Associations and Community Housing Cymru, and with the knowledge of the Northern Ireland Federation of Housing Associations. The Framework will be of positive assistance to both housing associations and HMRC officers in agreeing fair PE methods. It will help housing associations and HMRC officers to decide whether the standard method works well (as it often will do) or whether a partial exemption special method (PESM) is needed.

2. The Framework gives guidance on what is likely to work if a PESM is required. It sets out the range of activities carried out by Housing Associations (HAs). It discusses the challenges they may pose in designing a fair and reasonable PESM and describes ways that those challenges can be overcome. It suggests calculations that are likely to lead to a fair apportionment of input tax. It also goes through when the calculation may need to be split into the operational sectors of the HA in order to arrive at a fair answer.

3. This is the second version of the Framework, which is a living document that will continue to be regularly updated for changes in thinking, in VAT law and its interpretation, and for changes in the way housing associations do business.

4. The guidance on PE in this Framework looks at PESMs but is in no way meant to suggest that all or even most HAs should agree PESMs. The standard method of PE will be wholly adequate for the needs of many HAs, especially smaller HAs or those with a limited range of activities. Additionally, the standard method simplification measures introduced in April 2009 enable the provisional use of the previous year's recovery percentage which may assist in easing any administrative burden in completing the quarterly VAT returns.

5. This Framework is a useful tool to be used in agreeing methods quickly and with the minimum of dispute but it cannot guarantee that there will never be a dispute between a housing association and HMRC. The size and activities of housing associations are diverse. It is therefore not possible to cover every issue or give such detailed guidance that methods write themselves. Both sides need to approach the task of agreeing a method positively and with a willingness to listen and compromise. The Framework does not remove the need for HMRC officers to understand how the business operates so they will still need to ask questions to understand how costs are used.

Introduction

Partial Exemption (PE) is the process by which taxpayers that make both taxed and exempted supplies determine how much of the VAT they incur on their costs can be reclaimed. This Framework assumes a basic understanding of PE. PE is explained in Notice 706 Partial Exemption.

6. PE Frameworks for Partial Exemption Special Methods in specific sectors of the UK economy are additional guidance put together by HMRC with the assistance and involvement of sector representative bodies. They are jointly owned by HMRC and sector bodies. They are freely available to both taxpayers and HMRC staff. They cover when and why PESMs are likely to be needed in the sector. They are aimed at allowing PESMs to be agreed which are fair and consistent with the minimum of time and cost to both sides. Frameworks are regularly updated to ensure they remain accurate and up to date.

PESMs that are in line with the Framework will get quick approval in the vast majority of cases. However, Frameworks are not compulsory and PESM proposals that are not based on them will always be fully considered by HMRC. Where they are fair and reasonable such proposals will be approved. It is of course likely that HMRC officers will need to review proposals that are not based on a Framework in greater depth before reaching any conclusions on them and so approval may take longer and require more correspondence. There is also a greater risk that they may be found to not be capable of approval.

7. If HAs have non-business activities then this will have to be taken into account in calculating their deductible input tax. There have been a number of legal changes regarding non-business introduced with effect from 1 January 2011. These include: Allowing a partly exempt business to apply to HMRC to use a single method (a 'combined method') to carry out its business/non-business calculation and its partial exemption calculation. A partly exempt business will not be allowed to have separate business/non-business and PE special methods.

- Extending the 'clawback' and 'payback' rules which adjust input tax claimed on the basis of intended use to include changes in actual or intended non-business use - for this purpose non-business use is considered as exempt business use.
- Extending the Capital Goods Scheme (CGS) to require adjustments to reflect changes in levels of non-business use of the asset over the adjustment period.

These changes are covered in Public Notice 706 Partial Exemption. For further information about the
Capital Goods Scheme, see Public Notice 706/2.

8. Any HA that agrees a PESM that is in line with the guidance set out in the Framework within a reasonable time from its being updated can backdate the application of that PESM to the start of its first tax year within the capping limit for claiming input tax (currently four years) if it wishes. This applies whether the HA is using the standard method, an existing special method, or has not yet adopted a method. ***** HMRC, in conjunction with HA representative bodies, will announce when this offer is to terminate, giving at least 6 months notice.

***** *On 31 October 2019, HMRC gave written notice to HA representative bodies that this concession will be withdrawn with effect from 1 May 2020. Thereafter the normal retrospective/backdating approval rules will apply.*

See PE46500 - Consideration of PESMs: retrospective changes to a method and PE47000 - Consideration of PESMs: backdating approval.

Nothing in the above offer overrides normal VAT capping rules which prevent both input tax claims being made over four years after the tax was incurred and the correction of errors in input tax deduction over four years after they are made.

There is no such thing as a typical HA. HAs vary enormously, both in their size and the range of activities they pursue. Some HAs may be charities while others may not. However HAs have sufficient in common by way of aims and activities for it to be possible to write guidance that assists in the consistent and fair design of HA PESMs.

HA Activities

9. Apart from where they are non-business (explained below), this section of the Framework looks only at activities that are supplies for VAT purposes. Activities that are neither supplies nor non-business will feed in to activities that are supplies (for instance improvement programmes will feed into social housing rental or house sales). The paragraphs below set out the activities and VAT liability information. Impact on PESM design is covered later in this Framework.

10. This list is not and cannot be exhaustive. Where HAs have activities that are not referred to below and which use significant costs then they may wish to discuss the activities and their impact with HMRC before making a PESM proposal.

Core activities

Social housing rental

11. The core activity of most HAs is the rental of affordable housing to people in their area or target demographic. This is an exempt supply for VAT purposes. The exemption extends to cover associated service charges and garage facilities.

House sales

12. This includes houses built to sell and the sale of existing housing stock, possibly through right to buy or equivalent schemes. Sales may cover the whole equity or initially only part via shared ownership schemes. The VAT liability of sales will depend on whether the HA has 'person constructing status' (PCS) in relation to the dwelling in question (this is explained in paragraph 96) and whether a 'major interest' (also explained in paragraph 95) is being supplied for the first time. If the sale is not zero-rated then it will be exempt.

Commercial building sales or leases

13. HAs that construct new estates will frequently build shops or other commercial buildings as part of the project. They may also acquire or construct commercial buildings as part of activities aimed at helping communities or for pure commercial reasons. If the freehold in a new commercial building is sold then that is a compulsory standard rated supply (new is up to three years from completion). Other interests in commercial buildings, in other words all leases and freeholds in old buildings, are exempt from VAT. However HAs can opt to tax such supplies and make them taxable at the standard rate. Care should be taken as such options can be disapplied if the end user will use the building for non-business purposes or exempt business purposes when they are associated with the HA.

Separate garages

14. As set out in paragraph 12, when garages are rented in association with housing they share the liability of the housing rent, in other words the supply is exempt. The exemption applies where the garage is:

- reasonably close to the dwelling; and

- the tenant takes up both the lease of the dwelling and the lease of the garage from the same landlord, whether under a single or separate agreement.

It is extremely likely that any first garage rented by a person that also rents housing will be associated with that rental housing. Whether a second or subsequent garage is in association with housing will depend on circumstances. However, there is no reason in principle why they cannot be associated with housing rental supplies.

Garages rented out otherwise than in association with housing, for instance on their own to persons who do not rent housing from the housing association, are taxable at the standard rate. There is no need for an option to tax. Supplies of garages on their own are excluded from the exemption because they are supplies of parking facilities (which are excluded from exemption) and are not part of a supply of property rental.

The term garage is taken in this paragraph to include parking spaces and similar parking facilities. Further information is given in Section 4 of HMRC Notice 742, Land and Property.

Housing work recharges

15. HAs need to maintain and improve their housing stock and will undertake cyclical repairs and improvement programmes. Some costs incurred may need to be recharged to tenants, possibly to those who own some or all of the equity in their home or because tenants caused damage. There are a variety of scenarios that may result in a HA performing repair work to a property. Some examples of these are provided in the next three paragraphs.

16. If a repair is performed to a property under the terms of the lease or tenancy agreement (for instance where the repair falls within the scope of works covered by the service charge) then the tenant will not be separately charged for the work and any costs incurred in performing the repair should be attributable to the rental and service charge income, which are normally exempt.

17. If a repair is performed to a property for a current tenant and the scope of the work is not covered by the tenancy agreement (for instance where the property has been intentionally damaged by the tenant) then if a charge is raised by the HA to the tenant the works will represent a separate supply for VAT purposes. In these instances most repair works should represent a taxable supply.

18. If a repair is performed to a property and a charge is raised to a former tenant then the treatment should depend on the obligations in the tenancy agreement:

a. If under the tenancy agreement the former tenant is simply obliged to meet the cost incurred by the HA in returning the property to the HA’s required condition then the charge to the former tenant should not represent a supply for VAT purposes.

b. If under the tenancy agreement the former tenant has an obligation themselves to arrange for the property to be returned to the condition specified by the HA at end of a lease, which may include them authorising the HA to perform these works on their behalf, then any charge by the HA for the service should represent a taxable supply of repair services.

Please note there may be other scenarios when work will be required to repair a HA's housing stock and they may not fit within the above examples.

19. Sometimes where improvement works are undertaken under a stock transfer an HA may agree to supply the tenant with additional goods or services that fall outside of the general improvement works and which are not going to be recovered by way of an increased rent. Where this happens, the supply of additional goods and services should have VAT charged on it.

20. Service charges on dwellings are normally treated in line with the guidance given in section 12 of Public Notice 742, Land and Property.

However, if an ex-tenant bought the freehold of their property under an agreement that required them to pay service charges after the purchase then those service charges can be exempted under ESC 3.18 (see Public Notice 48).

