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 HM Revenue & Customs (HMRC) more readily to give approval for a VAT recovery method for which a Statutory Declaration has been made. The Framework has been prepared by working with the Health Finance Managers 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.

There is a flowchart at Annex D of this method 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 has been published by HMRC on its website. Further useful information, for example the VAT streams, is available on the TISonline website.

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 a non-business activity. Normally the VAT on expenditure used exclusively for non-business activity is irrecoverable. However, s41 of the VAT Act 1994 provides a special refund scheme for NHS Trusts whereby the VAT incurred on certain Contracted Out Services (COS) used for non-business activity may be reclaimed.

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 solely to make exempt supplies cannot be recovered. VAT on expenditure used exclusively to make taxable supplies is recoverable under s26 of the VAT Act 1994.

4. The VAT on expenditure used partly for business purposes and partly for non-business purposes should normally be apportioned using a business/non-business (BNB) method of apportionment. The VAT that relates to business purposes should then be further apportioned between taxable supplies and exempt supplies using a partial exemption (PE) method. However HMRC can approve a single method that is a combined method covering both your business/non-business and your partial exemption calculations. This is to save the cost of seeking approval of two separate methods. It also helps to make sure a fair recovery of VAT overall as the calculations can be considered in their entirety.

5. Most NHS Trust costs are used for a mix of taxable, exempt and non-business purposes and the VAT incurred has to be apportioned. This means that all VAT expended should be identified. A recovery method normally has three further steps:
The third step involves using a recovery method that has to be approved in writing for the individual Trust by HMRC.

6. Please note that the VAT recovery methods Trusts use are combined business/non-business and partial exemption methods. The partial exemption de minimis limit does not apply if a taxpayer has a combined method of this type so Trusts have to make any input tax restriction suggested by the calculation.

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

7. 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.

8. 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.

9. 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.

10. Apportionment means dividing residual VAT between non-business, taxable and exempt supplies. This is done using a proxy calculation. Where an activity has been sectorised, 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.

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

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.

12. For example, calculations based on meal numbers in catering outlets do not make good proxies because they are difficult to define and audit. Often they do 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.

13. 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. NHS Trusts may wish to apply for methods that allow for the OBDs calculation to be made once at the end of the tax year with the result applied provisionally in each return made during the subsequent tax year. Any changes in the OBDs figure for the subsequent figure can then be adjusted for as part of the normal longer period adjustment that all recovery methods include.

14. 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.

HMRC will only approve a recovery method if it is accompanied by a Declaration on which the Trust states that to the best of its knowledge and belief the method produces a fair and reasonable input tax recovery. Annex C sets out in detail the steps that an NHS Trust are advised to take to ensure that their proposal is fair and reasonable.

15. A Trust always has to get prior written approval from HMRC before changing its method.

Sectors

16. A Trust may wish to consider sectorising an activity in its recovery method if:

(a) the activity is subject to segmental accounting and uses tax in a different way to that suggested by the result of a global calculation; or
(b) the result of a global calculation is substantially different to the result of an attribution which represents the extent to which the goods and services are used to make taxable supplies while performing that activity.

HMRC normally regards a substantial difference to be £50,000, or half of the Trust’s input tax (excluding its CoS VAT) and at least £25,000. A Trust may feel that one or more of its activities should be sectorised when these guide figures are not reached. In such situations it should discuss the position with HMRC with a view to agreeing whether sectorisation is appropriate in those circumstances.
Distorting Supplies

17. Values-based methods work on the premise that each £ 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.

18. The main characteristic of a distorting supply is that very little taxed cost is used to generate the value of the income received. 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?

19. 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 through the creation of a sector.

Provisional Recovery

20. 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, may find itself defaulting to the standard partial exemption method. In such circumstances the Trust will have to make:

   a) A claim under section 41 of the VAT Act for VAT that is recoverable under the arrangements for Contracted out Services;
   b) A calculation under section 24(5) of the VAT Act to work out how much of its input VAT is used to support the making of business supplies; and
   c) A calculation under regulation 101 of the VAT Regulations 1995 to work out how much of its input tax is used to support the making of taxable supplies.

