Framework for Higher Education Partial Exemption Special Methods

August 2020

Compiled by:

- The British Universities Finance Directors Group
- HM Revenue & Customs
- KPMG

Contents

Abbreviations

BNB	Business/Non-Business
BUFDG	British Universities Finance Directors Group
CGS	Capital Goods Scheme
HEFCE	Higher Education Funding Council for England
HEI	Higher Education Institution
HMRC	HM Revenue & Customs
OfS	Office for Students
PE	Partial Exemption
PESM	Partial Exemption Special Method
TRAC	Transparent Approach to Costing

1. Introduction

1. HMRC has developed Frameworks for specific sectors in relation to business/non-business and partial exemption. These Frameworks are not mandatory or binding and do not replace the contents of public notices 706 (Partial Exemption) and 706/2 (Capital Goods Scheme) nor the published HMRC VAT Business / Non-Business and Partial Exemption guidance manuals; but adopting the principles set out in the Framework will enable HMRC to more readily give approval for the use of a either a Partial Exemption Special Method or a Combined Method.

2. Frameworks are not intended to be a complete VAT guide for specific sectors and will not cover generic business/non-business (BNB) or partial exemption (PE) principles but instead they provide additional guidance on issues for sectors to consider when they are reviewing their business/non-business apportionment and partial exemption methodology. The Frameworks should therefore be read in conjunction with the guidance contained in the HMRC VAT manuals which you will be signposted to from within the individual Frameworks.

3. This Framework provides guidance on formulating Partial Exemption (PE) special methods for Higher Education Institutions (HEIs), in particular:
   - How to determine a fair 'value' for supplies of grant-supported education;
   - When to add 'sectors' to a PE method; and
   - How to identify and deal with 'distorting supplies'.

   It is aimed at HEI staff with responsibility for partial exemption, advisers to HEIs and HMRC staff.

4. It is not intended as a guide to how to calculate PE adjustments themselves, but as a framework to assist in formulating and agreeing a PE Special Method (PESM). PE33000

5. This Framework is not mandatory and does not replace the content of any published HMRC guidance. Adopting its principles will enable HMRC to more readily give consideration to a PE special method proposal for which a Statutory Declaration has been made. PE 43000

6. The Framework was originally prepared in conjunction with the British Universities Finance Directors' Group (BUFDG), the representative body for the tax affairs of universities, and the university funding councils via the (then) Higher Education Funding Council for England (HEFCE). It took full account of the findings of the KPMG Review of Partial Exemption in the Higher Education Sector (KPMG Review) that was commissioned by BUFDG, HEFCE and HMRC and which was published in June 2007.

7. This version, June 2020, was prepared by BUFDG, KPMG and HMRC.

8. This Framework is intended to improve fairness and consistency and reduce administrative burden by:
   - Giving HEIs and their advisers clear guidelines on what constitutes a fair and reasonable, but simple to operate, PE method; and,
   - Enabling HMRC to give speedy approval with the minimum of additional enquiry.

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

10. This Framework will be reviewed regularly every two years. Readers wishing to suggest improvements and new topics should write to BUFDG by contacting info@bufdg.ac.uk or HMRC by contacting hfesector.wmbc@hmrc.gov.uk.

1.2 Overview

This Framework is based on the following principles:

- Grant-supported education:
  a) Failure to adjust for the receipt of grants prevents a fair PE method for any HEI.
  b) Inclusion of teaching support grants can be a fair adjustment for teaching- orientated HEIs.
  c) Teaching support grants means the grants received which are provided for the purpose of supporting the supply of teaching including, but not limited to, grants provided by the UK HE funding bodies, the European Social Fund and the Training and Development Agency for Schools. If the purpose of a grant is unclear, it shall be included as teaching support grant unless it is specifically identified as being provided for non-education purposes. Examples of grant received for non-education purposes include research (R) grant, capital grants and grants such as HEIF that are provided for third mission activities.
  d) TRAC is a good alternative especially for research-intensive HEIs.
- Sectors:
  e) Sectors may improve accuracy but increase complexity.
  f) Sectors tend to benefit HEIs because they are in a low recovery environment.
  g) But, sectors must be even-handed and not 'cherry picked' (i.e. sectors should not only be applied for where it is financially beneficial, ignoring other instances).
- Distorting supplies:
  h) Some supplies made or received by HEIs have scope to distort PE results.
  i) But, distorting supplies can be taxable or exempt and still consume some costs.
  j) There are no hard and fast rules on what is distorting but there are good indicators.
- Agreeing methods:
  k) HEIs are free to apply for a PE method to meet their own circumstances, not just those within this framework document.
  l) And, HMRC will approve any fair method irrespective of its recovery rate.
  m) But, HEIs should help HMRC validate methods by disclosing options considered.
  n) All new partial exemption method proposals, regardless of whether they are based on one of the Framework options or not, must be accompanied by a PE Declaration.

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

- Allowing the TRAC cost of teaching (including the costs of teaching overseas students) to be substituted for the value of fees plus teaching support grant in an otherwise values-based method on the understanding that HEIs make supplies of teaching on a 'break-even' basis without an intention to report overall profit or losses;

- Allowing the netting-off of bursaries paid under an Access Agreement with the Office for Student (OfS), previously the Office of Fair Access (OFFA);
- Allowing TRAC to be used for PE on condition that its use meets funding body rules and that its controls are subject to routine assurance by the HEI;
- Allowing limited use of figures from an HEI's annual accounts as estimates of the value of supplies made, predominantly in the denominator of an output values-based calculation;
- Provisional in-year recovery using the prior year's rate, corrected annually;
- Delay of the longer period adjustment to the January accounting period; and
- Delay of the Capital Goods Scheme calculations to the April accounting period.

1.3 VAT and HEIs

HEIs are complex, dynamic organisations affected by a wide range of VAT matters. They have charitable status and often have trading subsidiaries; they receive grants, donations and subsidies; some have large investment and property portfolios; and most deal regularly with domestic, European and overseas customers. Some HEIs are the size of FTSE companies with annual income of £hundreds of millions. HEIs make both VAT taxable and exempt supplies (such as conferencing and education respectively) and undertake non-business activities (such as publicly- funded research). Despite their complexity, most HEIs can safely adopt relatively simple PE methods, provided the methods are sensibly designed, discussed openly with HMRC, and periodically reviewed and updated as needed. This is the approach to PE anticipated by this Framework.

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

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

From 1 January 2011 HMRC can approve a method covering B/NB calculations. All HEIs must also, of course, carry out partial exemption calculations. All HEIs have the option to ask HMRC to approve one single agreement covering both B/NB and partial exemption calculations. This is known as the combined method.PE34500

Although any current B/NB agreements remain valid, HMRC will no longer approve separate B/NB and partial exemption methods. Where approval for a B/NB calculation is sought it must also cover partial exemption calculations. This is to save the cost of seeking approval of two separate methods and also provides certainty to both sides and helps to make sure a fair recovery of VAT overall as the calculations can be considered in their entirety. However, HEIs are still able to carry

on using their own B/NB methodology (without prior approval) and seek approval for a PESM.

HMRC advises HEIs to seek approval for a combined method when they next routinely update their existing B/NB agreement. However, HEIs should note that it is not compulsory to have a combined method and they may wish to retain the flexibility of a separate unapproved B/NB method. In this case, the HEI can apply section 24(5) of the VAT Act, but without any certainty that HMRC will accept the result of the calculation, in particular where tensions arise between the reasoning for and the outcomes of a B/NB apportionment and that forming part of the approved PESM. HEIs may want to apply separate B/NB and PE recovery rates in some circumstances (e.g. a building used solely for NB and taxable use) even if agreeing a combined method, and in these cases a two-step method can be helpful.

