

Q&A guidance on VAT partial exemption measure announced at PBR 2006

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1. What is the measure?

The measure comprises two changes to the partial exemption special method regime:

- Method Declaration (Declaration): a new requirement for businesses to declare their proposed method is fair and reasonable, and
- Combined Method: a simplification to allow methods to deal with VAT relating to foreign and specified supplies.

2. Who will the measure affect?

The measure affects businesses that seek the approval of a partial exemption special method.

3. When will the measure take effect?

The measure will take effect from 1 April 2007, applying to methods approved on or after this date. Methods submitted before April will be processed under the current regime and will not be affected unless the approval straddles 1 April in which case a Declaration will be needed.

4. Why is the measure needed?

The Declaration will speed up the approvals process by encouraging businesses to propose a fair and reasonable method from the outset, and will improve fairness and equity by enabling HMRC to recoup input tax that is over-recovered¹ because an unfair method had been declared as fair and reasonable and subsequently approved.

The Combined Method will reduce business compliance costs and the risk of accounting errors by saving the need for a separate 'use-based' calculation, and will increase business certainty by giving a legal right to a combined method. Regulations 103A (investment gold) and 103B (input tax on incidental financial supplies) remain unchanged as does the interaction between regulation 103 and 101.

5. How will the Declaration work?

From 1 April 2007, HMRC will only approve a special method on receipt of a Declaration from the business to the effect that to the best of its knowledge and belief the method will produce a fair and reasonable attribution of input tax to taxable supplies². The Declaration will confirm that the method produces a fair and reasonable attribution from its effective date of application, and for the foreseeable future based on information the person making the Declaration could reasonably be expected to know at the time. If at any time, HMRC find the Declaration to be 'incorrect' they could serve a Special Method Override Notice (Notice) to override the method so that from its effective date VAT would be recovered in accordance with the principle of use.

6. What does the Declaration cover?

A Declaration relates to the whole method covering the entire VAT registration, and cannot be restricted to parts of the method or to parts of the business. The business

¹ 'Over-recovered' in the sense that the business is recovering more input tax than it is fair and reasonable for it to do so.

² Taxable supplies will include foreign and specified supplies if the method is a Combined Method.

is responsible for ensuring that whoever signs the Declaration does so with sufficient authority and knowledge, and understanding of its actual and planned use of costs.

7. How often is a Declaration needed?

A Declaration is needed each time a new method is approved or an existing method amended.

8. How is the Declaration submitted to HMRC?

The Declaration will normally be attached to the proposed method for which HMRC approval is requested. In some cases HMRC will invite an updated Declaration because the proposed method has changed from the one put forward, which may happen as a result of enquiries and discussion. Businesses may also choose to discuss with HMRC how general partial exemption principles apply to their business before they propose a method. A business should not attach a Declaration to a method it proposes before 1 April and if approval straddles this date HMRC will notify the business that it requires a Declaration before it approves the method. A template Declaration will be published in mid-March.

9. Will HMRC stipulate who should sign the Declaration?

No. It is right that the business decides who should make its Declaration having regard to its size, structure and complexity and how it manages its tax affairs. A large business might authorise the VAT or Tax Manager to make the Declaration whereas in a smaller business a director or partner might do this. In deciding who this might be, it is important to be aware that in applying its test of reasonableness HMRC will compare the actions of the signatory to the actions of a reasonable person (see Qs 21 and 22 below).

10. What if a business delegates its Declaration to a third party?

Whilst a business may choose to delegate the making of its Declaration to a third party, it still remains responsible for it being correct.

11. What is meant by an incorrect Declaration?

A Declaration is incorrect if two conditions are met:

- The method does not produce a fair and reasonable attribution of input tax to taxable supplies resulting in an over-recovery of input tax by the business; and

- The person signing the Declaration knew or ought reasonably to have known this at the time they made the Declaration.

12. What happens if HMRC uncovers an incorrect Declaration?

If HMRC uncovers evidence to show that a Declaration is incorrect they may serve a Notice to recoup the over-recovered input tax. The Notice and accompanying correspondence would clearly explain why HMRC consider the method unfair and why the signatory knew, or ought reasonably to have known this at the time of the Declaration. Subject to the normal rules of the three-year cap, the Notice will apply from the start date of the method and continue to apply until a replacement method is approved or directed. While the Notice remained in force, the business would be required to adjust for both over and under-recoveries of input tax in accordance with the principle of use and may be subject to interest and misdeclaration penalties.

