

FRAMEWORK FOR NHS BODIES VAT RECOVERY CALCULATION METHODS

VERSION 2.0 – January 2018

Introduction

1. This Framework is not mandatory and does not replace the content of VAT Notice 706 (Partial Exemption), but adopting its principles will enable HMRC more readily to give approval for use of a VAT recovery method for which a Statutory Declaration has been made. The Framework has been prepared by working with the Healthcare Financial Management Association (HFMA), the representative body for the tax affairs of NHS Trusts, and is jointly owned and supported by HFMA and HMRC.

Where this Framework refers to an “NHS Trust” that term should be taken to include any relevant NHS body, including Health Boards in Scotland and Wales and Clinical Commissioning Groups.

There is a flowchart at Annex D of this Framework which illustrates the flow of VAT through an NHS Trust and highlights some of the key considerations that a Trust’s recovery method can be used to address.

This Framework’s principles apply to Trusts of all sizes and complexities, but the likelihood is that the very simple method outlined in Annex A will give a fair and reasonable result for smaller NHS bodies. This Framework has been published by HMRC on the gov.uk website:

<https://www.gov.uk/government/publications/partial-exemption-frameworks>

Further useful information, for example the VAT streams, is available on the TISONline website:

www.tisonline.net/taxreference/vat_health

VAT and NHS Trusts

2. The principal activity of NHS Trusts is the provision of healthcare for no consideration, carried out under statutory regulation. This is not a business activity. Normally the VAT on expenditure used exclusively for non-business activity is irrecoverable. However, Section 41(3) of the VAT Act 1994 provides a refund scheme for NHS Trusts which enables the Commissioners to refund the VAT incurred on certain Contracted Out Services (COS) used for non-business activity.

Under section 41(3) the Treasury issues a Direction, commonly known as the Contracting Out Direction, which lists the services on which VAT can be refunded where it is incurred for a non-business purpose. A full list of these services is also available in HMRC guidance as follows:

<https://www.gov.uk/hmrc-internal-manuals/vat-government-and-public-bodies/vatgpb9700>

3. NHS Trusts also make business supplies. These include exempt supplies such as the provision of healthcare for a consideration to private patients and taxable supplies such as the supply of catering to staff and visitors. VAT on expenditure used to make exempt supplies cannot be recovered. VAT on expenditure used to make taxable supplies is recoverable under Section 26 of the VAT Act 1994.

4. Most NHS Trust costs are used for a mix of taxable, exempt and non-business purposes and the VAT incurred has to be apportioned. Once the VAT incurred on costs has been identified, the recovery will normally have three further steps:

- First, a direct attribution of VAT on costs that relate to your taxable business activities and exempt business activities. This relates to costs that are wholly used, or to be used, in making either taxable or exempt supplies.
- Second, a direct attribution of VAT on costs that relate to your non-business activities. This relates to costs that are wholly used, or to be used, in making non-business supplies. This step will identify VAT on costs which is not recoverable as it relates to non-business activities and may identify non-business VAT that should be dealt with under section 41(3), if covered by one of the COS Headings.
- Third, a business/non-business (BNB) and partial exemption method to calculate the recoverable proportion of non-attributable VAT, often referred to as 'residual VAT' or 'overheads VAT'. VAT that relates to taxable business activities is recoverable under Section 26(2)(a) of the VAT Act 1994; VAT relating to exempt supplies will be irrecoverable; VAT relating to non-business use of COS costs should be dealt with under section 41(3); and non-business use of non-COS VAT will be irrecoverable.

The third step may involve using a "combined" recovery method that requires approval in writing from HMRC (see paragraph 6 below).

Methods

5. Step 3 above refers to a method of apportioning non-attributable VAT. A Trust can choose three options when considering its VAT recovery:
- It can operate an unapproved business/non business calculation followed by the standard partial exemption method;
 - It can operate an unapproved business/non business method followed by an approved partial exemption special method;
 - It can operate an approved combined business/non business and partial exemption special method. The advantage of this is that the Trust has certainty over how it should carry out both calculations.
6. A Trust that has not sought or does not seek approval for a partial exemption special method, or a combined business/non-business and partial exemption method, must default to the partial exemption standard method. In such circumstances the Trust will need to make:
- A business/non-business calculation under Section 24(5) of the VAT Act to work out how much of its VAT expenditure is used in making business supplies. This amount is Input Tax;
 - A claim under Section 41(3) of the VAT Act for VAT that is refundable under the arrangements for Contracted Out Services; and
 - A standard method calculation under Regulation 101 of the VAT Regulations 1995 to determine how much of its input tax is used in making taxable supplies.