Further details on what is meant by 'used or to be used' (often called the principle of use are provided in section 4.7.1.

1.4 TRAC System for Costing

TRAC is an activity-based costing system used by HEIs to allocate their total costs between teaching, research and other activities. These three categories are broken down into sub-categories as follows:

- **Publicly Funded Teaching (PFT):** This includes tuition of domestic and EU students.
- **Non-Publicly Funded Teaching (NPFT):** This includes tuition of overseas students and closed courses.
- **Research by sponsor type:** This consists of eight categories. Originally TRAC identified research under the headings of publicly funded research and non-publicly funded research. These terms are widely understood in the sector and are used in the wording of many current methods. In order to avoid additional complexity, it is likely that most universities will preserve these categories in their PE calculations and amalgamate costs using the definition below:
    - **Publicly Funded Research (PFR):** is defined as including own-funded research as well as that funded by Research Councils or funded by the EU.
    - **Non-Publicly Funded Research (NPFR):** is defined as including research undertaken on behalf of UK industry, commerce and public organisations, UK based charities, the EU, and other overseas organisations.
- **Other:** This includes, by way of example, accommodation, catering, conferences and business consultancy.

Higher education providers in England that were previously funded by HEFCE, and higher education institutions funded by the Scottish Funding Council, Higher Education Funding Council for Wales and Department for the Economy (Northern Ireland), are required to submit an annual TRAC return by 31 January each year.

Annual TRAC returns are prepared in accordance with the TRAC requirements as set out in the TRAC guidance in order to ensure consistency across providers.

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

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

1.5 PE Methods and the Capital Goods Scheme (CGS)

HEIs should be aware of the impact of a new PE method on existing CGS items. Specifically, CGS adjustments for intervals falling after the approval of a new method will be made in accordance with how that new method ascertains use.

2. Special PE Methods for HEIs

The options likely to be suitable for most HEIs are:

- **Method 1: Teaching Support Grant plus Tuition Fees less Bursaries ("T-Grant Method")**. This option uses the teaching support grant plus the net amount of Tuition Fees as a value for grant-supported education.

- **Method 2: Modified Teaching Support Grant plus Tuition Fees less Bursaries ("Modified T-Grant Method")**. This option adjusts the above value to remove certain amounts of teaching support grant clearly anticipated as not for education purposes.

- **Method 3: TRAC Cost of Teaching**. This option relies on TRAC to determine the full cost of education (PFT and NPFT) which is then substituted for outputs in an otherwise outputs-based PE method.

- **Method 4: Full TRAC**. This option relies on TRAC to determine the full cost of all HEI activities and supplies to enable an essentially cost-based PE method.

- **Method 5: TRAC Variant.**

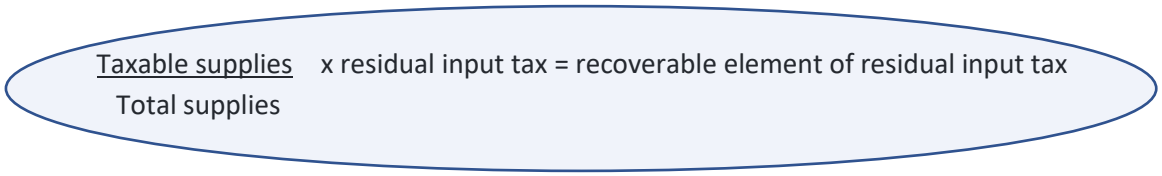
HMRC fully supports these options as likely to be suitable for most HEIs. HMRC also agrees that the options should give very similar PE results and thus any large variances between them should be carefully examined before a method is declared as fair. Illustrative examples of the lead options are provided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

2.1 Summary of features of the Framework methods

Method	Number of steps	Complexity	This method uses			The Framework says method likely to be suitable for
			Annual Accounts	TRAC	Other	
T-Grant	6	Easy	✔	✘	✔ (details of bursaries)	Teaching orientated institutions
Modified T Grant	7	Moderate	✔	✘	✔ (details of special grant funding & bursaries)	Teaching orientated institutions receiving material amounts of special grant funding
TRAC cost of teaching	7	Moderate	✔	✔	✘	Research orientated institutions which routinely spend less on education than the sum of Fees and grants
Full TRAC	28	Complex	✔	✔	✔ (needs analysis of taxable and other income by TRAC category)	Research orientated institutions which use funds from one activity to cross subsidise others
TRAC variant (2 pot TRAC)	13	Complex	✔	✔	✔ (needs analysis of taxable and other income by TRAC category)	As above

2.2 Income-Based Methods

An income-based method is based on the following calculation:



If you have a single-step combined B/NB and P/E method, non-business income will be added to total supplies.
The purpose of a B/NB method is to determine what proportion of VAT incurred on costs can be included in the partial exemption calculation. The purpose of a PE method is then to determine a sum of deductible residual input tax from that.

Output values / income-based methods are generally reliable because they:

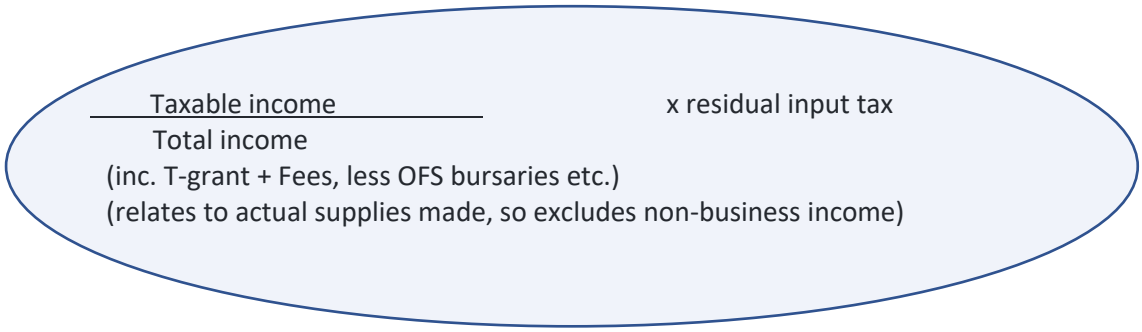
- Respond to changing circumstances (receipts vary with levels of activity);
- Rely on readily available records (such as income and sales); and
- Figures are objectively determined, tightly controlled and easily verified.

Under partial exemption legislation output supply values form the basis of partial exemption methods and are always used unless it can be shown that they produce inappropriate results. Discussions were undertaken in 2007 between HMRC, the HE sector and advisers, resulting in an agreed report that showed that supply value was often an inappropriate basis for partial exemption for universities. At this point, TRAC was discussed and agreed to be an appropriate alternative that could be used in some cases.

