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OFFICE OF RAIL REGULATION

REVIEW OF NETWORK RAIL'S CP5 CORPORATION TAX AND VAT FORECASTS

14 August 2013

NORTH AMERICA EUROPE MIDDLE EAST LATIN AMERICA ASIA

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ABBREVIATIONS

ACT	Advance Corporation Tax
CAA	Capital Allowances Act
CTA	Corporation Tax Act
DEFRA	The Department for Environment, Food and Rural Affairs
DfT	The Department for Transport
ECA	Enhanced Capital Allowances
HMRC	Her Majesty's Revenue and Customs
K	Thousand
M	Million
NR	Network Rail
ORR	Office of Rail Regulation
SBP	Strategic Business Plan
RSSB	Rail Safety and Standards Board (UK)
TOC	Train Operating Company
VOA	Valuations Office Agency
VPSC	Victoria Place Shopping Centre



INTRODUCTION

Mr. Jonathan Hulme
Office of Rail Regulation
One Kemble Street
London WC2B 4AN

2 August 2013

Dear Jonathan

REVIEW OF NETWORK RAIL'S CP5 CORPORATION TAX AND VAT FORECASTS

We are pleased to present our report on Network Rail's Corporation Tax and VAT forecasts for CP5 pursuant to the engagement framework agreement between Alvarez & Marsal Global Forensic and Dispute Services LLP (formerly Alvarez & Marsal Dispute Analysis and Forensics Services LLP) and The Gas and Electricity Markets Authority dated 21 August 2011 and the service order received from the Office of Rail Regulation ("ORR") dated 5 March 2013.

This report presents our key findings in what we hope you will find a clear and logical manner. We do not intend this report to be a standalone document. We want to ensure that the content and format of this report meets all of your requirements and we welcome the opportunity to discuss it with you further.

Recommendations are always a key part of our work. Where practical we have recommended a course of action or provided the options available to the ORR. Again we welcome the opportunity to discuss these recommendations and ensure the next steps are clear and appropriate.

We would like to thank everyone that we have met at the ORR and Network Rail for assisting us throughout our work.

Yours sincerely

Julian Jones
Managing Director
Alvarez & Marsal Global Forensic and Dispute Services LLP



EXECUTIVE SUMMARY

General

The scope of our work was to review the corporation tax and VAT forecasts for Network Rail (“NR”) in respect of Control Period 5 (“CP5”) which will cover the five years from 2014/15 to 2018/19.

Our review was based on the forecast T4 model (the “Model”), other supporting schedules and information provided by NR and various discussions in meetings and phone calls with the NR tax team (referred to as “Management” in this report). The Model sets out forecasts for the NR group. However, the focus of our review has been on Network Rail Infrastructure Limited (“NRIL”) which is the main trading and regulated entity.

Management has informed us that the NR group has a low risk tax rating and a good relationship with HMRC.

We have summarised below key findings from our review and provided further detail in the report.

Corporation Tax

- All corporation tax return filings up to and including the year ended 31 March 2012 are up to date. The tax return for the year ended 31 March 2011 is currently under enquiry by HMRC. NR are currently in discussion with HMRC on this. The outcome is not expected to have a material impact for CP5.
- NR has a significant amount of tax attributes including tax losses of £4,714M carried forward and unclaimed capital allowances of £5,828M at 31 March 2012. These should be available for offset and deduction against profits and therefore have a significant impact on the cash tax position for CP5.
- Based on the information reviewed, a current tax charge is forecast for 2014/15 and 2015/16. No current tax charge is forecast for the following three years due to the availability of tax losses.



EXECUTIVE SUMMARY

Corporation Tax (continued)