Trusts are reminded that use of the previous year’s recovery percentage became part of the standard method with effect from 1 April 2009.

21. It is recommended that a Trust asks for provisional recovery to be a feature of its special recovery 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 is applied to the 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.

A Trust that does not apply for provisional recovery has to determine its recovery percentage each individual tax period.

NHS Trusts and the Capital Goods Scheme (CGS)

22. 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 CGS items 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 CGS item, or about how to apply the CGS, it is welcome to contact HMRC.

Other Matters

23. Ordinarily the value of VAT incurred on purchases, recognised at the tax point, should be used when making a recovery method calculation. Purchase figures derived from trial balances may, because of any accruals and prepayments, differ slightly. Also, such values may fail to recognise situations where purchases from unregistered suppliers, or zero-rated supplies, form part of the trial balance figure. Using the trial balance figures to approximate the value of purchases may therefore produce a difference which would affect a Trust’s recovery of VAT.

However, after representations from HFMA, HMRC has agreed that for some Trusts the possible loss of accuracy arising from the use of trial balance figures, when compared to using purchase figures with precise tax points, is outweighed by the additional work required to produce exactly precise information.

If a Trust wants to use figures from the trial balance it will need to agree with HMRC that they may do so. In situations where there is a possibility that any purchases from unregistered suppliers, or zero-rated purchases, may prove significant, for example if the Trust has a significant catering spend, HMRC will work with a Trust to find a practical way in which to gather sufficient information to ensure a fair and reasonable result from the VAT recovery method calculation.

24. An NHS Trust may need to change its recovery method if new circumstances arise. Even if the change involves amendment to an existing method such changes will normally require formal approval by HMRC. A Declaration is required for any new method.

25. Where a Trust changes, or anticipates changing, its legal entity it should contact HMRC.

26. 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

Steps in a simple method for NHS Trusts

Please remember that this simple method is 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 get 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.

1. Directly attribute VAT against CoS headings, non-business, taxable and exempt activities.

2. Take the total of all the VAT you have recorded against CoS headings.

3. Recover as input tax the element that relates to taxable business activity by applying the ratio:

\[
\frac{\text{taxable income}}{\text{total income}}
\]

To the total amount of VAT you have recorded against CoS headings.

4. Disallow the element that relates to exempt business activity by applying the ratio:

\[
\frac{\text{exempt income}}{\text{total income}}
\]

To the total amount of VAT you have recorded against CoS headings.

5. Claim a refund 1 of the rest of the VAT recorded against CoS headings.

6. Calculate the recovery of tax within any sector of your method 2.

7. Take the actual amount of VAT incurred 3 against general overheads which support taxable business activity 4. Recover the element that relates to taxable business activity by applying the ratio:

\[
\frac{\text{taxable income}}{\text{total income}}
\]

To the total amount of VAT incurred against general overheads which support taxable business activity.

Notes

1. The VAT claimed against CoS headings is refunded to you under s41 of VAT Act 1994. The rest of the VAT you recover is claimed under section 26 of VAT Act 1994.

2. You should consider a sector if (a) an activity is subject to segmental accounting and uses tax in a different way to that suggested by the result of the calculation at step 6 or (b) the result of the calculation at step 6 is substantially different to 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. A substantial
difference is £50,000, or half of your input tax (excluding your CoS VAT) and at least £25,000.

3 If you cannot get the actual figure you should speak to HMRC about the possibility of applying the VAT fraction to the gross cost of overheads that support taxable activity.