2.2.1 Method 1: Teaching support grant plus Fees less bursaries ('T-Grant method')

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

- *Predominantly teach as opposed to undertake research so that education is the main driver for their expenditure; and*
- *Typically spend the full amount of the teaching support grant on delivering education; OR*
- *ANY university looking for a simple method, and happy to sacrifice a greater degree of accuracy for this.*



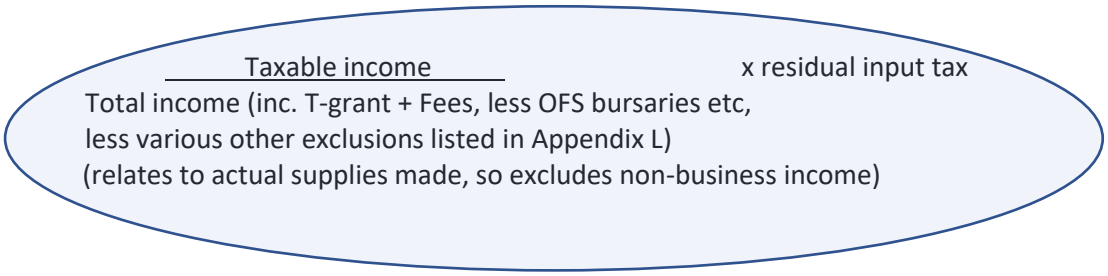
Teaching support grant plus fees less bursaries is arguably the simplest option. This option is acceptable to HMRC because the teaching support grant is independently determined by the funding councils in accordance with published rules so that HEIs deliver state supported education in a resource-constrained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

This option assumes the total money received for exempt education (which is the proxy value for PE purposes) equals the teaching support grant from the Funding Councils, plus fees charged to students, less amounts of fee income returned to students as a statutory bursary under the HEI's Access Agreement with the Office for Students (OfS). Other bursaries cannot be netted-off because they are not paid on a statutory basis.

2.2.2 Method 2: Modified teaching support grant plus Fees less bursaries (Modified T-Grant)

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

- *Wish to operate a teaching support grant-based method but receive amounts of 'special funding', the inclusion of which they feel would materially affect their VAT recovery; and*
- *Are 'teaching' universities looking for a greater degree of accuracy.*



Modified teaching support grant plus Tuition Fees less Bursaries is a refinement to the first option. This option is acceptable to HMRC because all amounts are independently determined and easily verified.

This option is the same as 2.2.1 above except there are some exclusions for elements of the grant which are considered not to support the cost of teaching. The exclusions are expected to be relatively minor and the impact on overall recovery rates minimal, so you may decide that, given the work involved in making the adjustments, this option is not worthwhile.

Examples of typical exclusions are listed in Appendix L.

2.3 Sectors

Sectorisation for PE means dividing the PE calculation into a number of sub-calculations, the results from which are added together to provide an amount of recoverable input tax.

The TRAC sectorised methods below are examples of using sectors. However, sectors can also be used in other ways. PE 22000

The income-based methods shown earlier are not sectorised. In those examples, the overall recovery rate of an HEI should reflect the mix of all its activities. Using a single calculation will give a broad-brush result that for many HEIs will reflect its mix of supplies and how its costs are used in making them. However, where an HEI has a particular activity that uses costs very differently from the rest of the organisation, then the PE method may no longer give a fair and reasonable result. In this situation the use of a sectorised method may be appropriate.

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

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

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

The HEI should consider the use of costs in the various parts of its business. Different supplies that use common costs in a broadly similar fashion can be considered for inclusion within the same sector. Where the HEI has activities that use costs very differently from the rest of the organisation, including these activities in a single calculation could lead to an overall result that is no longer fair or reasonable. In those circumstances, the supply and its associated costs should be put into a separate sector.

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

Common-sense dictates that, given the additional work involved, sectors should only be created when the impact on VAT recovery is material. Generally, there is no point to creating a sector unless the resulting amount of recoverable VAT is materially different from that available under the main PE method. Also note that the impact on the 'main' university recovery percentage (of stripping out certain activities into a sector) must also be considered, not just the rate in any potential new sector.

One area where input tax use can be significantly different to the overall recovery rate is in capital projects where costs are incurred in an earlier tax year than when activity is due to come on line. It is therefore quite common for HEIs to create capital sectors for projects over a particular cost value.

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

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

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

A reasonable indicator of the need to consider a sector is if the supply/supplies in question make at least a 1% difference to the actual recovery rate achieved by the main, non-sectorised PE method, or 10% difference to the prevailing rate.

For example, if a method gives a recoverable rate of 15%, a 10% difference will be 1.5% either side. Any supply that moves the result of the PE method outside the range of between 13.5% and 16.5% should be considered for possible sectorisation. However, if a method gives a recoverable rate of 5%, a 10% difference will be 0.5%. In that scenario the higher fixed tolerance of 1% applies and any activity that moves the result of the PE method outside the range of between 4% and 6% should be considered for sectorisation.

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

When considering your current PESM you should also consider whether any sectors within it are still appropriate – considering the tests above can help you determine whether the sectors are still necessary.

However, these are only indicators, as there may be times where there is a small, non-core activity e.g. a farm or a conference centre, where it may be appropriate to have a separate recovery rate.

When one of the indicative levels is exceeded, an institution should consider whether the impact on the PE method is material or not. A further £25k recovery resulting from a 2% change in recovery rate might be material to some HEIs but not to others when weighed against the costs involved in creating a separate sector for the activity (and any others that have a similar impact on input tax recovery).

Any sectors need to be agreed as part of the PESM with HMRC. The process of agreement (which could take time), possible advisory costs, and the potential wider impact should HMRC not agree with the approach, should be factored in when deciding whether to pursue a particular sectorisation.

See Annex H for examples of sectors used by various universities in their PESMs.

2.4 TRAC-based Methods

If a PE method is to work fairly it must compare 'like-with-like'; a method in which some supplies were reported at income value whilst others were at cost could be unfair.

The challenge for HEIs is to determine a fair, arms-length equivalent value for supplies of grant-supported education so as to compare like-with-like with the values of other supplies included in their values-based method. Exceptionally, for reasons set out below, HMRC will allow universities to use a hybrid method where the cost of teaching is used to represent the value of education in an otherwise output values-based calculation. TRAC may also be used for methods which allocate input tax based on the proportions of the various cost headings in TRAC.

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

Some HEIs that use TRAC based partial exemption methods use B/NB apportionment calculations that are not TRAC based. HMRC will review those agreements and if the calculations do not give equal weight to the same activities, HMRC will discuss alternatives with the HEI, operative from an agreed and notified future date.

2.4.1 TRAC Cost of Teaching

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

- *Focus more on research and routinely spend less on grant-supported education than the sum of their T-grant and student fee income.*

Methods using TRAC are acceptable to HMRC because TRAC provides a robust and reliable system for evidencing 'use of costs' in making supplies.

The TRAC (cost of teaching) option uses TRAC to provide a full cost of education (including non-VAT bearing costs such as salaries and employer payroll taxes, and amounts of irrecoverable VAT), which is used as a substitute for teaching income in the otherwise output values-based PE method.

HEIs adopting this option should exclude certain values, listed in Appendix L.

Care should be taken to use TRAC figures for the relevant VAT registration/VAT group only.

2.4.2 Sectorised TRAC (TRAC Variant)

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

- Major on research activities and use income generated by one activity to subsidise another.

Alternate methods relying on TRAC carve up the residual input tax incurred by the business into different activities or 'sectors', typically being teaching, research and other. It is possible to have other sectors too and for these sectors to be part of any of the methods described in this Framework. This is discussed in more in section 2.3).

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

TRAC VARIANT 1

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

Any split of the TRAC categories into more precise 'pots' should be addressed within the PESM proposal. When considering splitting the TRAC categories the following should be taken into account:

- Cherry picking, (Section 2.3 refers) and;
- Complexity vs. accuracy (i.e. is the additional accuracy worth the additional complexity and work/time?)

TRAC VARIANT 2

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

HEIs adopting this option should exclude certain costs, as listed in Annex L.

Care should be taken to use TRAC figures for the relevant VAT registration/VAT group only.