7. As part of the standard method operation the Trust needs to consider whether it should carry out a standard method override (SMO) adjustment. The SMO deals with circumstances where the standard method does not produce a fair and reasonable deduction of input tax. The override requires an adjustment to be made when the input tax deducted during the tax year using the standard method differs substantially from a deduction based on use or intended use. If there is a substantial difference then the trust must carry out the adjustment at the same time as the longer period adjustment (see paragraph 37). If the Trust regularly needs to carry out SMO adjustments, it may wish to seek approval to use a Partial Exemption Special Method. A difference is substantial if it exceeds £50,000 or 50% of the residual input tax incurred and £25,000 and is defined in Regulation 107C of the VAT Regulations 1995.
8. The use of partial exemption methods other than the Standard Method (known as Partial Exemption Special Methods) must be approved by HMRC before they can be used.
9. HMRC will not agree to a stand-alone business/non-business apportionment where a business makes exempt supplies. However, the VAT Regulations provide for a combined business/non-business and partial exemption method to be approved where both types of activity are undertaken.
10. A combined Partial Exemption Special Method does not set out to determine the amount of VAT refundable under Section 41(3), although this may be a by-product of the calculations carried out. For example, the method may deal with COS VAT separately from non-COS VAT. The Trust would then need to determine the amount of COS VAT eligible to be refunded under section 41(3). Further guidance on refunds under section 41(3) can be found in the HMRC manual 'VAT Government Departments and Public Bodies' which is accessible on the gov.uk website: <https://www.gov.uk/hmrc-internal-manuals/vat-government-and-public-bodies/vatgpb9700>
11. However, if the method does not distinguish between COS and non-COS VAT, the amount used for non-business purposes cannot all be dealt with under section 41(3). Any proposal needs to clearly set out which pot of VAT (COS or non-COS) the stage of the method addresses. A combined method will determine how much of the VAT incurred is used or is to be used for non-business purposes, but is not concerned with how to distinguish between COS and non-COS VAT.
12. The partial exemption de minimis limit does not apply if a taxpayer has a combined method. Consequently, a Trust would be unable to reclaim all their business VAT in full, and it will have to make any input tax restriction resulting from the calculation.
13. An example of a simple combined method is given at Annex A, with numerical examples at Annex B.

The Principles of VAT Deduction under a combined BNB and PE method

14. Direct attribution is the identification of VAT on supplies that are:
 - wholly used, or to be used, in making taxable business supplies; or
 - wholly used, or to be used, in making exempt business supplies; or
 - wholly used, or to be used, in non-business activities.

15. Trusts are encouraged to use their existing accounting systems and practice to directly allocate as many costs as they can when implementing methods based on the ideas set out in this Framework. Normally HMRC will accept that costs such as fuel and power, telephone bills and auditors' fees form part of the general overheads of a Trust; in other words they are costs which are used to support all of the Trust's activities. The input VAT on general overheads is known as residual VAT.
16. Allocation refers to dividing residual VAT between sectors in a recovery method. For example, a Trust might incur VAT on crockery, kitchen equipment and catering staff supplied by an agency. If it had a VAT recovery method which treated catering as a separate sector it would allocate those costs to the catering sector.
17. Apportionment means dividing residual VAT between non-business, taxable and exempt supplies. This is done using a proxy calculation.

If income is used as the proxy and an activity has been sectorised, in most cases only the income generated in that sector would be used in the proxy calculation for that sector and this income would be excluded from any calculations for other sectors.

The exception would be an overhead sector, where income from all the activities that the overhead supports could be used. An overhead sector will not be needed if all VAT on overheads is allocated proportionally to the activities of the Trust. If this is the case, it is most likely that the proxy for each sector should be based solely on the income of that sector.

If only some of the overhead costs are reallocated to other sectors then the associated income from those other sectors should be excluded from the overhead calculation.

The same principle applies to other proxies.

18. Income values based methods are the default proxy calculation. They are generally reliable because:
 - values change as the level of activity changes;
 - they rely on readily available records; and
 - figures are easily verified.

Grants and charges made to associated divisional VAT registrations are considered to be non-business income. Charges made to Trusts outside the divisional registrations are likely to be a business activity.