13. What happens if the business uncovers an incorrect Declaration?

A business that uncovers an incorrect Declaration should notify HMRC so it may serve a Notice to override the method. By voluntarily disclosing an incorrect Declaration, the business avoids the possibility of misdeclaration penalties in accordance with the normal rules, although interest may still be due. In circumstances where the business voluntarily discloses an incorrect Declaration and the business and HMRC are able to agree a suitable new method, HMRC may apply a 'light touch' and, exceptionally, allow the business to replace the existing method with the new method. This would save HMRC taking action under the measure and the business would not be liable to penalties. A Declaration would, of course, still be required for the new method.

14. Why is a method overridden from its effective date?

A Notice served under this measure overrides the method from its effective date and not the date at which an over-recovery first arose. Going back to the start date ensures a fair and reasonable result throughout the duration of the method correcting for both over and under-recoveries of input tax. A Notice served under this measure would only apply to accounting periods commencing on or after 1 April 2007.

15. What is meant by a fair and reasonable attribution of input tax?

A method produces a fair and reasonable attribution of input tax to taxable supplies if it satisfies the principle of use. The principle of use means that input tax is attributed in accordance with the 'use or intended use' of input tax bearing costs in making taxable supplies. The principle of use comes from European legislation supported by a wide body of European and domestic case law.

16. How does the principle of use apply in practice?

Partial Exemption published guidance, V1-15, provides in-depth discussion on how the principle of use applies in practice. The guidance, which is based on legislation and case law, refers to concepts of 'cost components' and 'direct and immediate links'. In simple terms, the principle of use means examining the main categories of business expenditure and determining how they relate to business supplies. In many ways this is no more than an exercise in cost accounting.

The trick is to identify 'what drives the cost' and then to use that 'cost driver' to attribute the input tax between the taxable and exempt supplies. For example, a business that buys an expensive computer system in order to handle its high volume of transactions, may judge that a transaction count is a fair basis for attribution whereas a sales value for the different transactions may not be.

Most businesses, especially the largest and most complex, focus carefully on costs and understand the importance of reliable 'cost drivers'. These businesses prepare management accounts to manage costs, plan investments and forecast profits. A robust system of management reporting that is logical, objective and transparent is invariably an ideal basis for a fair and reasonable method.

17. How can a method deal with 'unknown' events and still be fair?

A fair and reasonable method should take account of risks or potential events that might otherwise undermine its effectiveness. For example, if a business occasionally acquires new businesses then it could structure its method to deal with this possibility. One easy way to do this is to include within the method a 'catch-all' sector which stipulates that input tax on the costs of the newly acquired businesses is to be attributed in accordance with the principle of use, but does not specify how that is to be achieved. The actual basis for attribution can be determined after the event without risk of under or over-recovery. Accordingly, the relevant input tax will be

dealt with in a similar manner to the way input tax on foreign and specified supplies is attributed under regulation 103. Very large businesses typically include a 'use based' sector to deal with board-level projects that cannot be disclosed in advance. Then, if the project becomes a permanent feature, the business can amend its method and there is no risk to input tax recovery either way.

18. Will a fair and reasonable method have to be complex?

Few methods need to be complex. The vast majority of fair and reasonable methods are straightforward and typically comprise a single sector with single basis of apportionment. Very large businesses or those with diverse activities and rapidly changing cost structures will need more complexity. As a rule of thumb, the complexity of a fair and reasonable method will mirror that of the cost accounting systems that are relied upon for decision-making purposes.

Some businesses choose methods that hive-off some categories of cost to boost recovery rates. However, a method will not be fair unless it treats all categories of significant cost in a consistent manner, so if 'high recovery' costs are hived-off then so too must the 'low recovery' ones. This can quickly result in complexity without materially affecting the tax result, but this remains a decision for the business provided HMRC audit action is not compromised.

19. Can more than one method be fair and reasonable?

Yes. Fair and reasonable does not mean that there is only one acceptable method for a business, rather there are likely to be a number of fair and reasonable methods that are equally acceptable. They may give different tax results, although variances are unlikely to be large. The business can choose between them and will probably do so with regard to complexity and compliance cost, as well as tax result.

20. Will HMRC give advice as to what is fair and reasonable?

HMRC publish detailed guidance, public notices and regular business brief articles about partial exemption, including what is fair and reasonable. If a business has doubts on whether its proposed treatment is fair it should tell HMRC who can explain how the principles work and highlight relevant guidance and business brief articles.