Under TRAC Variants VAT is allocated between the TRAC categories in accordance with costs. HEIs should normally adjust for non-VAT bearing salary costs, unless these are either not easily identifiable, or relatively small and would therefore have a minimal impact on the allocation (e.g. salary costs in central support functions).

Residual VAT should be allocated to education in the same proportion as the total costs (after adjustment) are allocated to the TRAC cost of teaching. In most cases this input tax will be wholly irrecoverable. The remaining residual VAT should be allocated across the other TRAC categories. This can be addressed by amalgamating all the other residual VAT proper to the remaining TRAC categories into one 'pot' or can be done by allocating the remaining residual VAT proportionately to all the other TRAC headings.

3. Distorting Supplies

Values-based methods work on the premise that each £ value of output supply uses the same amount of VAT-bearing residual cost. In reality most output supplies will use proportionately more or less VAT-bearing residual cost than the average, but provided the ups and downs are small, the variances will cancel out and the PE method will still be fair. PE41500

Occasionally, a supply will use costs significantly differently than its supply value would suggest. The costs used may be far greater than the supply value infers where it is subsidised or far less where high value supplies use proportionately low values of taxed costs.

The general characteristics of a distorting supply are:

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

Whether or not a supply is distortive is to be determined by reference to the facts in each case, which requires the exercise of sensible judgement. It is not just a numerical test.

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

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

Once a distorting supply has been identified, the HEI must consider how it should be treated in the PE method. The income generated by the distorting supply should either be:

- excluded, or
- its impact limited through the creation of a separate sector.

All supplies will make some use of overhead costs, even if it is very little, so total exclusion may not, therefore, be fair and reasonable. However, where a distorting supply makes very minimal use of these costs, excluding the income will lead to a fair and reasonable recovery of residual input tax.

Alternatively, if the use of the overhead costs in making the distorting supply is significant, but different to other supplies, sectorisation may be appropriate.

Whether or not creating a separate sector will properly address the distortion will depend heavily on how accurately the HEI allocates the costs of the distorting supply. Annex G explores this point in greater detail.

It may be that no single supply causes the distorting effect – it could be the result of the cumulative impact of a number of smaller supplies. What is important is that the method overall gives a fair and reasonable result. If the cumulative impact exceeds the criteria set out within section 2.3, an HEI should consider whether it needs to sectorise the supplies that cumulatively lead to the distorting effect.

Examples of potentially distorting supplies within the HE sector are:

- Income from Property;
- Largely non-VAT bearing management services or salary recharges supplied to a separately VAT registered subsidiary company;
- Loans;
- Sale of capital assets, the supply value of which are always excluded from PE methods by law.

This list is not exhaustive.

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

Once a method is approved the only way in which distorting supplies arising and / or identified afterward can be addressed (if not otherwise already addressed in the method) is to seek approval for a new method.

4. The Mechanics of seeking approval for a method and its subsequent operation

4.1 The process of seeking approval

HEIs must obtain written approval before adopting a PE special method, even if the method mirrors an option in this Framework. HMRC cannot approve a PE method unless the HEI first declares that the proposed method is to the best of its knowledge and belief fair and reasonable.

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

When submitting a proposal for a PESM to HMRC you should refer to Public Notice 706, for examples of the information that it is helpful for HMRC to have in order to process the PESM application quickly. This includes:

- a brief explanation of why your current method is no longer suitable or the proposed new method is better;
- details of all the business supplies which you make or intend to make including any 'foreign' supplies and 'specified' supplies (see section 9 of Notice 706) and their approximate value;
- the VAT liabilities of your main supplies and their place of supply;
- details of the main costs you incur which bear VAT and the activities to which those costs relate;
- details of other methods you considered but rejected, and why these were rejected;
- reference to this Framework, if relevant;
- a worked example of your proposed method using actual figures. HMRC consider this is very important as without a worked example they cannot judge if the proposed method is fair and reasonable. You should only use projected figures where it is not possible to use actual figures, for example if you are starting a new business activity, and where possible should use projections prepared for other business purposes e.g. to obtain funding for the activity from a bank;
- an explanation of how the method would deal with changes in your activities that might arise in the future;
- a copy of your most recent annual accounts;
- your Declaration that the method you propose is fair and reasonable;
- details of your non-business activities and any other sources of income with approximate values (especially important if you are applying for a combined N/NB and PE method);
- details of any income which you consider to be incidental or which would distort your partial exemption calculations.

Make sure you also provide the following administrative details to HMRC to avoid delays in the consideration of a new method:

- who is the point of contact for your application?
- if you are using an agent/advisor to oversee negotiations, have you enclosed form 64-8 (if not already submitted)?
- when do you want the method to start (for example, the start of the current tax year, the next VAT accounting period)?
- do you have any plans or proposals to change your business activities within the foreseeable future?
- define clearly any words in your proposal which are not standard or legal terms, or which are specific to your HEI or to the HE sector;
- any other information you feel is relevant to your HEI or proposed method which will help HMRC approve the method.

HMRC must approve a new method in writing and until such point as you receive a letter from HMRC formally setting out the approved method, you must continue to use any extant partial exemption method.

4.2 Annual Accounts

There are a number of practical reasons why HMRC considers the use of figures derived from annual accounts to be an acceptable basis on which to calculate total income (and, potentially, elements of zero-rated taxable income):

- HEIs have low PE recovery rates. This means that taxable income is a low proportion of the total business income. Using values of positive-rated supplies based upon the relevant time of supply in the numerator of an apportionment fraction and annual accounts income figures in the denominator will mean any potential variance in PE rate should be minimal;
- HEIs have diverse business activities and also diverse accounting systems resulting in undue administrative burden if HMRC were to reject a proposed method solely because it made use of aggregate data derived from annual accounts;
- Exempt business income may be paid in various ways rather than through an invoicing system;
- Published annual accounts are subject to careful preparation in accordance with international accounting standards with associated internal audit procedures and are also subject to audit by external professional auditors.

When an HEI proposes to derive any figures in its PESM from annual accounts, this should be clear in the proposal made to HMRC.

4.3 Timing

Many HEIs agree with HMRC, in the written PESM approval, that the annual adjustment for partial exemption can be carried out in the second period after the tax year-end. Most HEIs have a tax year end aligned with the financial year end of 31 July. This would mean making annual adjustment on the January VAT return, rather than on the October VAT return. This is for a number of reasons, including preparation of some figures used such as the annual accounts or TRAC. This must be included within the written PESM approval letter.

4.4 Translation of a written method to systems

It is important to understand what your written PESM means in relation to your financial and other systems and where you obtain the figures required in the PESM from. You may find it helpful to 'translate' the written PESM into procedure notes stating exactly which pieces of data from which systems are used at which part of the calculation, or even a flowchart or diagram showing this. It could also be helpful to share this 'translation' with HMRC to ensure that there is no misunderstanding by either party regarding what the PESM means in practice – this can help avoid nasty shocks in later years if HMRC check the implementation of the PESM as part of a VAT audit.

4.5 Input tax for the first quarter of the partial exemption year

If the PESM states that the annual adjustment is undertaken on the January VAT return, then the input tax recovery for the October period will be based on the provisional recovery rate for the prior year, as the prior year's final recovery rate (and therefore the current year's provisional recovery rate) will not be known until the January VAT return is completed.

You will therefore need to agree whether the VAT recovery for the October period is adjusted to the current year's provisional rate when preparing the January VAT return, and then adjusted again when the current year annual adjustment is undertaken the following January, or whether to simply adjust it once when the current year's annual adjustment takes place.