19. Trusts wishing to use a proxy other than one based on income values should be prepared to show HMRC:
 - why an incomes based method gives a result that is not fair and reasonable; and
 - how the proposed alternative proxy successfully addresses that issue.
20. For example, calculations based on meal numbers in catering outlets may not make good proxies because they are difficult to define and audit. They may not use like-for-like values; for example, a full meal and a snack may both be counted as one 'meal' without taking into account how the taxed costs of providing a full meal compare with those of providing a snack.

If a trust does wish to use a transaction count it will need to demonstrate that the transactions are on a like-for-like basis.

21. HMRC accepts the use of Occupied Bed Days (OBDs) as a valid method for calculating the split of costs used to care for NHS and private patients. The OBD count shall be taken from the data the Trust keeps to complete its monthly returns for the NHS Information Centre.

Proposing a partial exemption or “combined” method

22. To determine the extent of taxable business use that carries a right to deduct input tax a recovery method must be fair and reasonable. It must:
 - reflect how goods or services are used to make taxable supplies
 - be simple to operate and easy to check
 - be easily understood but respond to foreseeable changes.

Whilst an approval can only cover the recovery under Section 26 of the VAT Act 1994, it would be advisable that the calculations consider not only how much COS VAT is used for taxable business but also how much is used in making exempt business supplies. This is a necessary step before making a claim under Section 41(3).

23. HMRC will approve the use of Partial Exemption Special Methods (including “combined” methods) only if the proposal is accompanied by a Declaration in which the Trust states that to the best of its knowledge and belief the method produces a fair and reasonable input tax recovery, and that it has taken all reasonable steps to satisfy itself on this point. The declaration must clearly identify the document containing the proposal.

An agent will often be involved in making proposals on behalf of the Trust. However, the method must reflect the full activities of the Trust, and as it determines the amount of input tax recovery the Trust may claim, HMRC normally expect the declaration to be signed by an appropriate employee of the Trust.

All proposals for Partial Exemption Special Methods (including “combined” methods) should be accompanied by a worked example using actual figures. The worked example must provide a clear audit trail showing how the total amount of VAT incurred is allocated and apportioned in order to determine how much is used for taxable business purposes and how much is used for non-business purposes.

24. Annex C sets out in detail the steps that an NHS Trust is advised to take to ensure that its proposal is fair and reasonable.
25. A Trust always has to obtain prior written approval from HMRC before changing its partial exemption method, even if the proposed new method is largely based on the existing method. Any new proposal must be accompanied by a declaration from the Trust and must cover all the activities of the Trust not just the new activity.
26. If there are no changes in the Trust’s activities, there is no need to make proposals to replace an approved method unless that method is, on reflection, considered to be flawed. HMRC will expect an explanation of why the current method fails to produce a fair and reasonable recovery of tax.

27. If a Trust changes, or anticipates changing its legal entity this may require approval of a new method. The Trust should contact HMRC.
28. An approved method will normally have effect no earlier than the start of the tax year in which HMRC receive the Declaration for the approved proposal. This applies to the first approval of a partial exemption special method (including “combined methods”) as well as replacements to such methods.

Sectors

29. A Trust may wish to consider sectorising an activity in its Partial Exemption Special Method or Combined method if:
- the activity is subject to segmental accounting and uses taxed costs in a different way to that suggested by the result of a global calculation; or
 - The result of a global calculation does not fairly and reasonably reflect the use of related VATable costs and a sectorised calculation does; or
 - a sectorised calculation is more accurate than a global calculation and is not excessively complex or difficult to audit.
30. It is possible that expenditure on some capital projects may not be used throughout the Trust as a whole, nor by a single department. For example, the Trust may be located across several sites, but undertake a capital project at one which houses some but not all departments. It is also possible that those departments may have a presence at other sites. HMRC would normally expect a separate sector for capital project expenditure. As projects arise, the VAT incurred would be allocated to that sector. The deductible element should then be determined by the extent that it is incurred on goods or services which are used or to be used to make taxable supplies, expressed as a proportion of the whole use or intended use. HMRC would normally expect the calculation to be on a project by project basis.
31. HMRC consider that such a sector is appropriate where VAT-exclusive taxable expenditure on a capital project is £250,000 or more. It will therefore include VAT on and land and buildings which falls to be adjusted under the Capital Goods Scheme (see paragraph 45).