21. What is meant by 'ought reasonably to have known'?

The Declaration is based on the concept of reasonableness. In forming an opinion as to whether the signatory of a Declaration 'ought reasonably to have known' the method would result in an unfair over-recovery of input tax, HMRC will consider whether a reasonable person charged with making a Declaration on behalf of the business who had taken reasonable steps would or should have identified this fact at the time they signed the Declaration. HMRC will consider all available facts including any information which relates to the business's actual and planned use of costs and the steps that were taken by the person who signed the Declaration.

22. What is a reasonable person?

A reasonable person is a competent and conscientious person who has sufficient authority to take reasonable steps to establish whether the proposed method is fair and reasonable before they sign the Declaration.

23. What are reasonable steps?

Reasonable steps might include but are not limited to:

- Referring to partial exemption published guidance and relevant business brief articles when formulating a special method.
- Speaking with senior managers, such as business heads, about planned events that might affect how costs are attributed.
- Having regard to relevant issues that have arisen during the audit process or as a result of taking advice or assurance.
- Making enquiries about new income streams or where expenditure patterns have clearly changed since any previous method was approved.
- Maintaining a list of cost drivers where they are the basis for the special method apportionment.
- Ensuring that acquisitions and disposals and changes to corporate structure are reflected in the method.
- Taking account of concerns made previously by HMRC during routine VAT assurance and when discussing partial exemption.
- Speaking with HMRC if there are doubts as to how partial exemption principles apply in a particular situation and drawing their attention to known risk and issues.

It is important to note that HMRC does not necessarily expect everyone to carry out all of these steps each time they sign a Declaration. What constitute reasonable

steps will vary from business to business and is likely to depend on changes in circumstances and plans since the business last satisfied itself that its method was fair and reasonable. This will be a matter of professional judgement for the signatory of the Declaration.

24. Will a business have to evidence that it took reasonable steps?

No. HMRC will not seek evidence of the reasonable steps taken in Declaring a method as part of routine VAT enquiries. However, a business may choose to keep evidence and to ask HMRC to take this into account in the event of problems arising.

25. Are there circumstances where HMRC will not apply the measure?

Yes. Subject to cases of abuse, HMRC will not apply the measure where a method became unfair as a direct result of a new case precedent, or because of a change in legislation or policy. In these situations any action would be prospective only.

26. Is a Declaration incorrect if the method results in an under-recovery?

A Declaration is not incorrect if it relates to an under-recovery of input tax. This is because there are already ways to deal with under-recoveries. The measure is designed to speed-up the approvals process, which might not happen if special methods were routinely subject to backdated requests. It remains important for the business to consider its circumstances at the time of making the Declaration, and if subsequent problems do arise, to speak with HMRC at an early stage.

27. Can a business invoke the measure to correct an under-recovery?

The measure is intended to speed-up the approvals process and is not to encourage adjustments, up or down, that might be justified with the benefit of hindsight. Provided a business has acted reasonably in proposing a fair and reasonable method, HMRC will not use the measure to correct an over-recovery of input tax. This is to give the business maximum certainty. However, by the same token, a business cannot invoke the measure to correct an under-recovery.

If a business discovers it is under-recovering it can apply for an alternative method to be backdated to the start of the current tax year. If a business is concerned by a possible under-recovery on certain costs in the event of some circumstance arising, then it can often protect its position by applying for a method in which the certain

costs are ring-fenced in a sector in which attribution is based on the principle of use (cf. Q17). Finally, if despite having acted reasonably and having proposed a fair and reasonable method, a substantial under-recovery arises because of a wholly unexpected occurrence, HMRC may allow exceptional backdating to the limits of the three-year cap. Examples of events for which exceptional backdating was available include, Sterling's ejection from the Exchange Rate Mechanism, Foot and Mouth disease, and the World Trade Centre disaster.

28. Will the Declaration remove the need for HMRC enquiries?

No, HMRC must still make enquiries before approving a method. HMRC has a duty to protect tax revenues and must make sufficient enquiries to minimise the risk of approving unfair methods. However, the Declaration will enable HMRC to risk-target its enquiries with the result that most businesses will benefit from simpler, speedier, and lower cost approvals.