See the table below as an example:

	Rate	October 2017	January 2018	January 2019
2016/17 provisional rate	12.25%	Use 12.25% (only rate available)		
2016/17 final rate & 2017/18 provisional rate	12.89%		***12.89% - do you adjust the Oct 2017 recovery to 12.89% here? (and then again when final 2017/18 rate is known in Jan 2019).***	
2017/18 final rate	12.76%			12.76% - you MUST adjust the Oct 2017 recovery to 12.76% here

4.6 Ongoing operation of a PESM

Once the new PESM has been approved and is up and running you should ensure that you:

- Make use of any written procedures/flowcharts etc. that have been created;
- There should be an internal review of all PESM calculations by someone other than the person who undertook the calculations;
- Update any internal templates or procedures/flowcharts if any of the information sources change (e.g. new systems, or even changes to relevant account codes etc.);
- Review the results of the annual adjustment for any unexpected/unexplained fluctuations in the recovery rate or amount of residual input tax;
- Implement a process for regular review of the PESM to ensure that it continues to produce a fair and reasonable outcome;
- Review the appropriateness of the PESM when any major business changes are proposed.

4.7 Other Matters

4.7.1 Changes to Methods

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

Typical examples of such change could be:

- The existence of distorting costs or supplies not adequately catered for by the current method;
- New activities or cessation of existing activities;

- Gaps have arisen involving tax incurred, the recovery of which is not adequately covered in the method;
- Fundamental structural changes such as acquisitions, mergers, disposals and/or VAT Group composition changes.

If the mechanism for attributing tax incurred against an activity cannot be agreed immediately it may be possible to sectorise that activity in a new PE method and apply the principle of use to it.

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

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

Subsequent discussion between HMRC and an HEI can take place to agree how use should be measured, and this measurement can then be applied from the date on which the new PE method starts. PE41000

4.7.2 Retrospection of new PE methods

Established HMRC policy is to offer retrospection for newly approved PE methods to the start of the current tax year. In exceptional circumstances retrospection can extend further although adjustments to input tax deductions are limited by the cap (4 years). PE46500

4.7.3 Resolving disputes about PE

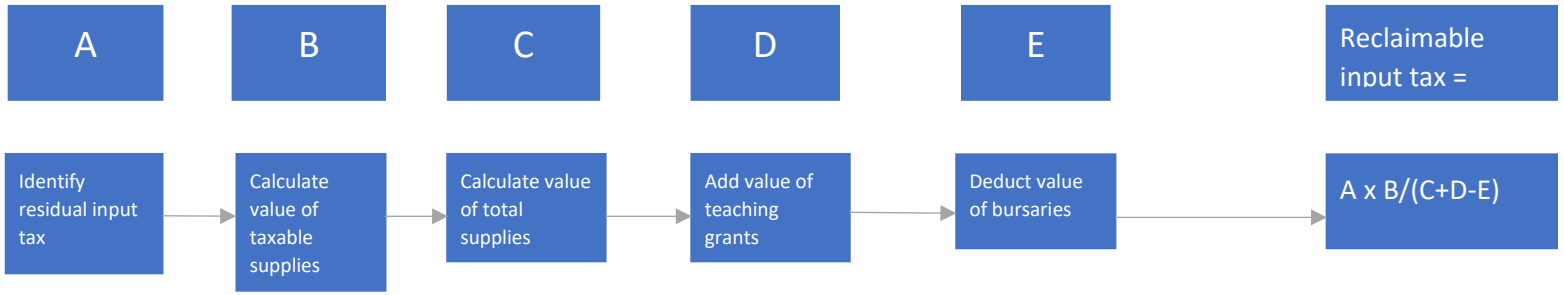
This Framework is intended to lessen the risk of PE disputes with HEIs. The normal procedures for resolving disputes involve an independent statutory review, Alternative Dispute Resolution, or appeal to the First-tier Tax Tribunal. Furthermore, as part of the development of this Framework, HMRC's Public Bodies Group meets regularly with BUFDG to monitor progress in implementing fair methods for all HEIs and to agree improvements to this Framework. These meetings never discuss individual cases.

Annex A - Summary of Features of Framework Methods

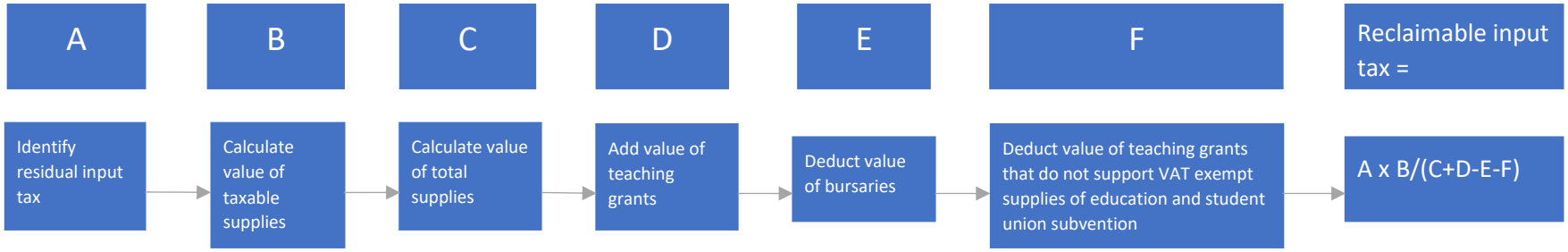
Method	Number of steps	Complexity	This method uses			The Framework says method likely to be suitable for
			Annual Accounts	TRAC	Other	
T-Grant	6	Easy	✔	✘	✔ (details of bursaries)	Teaching orientated institutions
Modified T Grant	7	Moderate	✔	✘	✔ (details of special grant funding & bursaries)	Teaching orientated institutions receiving material amounts of special grant funding
TRAC cost of teaching	7	Moderate	✔	✔	✘	Research orientated institutions which routinely spend less on education than the sum of Fees and grants
TRAC Variant 1 (Full TRAC)	28	Complex	✔	✔	✔ (needs analysis of taxable and other income by TRAC category)	Research orientated institutions which use funds from one activity to cross subsidise others
TRAC variant (2 pot TRAC)	13	Complex	✔	✔	✔ (needs analysis of taxable and other income by TRAC category)	As above