Distorting Supplies

32. Output Values-based methods work on the premise that each pound value of output supply uses the same amount of VAT-bearing residual cost. However, occasionally a supply will use a disproportionate amount of residual cost thereby distorting the entire method.
33. For example a supply may be distortive if: comparatively little taxed costs are used to generate the value of the income received; or different supplies use the same costs but in different ways. When considering whether a supply is distortive it helps to ask the following questions:
- how does this supply’s value change the recovery rate?
 - how much extra input tax does that imply should be recovered or restricted?
 - does that reflect the tax actually incurred on the taxed costs of that supply?
34. Once a distorting supply has been identified, a Trust should consider how it should be treated in the recovery method. The income should either be excluded or its impact limited, perhaps through the

creation of a sector. If the Trust intends to exclude any particular income, it should identify this and explain the reason within its proposal and demonstrate the impact of its inclusion/exclusion.

35. Salary deductions and salary sacrifice mean the Trust may have to account for output tax on amounts deducted or sacrificed, on the basis that a supply to the employee has taken place. Including the value of the supply in any output value-based apportionment may distort the outcome, especially where the supplies are high value. If you wish to include or exclude these values within your calculations your proposals should clearly explain why they should/should not be excluded.

Longer Period Adjustment (or Annual Adjustment)

36. A taxable person using any partial exemption method must undertake a longer period adjustment. This reviews how VAT was allocated to sectors and attributed to taxable supplies for each period VAT return, and makes adjustments if the use of the underlying cost during the longer period was different from the outcome of the monthly calculations. A longer period is normally a year.

This is distinct from the adjustment to provisional recovery of COS VAT, although the method may provide the necessary calculation to determine the COS adjustment.

37. The default position is that a Trust must carry out its longer period adjustment in the period after the end of the VAT tax year. Trusts complete monthly returns, meaning that HMRC would expect to see the longer period adjustment being carried out in the April return.
38. As a facilitation measure HMRC are willing to approve a later VAT period in which to carry out the longer period adjustment if requested. HMRC considers that the August return normally allows sufficient time for the necessary review. Any variation from the default April return requires HMRC's specific agreement.
39. Alternatively, HMRC allow the adjustment to be carried out in the final period of the year (i.e. the March return).
40. For the avoidance of doubt, the discretionary extension applies only to the Combined Method longer period adjustment or Standard Method longer period adjustment required under Regulation 107. New claims for COS VAT under the refund provisions of Section 41(3) must be made no later than the June VAT Return following the end of the year in which the costs were incurred.

Provisional Recovery

41. Provisional use of the previous year's recovery percentage became part of the standard method with effect from 1 April 2009.
42. A Trust may consider asking HMRC to approve provisional recovery as a feature of its combined special method. Provisional recovery means that the previous year's recovery percentage can be applied in all tax periods during the current tax year.

This can ease the administrative burden for a Trust because the full calculation only has to be made once each year. The revised figure using current year data is applied to that tax year as part of the longer period adjustment that forms part of all partial exemption, and combined business/non-business and partial exemption methods.

43. In practice, using a provisional recovery rate will involve using two rates during the year, as the rate for the previous year will not be finalised until the longer period (annual adjustment) is carried out.

Year 1:

- (a) provisional rate applied in each prescribed accounting period = x
- (b) finalised rate calculated at the longer period adjustment stage = y

Year 2:

- (a) apply "x" to each prescribed accounting period before Year 1 longer period adjustment is determined
- (b) apply "y" to each prescribed accounting period once the Year 1 adjusted rate is known
- (c) Revise this provisional recovery in the year 2 longer period adjustment, using the true data for year 2.

44. A Trust that does not apply for provisional recovery has to determine its recovery percentage each individual tax period. If the Trust is using the standard partial exemption method, the default position is that the monthly recovery will be determined provisionally using the proportions resulting from the previous longer period adjustment.

NHS Trusts and the Capital Goods Scheme (CGS)

45. In many cases the CGS will not affect assets acquired by NHS Trusts (or assets on which a Trust spends money) because the scheme does not apply to assets which are wholly used for non-business purposes.

However, if a Trust does have any capital items (that is, assets which fall within the CGS) it needs to be aware of the impact of a new recovery method. Specifically, CGS adjustments may be required where a new method results in a recovery rate that is higher or lower than that allowed under the previous method. If a Trust has any questions about whether it has a capital item, or about how to apply the CGS, it is welcome to contact HMRC.