21. Sometimes charges may be made to non-tenants for improvement works. For example, an HA may replace the roofs on a row of terraced houses, some of which are occupied by non-tenants. Normally the supply to the non-tenant would be standard rated because it is not linked to a supply of housing.

However, some non-tenants will be former tenants who have acquired their property under Right to Buy or Right to Acquire and may still pay ground rent or a service charge to the HA. Again, the charge to these non-tenants will be standard-rated unless the improvement work falls under the service charge.

As part of the delivery of qualifying improvement works an HA may perform works to non-tenant properties but not charge for it. Where it is more cost effective to do so the HA can regard the VAT incurred on the entire cost of the replacement as input tax relating to the qualifying improvement works. This might happen when, for example, an HA incurs VAT on the cost of replacing the roofs on a whole row of terraced houses because it is less expensive than not performing the works on any non-

tenants' houses in the row. This is because the VAT on the non-tenants' roofs has been incurred for the purpose of efficiently delivering the improvement works.

An HA may undertake works to tenant properties which include works to non-tenant properties for which no charge is made. The VAT incurred on all of the works is likely to be wholly irrecoverable when the works to tenant properties are not qualifying improvement works.

Other activities

Stock transfers from local authorities (LAs)

22. This area is covered under other, rather than core, activities because although the acceptance of a stock transfer will often be the reason an HA is created, PE looks at supplies made rather than ultimate purposes.

23. Many HAs have received housing rental stock from LAs. Typically it is the intention that the stock will be renovated up to a better standard after the transfer. This has been described as decent homes standard but terms vary with different initiatives and with which UK "devolved administration" the housing stock is in. The receipt of housing stock is clearly not a supply by the HA. However the HA typically agrees to act as main contractor in supplying future refurbishment services to the ceding LA, making a supply of future construction services to the LA simultaneously with the transfer. That is a taxable supply at the standard rate.

Please note that the decent homes standard has changed over the years. Whether work to renovate houses is part of a stock transfer should be determined by reference to the decent homes standard in place at the time the stock transfer was agreed.

Services to other HAs or organisations

24. Larger HAs may provide services to smaller HAs or other bodies. As they have well developed systems for collecting rents and dealing with tenant queries (possibly via call centres) they can offer to carry out these functions for a fee. One reason why this might be a sensible solution is that a single estate may have units owned by several HAs, with one being the predominant owner. It could be inefficient to duplicate estate offices or officers. Rent collection and water rate collection services are taxable at the standard rate. Call centres can carry out a range of functions but the supplies made are most likely to be taxable at the standard rate.

25. HA's may decide to set up or take part in cost sharing groups (CSG's). Further information about CSG's and the impact of working with a CSG on an HA's VAT recovery can be found in VAT Information Sheet 07/12.

One area where issues particular to HAs can impact CSGs is over whether potential distortion of competition can prevent supplies from being exempt. If two or more HAs, or other qualifying parties, come together to form a CSG and take themselves out of the market (in that they automatically use the CSG without any tender process) then there will be no question of distortion of competition preventing exemption. However, by law HA's have to put certain purchase contracts out to competitive tender. If there is a tender process before a contract is awarded to a CSG, it is likely that the distortion of competition test may not be satisfied.

Feed in Tariffs

26. The Feed in Tariff is an initiative to promote the greater use of electricity generated from renewable sources, such as solar or wind power. Its purpose is to incentivise small-scale production and it will be funded by a levy paid by electricity suppliers.

It is expected that the scheme will be attractive to HAs who will be encouraged to generate electricity through a renewable source.

HAs might generate more electricity than they need, and this will become available for electricity suppliers to supply to others. In return, HAs participating in the Feed in Tariff scheme will receive payments under an "export tariff". These payments are consideration for supplies of electricity by people participating in the Feed in Tariff scheme to the electricity company, where they are made by taxable persons in the course of their business.

HMRC guidance manual Business/Non-Business explains the tests to apply in order to determine whether a supply is made in the course of a business.

Other activities or schemes

27. HAs sometimes run other schemes, whether to assist people onto the housing ladder, to assist vulnerable members of the community, or in response to government initiatives. Such activities may be low level and subsidiary to the core activities set out above or a major area for the HA, possibly even a core function.

28. Each activity should be looked at in its individual circumstances to determine whether it involves the making of supplies for VAT purposes and, if it does, what the

VAT liability of those supplies is. Some activities may not be business activities for VAT purposes at all and the VAT incurred on any such activities cannot be deducted. Where activities are supplies their VAT liability will be taxable at the standard rate unless a relief is available under the law. Reliefs exist for education, welfare, improvement works for the use of the disabled and other areas as well as the property related reliefs discussed above. HMRC has published Public Notices discussing these areas which are available on the HMRC web site, so the notes below are restricted in scope.

29. Education supplies include vocational training and can be exempted when made by an 'eligible body' or when they are ultimately paid for by government funds under certain Acts of Parliament. The question for a HA will often be whether they are an eligible body. Eligible bodies for this purpose are defined in VAT Education.

30. When welfare services are supplied by a charity or state regulated welfare institution they are exempt. HAs will need to work out whether what they are supplying is considered to be welfare and whether they are state regulated (if they are not a charity). There is a reduced rate (5%) relief available for welfare advice supplies. There are a variety of zero-rating reliefs available for supplies to, or for the use of, disabled persons that are required because of their condition. Although there are many reliefs available there is no general relief so it is sensible to check the relevant Public Notice before reaching a decision about any supply or scheme.

Non-business activities

31. VAT covers supplies that are within its scope. VAT on the costs of making those supplies can be deducted insofar as the supplies are taxable rather than exempt. The scope of VAT is wide, but not all activities or supplies are within it.

32. Activities and supplies that are outside the scope of VAT may still consume costs. The VAT on those costs will not normally be deductible. Activities and supplies that are outside the scope of VAT and whose costs are not deductible are normally referred to as 'non-business'.

33. Where activities are carried out for no payment (the VAT term is consideration) then they will normally be non-business. However it can still be difficult to determine whether an activity is business when funds change hands as there may be a question as to whether the funds are consideration for the service or are a grant or donation. There are no easy answers to such questions. Where a HA is unsure as to whether payments it receives are consideration for supplies or grants then it may wish to write

to HMRC with the full facts for a ruling. Any contracts or similar documents that exist will always be relevant information and should be provided to HMRC to help them provide the ruling.

34. As non-business activities do not allow for deduction of VAT on their costs, organisations that have non-business activities must take this into account when calculating their deductible input tax. Direct costs must be excluded from deduction and an apportionment of general costs may be needed when they partly support nonbusiness activities. A business/non-business apportionment must be done prior to PE calculations. There is no set way of carrying out such apportionments – anything that produces a fair result being acceptable.

35. However, from 1 January 2011, HMRC are able to agree a 'combined' business/non-business and PE method. Although it is possible to approve a method that starts part of the way through a year, in practice HMRC expect HAs that want a combined method to apply for them with effect from the start of their next tax year. A combined method cannot be backdated to the start of a tax year which begins before 1 January 2011. Please note that, if you have a combined business/non-business and PE method you cannot apply the PE de minimis provisions.

There is no direct correlation between non-business income, such as government grants received, and non-business activities. There can be non-business income but no non-business activities and vice versa. The important consideration is what costs are incurred and how they are used.

Addressing PE issues in PESMs or Standard Method Override (SMO) calculations

36. This section deals with the design of a PESM and offers suggestions to deal with the PE issues most commonly reported by HAs and HMRC officers. This section has been updated since the first draft of this Framework. Although it now covers areas in greater detail it can never be comprehensive and HMRC are still keen to receive further information and feedback so that it can be improved further.

37. In designing PESMs we focus on costs incurred, how the business manages those costs, how those costs are reported and how those costs feed into the making of the business’s supplies. For HAs the supplies will be the ones identified in the previous section of this Framework.

38. Some methods (such as the standard method) are simple, broad brush calculations that do not significantly rely on the business's systems, cost accounting records or the way the business organises its human resources. Others involve more complication for the sake of greater accuracy. When more complication is needed and justified is covered in both this and the following section of this Framework.

The Standard Method, SMO calculations and HAs

39. The partial exemption standard method is a simple, broad-brush calculation. However it gives a fair result for most partly exempt businesses and will be fair for many HAs, especially smaller HAs or those with a limited range of activities.

40. Where the standard method is fair for a HA a PESM will not be needed. Where a PESM is not needed the agreement of one will impose unnecessary costs on both the HA and HMRC.

41. The standard method is the default PE calculation and so applies until and unless a PESM is agreed. Where the standard method is not suitable for a HA this may lead to under or over recovery of input tax on VAT returns. Even where the standard method is likely to be fair in the long term there may be reasons why it may not give a fair answer in unusual circumstances.

42. To protect the position of both sides in the event of substantial distortions arising the standard method is covered by a backstop provision; the standard method override (SMO). This states that if, over a tax year, the standard method produces an attribution of input tax to taxable supplies that differs 'substantially' from the way tax bearing costs are "used or to be used in making taxable supplies" then an adjustment is due. Adjustments can be due either in the business's favour or HMRC's.

At the time of writing, 'substantially' means:

- more than £50,000 or
- more than 50% of the residual input tax incurred and at least £25,000.

43. Where HAs find that they need to make adjustments under the SMO in most tax years this is a strong indicator that a PESM is needed. But if a distortion is caused by a one-off occurrence and recovery under the standard method will normally be fair, a PESM may be unnecessary.

44. The best way to approach the SMO is to identify the reasons for the significant distortion and correct them with the simplest possible calculations that sensibly compensate for them.

45. The guidance in this Framework should help HAs that need to consider the SMO and perform one-off use-based PE calculations. HMRC are also happy to discuss the concerns that any HA may have if they are in doubt.