4 Typically these will include, but are not limited to, utility bills, auditors fees etc.

5 Excluding the values generated by any sectorised activity when sectors form part of your method.
Annex B

Worked examples*

Example A

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: £292.0M

Total income: £296.5M

It incurs VAT as follows:

- CoS Headings: £2,500,000
- Catering Costs: £100,000
- General Overhead Costs: £1,200,000

Total VAT incurred: £3,800,000

After it has directly attributed VAT and recovered any VAT attributed to taxable activities, it works out the rest of its VAT recovery as follows:

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

\[
\text{Taxable Income} \times \text{CoS Headings VAT} = \frac{\text{Total Income}}{\text{Total Income}} \times \text{CoS Headings VAT}
\]

\[
\frac{3.5}{296.5} = 1.18\% \times 2,500,000 = £29,510
\]

It can recover £29,510.

(2) It needs to know what amount of VAT incurred under CoS headings relates to exempt business activity so applies the formula:

\[
\text{Exempt Income} \times \text{CoS Headings VAT} = \frac{\text{Total Income}}{\text{Total Income}} \times \text{CoS Headings VAT}
\]

\[
\frac{1.0}{296.5} = 0.34\% \times 2,500,000 = £8,431
\]

It cannot recover £8,431.
(3) The balance of the VAT incurred under CoS headings relates to non-business activity:

<table>
<thead>
<tr>
<th>CoS Headings VAT</th>
<th>£2,500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>VAT relating to taxable business activity</td>
<td>£29,510</td>
</tr>
<tr>
<td>VAT relating to exempt business activity</td>
<td>£ 8,431</td>
</tr>
<tr>
<td>-----------</td>
<td>(£ 37,941)</td>
</tr>
<tr>
<td>--------------</td>
<td>------------</td>
</tr>
</tbody>
</table>

£2,462,059

The Trust can get a refund of £2,462,059.

(4) The Trust has identified it has incurred VAT on catering costs and general overhead costs, part of which will be recoverable.

It applies the formula:

\[
\text{Taxable Income} \times \frac{\text{Catering and General Overheads VAT}}{\text{Total Income}}
\]

\[
\begin{align*}
3.5 & = 1.18\% \times 1,300,000 \\
296.5 & = £15,340
\end{align*}
\]

It can recover £15,340.

The recovery rate for the Trust’s method is 1.18%.

**Summary**

The Trust will get back:

- VAT on CoS Headings refunded due to non-business activity £2,462,059
- VAT on Catering Costs and General Overhead Costs £15,340
- VAT on CoS Headings that relates to taxable activity £29,510

£2,506,909

This represents 65.97% of all the VAT it has incurred (£2,506,909/£3,800,000).

* Please note that figures in worked examples may be subject to rounding.
Example B

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: £295.5M

Total income: £300.0M

It incurs residual VAT as follows:

- CoS Headings: £2,500,000
- Research and Development (R&D) Costs: £300,000
- General Overhead Costs: £700,000

Total: £3,500,000

* 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. It needs to know what amount of VAT incurred under CoS headings relates to taxable business activity so applies the formula:

\[
\text{Taxable Income} \times \frac{\text{CoS Headings VAT}}{\text{Total Income}} = \text{Amount to recover}
\]

\[
\frac{1.5}{300.0} = 0.50\% \times \frac{\£2,500,000}{\£12,500}
\]

It can recover £12,500.
(2) It needs to know what amount of VAT incurred under CoS headings relates to exempt business activity so applies the formula:

\[
\text{Exempt Income} \times \text{CoS Headings VAT} \over \text{Total Income} = 1.00\% \times £2,500,000 = £25,000
\]

It cannot recover £25,000.

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

\[
\begin{array}{c|c}
\text{CoS Headings VAT} & £2,500,000 \\
\hline
\text{Less:} & \\
\text{VAT relating to taxable business activity} & £12,500 \\
\text{VAT relating to exempt business activity} & £25,000 \\
\hline
(£37,500) & \\
\hline
\text{£2,462,500} & \\
\end{array}
\]

The Trust can get a refund of £2,462,500.