Estimation of input tax

46. Ordinarily, it is the value of VAT incurred on purchases, recognised at the tax point, which should be used when making a recovery method calculation. Most NHS bodies now have financial systems that are able to record and analyse VAT in this way and therefore estimation of input tax figures is not required.
47. HMRC may exceptionally agree to the estimation of input tax figures, if requested by the Trust. The Trust will need to explain why they consider it necessary, and must correct the figures in the following return. The need for such estimation will therefore arise only in temporary situations.

Agreement to estimation is separate from approval of the proposed method. It concerns the amount of VAT to be dealt with by the method, not the apportionment methodology itself.

Other Matters

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

Annex A

Simple method for NHS Trusts

The simple method outlined below is likely to be suitable for smaller and less complex NHS bodies.

Please remember that this simple method is still a special method. Like all special methods its use needs to be approved in advance by HMRC. Please refer to Annex C for advice on how to obtain that approval. Remember that, as part of the approval process, you will need to make a statutory declaration that the method gives a fair and recovery of VAT for your organisation, and that you have taken reasonable steps to satisfy yourself on this point.

1. Directly attribute VAT on costs that are used, or to be used, wholly in making taxable business supplies or exempt business supplies. VAT attributed to taxable business activities is recoverable under section 26(2)(a) of the VAT Act 1994. VAT attributed to exempt business supplies is irrecoverable.
2. Directly attribute VAT on costs that are used, or to be used, wholly in making non-business supplies. Non-business VAT that is covered by one of the COS Headings (COS VAT) should be dealt with under section 41(3) of the VAT Act 1994. Non-business VAT that is not covered by one of the COS Headings is not recoverable nor can it be dealt with under section 41(3).
3. VAT that cannot be directly attributed is your residual VAT and relates to costs for 'mixed-use'. This includes both 'residual non-COS VAT' and 'residual COS VAT'.
4. To calculate the recoverable element of your 'residual COS VAT' identified at step 3 that relates to taxable business activities, multiply your 'residual COS VAT' by the following ratio (expressed as a percentage rounded up to 2 decimal places).

$$\frac{\text{Taxable income}}{\text{Total income}^1}$$

Note:

This is not 'additional recovery'. It is the amount of the residual COS VAT which relates to your taxable business activities and therefore is input tax which may be recovered under Section 26(2)(a) of the VAT Act 1994. The Trust's overall recovery (COS VAT plus input tax) is unaffected.

5. Disallow the element of your 'residual COS VAT' that relates to exempt business activity by multiplying your 'residual COS VAT' by the following ratio (expressed as a percentage and rounded up to 2 decimal places):

$$\frac{\text{Exempt income}}{\text{Total income}}$$

Note:

This VAT is not recoverable under the COS refund scheme nor as input tax

6. The remaining COS VAT (after deducting the amounts calculated in 4 and 5 above) is the residual COS VAT that relates to the Trusts non-business activities which should be dealt with under section 41(3).

¹ For the purposes of the apportionment calculations, the amount of statutory grant income should be included in the denominator (total income).

7. To calculate the recoverable element of the 'residual non-COS VAT' identified at step 3 which supports taxable activities, multiply that tax by the following ratio (expressed as a percentage and rounded to 2 decimal places):

$$\frac{\text{Taxable income}}{\text{Total income}}$$

This VAT is input tax which is recoverable under Section 26(2)(a) of the VAT Act 1994.

Annex B

Simple Method Numerical examples

Percentages used in these examples are rounded to two decimal places.

Example B1

In Year X, a Trust has the following sources of income:

Catering Income	£1.0M	
Car Park Income	£2.0M	
Other Taxable Income	£0.5M	

Total Taxable Income		£3.5M
Exempt Income (private patients)		£1.0M

Total Business Income		£4.5M
Non-Business Income (grant funding)		£292.0M

Total income		£296.5M

It incurs VAT as follows:

VAT directly attributable to taxable supplies	£ 200,000
VAT directly attributable to exempt supplies	£ 300,000
COS Headings (directly attributable to non-business)	£1,000,000
COS Headings (Residual COS VAT)	£2,500,000
Catering Costs (Residual VAT)	£ 100,000
General Overhead Costs (Residual VAT)	£1,200,000

	£5,300,000

After it has directly attributed VAT (that is, attributed tax that is used wholly in making taxable business supplies, exempt business supplies, or for non-business purposes, the Trust needs to identify the residual input tax and residual COS VAT. The Trust works out its VAT recovery on residual costs through the following four stages:

- (1) The Trust needs to know what amount of VAT incurred under COS Headings is residual VAT that relates to taxable business activity so applies the formula:

$$\frac{\text{Taxable Income}}{\text{Total Income}}$$

$$\frac{3.5}{296.5} \times 100\% = 1.18\%$$

The resultant percentage is then applied to the COS Headings Residual VAT.

$$£2,500,000 \times 1.18\% = £29,500$$

The Trust can recover £29,500 as input tax under Section 26(2)(a).