Post-stock transfer programmes of work

46. Where there has been a supply of future refurbishment at the time of a large scale voluntary stock transfer (covered in the previous section of this Framework) the receiving HA will carry out the pre-paid work over a number of years. In the year of the transfer the supply value will be distortive as it covers substantial works that have not yet been carried out. In years subsequent to the transfer there will be no supply value to include in the standard method or a PESM based on output values. Such methods will thus attach none of the residual input tax on overhead costs to this activity. However there will be at least some use of overheads in the delivery of the programme.

47. There is thus a clear risk of distortion in recovery when HAs are carrying out this work. Whether the distortion is substantial enough to require a PESM to correct it may depend on the size of the programme and how the HA delivers its obligations under it. This section will discuss how distortions may be addressed in PESMs (as distortions will span the life of the programme a PESM should be preferred to year on year SMO adjustments). However this guidance may be of assistance to HAs that need to calculate a SMO adjustment whilst they are negotiating a PESM.

48. The first step must be to establish the facts over how the programme will be delivered and therefore how VAT bearing costs will be used in that delivery. The works may be done by in house staff (possibly including ex-LA DLO staff transferred with the stock). This may apply differently to the various functions involved in the delivery. These may include but are not limited to:

- Architect services,
- Construction services,
- Surveyor services,
- Awarding, monitoring and paying contracts,

- Consultations with tenants (which may occur before, during and after work is done), and
- Arranging temporary accommodation (if tenants need to vacate premises).

49. The following three approaches have been suggested. Their pros and cons and when they are likely to give a sensible answer are discussed below. They are not the only ways in which these issues can be addressed, and other ways will always be fully considered, but they are the most obvious ways:

- Adding an additional amount to taxable supplies to make up for the missing supply values; or
- Allocating overhead costs to the programme delivery function based on an analysis of staff delivering the programme and staff carrying out core HA activities; or
- Using HouseMark data to allocate a sensible proportion of costs to post-stock transfer programmes of work.

Further information on how to use HouseMark data in a PESM is given in Annex C to this Framework. Example calculations are also set out in that Annex.

50. At a HA which uses the full range of its overhead costs to deliver the programme of improvement works, for example where the improvement works are fully carried out by HA staff, the principal problem to be addressed will be the lack of output value as the programme is delivered.

A simple splitting of the initial consideration paid over the life of the project is likely to be arbitrary and unresponsive to change (for instance if a lot of work is done in one year and little in the next this won't be reflected in input tax recovery). This problem may be countered by using the cost of work done in substitution for the missing supply value. It is recognised that cost values may be marginally lower than supply values early in the programme. However they may rise above supply values later on, due to inflation, and it is expected that, overall, they will give a fair answer.

51. At a HA which does not use the full range of its overhead costs to deliver the programme of improvement works, for example where the improvement works are not fully carried out by HA staff, the HA will get direct recovery of costs such as telephone and IT within the charge made by the contractor but will incur less residual cost. Where an HA outsources the improvement works, including the income from those works can

in some cases still distort the recovery of tax on overhead costs even if the income is split over the life of the project.

52. A further refinement in the calculations which can better reflect the use of common costs is to split HA costs into separate cost streams – one or more linked to the delivery of the programme and one or more that are not. Cost streams containing costs linked to the programme would take the additional supply value into account. Cost streams not so linked would be apportioned by sensible calculations that do not include the additional supply value. Please see the section of this Framework called 'When sectorisation is appropriate' for more about this approach.

53. Please see the examples at Annex A for some ideas on how to reflect the use of costs in PE methods.

54. Where many functions are delivered by contractors with HA staff primarily awarding, monitoring and paying contracts an analysis of staff numbers, applied to overhead costs used to support those staff in fulfilling their duties, is likely to provide a sensible solution.

55. Methods based on staff count work best where most staff are predominantly employed in one sort of activity (occasional or very minor involvement in other activities can be safely ignored). If staff time is split between various activities then it can be possible to use staff time rather than simple numbers but only when the business accurately records time spent for other, non-PE purposes. Where the basic requirements for a staff based PESM do not exist it is a sign that a different calculation is needed, not that further records need to be created.

56. It is normal when completing calculations using a proxy for use (such as staff count) to use a taxable divided by taxable plus exempt basis of calculation. Here the 'taxable' would largely be the staff awarding and monitoring contracts and the 'exempt' would largely be the staff delivering affordable rental housing to tenants. Staff delivering other services direct to customers would be judged on the VAT liability of what they are doing. Backroom staff, such as central accounting or HR staff, would normally be excluded. However a taxable divided by total calculation can be used as a quid pro quo for limited analysis of costs into cost streams or if both sides agree that a staff based calculation is the best way to go but taxable divided by taxable plus exempt cannot provide a sensible solution.

Shared ownership sales

57. There have been arguments raised that shared ownership sale values can be distortive in outputs based calculations (such as the standard method). HMRC believe that, in general, this is not so because shared ownership is part of the core activities of HAs and is a trading activity rather than a capital sale. However we are prepared to be persuaded otherwise if evidence justifies this in any particular case, in which case application of the Standard Method Override or use of a partial exemption special method may be appropriate.

58. If shared ownership receipts are to be excluded in any PESM then it must be done on a consistent basis. In particular all tranche sales must be treated the same in any PE method. So, for instance, if shared ownership tranche sale values are to be excluded from or weighted downwards for the purposes of calculations then no distinction between first tranche and subsequent tranche sales is appropriate.

59. Sales of normal housing stock, whether under right to buy, something similar or for other reasons, are treated differently to shared ownership sales. This is because they are sales of capital goods used in the business. As such they are excluded from all PE calculations regardless of their liability. The liability is thus important only to determine the deductibility of direct costs such as solicitors' fees.

Services supplied to other HAs or similar organisations

60. It is sometimes convenient for one HA to manage properties for other HAs and charge a fee for this service. Such fees are taxable. Where this is done the supplying HA will normally put a similar level of effort and resources into managing all rental properties, but the income from owned properties will be much higher than for managed ones.

61. Because outputs based methods, such as the standard method, will attach more input tax to each owned property than each managed property there may be significant distortion if the managing activity is big enough. The underlying cause of this is that the two supplies are not made on the same basis; one is as principal (owning the asset, taking all risks) and the other as agent for a fee.

62. Where the problem is that supplies are made on different bases the answer is often to amend one value so that a like with like comparison results. Here that might

be by substituting the rents collected for the fees payable from other HAs or alternatively by removing the element of own rents that fairly represents financing the capital value of the properties.

63. Any HA involved with Private Finance Initiative (PFI) projects may wish to speak to their HMRC VAT contact to discuss the issues.

64. When an HA incurs costs against an abortive taxable supply VAT on the costs associated with that supply may still be recovered. The reasons for this are given in the section headed 'Failed business – before supplies have been made' in the VAT Business/Non-Business guidance manual.

65. Any HA involved in design and build contracts may want to look at HMRC's published guidance in the VAT Construction manual.

New build projects

66. Where HAs have new build construction projects the units constructed will often be put to a range of purposes. Examples include general needs rental (exempt), shared ownership sale (taxable in terms of construction costs) and sale (either commercial or to other HAs; both taxable). The costs incurred in the project will therefore be residual for PE. However the mix of sales generated by the project will often be very different from the HA's overall mix of supplies. Where there is a significant amount of tax incurred on projects this may lead to distortion.

67. The obvious way to correct any distortion is by having a sector for new build projects. The recovery of input tax in this sector could either be by a single calculation taking all current projects into account or split into a cost stream per project, with each apportioned based on its own unique position. The tax at stake and the impact on recovery will inform how much complication is justified.

68. Using sales values is unlikely to give a good result because there are no sales values while the project is under construction when the main costs are incurred and because the various uses generate income in different ways and over different time scales. However there are a range of measures that will commonly give a good answer. These include numbers of units created and the floor areas of units created.

The one chosen will depend on the nature of the projects, the records the HA keeps and the tax at stake. It is important to compare 'like with like' when apportioning between taxable and exempt, so for example, if the constructed units are the same whether sold or rented, then numbers of units may be a fair basis for the PE calculation. Please note also that in some cases, particularly if the HA has subcontracted the work and is simply monitoring the project, including the new build sales income in the partial exemption recovery method can distort the recovery of tax on central overhead costs.

69. Where costs are incurred a significant amount of time before sales are made, a method using 'intention' may give a good answer if based on well-evidenced projections. The deduction established by such a method would probably not be subject to 'payback' or 'clawback' which normally take account of any changes in intention up until first use. 'Payback' and 'clawback' apply where there has been a 'category' change between fully exempt and fully taxable (or vice-versa) or between fully exempt or fully taxable and residual.

For input tax incurred on or after 1 January 2011 it also adjusts for category changes for business and non-business. In most cases, the 'category' will not change before first use so 'payback' or 'clawback' will not apply.

70. See Public Notice 706 for more information on 'payback' and 'clawback'.

71. HA’s should keep in mind whether homes are being created or acquired as trading stock or created or acquired as rental stock. If they are trading stock then the activity of trading homes should be reflected in any proxy used to determine the recovery of non-attributable VAT. Usually this would be done by including the value of such transactions in an income based PE method. If they are rental stock the homes are normally regarded as fixed assets (or equivalent) of the HA and any subsequent sale of those properties should be disregarded. This is because the sale of rental stock is regarded as a real estate transaction within the meaning of VAT regulation 101(3)(b)(iii).

When sectorisation is appropriate

72. The purpose of a PESM is to increase accuracy in the calculation of deductible input tax. However a balance needs to be struck between the materiality of

increases in accuracy and the additional compliance costs in carrying out PESM calculations.