29. Is the Declaration intended to lessen dialogue about partial exemption?

No, HMRC actively encourage businesses to discuss their proposed method, to highlight concerns and to explain why it is considered fair and reasonable. Doing so helps ensure speedy approval and enables Policy Team to identify generic issues for which improved guidance or policy clarification is needed. Furthermore, in the event that HMRC refuses approval, they can offer comprehensive reasons so as to help the business prepare an alternative proposal.

30. How will the Declaration affect business certainty?

The Declaration will improve business certainty by enabling HMRC to give speedy approvals in most cases. The risk of an approved method being over-ridden is rare. This is because, provided the signatory of the Declaration has acted reasonably in proposing a fair and reasonable method, HMRC will not take action under this measure.

31. Will local officers invoke the measure if they feel a method is unfair?

Local officers will not have authority to invoke the measure in any circumstance and all cases will be referred for decision to the central Policy Team. On the assumption that most businesses act reasonably to ensure their method is fair and reasonable at the time it is proposed, then cases in which the measure is applied will be rare.

32. Will the measure apply if a method becomes unfair after approval?

The measure only applies if a Declaration is incorrect. Factors arising after the date of the Declaration are not relevant in deciding if an approved method was fair and reasonable, unless of course, they could reasonably have been anticipated.

33. Will HMRC give binding approval so a business can have full certainty?

No, the business is responsible for ensuring that its proposed method is fair and reasonable and HMRC will not offer binding approval. This is because, in order to give binding approval HMRC must make extended enquiries in all cases, delaying approvals and reducing certainty. The Declaration will save the need for this.

34. What happens if HMRC decline approval despite a Declaration?

HMRC will not approve a method that it judges unfair or unreasonable despite the existence of a Declaration. HMRC will only refuse a method if there are good reasons for doing so and will in all cases explain the reasons to help the business consider an alternative proposal. A refusal to approve a method can be appealed.

35. What are the rights of appeal under this measure?

A business can appeal HMRC's decision to serve a Notice under this measure. If the case progressed to tribunal, it would be for HMRC to establish its case for serving the Notice and for the business to disprove HMRC's case. We take the view that the court will need to determine whether the statutory conditions had been satisfied i.e. whether the method was fair and reasonable for the business and, if not, whether the business knew, or ought reasonably to have known this at the time of its Declaration. Rights under Extra-Statutory Concession 3.5: 'Misdirection' are unaffected.

Businesses can also appeal any assessments raised by HMRC under the Notice and we take the view that the tribunal could amend such assessments as it saw fit.

36. Is there an impact for Capital Goods Scheme, Clawback or Payback?

Many Capital Goods Scheme, Clawback or Payback adjustments are calculated by reference to a partial exemption special method. Where an adjustment calculated by reference to the method means that the Declaration was incorrect, HMRC could serve a Notice to correct the position.

37. What is the Combined Method?

The Combined Method gives businesses the legal right to apply, and HMRC to approve or direct, a special method that deals with input tax on foreign and specified supplies.

38. Why is the Combined Method needed?

Under current legislation (prior to 1 April 2007), a special method can only attribute input tax to UK taxable supplies (and, by default, supplies that do not confer the right of input tax deduction). However, for administrative ease and where it did not pose a tax risk, HMRC will allow some businesses to operate methods that attribute input tax to foreign and specified supplies (so called combined methods). The Combined Method dispenses with the need for administrative agreements and gives businesses the legal right to apply for a combined method.

39 What else is new about the Combined Method?

There are two things to be aware of. The first is that if a business elects for a Combined Method, that method will attribute all of the input tax incurred by the business [except for input tax attributed under regulation 103A (investment gold) and 103B (input tax on incidental financial supplies)]. This is to avoid confusion that might otherwise arise as to which regulation recovery of input tax is made under.

The second is that the method must clearly state whether it (a) attributes input tax to UK taxable supplies (supplies falling under section 26(2)(a) of the VATA 1994) or whether it attributes input tax to UK taxable supplies, foreign supplies and specified supplies (supplies falling under section 26(2)(a),(b) and (c) respectively). This is to make it clear whether or not it is a Combined Method.

40. Is the Combined Method mandatory for some businesses?

No, a business can apply for a method that just attributes input tax to UK taxable supplies. If it does, input tax on foreign and specified supplies must be determined (prior to input tax on UK taxable supplies) under regulation 103 in accordance with the principle of use.

42. What happens if there is a gap in a Combined Method?

Sometimes the terms of a method do not specify how to recover all of the input tax it is meant to address. In these circumstances there is a 'gap' in the method and input tax falling within that gap is deducted on the basis of use.