Note:

This is not 'additional recovery'. It is the amount of the residual COS VAT which relates to your taxable business activities and therefore is input tax which may be recovered under Section 26(2)(a) of the VAT Act 1994. The Trust's overall recovery (COS VAT plus input tax) is unaffected.

- (2) The Trust needs to know what amount of VAT incurred under COS Headings is residual VAT that relates to exempt business activity so applies the formula:

Exempt Income

Total Income

$$\frac{1.0}{296.5} \times 100\% = 0.34\%$$

The resultant percentage is then applied to the COS Headings Residual VAT.

$$£2,500,000 \times 0.34\% = £8,500$$

The Trust cannot recover £8,500 as this relates to exempt supplies.

- (3) The balance of the VAT incurred under COS Headings Residual VAT relates to non-business activity:

COS Headings Residual VAT		£2,500,000
Less:		
COS Headings Residual VAT relating to taxable business activity	£29,500	
COS Headings Residual VAT relating to exempt business activity	£ 8,500	(£ 38,000)

Balance of COS Headings Residual VAT relating to non-business activities		£2,462,000

This VAT is not part of the Partial Exemption Special Method and should be dealt with under section 41(3).

- (4) The Trust has identified that it has incurred VAT on catering costs and general overhead costs, part of which will be recoverable. These costs are residual as they relate to taxable and exempt business supplies, and non-business activity.

The Trust applies the formula:

Taxable Income

Total Income

$$\frac{3.5}{296.5} \times 100\% = 1.18\%$$

The resulting percentage is then applied to the Catering and General Overheads Residual VAT

$$£1,300,000 \times 1.18\% = £15,340$$

The Trust can recover £15,340 as input tax under Section 26(2)(a).

Summary

Through the PESM, Trust may claim:

VAT on Catering Costs and General Overhead Costs	£ 15,340
VAT on COS Headings that relates to taxable activity	£ 29,500
VAT directly attributed to taxable supplies	£200,000

It may also be able to make a Section 41(3) claim:

VAT on COS Headings refunded due to non-business activity	£3,462,000

	£3,706,840

This represents 69.94% of all the VAT it has incurred (£3,706,840/£5,300,000).

Example B2

In Year Y, a Trust has the following sources of income:

Taxable Catering Income	£0.3M
Taxable Car Park Income	£1.0M
Taxable Research and Development Income	£0.1M
Other Taxable Income	£0.1M

Total Taxable Income	£ 1.5M
Exempt Income from private patients	£2.1M
Exempt Research and Development Income	£0.9M

Total Exempt Income	£ 3.0M
Total Business Income	£ 4.5M
Non-Business Income (grant funding)	£295.5M

Total income	£300.0M

It incurs VAT as follows:

VAT directly attributable to taxable supplies	£ 200,000
VAT directly attributable to exempt supplies	£ 300,000
COS Headings (directly attributable to non-business)	£1,000,000
COS Headings (Residual COS VAT)	£2,500,000
Research and Development (R&D) Costs (Residual VAT)	£ 300,000
General Overhead Costs (Residual VAT)*	£ 700,000

	£5,000,000

* The VAT on R&D costs figure includes any VAT on overheads related to R&D activity. The VAT on general overhead costs relates to the rest of the Trust's activities, excluding R&D.

The residual VAT excludes any VAT directly attributed to non-business, taxable or exempt supplies.

The Trust works out its VAT recovery on residual costs as follows:

(1) The Trust needs to know what amount of VAT incurred under COS headings relates to taxable business activity so applies the formula:

$$\frac{\text{Taxable Income} \times \text{COS Headings VAT}}{\text{Total Income}}$$

$$\frac{1.5}{300} \times 100\% = 0.50\%$$

$$£2,500,000 \times 0.50\% = £12,500$$

It can recover £12,500 as input tax under Section 26(2)(a).

Note:

This is not 'additional recovery'. It is the amount of the residual COS VAT which relates to your taxable business activities and therefore is input tax which may be recovered under Section 26(2)(a) of the VAT Act 1994. The Trust's overall recovery (COS VAT plus input tax) is unaffected.