73. Sectorisation is the splitting of a single VAT registration down into two or more smaller units (sectors) so that PE calculations can be completed within each sector. The deductible input tax from each calculation is added together to get the total deductible amount.

74. Sectorisation, as long as it follows the natural divisions of the business, increases accuracy. However any increase in accuracy will not always justify the additional effort needed in completing multiple PE calculations. This section of the Framework discusses when sectorisation is an appropriate solution and some of the practicalities.

75. A sectorised method may allocate a fair amount of the input tax incurred on central overhead costs to a sector. This allocation could be based on management accounting records or could be made by applying another appropriate driver for the use of central costs. Once the allocation is made, recovery of that input tax is determined using the same proxy that is applied to work out the recovery of input tax incurred on costs directly allocated to that sector. If such an allocation is performed then the activity of the sector should normally be excluded from the proxy calculation used to determine the recovery rate for the remaining central overheads.

HMRC is aware that HAs' management accounting systems frequently do not allocate central overheads to different parts of the organisation. Where this happens, it may be that either no sectorisation may be appropriate or part sectorisation (focussing on the direct costs only) is appropriate.

Where a method does not reallocate central overheads, in other words, part sectorisation, but includes a sector for central overheads, in other words costs which are used to support all activities of the VAT registration, it is normally appropriate to include all activities, or income streams, in the calculation for the central overheads recovery. The recovery rate for this central overheads pot should still be reviewed to ensure that it is a fair and reasonable reflection of the use of those central overheads.

Where a sectorised PE method is used, care should be taken to ensure that the costs considered in a sector are matched up with the activity that uses those costs. For example, if a method has only two sectors, A and B, and sector A and sector B do not share any costs then it is likely to be distortive to include, say, the income generated by the activity of sector A in the calculation of the recovery of the VAT on the costs of sector B, and vice versa.

Where a proposed sector for central overheads that determines its recovery of VAT by reference to all of the VAT registration's activities does not achieve a fair and

reasonable result then several remedies could be tried. One is to exclude the income stream(s) that give rise to the unfair and unreasonable result from the calculation. Another is to perform a more detailed analysis of the central overhead costs to separate the costs into smaller pots where drivers for determining recovery, or reallocating the cost, are more readily available.

76. An area where sectorisation is more frequently appropriate is in connection with new build activity. The more important to the HA their new build projects are, the greater the sale values realised are likely to be, the more input tax is incurred in relation to them, and the less likely it is that a part sectorisation, i.e. only sectorising the direct costs, will provide a fair result.

Where VAT bearing overhead costs are being incurred for new build developments then there is frequently a timing difference between incurring the overheads that support the new build activity and the subsequent receipt of the proceeds of the sales and any rental income for those new build projects. Whether this is distortive is likely to depend on the extent to which the new build activity fluctuates from year to year.

Where there are fluctuations in new build activity then a housing association with a new build sector is likely to need to explore the most fair and reasonable driver for VAT recovery, for example the number of or income to be generated from the intended units in development, which may reflect use and be readily available.

77. Smaller HA's that could generally apply the standard method may find the addition of small sectors for certain activities helpful. For example, a sector that allowed a similar amount of input tax to be recovered as is charged as output tax on tenant recharges may help. Where the cost and the recharge are identical and the supplier is VAT registered it should be possible to agree such a sector fairly readily.

Scope of sectorisation

78. The number of sectors needed in a PESM for a HA will vary. A small HA that concentrates on social housing rental is unlikely to need to sectorise at all. A very large HA with a disparate range of activities might need half a dozen sectors. The following non-exhaustive list of factors may impact on the range of sectors needed:

- What customer groups the HA has (e.g. housing tenants, commercial tenants, other HAs, vulnerable people in the location, etc.),

- Regions (e.g. if the cost-base and type of product varies substantially between different areas that the HA operates in) and,
- Management structures (e.g. strategies, senior management commands, source of funding etc.)

Natural sectors

79. PE sectors often arise naturally from the way the business organises itself. In this case the PE sectors may correspond with semi-autonomous, clearly identifiable, subbusinesses within the VAT registration. In rare circumstances, a PE sector may be needed simply because the costs incurred and activities undertaken are so disparate as to make it impractical to formulate a fair basis on which to apportion between taxable and exempt.

80. Sectors should have their own records so that their input tax and outputs (or whatever other proxy for use is to be adopted) can be readily identified. Records put together purely for doing PE tend to be less reliably maintained as there is no real business purpose to keeping them. The need for such records is a strong indicator that the division in question is not a natural sector

Materiality

81. Sectorisation is only appropriate where it makes, or is likely to make in the future, a material impact on the amount of deductible input tax. That impact can be in favour of the business or of HMRC.

82. What is material for a business will often depend on that business and no hard and fast rule can be laid down. The extra effort required will also be a factor in decisions over whether sectorisation is sensible. However a few guidelines on materiality can be set out.

83. If a business does not separate out and monitor the performance of the area in question for management or other purposes then it is unlikely to be material to the business.

84. The differences in proportional use of costs between the area under consideration and the organisation as a whole will influence the decision. The smaller the difference the less likely it is that a sector is needed.

The law has a definition of a distortion that is substantial enough to require adjustment in the SMO rules. That limit is basically £50,000 of VAT. If the difference in input tax recovery that would come out of a sectorisation is over £50,000 it is likely to be material. However, smaller differences may also be material to some HAs.

Companies or activities

85. Sectors will often be separate companies in a VAT group, possibly based in separate buildings. It is common for new or different activities to be put in separate companies for reasons such as protecting the core business or corporation tax (CT) implications when one of the companies is a charity.

86. However there is no need for each company to be a sector and sectors should not be restricted to separate legal entities. The principle is that it is the separable business activity that is sectorised. Company structures can change and it is good practice to define a sector in terms of the activity it covers, not the legal entity that undertakes it.

Cost allocations

87. Where sectors are established they will accept their direct costs but there is likely to also be use of central and general costs by the sector in delivering its supplies to customers. If the overall business has management accounting systems that share central costs between its activities using suitable drivers for the main VAT bearing costs then this can generally be used to sensibly allocate input tax between the sectors.

88. Some HAs do not have management accounting systems that can deliver a split of this kind. As discussed earlier, this may be an indicator that the HA does not need to sectorise. However HMRC recognise that HAs will sometimes have activities that are material, so that sectorisation is indicated, but not have management accounting systems that easily facilitate the allocation of central and general costs to sectors. Where this is the case either the best allocation practicable will need to be agreed or central costs may need to be separately attributed based on the outputs of the whole organisation.

Other issues

89. This section covers a number of issues that have arisen during the negotiation of this Framework. It does not seek to cover them all exhaustively and if further information is needed then normal HMRC guidance and notices should be consulted.

Zero-rating of dwelling sales

90. There is a zero rate available for sales of dwellings. There are conditions that must be passed before zero-rating can apply. These are:

- The sale must be of a major interest,
- The seller must be the person who constructed or converted the dwelling, and
  - It must be the first time that they have supplied a major interest in the dwelling.

91. Any supply of a dwelling that does not come within these conditions will be exempt from VAT with no option to tax.

92. A major interest is the freehold or a long lease. A long lease is one of at least 21 years except in Scotland when it is one of 20 years.

93. The person constructing (or converting) a dwelling is the developer who has an interest in the land and incurs construction services in causing the dwelling to be built (or converted from a non-dwelling) with a view to subsequently commercially exploiting the dwelling created. The status of person constructing (PCS) attaches to that person and only they can make a zero-rated supply. If a housing association transfers a dwelling without making a supply for VAT purposes (e.g. sale by way of TOGC, or sale within a VAT group), PCS possessed by the housing association will not pass to the new owner. As the new owner will not have PCS they will not be able to make a zero-rated supply of that dwelling.

94. Zero-rating is available for the sale of part completed dwellings when the new owner will finish the construction. The construction must have advanced beyond foundation level. Where there is such a sale both the seller of the part completed building and the new owner who completes the dwelling will have PCS.

95. Where the major interest sold is a leasehold then only the first payment under the lease is zero-rated (whether it is a premium, representing the transfer of some or all of the equity in the dwelling, or simply rent). This may affect HAs, notably in relation to shared ownership sales.

In such sales part of the equity is initially transferred with a view to further tranches of equity passing later. A reduced rental will also be payable until full equity is passed. Only the first tranche payment is zero-rated and all subsequent tranches and rentals are exempt. HMRC is content that all construction costs are attributable to the first tranche and that VAT on them is deductible. However further costs, such as legal costs associated with subsequent tranche sales and cost of rent collection, will relate to the subsequent exempt supplies made.

Zero-rating of construction services

96. Construction services supplied in the course of construction of a new dwelling are zero-rated with no action required by the developer in order to justify this. Zero-rating also applies to communal residential buildings such as old people's homes and charitable buildings such as community centres but there is a requirement for the end use to be certificated.

Site preparation services, for example site investigation and demolition services, are normally standard rated where supplied in isolation, in other words without being part of a single project that provides construction services. Zero rating is available for elements of site preparation if it forms part of the services provided under a single project to construct new housing. Points to consider in determining whether the site preparation services form part of a supply of construction services capable of zero rating include:

- Whether new dwellings are being constructed;
- Whether there is a single contract and the site investigation is merely incidental to another element of the contract; and
- Whether planning permission has been granted;

If the services are not part of a single contract and performed before planning permission then they are standard rated whether or not they are performed at a similar time as other services from the same contractor.

Further information on this topic can be found in section 16 of HMRC Notice 708.

97. The course of construction covers the demolition of whatever may have previously occupied the site as part of a single project ending in new dwellings. However zero-rating will not be available for site clearance which is not part of a single project.