(4) The Trust considers whether it needs a 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:

\[
\text{Taxable Income} \times \text{R&D Costs and General Overheads VAT} \over \text{Total income} = 0.50\% \times 1,000,000 = £5,000
\]

(b) If R&D income were taken out into a separate sector the amount of VAT the Trust gets back would be worked out using the formulae:

(i)

\[
\text{Taxable Income (less taxable R&D income)} \times \text{General Overheads VAT} \over \text{Total income (less taxable and exempt R&D income)} = 0.47\% \times 700,000 = £3,278
\]
(ii) 

\[
\begin{align*}
\text{Taxable R&D income} & \times \text{R&D Costs VAT} \\
\text{Total taxable and exempt R&D income} & = 10.00\% \times 300,000 = £30,000
\end{align*}
\]

So the Trust would get £33,278 (£3,278 plus £30,000) if R&D activity was sectorised, compared to £5,000 if it were not. Since this represents a difference of £28,278, which is less than £50k (or £25k and 50% of the Trust's input tax) there is no reason to create a sector for rental income even though the activity is subject to segmental accounting.

(5) The Trust knows that car parking uses very little taxed cost but drives a large part of its VAT recovery. Without the car park income being included in the calculations the trust would recover

\[
\begin{align*}
\text{Taxable Income (less car park income)} & \times \text{R&D Costs and General Overheads VAT} \\
\text{Total income (less car park income)} & = 0.17\% \times 1,000,000 = £1,672
\end{align*}
\]

So the Trust would get £3,328 less (£5,000 less £1,672) if the car park income were excluded. However, since this represents a difference of less than £50k (or £25k and 50% of the Trust's input tax) there is no need to exclude the car park income as it does not represent a distorting supply.

Summary

The Trust will get back:

\[
\begin{align*}
\text{VAT on CoS Headings refunded due to non-business activity} & = £2,462,500 \\
\text{VAT on R&D Costs and General Overhead Costs} & = £5,000 \\
\text{VAT on CoS Headings that relates to taxable activity} & = £12,500 \\
\text{----------------} & \\
\text{Total} & = £2,480,000
\end{align*}
\]

This represents 70.86% of all the residual VAT it has incurred (£2,480,000/£3,500,000).

* Please note that figures in worked examples may be subject to rounding.
Annex C

Seeking approval for a VAT recovery method

C1. Have you taken reasonable steps?

The person making a statutory Declaration that a proposed VAT recovery method would give 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 C2 to C5.

C2. Have you considered whether your method needs sectors?

You should consider a sector if:

(a) an activity is subject to segmental accounting and uses tax 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 substantially different to 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. HMRC normally regards a substantial difference to be £50,000, or half of your input tax (excluding your CoS VAT) and at least £25,000. Please see paragraph 16 of this Framework for more detail on this point.

C3. Have you prepared a worked example of your proposed method?

HMRC prefers to receive a worked projection of how your proposed method will work in practice, using real figures, and also an explanation why you feel your proposed method gives a fair and reasonable result. HMRC might not be able to give approval for a proposed method if there is uncertainty about its methodology in the absence of any documented projection of the result that the proposed method would generate.

C4. Have you designed your method using the Framework and HMRC guidance?

If your proposal is not based on the VAT recovery method in this Framework HMRC will still fully consider it without preconceptions over its acceptability. However, it is not unreasonable to expect that more detailed enquiries will be made and the proposal fully tested.

C5. Have you made your declaration?

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.
Annex D

How do NHS Trusts claim VAT?

Chart One – VAT incurred on COS Headings

What type of activity does the purchase support?

- If it is a non-business activity covered by the CoS heading claim the VAT back in full as a refund under section 41
- If it is a business activity that is taxable claim the VAT back as input tax under section 26
- If it is a business activity that is exempt do not claim any of the VAT back as input tax

Chart Two – VAT not incurred on COS Headings

What type of activity does the purchase support?

- If it is a business activity that is taxable claim the VAT back as input tax under section 26
- If it is a business activity that is exempt do not claim any of the VAT back as input tax
- If it is a business activity that is both taxable and exempt apply your VAT recovery method to claim some VAT back as input tax under section 26