- (2) The Trust needs to know what amount of VAT incurred under COS headings relates to exempt business activity so applies the formula:

$$\frac{\text{Exempt Income} \times \text{COS Headings VAT}}{\text{Total Income}}$$

$$\frac{3.0}{300} \times 100\% = 1.00\%$$

$$£2,500,000 \times 1\% = £25,000$$

It cannot recover £25,000.

- (3) The balance of the VAT incurred under COS headings relates to non-business activity:

COS Headings VAT		£2,500,000
Less:		
VAT relating to taxable business activity	£ 12,500	
VAT relating to exempt business activity	£ 25,000	
	-----	(£ 37,500)

		£2,462,500

This VAT is not part of the Partial Exemption Special Method and should be dealt with under Section 41(3).

- (4) The Trust has identified that it has incurred VAT on R&D and general overhead costs, part of which will be recoverable. These costs are residual as they relate to taxable and exempt business supplies, and non-business activities.

The Trusts considers whether it needs a separate sector for Research and Development (R&D), which it reports under segmental accounting.

- (a) If R&D income is kept within the main recovery method the amount of VAT the Trust gets back would be worked out using the formula:

$$\frac{\text{Taxable Income} \times (\text{R\&D Residual VAT plus General Overheads VAT})}{\text{Total income}}$$

$$\frac{1.5}{300} \times 100\% = 0.50\%$$

The resultant percentage is applied to the R&D Residual VAT plus the General Overheads VAT.

$$(\pounds 300,000 + \pounds 700,000) \times 0.50\% = \pounds 5,000$$

Under this method the Trust would recover £5,000 as input tax under section 26(2)(a).

(b) If R&D income was sectorised, the amount of VAT the Trust gets back would be worked out using the formula:

Step 1

$$\frac{\text{Taxable Income (less taxable R\&D income)}}{\text{Total income (less taxable and exempt R\&D income)}} \times \text{General Overheads VAT}$$

$$\frac{1.4}{299} \times 100\% = 0.47\%$$

The resultant percentage is applied to the General Overheads Residual VAT

$$\pounds 700,000 \times 0.47\% = \pounds 3,290$$

Step 2

$$\frac{\text{Taxable R\&D income}}{\text{Total taxable and exempt R\&D income}} \times \text{R\&D Residual VAT}$$

$$\frac{0.1}{1.0} \times 100\% = 10.00\%$$

The resultant percentage is applied to the R&D Residual VAT

$$\pounds 300,000 \times 10\% = \pounds 30,000$$

So the Trust would claim £33,290 (£3,290 plus £30,000) if the R&D activity was sectorised, compared with £5,000 if it were not.

(5) The Trust knows that car parking uses very little taxed cost but drives a large part of its VAT recovery. Therefore it considers whether the car parking income is distorting its VAT recovery.

(a) If car park income is kept within the main recovery method the amount of VAT the Trust recovers would be worked out using the formula:

$$\frac{\text{Taxable Income} \times (\text{R\&D Residual VAT plus General Overheads VAT})}{\text{Total income}}$$

$$\frac{1.5}{300} \times 100\% = 0.50\%$$

The resultant percentage is applied to the R&D Residual VAT plus the General Overheads VAT.

$$(\pounds 300,000 + \pounds 700,000) \times 0.50\% = \pounds 5,000$$

Under this method the Trust would recover £5,000 as input tax under section 26(2)(a).

(b) If car park income was excluded from the calculation as a distortive supply, the amount of VAT the Trust gets back would be worked out using the formula:

$$\frac{\text{Taxable Income (less car park income)} \times (\text{R\&D Residual VAT plus General Overheads VAT})}{\text{Total income (less car park income)}}$$

$$\frac{0.5}{299} \times 100\% = 0.17\%$$

The resultant percentage is applied to the General Overheads Residual VAT

$$\pounds 1,000,000 \times 0.17\% = \pounds 1,700$$

So the Trust would claim £3,328 less VAT recovery (£5,000 minus £1,700) if the car park income were sectorised.

Summary

Through the PESM, the Trust may claim:

VAT on R&D Costs ² and General Overhead Costs	£ 5,000
VAT on COS Headings that relates to taxable activity	£ 12,500
VAT directly attributed to taxable supplies	£200,000

It may also be able to make a section 41(3) claim:

VAT on COS Headings used wholly for non-business activity	£1,000,000
VAT on COS Headings used partly for non-business activity	<u>£2,462,500</u>
	£3,680,000

This represents 73.6% of all the residual VAT it has incurred (£3,680,000/£5,000,000).