98. Certain professional services, such as surveyor or architects fees, are excluded from zero-rating when separately supplied. However when a single service of design and build is supplied it will be wholly zero-rated despite the fact that professional services are embedded within it. This can occur when an HA sets up a construction subsidiary to receive disparate construction services from contractors and supply them on to the HA.

Stock transfer issues other than impact on PESM design

99. There have been a significant number of transfers of housing stock from local authorities (LAs) to HAs. This note addresses those where the stock, although not yet improved by a programme of necessary works, is transferred at a value that reflects planned improvements. The HA will have contracted to deliver the required work as main contractor of the ceding LA after the transfer. The future works charge will be offset against the charge for the stock in the transfer process.

100. The programme of works will be a specific program aimed at getting all the units up to the agreed standard. The programme may be scheduled to span a number of years, possibly as long as ten or fifteen years. Staff from the ceding LA's direct labour organisation may or may not be transferred across with the stock to carry out work on the program, or to carry out cyclical repairs. Work may also be carried out by third party sub-contractors appointed and monitored by the HA in their role as main contractor on the programme.

101. In PE taxpayers can deduct tax incurred on the cost components of their taxable supplies from the output tax payable on those supplies (if any). Any input tax directly incurred in writing/agreeing the initial contract with the ceding LA will be deductible as a direct cost of the large taxable supply made. Any input tax incurred on delivering the programme (for instance sub-contractor fees) will also be deductible in principle. The

concerns over deductibility are the fact that the costs are incurred after the supply is made and the length of time between the supply and the incurring of those costs.

102. Case law states that cost components will normally precede their supply but that they may be incurred after the time of supply where the time delay is not too great and where they are in the normal causal chain of supply for the supply in question. HMRC are content that the temporal link arm of the test will not be broken while the contract runs its normal course. The next obvious question is what if the contract overruns or the parties agree to alter its terms?

103. HMRC will take a pragmatic approach to circumstances like minor overruns, rescheduling of the contract or minor changes to specification. While we are looking at what is fundamentally the same programme of works HMRC will not be seeking reasons to deny input tax recovery.

104. However only the works contracted for when the contract was signed will be in the normal causal chain of supply. Re-done works will not qualify (unless in the normal snagging process) and nor will additional capital works or any ‘revenue’ works. Because input tax can only be deducted as a cost component of the supply that was made at the point of transfer, the HA and the LA amending the contract at a later date to expand the programme will not lead to additional deduction of input tax.

105. Normally, there are backing schedules that show what works are covered by a Development Agreement (DA) entered into when an HA receives housing stock from an LA. The works will likely be broken down into programmes for years 1-5, 6-10 etc, and normally most of the effort will be put into bringing the homes up to Decent Homes Standard. Those programmes should be broken down into a schedule of works and a list of professional services.

Please note that, as stated in paragraph 26 of this Framework, the decent homes standard has changed over the years. Whether work to renovate houses is part of a stock transfer should be determined by reference to the decent homes standard in place at the time the stock transfer was agreed.

106. Where an HA wishes to regard improvement works as part of the supplies made in relation to a DA the onus is on the HA to produce the backing schedules to justify any claim that work is covered by the DA.

Some contracts may have a clause relating to improvements which effectively says 'all of the work scheduled plus anything else we agree needs doing'. Where 'anything else' had actually been agreed after the initial schedules had been drawn up and contracts

signed then it is insufficient for an HA to simply assert that the initial contract permits variations and so the extras fall within it; they should show that:

- a variation to the contract had actually been enacted; and
- where this is so further consideration should pass from LA to HA for additional works and responsibilities to be taken on - this would create a further supply by the HA.

107. There are many reasons why the housing stock transferred to a HA in one of these arrangements may subsequently be further transferred on. Many cases will not pose VAT questions as a result of the secondary transfer. In some the HA will nonetheless go on to complete the planned programme of works and the incurring and recovery of input tax will be undisturbed. If as a result of a sale or other transfer the capital works are abandoned then no further input tax will arise.

The case that needs to be addressed here is when units are transferred in a transfer of a going concern (TOGC) of a property rental business to another body (probably another HA) that will complete the works and incur any input tax.

108. There is a TOGC for VAT purposes when assets are transferred from a taxable person to another taxable person (or a person who will become a taxable person as a result of the transfer) who will use them to carry on a similar business without there being a significant break in trading across the transfer. If there is a TOGC the transfer of the assets is treated as not being a supply for VAT purpose.

109. When there is a TOGC all VAT related rights and responsibilities attaching to the assets transferred go with them except the ability to make a zero-rated supply (see paragraph 97). The new owner acts in substitution for the old owner in relation to those rights and responsibilities. For instance any capital goods scheme (CGS) adjustments on any capital items transferred must be declared by the new owner after the transfer until the item is fully adjusted.

110. There may be a TOGC of some or all of the housing stock ceded to a HA by a LA, possibly to a smaller HA or because of the merger of HAs. If the obligation to complete the programme of work initially contracted for passes across as part of the TOGC the new owner can deduct input tax on the costs of the programme just as their predecessor did. This is because the responsibility to complete the works is one of the

responsibilities attaching to the assets transferred, just as continuing CGS adjustments is.

111. The transferor HA must make records available to the transferee sufficient to identify the scope and duration of their remaining obligations under the contract so that the transferee can demonstrate that their costs are cost components of that original contract. Section 49(5) of the VAT Act allows transferees to reasonably require such records.

Using estimated figures in VAT accounting

112. A few HAs have accounting systems that do not identify input tax amounts when purchase invoices are processed so that input tax cannot later be reported. When it comes to completing VAT returns they seek to estimate the input tax they have incurred so that returns can be rendered as required by law.

113. VAT law does not permit such input tax estimations, which will not in a short period of time be replaced by true figures. Any HAs that are in this position will thus need to move onto normal VAT accounting. They may wish to discuss with HMRC how they will achieve this.

Incidental supplies

114. There are a number of exclusions from the supplies to be taken into account in the standard method and all other methods based on supply values. These include incidental financial or real estate supplies and capital goods used in the business.

115. An incidental supply must be incidental to one or more of the business's normal business activities that leads to the making of supplies. The use of overhead costs by the business in making the incidental supply must be slight. Also the supply cannot be a direct, necessary and permanent extension of the activity to which it is incidental. Incidental supplies are further covered in HMRC guidance in PE1400.

116. HAs are in the business of renting and selling property; i.e. real estate transactions. As such it is unlikely in general for real estate transactions to be incidental for HAs. However property sales can be the sale of capital goods used in the HA's business. For instance habitually occupied office and rental housing stock will normally be capitalised in accounts and meet normal accounting definitions of capital goods.

Sales of such properties will be excluded from PE calculations whether they are exempt or taxable.

117. Shared ownership equity sales are not the sale of capital goods used in the HA's business. Shared ownership is a sale rather than rental activity with the rents subsidiary to the sales (although not incidental to the sales as the rentals are a direct, necessary and permanent extension of the activity). Although remaining equity will often appear on balance sheet shared ownership properties remain trading stock for the HA.

118. If a HA buys a large plot of land with a view to developing housing but in fact resells the land without developing it then the sale value is likely to distort their PE calculations. It will have direct costs but the use of overhead costs in making the sale will be slight. Such a sale of undeveloped land will be an exception to the general rule that real estate transactions are not incidental for HAs unless the HA has a speculative land purchase activity.

119. An HA may use its development expertise to help other parties with the construction of new properties. These services are taxable and may in some cases represent core activities to the HA of developing, managing and/or trading in property. However, it is likely that the income values generated by these activities may be distortive. Consideration should be given to sectorising these activities.

Short term property rentals prior to a zero-rated supply

120. Sometimes market conditions may lead to house builders that have built to make a zero-rated major interest grant deciding to rent for a period before making that grant. Some HAs may come within this group. Examples of rental before major interest grant for HAs may include fixed term lets of properties built for commercial sale or shared ownership type arrangements where the occupant does not acquire any equity in the property before they move in.

121. Direct attribution of all construction input tax to the zero-rated grant of a major interest is only appropriate when that is the first use of the dwelling. So rental before sale means that any costs incurred in constructing the housing will relate to exempt as well as taxable supplies. It may require adjustments to input tax incurred before market conditions forced changes to plans. Adjustments might be via PE annual calculations or 'clawback'. These areas are covered in Public Notice 706 and HMRC PE guidance.

122. HMRC issued further guidance in this area in Information Sheet 07/08 setting out what impact on input tax recovery this might have and how the need for adjustments might be judged as well as how they might be calculated. Because HAs are normally heavily exempt organisations there is more chance of adjustments being due for HAs than for other developers. HAs that need to address this area may wish to contact HMRC who will take a pragmatic view in agreeing fair adjustments. 123. Where VAT bearing construction costs are sufficient to create CGS items and a fair initial adjustment is agreed that takes initial exempt and planned taxable use into account the CGS should not disturb the input tax recovery unless, and only to the extent that, planned use changes. HAs that have CGS items that have had their initial recovery finalised based on an initial exempt rental to be followed by a taxable sale may wish to contact HMRC to ensure that measures to ensure fair CGS adjustments are in place.

Backdating and retrospection in PESM agreements

124. The default way of calculating PE is by the standard method, which applies unless a PESM has been approved. There are legal conditions to be met before a PESM can be considered approved. Since 2005 the approval must be a document identifying itself as such (as opposed to a verbal or implied approval). Since 2007 the PESM must also have been declared in writing as fair and reasonable by the business prior to HMRC approval.

125. If a PESM has not been legally approved then what was in place before will still be in place. That will be the previous PESM or, if there was none, the standard method.