Annex B – Summary of Steps for Different Methods

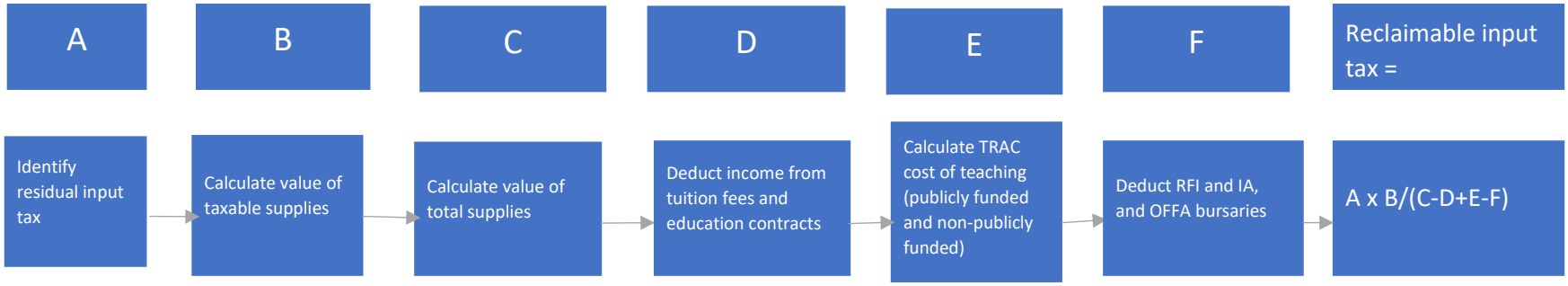
T-Grant



Modified T-Grant

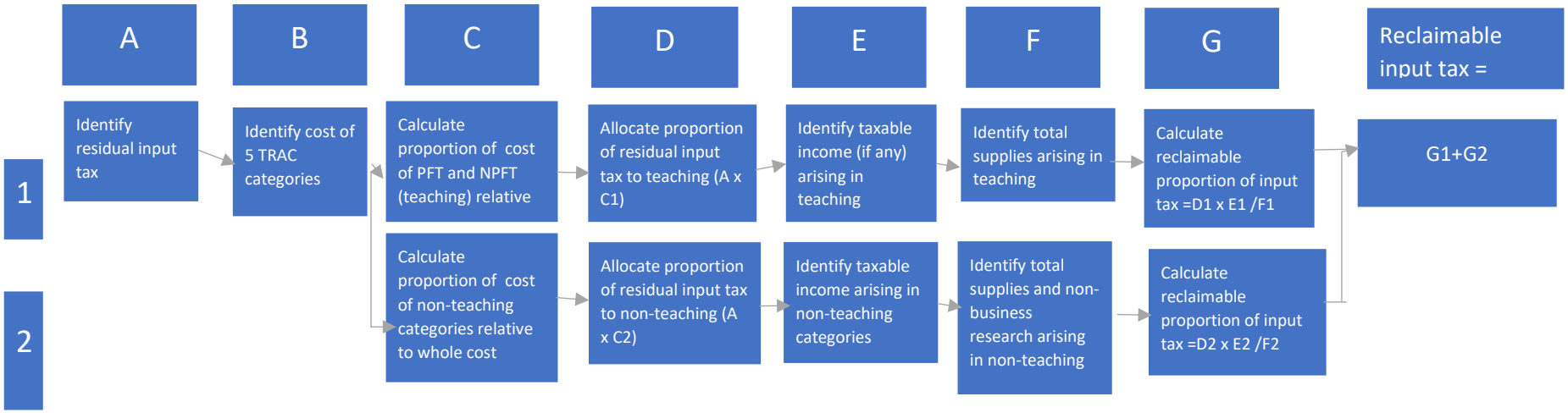


TRAC cost of teaching



TRAC Variant 1 ('Full TRAC')

TRAC Variant 2 (‘2 Pot TRAC’)



Note that for TRAC costs you may agree to use either the full cost or only the VAT bearing costs (e.g. deducting costs such as pay which are not subject to VAT).

Annex C - Examples of Teaching support grant and TRAC methods

I. Example of a method using 'Teaching support grant plus Tuition Fees less Bursaries'

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

Income	***Income / £millions***	
Taxable consultancy	0.8	
Taxable commercial income	9.2	
Total taxable income		10.0
Tuition Fees	15.0	
Exempt income (student residences etc.)	55.0	
Total exempt income		70.0
Total business income		80.0
Teaching support grant	45.0	
Non-business income (research)	16.0	
Total Income		**141.0**

Expenditure	***£k***	***Expenditure / £millions***	
Residual VAT		1.1	
Residual input tax; academic departments	146		
Residual input tax; commercial activities	243		
Residual input tax; general overheads	584		
Total residual input tax		0.973	
OfS bursaries			2.5
TRAC cost of teaching (assume net of adjustments)			56.0

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

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

*Plus Teaching support grant less OfS bursaries

** Less OfS bursaries

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

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

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

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

- Residual input tax; academic departments relates to taxable consultancy and exempt education;
- Residual input tax; commercial activities relates to taxable supplies such as conferencing and holiday lets, and exempt supplies such as student accommodation etc.;
- Residual input tax; general overheads relates to general fabric of buildings and administration;
- PE recoverable percentages are calculated to two decimal places.

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

- Less than 1% of the supplies of the academic departments are taxable (such as short courses) and yet 8.16% of the academic departments' input tax is recovered;
- However, an estimated 15% of commercial activities are taxable and yet only 8.16% of the residual input tax is recovered;
- The general overheads will be used to support all the activities of the institution, in this case 8.16%.

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

- The aim of a sectorised method is greater accuracy – to achieve this, the university must clearly identify which activities are supported by which costs and allocate these to sectors in a way that makes consistent use of its accounting information and systems;
- A sectorised approach that fails to assign costs to sectors in a sensible way can lead to a result that is neither fair nor reasonable;
- The added burden of identifying the costs to be allocated to sectors - especially if the university's cost centres do not analyse expenditure at this level; and
- Whether the difference in overall recovery warrants the extra work. Note that, as with the addition of any sector, there is also an impact on the recovery rate for the wider university (i.e. the 'main' sector that the newly sectorised activity has been removed from).

II. Example of a method using TRAC cost of teaching

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

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

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

* Less Tuition Fees plus TRAC cost of teaching

** Less Tuition Fees and T grant plus TRAC cost of teaching

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

A single sector option using the pro-rata calculation:

$$\frac{\text{Total taxable income}}{\text{Total business income less tuition fees}} = \frac{10.0}{121.0} = 8.26\%$$

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

Points to note:

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

Annex D - Example of a modified teaching support grant method

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

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

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

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

So, the modified Teaching support grant figure is:

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

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

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

* Plus modified Teaching support grant – OfS Bursaries

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

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

Points to note:

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

Annex E - Example of TRAC Variant Methods

I. Example of a TRAC Variant 1 Method

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

The University should first:

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

TRAC variant 1 works on the premise that tax use follows TRAC's assignment of that cost. So, if a cost is significant but non-VAT bearing, it should be taken out of its pool before comparison is made across the pools. This improves the allocation of tax to the TRAC categories but does not address the apportionment of tax within a pool between taxable and exempt supplies. For this apportionment the normal rules for creating an appropriate proxy still apply.

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

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

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

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

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

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

The result of these allocations is shown below:

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

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

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

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

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

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

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

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

The University is now able to consider how its proposal might look in practice.

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

The recoverable input tax is as follows:

Table E

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

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

University therefore concludes that the TRAC variant 1 method gives a reasonable result.

Conclusions:

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

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

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

II. Example of a TRAC Variant 2 Method

The HEI is a research-intensive institution. Its TRAC system has been in place for some time and the University is confident that it is a robust and reliable tool for allocating costs to the various categories. It considers adopting a TRAC variant 2 methodology with a single PE calculation enabling input tax recovery against all non- teaching activities of the HEI.

The University should first:

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

TRAC variant 2 works on the premise that tax follows cost. So, if a cost is significant but non-VAT bearing, it should be taken out of its pool before comparison is made across the pools. The same principles outlined in Annex E1 will also apply to allocation. This improves the allocation of tax to the TRAC category but does not address the apportionment of tax within a pool between taxable and exempt supplies. For apportionment, the normal rules of creating a proxy for the value for state supported education apply. The cost of engaging associate colleges is a cost of teaching and must be included in the denominator of any proxy calculation that works out how much tax is apportioned to taxable activities.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

In some cases, it will be possible to demonstrate the reasonableness of the proposed method by looking at a single pot output values-based calculation. In this case, it has taxable income of £12.5M and total income (including teaching fees, teaching grants and non-teaching activities) of £160.5M.

It would therefore recover 7.79% of its residual VAT of £1,669,691 or £130,090 using such a method.