² If no separate R&D sector
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Annex C

Seeking approval for a VAT recovery method

Have you taken reasonable steps?

1. The person making a statutory Declaration that a proposed VAT recovery method gives a fair and reasonable attribution of input tax has to state that they have taken reasonable steps to ensure that they have all relevant information relating to the proposed method. If you have to make a Declaration you might want to check that you have covered the points in paragraphs 2 to 5 below.

Have you considered whether your method needs sectors?

2. You should consider a sector if:
 - (a) an activity is subject to segmental accounting and uses taxed costs in a different way to that suggested by the result of a single calculation covering all of the Trust's activities or
 - (b) the result of a single calculation covering all of the Trust's activities is materially different from the result of an attribution which represents the extent to which the goods and services are used, or to be used by you, in making taxable supplies while performing that activity.

Have you prepared a worked example of your proposed method?

3. To accompany the explanatory narrative of how the method works, HMRC needs to receive a worked example of how your proposed method will work in practice, using actual figures. The worked example should clearly show how the total amount of VAT incurred is allocated to business and non-business activities, and how the business VAT is apportioned between taxable and exempt supplies.

An explanation of why you feel your proposed method gives a fair and reasonable result should be given. The absence of a worked example showing the result that the proposed method would generate may create uncertainty about the methodology. HMRC will not be able to give approval for a proposed method if there is uncertainty or ambiguity.

Have you designed your method using the Framework and HMRC guidance?

4. If your proposal is not based on the VAT recovery method in this Framework HMRC will give it due consideration, without preconceptions over its acceptability. However, you should expect more detailed enquiries will be made and the proposal fully tested.

Have you made your declaration?

5. You will need to make a statutory Declaration in accordance with the law (set out in Regulation 102(9), SI 1995/2518). You should be able to do so if you have taken the reasonable steps described in paragraphs C2 to C4 to ensure that your proposed method gives a fair and reasonable result. The declaration must clearly identify the document containing the proposal. This is usually the letter setting out the stages of the method.

Annex D

How do NHS Trusts claim VAT?

Chart One – VAT incurred on costs covered by one of the COS Headings

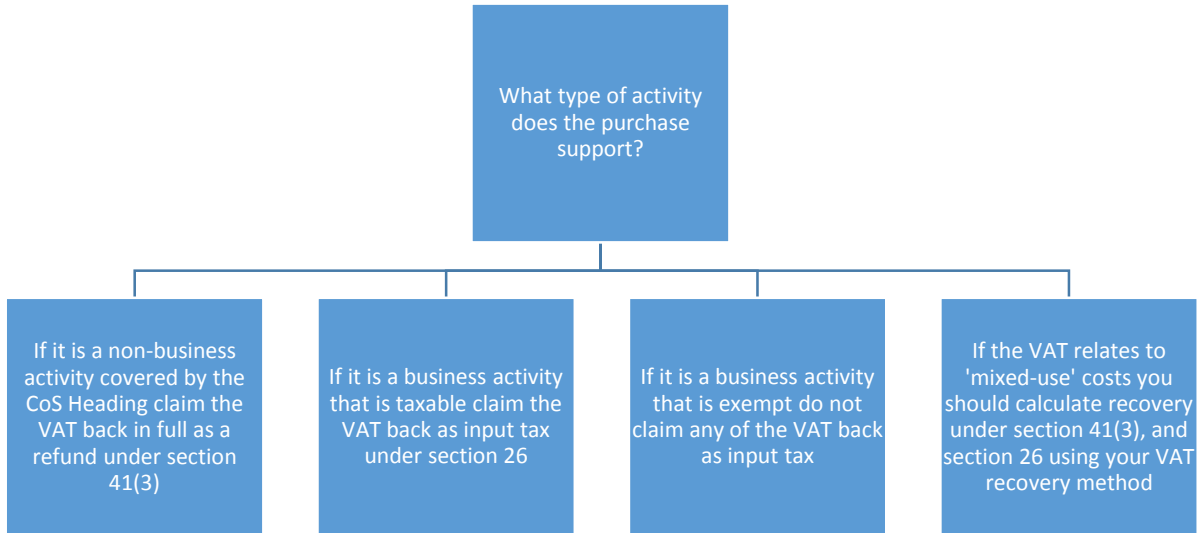


Chart Two – VAT incurred on costs not covered by one of the COS Headings