Some HAs may need to regularise a position where the calculation they are using is not legally their PESM. Others may wish to change their PE method, possibly with backdated effect. The following paragraphs cover those situations.

126. A retrospective *change* of method is not normally allowed (but see HMRC's offer for post-framework PESMs set out at paragraph 8 of this Framework) except to the extent that its use may be approved with effect from the start of the tax year in which the written application (being the approved application) is received.

Retrospective changes beyond this will only be approved in exceptional circumstances such as where HMRC has been at fault, the method is inoperable, or where the method of calculation does not give any result because both the top and bottom of the calculation are zero. Any HA that feels its circumstances justify an exceptional approval should contact HMRC. See PE Guidance for further details.

127. In the first instance, HMRC will need to consider whether the unapproved method is fair and reasonable for current and future periods. If it is also fair and reasonable for past periods HMRC may consider backdating the approval depending on the individual circumstances of the case. Where approval is sought for a PESM a Declaration must be provided. Further details on the 'Declaration' can be found in HMRC Guidance PE3700 or in Public Notice 706.

128. In contrast, the retrospective *approval* of a PESM (where there was no PESM before) may be granted where a partly exempt business has failed to adopt any method to apportion input tax since it commenced incurring exempt input tax. This is referred to as 'backdating' a method and may occur in situations where:

- An HA has not used any method to apportion input tax (possibly where it has not realised that it was partly exempt or has claimed only directly attributable input tax and left a complete claim until later); or
- A method other than the standard method has been used to apportion input tax since the effective date of registration (EDR) but that method has not been formally approved by HMRC.

129. If a HA has not used any method to apportion its residual input tax then any PESM that is fair for all periods and the future can be approved from EDR, subject to declaration (although where older VAT periods are 'capped' no repayments of input tax can be made). If different calculations for the past and the future are needed then they can be put in place once agreed.

130. If a HA has only ever used an unapproved method since EDR and it is fair and reasonable for all past periods as well as current and future periods HMRC will backdate its approval to EDR, again subject to receipt of a declaration.

131. If a HA previously used the standard method, and that method produced an attribution differing substantially from how costs were used to the extent that the SMO would be triggered, and the unapproved method is fair for past as well as current and future returns, HMRC may backdate a PESM to cover tax periods that would otherwise be affected by the SMO.

132. If an unapproved method does not give a fair result it cannot be approved. Nor can an alternative PESM be substituted for the unfair one, subject to the policy set out above. The HA will need to recalculate its recoverable input tax in accordance with the

method they were on before starting to use the unapproved method. This will be the standard method, adjusted by the SMO if appropriate, unless a previous PESM was approved.

Change of legal or VAT entity

133. When a HA forms a VAT group, merges or otherwise changes its VAT entity this will often impact on its PESM (if it has one) or need for a PESM. If any change leads to a new VAT registration then all existing PE agreements will lapse. Even if the PESM used before remains suitable it will need to be approved anew. However it is sensible to review the position as other changes may mean that changes to the PESM are needed.

134. If a VAT group member joins or leaves but the VAT registration continues then the existing PESM will remain in place. This may leave otiose provisions in the PESM or gaps (areas where the PESM does not specify how input tax is to be addressed). It is sensible to review the PESM whenever such a major change occurs.

Annex A – Example PE methods

These examples are purely for illustrative purposes and should not be taken as implying that certain mixes of activities will result in the recovery rates quoted. Each housing association should consider its own mix of activities and own accounting systems before applying the principles shown in these examples. These examples assume that a separate calculation has been carried out in respect of any non business activities that the housing association undertakes.

The changes in the proportion of VAT recovered are a natural consequence of the changes in activity and organisation in each of the examples. These proportions are quoted simply to show that changes in the mix of activities and the way an association is structured can be reasonably expected to result in changes to the amount of tax recovered overall.

Example 1

A housing association has 10,000 general needs units and 10 extra care schemes. The extra care schemes include cafeterias, shops and hairdressers. The housing association operates the cafeterias and shops itself and generates taxable income from them. It rents an empty room in a property on which the option to tax has not been taken to the hairdresser and gets exempt income from this.

The housing association gets exempt income from renting the residential units. This income includes monies received for garages and monies received for repair costs under the terms of a lease or tenancy agreement. It gets taxable income from the facilities at the extra care schemes (cafeterias and shops), garage rental to non-tenants and rechargeable repairs to tenants. Any repairs will be performed by the housing association's in-house direct labour organisation.

It is partly exempt and so has to apply a method to determine how much of its input VAT can be recovered. The default method is the standard method which is broadly speaking a turnover calculation where the amount of non attributable tax (residual input tax) is determined by the proportion of taxable income to total income.

Taxable Income		**Exempt Income**			
Cafeteria and shops	£ 525,000.00	Rental from Residential Units	£ 26,000,000.00		
Garage Rental to non tenants	£ 10,000.00	Rental from Commercial Property	£ 5,000.00	**Residual Input tax**	£ 700,000.00
Rechargable Repairs to tenants	£ 35,000.00				
Total Taxable Income	£ 570,000.00	**Total Exempt Income**	£ 26,005,000.00		
Taxable input tax	£ 30,000.00	**Exempt Input tax**	£ 120,000.00		

Standard Method Calculation

Taxable Income (A)	£ 570,000.00
Total Income (B)	£ 26,575,000.00
Recoverable percentage (A/B*100)	2.14%

HA is able to round the percentage to nearest whole number because residual input tax is less than £400k per month on average

Recoverable percentage (C)	3%
Residual Input tax (D)	£ 700,000.00
Amount of Residual Input tax to be recovered (C x D)	£ 21,000.00

Standard Method Override

For each of the activities the association takes part in, income seems to be a fair measure of the use of overheads. The main costs incurred are estates and IT costs, and any increase in these costs is reflected in an increase in the price that is charged for the services the association provides. There is a clear link between costs incurred and prices charged and so the association decides there is no need to apply a standard method override (SMO) calculation. If an association finds that it continually has to make SMO calculations then it is usually indicative that the association should apply for a special method.

Example 2

After three years, the housing association receives 10,000 general needs units from a local authority. Prior to the stock transfer, the association enters into a contract with the local authority to perform a cycle of improvement works to the properties that it receives. Half the improvement works will be performed by the housing association's in-house direct labour organisation and half by contractors. All the improvement works will be managed by the housing association. The programme of improvement works will last for ten years.

Taxable Income **Exempt Income**

Improvement works	£ 30,000,000.00	Rental from Residential Units	£ 39,000,000.00		
Cafeteria and shops	£ 525,000.00	Rental from Commercial Property	£ 5,000.00		
Garage Rental to non tenants £ 35,000.00	10,000.00	Rechargable Repairs to tenant £	£ 39,005,000.00		£ 300,000.00 £ 700,000.00
Total Taxable Income	£ 30,570,000.00	**Total Exempt Income**		**Residual Input tax**	£ 1,000,000.00

Taxable input tax **Exempt Input tax**

				Overheads used for all activities
Improvement works	£ 540,000.00		£ 120,000.00	including improvement works
		Exempt Supplies		Overheads not used for improvement works
Other taxable supplies	£ 30,000.00			
Total taxable Input tax	£ 570,000.00	Total Exempt Input tax		

Standard Method Calculation

Taxable Income (A)	£ 30,570,000.00
Total Income (B)	£ 69,575,000.00
Recoverable percentage (A/B*100)	43.94%

HA is able to round the percentage to nearest whole number because residual input tax is less than £400k per month on average

Recoverable percentage (C)	44%
Residual Input tax (D)	£ 1,000,000.00
Amount of Residual Input tax to be recovered (C x D)	£ 440,000.00

Standard Method Override

As before the Housing Association is required to consider the Standard Method Override

For most of the activities the association takes part in, income seems to be a fair measure of the use of overheads. However, the length of the programme of improvement works presents a problem – the income is all received in year one but the work is carried out (and the costs incurred) over the ten year life of the programme.

This would mean in year one that the association would recover 44% of its input tax but in years two to ten it would recover 2% of the input tax incurred. This is because in years two to ten the association would only have £570,000 taxable income out of a total income of £39,575,000.

Costs will be incurred over the ten year life of the programme but the income is only included in the standard method calculation of year 1 of the contract. This would be unfair because the costs are being used in the same way throughout years one to ten.

In line with the comments in the Framework they substitute the cost of work done for a pro-rata share of the initial supply value to make the calculation responsive to variations over time.

This gives the following calculation:

Taxable Income **Exempt Income**

Costs of improvement works done in year 1	*£ 2,800,000.00*	Cafeteria and shops	£ 525,000.00	
Garage Rental to non tenants £ 35,000.00	10,000.00	Rechargable Repairs to tenant £	Rental from Residential Units Rental from Commercial Property	£ 39,000,000.00 £ 5,000.00
Total Taxable Income	£ 3,370,000.00			
		Total Exempt Income		£ 39,005,000.00
Taxable Income (A) (Amended cost of improvement works)			£ 3,370,000.00	
Total Income (B)			£ 42,375,000.00	
Recoverable percentage (A/B*100)			7.95%	

HA is able to round the percentage to nearest whole number because residual input tax is less than £400k per month on average

Recoverable percentage (C)	8%
Residual Input tax (D)	£ 1,000,000.00
Amount of Residual Input tax to be recovered (C x D)	£ 80,000.00

Amount of input tax recoverable under standard method	
Amount of input tax recoverable by substituting the cost of improvement works	£ 440,000.00
Difference	£ 80,000.00
	£ 360,000.00

As this calculation gives rise to an over recovery of 36% (£360,000) the Housing Association realises it will need to carry out a Standard Method Override adjustment as part of its longer period adjustment

The association can identify those overhead costs that support all of its activities including the improvement works and those that do not support the improvement works. As part of the Standard Method override calculations It thinks about whether the costs need to be dealt with separately. It knows that it should recover 8% of the non attributable VAT incurred on costs supporting improvement works. It also knows that it should recover 2% of the non attributable VAT incurred on its other costs.