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

The HEI is able to readily isolate the costs and income from its conferencing activity. It knows conferencing has 71.62% taxable income (£5.3M out of £7.4M) and residual input tax of £142,500, which it has confirmed is reasonable by reference to the known VAT bearing costs shown in the financial statements for the HEI's conferencing subsidiary company.

It proposes to sectorise this activity because of the dampening effect on recovery caused by the other, predominantly exempt activities considered by the single TRAC variant 2 calculation.

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

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

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

Table D

	Total VAT bearing Expenditure	Allocated VAT	B/NB	Residual Input Tax
PFT	30,500,000	£1,051,724	100%	£1,051,724
NPFT	1,500,000	£51,724	100%	£51,724
PFR	10,100,000	£348,276	17%	£59,207
NPFR	2,200,000	£75,862	91%	£69,034
Other	13,700,000	£472,414	100%	£472,414
Total	58,000,000	£2,000,000		£1,704,103
Of which		**Residual VAT**	**Recovery Rate**	**Recovery**
Attributable to teaching:		£1,103,448	0.00%	£0
Attributable to conferences:		£142,500	71.62%	£102,059
Attributable to non-teaching excluding conferences:		£458,155	21.75%	£99,649
Total		£1,704,103	11.84%	£201,707

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

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

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

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

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

I. TRAC Variant 1

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

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

The result of these allocations is shown below.

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

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

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

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

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

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

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

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

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

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

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

II. TRAC Variant 2

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

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

The result of these allocations is as follows:

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

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

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

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

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

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

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

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

The University has calculated its recoverable input tax as follows:

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

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

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

Annex G - Example of when a capital sector is appropriate

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

Income	***Income / £millions***	
Taxable consultancy	0.8	
Commercial Income	2.5	
Total taxable income		3.3
Tuition Fees	12.0	
Exempt income (student residences etc)	40.0	
Total exempt income		52.0
Total business income		55.3
Teaching support grant	45.0	
Arts Venue Income (projected taxable)	5.5	
Arts Venue Income (projected exempt)	2.5	

Expenditure

	£k	***Expenditure / £millions***	
Residual input tax; academic departments	150		
Residual input tax; commercial activities	250		
Residual input tax; general overheads	600		
Total residual input tax		1,000	
Residual input tax; Arts venue (capital costs)		890	
OfS bursaries			2.5
TRAC teaching costs (net of adjustments)			52.0

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

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

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

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

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

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

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

The following points must be considered:

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

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

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

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

It has two options:

- either it can use its TRAC data and drivers to work out what proportion of the overheads relate to the Arts Centre, or
- it can use its internal recharging mechanism to determine what part of the central costs should be allocated to the centre.

It chooses the TRAC option and this calculation results in £12k of the £600k residual input tax incurred on general overheads being allocated to the Arts Centre. So, in total, the University has £17k residual input tax to allocate to the Arts Centre - £5k that was incurred on direct costs and a £12k share of the residual input tax incurred on general overheads.

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

The pro-rata for each sector would be:

University:

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

(* excluding Arts Centre Income)

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

Arts Centre:

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

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

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

Points to consider

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

Annex H - Examples of Sectors used by Universities within PE Methods

- These are examples of sectors used within the PESMs of some universities
- These are just examples of areas you may wish to consider in relation to whether they create distortion and may be appropriate for sectorisation
- These sectors will not be appropriate and/or necessary for all universities
- Always consider complexity and materiality when considering distortion/sectorisation
- Some of these relate to PESMs for VAT groups

Capital Items with a value above £X threshold (see Annex G)
Car parking
Catering
Computer Services
Conference centre
Examination Board
Farm
Investment Property
Museums (s33a)
Press/publishing
Residences
Sport
Subsidiaries (within a VAT group PESM)
Veterinary Services

Annex I - An example of how to determine whether a supply is distorting

An HEI VAT group has the following income and expenditure:

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

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

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

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

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

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

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

The university as a whole is still supplying the same services to the end customer, although now

through a closely linked subsidiary. The use of the general overhead costs that do not directly support these supplies has not changed materially. However, the effect on the PE calculation is as follows:

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

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

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

The new supply meets the criteria of a distorting supply because the change in the recovery rate is 5% which is greater than both the fixed 1% limit and 10% of the prevailing rate (10% of 2% or 0.2%). Please refer to section 3 on how to proceed in addressing distortive supplies made or received within deduction methods.

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

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

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

1. **Considered more than one method?**
   - Have you considered the cost/benefit of several methods, to confirm that the method being requested is not significantly at variance to other methods and then explored why?

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

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

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

you considered, HMRC may wish to discuss with you why this is so.

5. **Designed your method using the framework and HMRC guidance?**
   - If your proposal is not based on one of the methodologies in the Framework, HMRC will still fully consider it without preconceptions over its acceptability. However, you must expect that more detailed enquiries will be made, and the proposal fully tested.
   - When you design your partial exemption special method you may wish to use the standard paragraphs set out in HMRC Guidance. These can be found at Section PE36000 of the Partial Exemption Guidance Manual available via the HMRC website.
6. **Made your declaration?**
   - You will need to make a statutory Declaration in accordance with PE law (set out in Regulation 102(9), SI 1995/2518). You should be able to do so if you have taken these reasonable steps to ensure that your proposed method gives a fair and reasonable result.

On receipt of your proposal HMRC will:

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

Annex K - HEIs and Farms

Please note that the figures used in the example calculations are illustrative and are not meant to be indicative of the range of results a BNB or PE calculation might give at any particular HEI.

The motivations for HEIs to hold a farm are quite varied, and include (but are not limited to):

- Acquired by way of legacy (and in some cases the HEI is precluded from selling the farms and/or associated land under specific covenants laid down when the land/asset was donated or gifted);
- Run to generate income for the benefit of the university which as a charity is obliged to make the most of its assets for the benefit of the charitable purposes;
- Run to provide a physical/study resource for the delivery of land-based courses;
- Land bank for development e.g. student or key worker accommodation.

In most cases some students of the university will visit the farm as part of their studies – this could be as part of a veterinary course, a rural studies course or other agricultural degree program. Most universities undertake some contract or non-business research on their farms. Some farms may set aside land for the purpose of staff and students' research projects. Some farms may structure themselves to provide a study resource for teaching; for example, a farm may run a number of sheep flocks to demonstrate different management systems.

Direct attribution may be possible for certain types of farm activity. In this case the costs will be directly attributable to taxable, non-business or exempt activities.

However, some costs are not wholly and exclusively for taxable, non-business or exempt activities. In this case, all, or part of the farming activity should form a separate sector. As set out in section 2.3, "the overall recovery rate of an HEI should reflect the mix of all its activities…where an HEI has a particular activity that uses costs very differently, the PE method may no longer give a fair and reasonable result. In this situation the use of a sectorised method may be appropriate."

All farms will produce statutory and operational information to support the commercial farming activities. In some cases, the teaching and research functions will make use of this information, but this will not impact on the day to day operation of the farm. This may be augmented by data generated from the 'study resource' activities referred to above. Farm data produced solely for the purposes of commercial farming activities may be used incidentally for teaching or in non-business research. However, such incidental use does not create a direct and immediate link between the costs incurred and the use of the information in any teaching or research activity and thus has no influence on the recovery rate for the commercial farm.

In order to determine the appropriate PE rate for a farm sector, the HEI will need to value the research or teaching. This is discussed at sections KI and KII below.