Residual Input tax

Overheads used for all activities including improvement works	£ 300,000.00	8%	£ 24,000.00
Overheads not used for improvement works	£ 700,000.00	2%	£ 14,000.00
	£ 1,000,000.00		£ 38,000.00

Difference between an adjusted turnover calculation and a more refined calculation

Adjusted Turnover calculation	£ 80,000.00	More refined calculation	£ 38,000.00
Difference			£ 42,000.00

The housing association concludes that this amount is not material in the context of its business and that the simple calculation (with overhead VAT viewed as a single pot) is fair.

In order to be able to continue using this calculation over the remaining 9 years of the improvement programme a special method would be needed. This percentage may vary in subsequent years if the level of work done or income from the cafeterias, shops, garages, repairs and rentals changes. However, the association is happy that its prices continue to reflect its costs and so an output values based method remains valid. Normal HMRC policy is that recovery rates in special methods should be rounded to 2 decimal places, so rounding to the next whole number will not be available.

Example 3

The method discussed in example 2 has been approved by HMRC. It has been including the cost of work done on the programme of works in substitution for a share of the income received up front.

After two more years the housing association decides to disband its in-house direct labour organisation and put all improvement works and repairs on its housing stock out to contractors.

This means the housing association now has one less taxable activity because it is no longer providing rechargeable repairs to its tenants. However, the association will have considerable additional input tax because it now incurs VAT on costs from sub-contractors for services that were previously done in-house.

Taxable Income			**Exempt Income**		
Costs of improvement works done in year	£	3,300,000.00		£ 39,000,000.00	£ **Residual Input tax**
Cafeteria and shops	£	525,000.00		5,000.00	
Garage Rental to non tenants and	£	10,000.00	Rental from Residential Units		
			Rental from Commercial Property		Overheads used for all activities
Total Taxable Income	£	3,835,000.00		£ 39,005,000.00	including improvement works
					Overheads not used for
Taxable input tax			**Total Exempt Income**		improvement works
			Exempt Input tax		
Improvement works	£	640,000.00		£ 1,800,000.00	
Other taxable supplies	£	30,000.00	Exempt Supplies		
Total taxable Input tax				£ 1,800,000.00	
		£ 70,000.00	Total Exempt Input tax		

The housing association now has to think about the impact on its recovery method of the outsourcing of its repair work.

Taxable Income (A) (Amended cost of improvement works)	£	3,835,000.00	
Total Income (B)	£	42,840,000.00	
Recoverable percentage (C) (A/B*100)		8.95%	£ 400,000.00
Residual Input tax (D)	£	1,350,000.00	£ 950,000.00
Amount of Residual Input tax to be recovered (C x D)	£	120,850.84	£ 1,350,000.00

It looks at the more refined calculation to see whether a single adjusted turnover calculation remains fair and reasonable

The association can identify those overheads which does not relate to improvement works. It decides to look at a two-pot partial exemption calculation. Pot one will deal with the VAT on the overheads which include the costs of the improvement works while pot two will deal with the VAT on the costs of the association's other activities.

Residual Input tax					
Overheads used for all activities	£	400,000.00	8.95%	£	35,800.00
Overheads not used for improvement works	£	950,000.00	1.35%	£	12,854.07
	£	1,350,000.00		£	48,654.07

Difference between an adjusted turnover calculation and a more refined calculation

Adjusted Turnover calculation	£	120,850.84	More refined calculation	£ 48,654.07
Difference				£ 72,196.77

It decides that the difference is material and that including the improvement programme income in relation to all residual input tax is therefore causing a distortion that prevents the partial exemption recovery method from giving a fair result

The association therefore decides to apply for a new special method which has two pots (one for overheads that relate to all activities including improvement works, and one for costs unrelated to its improvement works).

Example 4

The method discussed in example 3 has been approved by HMRC. It has been including the cost of work done on the programme of works in substitution for a share of the income received up front.

Five more years have elapsed and the majority of the cycle of improvement works are now almost completed. The improvement works have been for the most part carried out by contractors although the programme has been managed by the housing association.

The housing association has now decided to reform its in-house direct labour organisation to perform repairs to the housing stock.

In addition, the housing association has been awarded HCA funding for a development programme. It will now be developing 100 properties a year for a mixture of affordable rents, shared ownership and outright sales.

For the purposes of this example we will use the term 'shared ownership". However, it is acknowledged that there are a number of schemes, which may be known by other names, but the relevant principle for this example will be the same. That principle is that there will be a zero-rated grant of a major interest which enables construction costs to be attributed to taxable supplies even though there may be subsequent exempt rental income and/or staircasing payments.

Taxable Income

Costs of improvement works done in year	£	3,400,000.00
Income from the sale of new hous	£	2,400,000.00
Cafeteria and shops	£	525,000.00
Garage Rental to non tenants and second garage income Rechargable repairs to tenants **Total Taxable Income**	£	10,000.00 £ 35,000.00 £ 6,370,000.00

Exempt Income

Rental from Residential Units	£	39,000,000.00
Rental Income from HCA development programme Rental from Commercial Property	£	400,000.00 £ 5,000.00
Total Exempt Income	£	39,405,000.00

Taxable input tax

Improvement works	£	650,000.00
Development Properties	£	410,000.00
Other taxable supplies	£	30,000.00
Total taxable Input tax	£	1,090,000.00

Exempt Input tax

Exempt Supplies	£	1,500,000.00
Total Exempt Input tax	£	1,500,000.00

Residual Input tax

Overheads used for all activities including improvement works	£	300,000.00
Overheads purely used for HCA programme		
Overheads not used for improvement works	£	535,000.00
	£	710,000.00
	£	1,545,000.00

Existing method calculation

Turnover calcualtions

	Taxable	Percentage
All Activities	£ 6,370,000.00	13.92%
All activities excluding inprovement works	£ 2,970,000.00	7.01%

Residual Input tax

Overheads used for all activities	£	300,000.00
Overheads not used for improvement works	£	1,245,000.00
	£	1,545,000.00

	£	41,747.68
	£	87,260.18
	£	129,007.86

Total	
£	45,775,000.00
£	42,375,000.00

The new income stream in the sector dealing with all other activities other than the improvement works has caused the recoverable percentage to increase from 1.35% to 7.01% and an increase in the other sector from 8.95% to 13.92% . The Housing Association has to consider whether the income received from the HCA programme might distort the result of this method.

Having looked at its management accounts the assocation has determined that it can identify the overhead costs, used by both the development programme and the improvement works programme and that the partial exemption method does not reflect the management accounts. The association decides that as the income received from the programme is distorting the result of its partial exemption method and the allocation of input tax does not reflect the management accounts the partial exemption method is no longer fair and reasonable.

The management accounts allocate costs to the department that runs the development programme using a range of suitable cost drivers as part of its normal management accounting process for running its business.

Since it involves no extra work to use the result of this process to allocate VAT bearing costs to a sector in the partial exemption method the association decides to adopt this method of allocation. It applies it to both the HCA management department and the sector for dealing with the costs that support the programme of improvement works because the association also has to consider whether it is still appropriate to have a sector for the improvement works now that the activity has been brought back in-house.

The association is aware that income values do not make a good proxy for a sector that deals with the development properties. See paragraph 73 of the Framework. It has identified that the development consists of 100 houses, all of the same size and value. It decides that the number of units would be an appropriate proxy.

The Management Accts allocates the residual input tax of £1.545m in the following way

Improvement works	£	60,000.00	Recoverable in full as relates to wholly taxable activity	
			Amount of residual input tax to be recovered	£ 60,000.00
Development Properties	£	580,000.00	Residual - to be apportioned by number of properties	
			Number of Units for resale (Taxable)	30
			Number of Units for rent (Exempt)	70
			Total Units	100
			Percentage	30%
			Residual Input tax	£ 580,000.00
			Amount of residual input tax to be recovered	£ 174,000.00

All other activities

£ 905,000.00	Turnover calculation to exclude development properties and improvement works		
	Taxable Income	Total Income	Percentage
	£ 570,000.00	£ 39,975,000.00	1.43%
	Residual Input tax		£ 905,000.00
	Amount of residual input tax to be recovered		£ 12,904.32
	Total Residual Input tax to be recovered under new Proposal		£ 234,000.00
	Total Residual Input tax to be recovered under exisitng method		£ 129,007.86
£ 1,545,000.00	Difference		£ 104,992.14

The association decides that the best way to get to a fair recovery of input tax is to sectorise the income and costs relevant to the HCA development programme. It therefore proposes a new partial exemption special method to make a three sector calculation, one for the improvement programme, one for the HCA development programme and one for the association's other activities

Annex B - Seeking approval for a PE method: taking reasonable steps

B1. 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.

B2. When deciding whether the steps taken are reasonably sufficient, have you**:**

1. **Considered whether you would get a fair result from the standard method?**
   - You will need to consider whether you have a range of activities that could be reasonably dealt with using the standard method
   - You will need to consider whether you are able to cope with the additional administrative burden that preparing a special method calculation would bring
   - You will need to consider whether the provisional use of the previous year's recovery percentage, which is part of the standard method, would ease your administrative burden

2. **Considered more than one method?**

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

3. **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 and uses sensible drivers to allocate VAT bearing costs to sectors

4. **Prepared a worked example of your proposed method?**

    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.

5. **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 the proposed method you 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.

6. **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.

7. **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.