KI. Valuation of Research in Methods

The HEI should apply a hierarchy of four methods

i. The default method should be that the value of any non-business research contract which uses the farm's resources is the income from that non-business research. Where the level of research is low in comparison to the commercial output from the farm, HEIs may choose to adopt this method which is simple to apply and audit.

For example, the B/NB calculation could be:

	£m
Commercial Farming Income	0.750
Non-business Contract Research Income which uses the farm's resources	0.150
Total Income	0.90
B/NB %	83.3%

ii. There is a risk that method (i) will overstate the use of costs to generate the non-business income relating to the farm. A scientific research contract may use the farm resources, but it will probably also use the university's laboratory space and/or computing facilities. The management accounting systems for some universities will be capable of isolating the income element relating to the farm only.

Using the example above:

	£m
Farm	0.05
Laboratory	0.05
Computing Facility	0.05
Total	0.15

This would impact on the B/NB calculation as follows:

	£m
Commercial Farming Income	0.750
Non-business Contract Research Income	0.05
Total Income	0.80
B/NB %	93.8%

iii. In some institutions, intra-organisational journals will be posted to reflect the income generated by each school or cost centre. In the example above, the university would credit the farm with £50k of income. Where a university operates a model of this type and is able to demonstrate a sound basis for the journals, HMRC will accept these recharges as a proxy value for the non-business research income.

iv. In a small number of cases, an income-based method would be impractical or not fair and reasonable. If an HEI can demonstrate this to be the case, then the framework will permit HEIs to agree an alternative method which could be based on headcount, space and/or time. As always, the onus will be on the HEI to demonstrate that the method chosen is fair and reasonable.

KII. Valuation of Teaching in Methods

As for research, the HEI should apply a hierarchy of three methods

i. The default method should be that any income from teaching modules which use the farm's resources is the value of exempt income from teaching. Where the level of teaching is low in comparison to the commercial output from the farm, HEIs may choose to adopt this method which is simple to apply and audit.

For example:

If the total income for each student at the college is £9k, and all courses comprise 9 modules; the income for each module is therefore £1k.

During the course of the academic year, 4 modules use the farm's facilities. Each module holds 20 students. The total income from this activity is therefore 4x20x1 i.e. £80k. The PE calculation could be:

	£m
Commercial Farming Income	0.750
Exempt teaching income which uses the farm's resources	0.080
Total Income	0.830
PE%	90.4%

ii. Again, mirroring the approach for research, the income from teaching modules could be refined to reflect the fact that the module is unlikely to be entirely farm based. Looking at each module, it should be possible to refine the income relating to the farm – this will be hours taught on the farm and any elements very closely related to the farm.

Using the example of the 4 modules, the calculation, based on 20 taught hours per week, would look something like:

Module	Taught hours on or closely related to the farm	% Farm time	Income for Module (£k)	Income relating to farm
A	15	75%	20	15
B	10	50%	20	10
C	8	40%	20	8
D	4	25%	20	4
Total			80	37

The PE calculation would be:

	£m
Commercial Farming Income	0.750
Exempt teaching income	0.037
Total Income	0.787
PE%	95.3%

An alternative calculation basis could be to use total student hours spent on the farm if this is readily available. Again, using the example of the 4 modules above, with income of £80k the calculation would be:

Number of modules	4
Total hours per week	20
Weeks per module	9
Hours per module	180
Total hours	720
Farm hours	415
% farm based	57.6%
Income for farm	£46k

The PE calculation would be:

	£m
Commercial Farming Income	0.750
Exempt teaching income	0.046
Total Income	0.796
PE%	94.2%

iii. Some universities will have a third-party comparative – in most cases students will visit other third-party farms or animal/rural organisations. Where the third-party organisations make a charge to the university, this could be used as a proxy for income. This may be an hourly charge per student. Again, the onus would be on the HEI to demonstrate that the amount is reasonable.

All universities should be able to use one of the methods above. However, these approaches are all based on calculating the physical amount of time a student spends using the farm i.e. attending the farm or accessing teaching material derived from farm activity. Where an HEI believes that it is possible to work out the economic value of teaching that is given through attendance on the farm or from accessing farm derived teaching materials by application of any existing cost drivers in their current accounting procedures, they should consider application of these alternative methods.

Some farms may have the potential for separate sectors for arable, livestock or dairy depending on how those sectors are utilised. Many HEIs will already have a capital sector which would encompass capital expenditure on the farm. It is possible for an HEI to have a 'use' based capital sector where the inclusion of farm and non-farm expenditure might be subject to differing thresholds. The basic principles applying to any capital sector will apply to a farm building e.g. looking at space/time or build cost.

Annex L – Exclusions from PESM Calculations

The law excludes certain supplies from being incorporated into any supply value based PESM apportionment calculation as follows:

- Any sum receivable in respect of any supply of capital goods used for the purposes of the business;
- Any supply of the following where they are incidental to one or more of the business' activities:

  (a) Supplies of a description falling within VAT Act 1994 Schedule 9 Group 5;

  (b) Any other financial transaction;

  (c) Any other real estate transaction;
- Any self-supply value (such as reverse charge);
- The value of supplies made from an overseas branch.

Where any part of a method bases apportionment on anything other than supply values it is best practice to make specific provision for excluding the above activities.

[SI 1995 / 2518 Regulation 101(3) refers].

It is recognised that other forms of supply, either made or received by HEIs, also have the capacity to distort apportionment calculations but are not excluded by law. The terms of an approved PESM must therefore specify any additional exclusions. This appendix sets out those costs, supplies and forms of funding which HMRC accepts have the capacity to distort income and / or TRAC based methods.

The content below is not exhaustive and will be reviewed periodically to reflect changes in terminology and address novel forms of funding for the sector. Please note that should an HEI be concerned whether a cost or supply value specific to that HEI has scope to create a material distortion in recovery, it should provide its reasoning to HMRC for consideration.

Income / Outputs based Apportionments

The values listed below have scope to be distortive if included, or included without modification, within apportionment formulae:

HEI Specific

- Subvention payable to a Student Union;
- If the method includes teaching grant, then certain elements may be omitted with agreement:
  - Share of Rewarding and Developing Staff funding attributable to research activity;
  - Share of additional funding for Pensions Increase attributable to research activity;
  - Element of Widening Participation funding that is spent on aspiration raising;
- Third Mission funding such as HEIF;
- Office for Students (OfS) related bursaries;
- Research Council Recurrent Grant elements.

Non-Sector Specific

- Any supply of goods or services made to connected parties, where the supply is acquired for the purposes of your business and supplied to the connected party without material alteration or further processing;
- Supplies made where it is intended that the same, or equivalent, goods or services will be subsequently used by the business including for example, goods or services forming part of a sale and leaseback transaction.

TRAC Methods

There are two different forms of calculation based on TRAC. The first substitutes the TRAC cost of teaching for the income arising on teaching. It is accepted that the following costs can be excluded from the calculated TRAC cost:

- TRAC cost of infrastructure;
- TRAC cost of return for financing/investment;
- Office for Students (OfS) related bursaries;
- Payments to associated further education colleges;
- Subvention payment to the Student Union.

Where TRAC cost is used as the basis of allocation, the Framework encourages the exclusion of non-VAT bearing costs from the TRAC cost totals. These would include the following general categories, but there may be others specific to each institution.

- All of the items above;
- Wages, salaries, pensions and related non-taxable employment costs;
- Depreciation; and
- All bursaries, scholarships and subsistence allowances.

Annex M - Glossary

HMRC's Guidance Manuals include a glossary explaining some of the terms relating to Partial Exemption, which may be of help to those using this document. The Partial Exemption Glossary can be accessed here.