B3. 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 a Housing Association (HA) using a method that produces a higher recovery rate provided that it is an appropriate methodology for that HA. Please note that HMRC does not have a pre-determined range of recovery rates for particular types of housing associations.

- 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 HA 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. However, this would only happen if an HA had made its Declaration knowing that the proposed method could not give a fair and reasonable result. If the result of a method that was thought at the time it was proposed would be fair subsequently proves to be unfair because of circumstances that could not have reasonably been foreseen, HMRC is unlikely to exercise its powers.

Annex C

Use of HouseMark data in PESM calculations

HMRC is content that information provided to HA's by HouseMark in a validated HouseMark Report ("HouseMark data") is sufficiently robust to form part of an HA's PESM calculations if an HA wishes to use the data to calculate the recovery of input tax on costs such as premises, IT, finance and general overheads.

Please note that any HouseMark data used must be taken from a validated HouseMark Report as it stands and no adjustments should be made to it since this would compromise the safeguards that HouseMark validation provides. Also, please note that information from HouseMark Scenarios cannot be used in PESM calculations as this data has not been validated.

There is a possibility that, for a year covered by a PESM using HouseMark data as the basis for recovery, an HA might not have its HouseMark data validated. If, in the unlikely circumstance that by the time its PESM annual adjustment is due an HA has not yet received a validated HouseMark report, the HA should contact HMRC. The HA should let HMRC know the reasons why the data has not been validated.

If the reasons do not have an impact on VAT recovery then HMRC will approve use of the PESM for that longer period.

1. Residual input tax

The use of HouseMark data is primarily designed to provide a mechanism to allocate the relevant proportion of VAT incurred on overhead and similar types of costs, including office and IT costs, to VAT shelter work so that it may be recovered.

It is sensible to exclude from a calculation based on HouseMark data any significant[1] amounts of residual input tax that are incurred on costs which do not support VAT shelter work in any way.

2. HouseMark Input Report 2 – Direct employees

Here is an example of how the HouseMark data may work in practice. The example uses dummy data taken from the validated HouseMark Input Report 2 – Direct employees for an HA with 600 staff whose activities can be allocated to front line activities:

[1] For the purposes of this suggested method overhead residual input tax will be considered as significant where the total overhead residual input tax which does not support VAT shelter work exceeds £250,000.

	All Direct WTEs	
Major Works & Cyclical Maintenance Functions	**WTEs**	**%**
Major Works (Service Provision)	60.00	10.0
Major Works (Management)	30.00	5.0
Cyclical Maintenance (Service Provision)	65.00	10.8
Cyclical Maintenance (Management)	5.00	0.8
Sub-total of Major Works & Cyclical Maintenance Functions	**160.00**	**26.6**

Here, the direct WTE proportion allocated to Major Works represents 15% of the staff of the HA. Please note that the Major Works percentage for each category of residual input tax is derived by adding together the WTEs for Major Works (Service Provision) and Major Works (Maintenance) from HouseMark Input Report 2.

3. Major Works

It is important that HAs are aware that the HouseMark definition of Major Works is not a perfect fit with the definition of VAT shelter works, for which VAT is recoverable. To bring the two definitions together an HA can adopt a simple calculation. In doing so it needs to take into account both the Service Provision and Management elements of Major Works.

An HA could refer to the HouseMark Whole Time Equivalent (WTE) data given on Input Report 2 and the value of VAT shelter works performed in that year. It could then apply a formula, such as:

$$\frac{\text{Major Works WTE}}{\text{Total direct WTE}} \times \frac{\text{Value of VAT shelter works}}{\text{Value of all third party employees and internal Major Works}} = \text{recoverable percentage}$$

Assuming that, for the purposes of this example, the value of VAT shelter works is £1.5M out of a total of £2M value of all third party and internal works.

Therefore the recoverable percentage would be:

$$15.00 \times \frac{1{,}500{,}000}{2{,}000{,}000} = 11.25\%$$

An HA could then apply this recoverable percentage to a single pool of residual input tax to work out how much of the input tax incurred on its overheads can be recovered.

For example, residual input tax is incurred on the following overheads:

Office Premises	£ 40,000
IT	£ 80,000
Finance	£ 50,000
Central Overheads	£150,000
Total residual input tax	**£320,000**

So the HA would recover 11.25% of the residual input tax of £320,000 or £36,000.

Please note that, as staff in overhead functions (as defined by HouseMark) support all front line activities, overhead function staff should be excluded from the calculation to determine the proportion of residual VAT that should be allocated to major works and other front line activities.

4. Other taxable activities

These calculations of course only give expression to the VAT recovery that results from an HA undertaking VAT shelter work. An HA will also need to work out what recovery of overheads should result from the other taxable activities which it undertakes.

Options on how to do this are discussed in this Framework. An HA might find it helpful to read the section of this Framework that discusses the use of sectors, paragraphs 72 to 88, before deciding whether to propose the use of more than one pool of residual tax for the purposes of determining its recovery of input tax against taxable activity other than VAT shelter works.

5. Longer period adjustment

Businesses usually carry out longer period adjustments immediately following the end of each tax year and enter any resulting over or under-deductions in their VAT account for the next prescribed accounting period following the end of the tax year. HMRC can allow businesses to account for the adjustment in a later prescribed accounting period.

Where an HA can show that they will not receive the validated HouseMark report in time to include the adjustment in the first prescribed accounting period after the end of the tax year it should ask HMRC if it can defer the annual adjustment until a later prescribed accounting period (and say which period it would prefer).

Deferring the annual adjustment may mean that the HA will have to apply a provisional recovery rate until such time as the final recovery rate is known from the

annual adjustment calculation. Again, an HA should ask HMRC for permission to do this when it applies for its HouseMark data based PESM.

Here is an example of how this would work in practice;

The HA has had a HouseMark data based PESM approved from 1 April 2010 and used a different PE calculation before then. The HA's tax year ends on 31 March and it has been approved to do its annual adjustment in the tax period ending 30 September.

Tax year ended 31 March 2010

The HA will know its recovery rate for the year from its old PE method*. In this example it is 10%.

(* Alternatively the HA could ask HMRC if the recovery rate from the worked example submitted in support of its PESM proposal can be applied provisionally in the tax year ended 31 March 2011).

Tax Year ended 31 March 2011

Now that the HA is operating a HouseMark data based PESM it cannot be sure at this stage what the recovery percentage will be. It therefore provisionally recovers 10% for all four VAT quarters based on the result of its old PE method.

Tax Year ended 31 March 2012

The HA will not know its recovery rate for the tax year ended 31 March 2011 until the end of the September 2011 quarter when it makes its annual adjustment. So in the June 2011 quarter it continues to apply 10% to make its provisional recovery.

In September 2011 the HA makes its annual adjustment and finalises its VAT recovery position for the tax year ended 31 March 2011. The new rate is 13%.

The HA now has a better idea of what its recovery rate will be and so uses 13% to make its provisional recovery for the September 2011 to March 2012 quarters.

Tax Year ended 31 March 2013

The HA continues to use 13% in the June 2012 quarter.

In September 2012 the HA makes its annual adjustment and finalises its VAT recovery position for the tax year ended 31 March 2012. The new rate is 11%.

The HA applies the finalised rate for the tax year ended 31 March 2012 of 11% to make its provisional recovery in the September 2012 to March 2013 quarters.

Example of how provisional and final recovery rates work in practice

This is how, in this example, the provisional and final recovery rates would look:

Quarter Ended	Provisional Recovery Rate	Recovery Rate after Annual Adjustment
Tax Year 2011		
30 June 2010	10%	13%
30 September 2010	10%	13%
31 December 2010	10%	13%
31 March 2011	10%	13%
Tax Year 2012		
30 June 2011	10%	11%
30 September 2011	13%	11%
31 December 2011	13%	11%
31 March 2012	13%	11%
Tax Year 2013		
30 June 2012	13%	To be determined in September 2013
30 September 2012	11%	To be determined in September 2013
31 December 2012	11%	To be determined in September 2013
31 March 2013	11%	To be determined in September 2013

How to deal with errors in provisional recovery rates

Please note that there is no need to revisit the June period each year after the annual adjustment has been done and substitute the recovery rate from the annual adjustment for that used to make the provisional recovery in that period. The approved PESM expects the previous year's provisional rate to be used in the June quarter and so this is not an error.

However, HA's need to be aware that any error made on prior periods may affect the VAT recovery position for the relevant tax year. When that happens, any consequent changes to a recovery rate that is being used for provisional recovery will have to be reflected. This may mean that a provisional recovery rate has to be adjusted.

In the earlier example, an HA is using its recovery rate of 10% from 2010 to make provisional recovery in the June 2011 quarter. In May 2011 the HA finds an error in

its calculations under its old PE method for the tax year ended 31 March 2010 and this means that the provisional recovery rate for 2011 drops to 8%.

The new rate of 8% should now be applied to all periods where provisional recovery was based on the 2010 recovery rate. This will mean that the HA will have slightly over-recovered input tax each quarter on its provisional recovery. The HA will therefore have to revisit its provisional recovery for the VAT returns that the 8% recovery rate applies to.

How to deal with late claims to input tax if a provisional recovery rate has been used

In our earlier example in November 2013 the HA has now found an invoice with £10,000 residual input tax that has not yet been processed. The invoice should have been processed in the June 2012 quarter.

This input tax will be subject to two different recovery rates. Since it should have been processed in the June 2012 quarter the provisional recovery rate for that period should be applied. This is 13%, and so £1,300 should be recovered in the June 2012 quarter.

When, in the September 2013 quarter, the annual adjustment was made for the tax year ended 31 March 2013, the recovery year for the tax year was found to be 11%.

So in the September 2013 quarter the HA would have to repay 13% less 11%, or 2%, which is £200, back to HMRC.