- There are two main tax incentives that will be relevant for NR in CP5. These are Enhanced Capital Allowances (“ECAs”) and Research & Development (“R&D”) tax credits. Depending on the level of qualifying expenditure in both cases, NR could receive a significant tax benefit in CP5. Subject to meeting the relevant conditions, NR may also be in a position to claim cash tax credits from HMRC for these incentives.
- The Model does not forecast the above incentives for CP5. We understand from Management that a number of preliminary steps need to be taken in order to try and assess the level of ECAs that may be claimed. Similarly, on R&D subject to the budget provided a detailed review will be required to assess the level of qualifying expenditure and how much R&D credit can be claimed.
- We recommend in both cases that further review and work is performed as appropriate in order to optimise the benefit from these tax incentives in CP5.
- Based on the information provided by Management with regard to major projects and initiatives being considered by NR, we do not expect a material tax impact for CP5.
- There are a few observations we have noted in this report regarding the Model which relate to the tax rate used, adjustment for permanent differences, cash tax payments and short term timing differences (“STTDs”). We understand that the Model is now “locked down” and will not be updated. We have factored in the adjustment for permanent differences in our review. The Model does not include STTDs for CP5. Based on the 2012 tax computation, the majority of STTDs are made up of general reserve provisions. Management has informed us that reserve provisions for CP5 will mainly be specific in nature following a change in accounting policy from 2013 onwards. Consequently, the tax impact of such provisions being treated as STTDs for CP5 should be minimised. Further work would be required to estimate the effect of this change on the tax position.
- We do not envisage the other factors noted above for the Model to have a material impact on the current tax charge for CP5.



EXECUTIVE SUMMARY

Value Added Tax

- NR appears generally to have robust and effective VAT accounting procedures. Having discussed current VAT processes with NR's Group VAT and Indirect Tax Manager and Head of Central Accounting Services we have found no additional areas where significant claims or assessments are likely other than those already highlighted.
- While areas such as structural reform in the industry, the potential devolution of Scotland, and the potential withdrawal of the UK from the European Union are significant matters in themselves, NR is a mainly VAT-neutral business (it is entitled to claim virtually all VAT it incurs on expenditure) and therefore its VAT situation should not be significantly affected by these matters.



CORPORATION TAX

Scope

The scope of our work was to review the corporation tax forecasts and underlying assumptions for Network Rail (“NR”) in respect of CP5 (period covering the 5 years from 2014/15 to 2018/19 inclusive). In particular, ORR requested us to conduct the following:

1. High-level review of NR’s corporation tax forecasts and opening tax balances, i.e. whether the forecast appears reasonable and whether there are any major issues with the way it has been developed
2. Review of the corporation tax opportunities that have been highlighted in NR’s Strategic Business Plan submission, i.e. likelihood of these opportunities crystallising and potential pay-outs
3. Consider any additional future corporation tax opportunities that we are aware of and which may impact NR in CP5
4. Consider any tax impacts of industry reform initiatives for CP5
5. High level review of ORR’s financial model tax worksheet.

Approach

We have based our review on the information received as set out in Appendix A and various meetings, telephone calls and email correspondence with NR’s tax team, specifically Pippa Johnson (Head of Group Tax), David Bush (Tax Manager) and Michael Hunt (Tax Asset Specialist) together referred to as “Management”.

We have reviewed the Forecast Model (Version v3.45 T4) (the “Model”), the tax forecast (SBP CT model 020413) together with supporting documentation and 2011 and 2012 tax computations for Network Rail Infrastructure Limited as provided to us.

It should be noted that whilst the Model includes forecasts for other group companies such as Network Rail High Speed Limited, the focus of our review has been on Network Rail Infrastructure Limited which is the main trading and regulated entity and comprises the major part of the forecast numbers in the Model.

We have placed reliance on the forecast numbers included in the Model and our work has not included an audit of these numbers or any verification on the completeness and/or accuracy of the financial information provided.

Overview

Tax status

The main trading company is Network Rail Infrastructure Limited (“NRIL”). We understand from Management that the tax filings for the company are up to date with the last tax computation for the year ended 31 March 2012 having been submitted to HMRC by the filing deadline of 31 March 2013.



CORPORATION TAX

Management has informed us that NRIL's tax return for the year ended 31 March 2011 is currently under enquiry. NR are currently in discussion with HMRC on this, however the outcome is not expected to have a material cash tax impact for CP5.

Management has informed us that the NR group has a good relationship with HMRC and the group is classified as a low risk tax payer.

Tax attributes

The company's significant tax attributes are tax losses and unclaimed capital allowances (tax depreciation). According to the latest filed tax computation for the year ended 31 March 2012, the tax attributes were as follows:

1. Tax losses carried forward £4,714M

These are available for unlimited carry forward and offset against future trading profits from the same trade

2. Advance Corporation Tax balance carried forward £33.9M

ACT can be offset against future corporation tax liabilities but subject to complex rules requiring the offset of notional ACT ("shadow ACT") first, as set out in Statutory Instrument 1999/358.

3. Tax written down values

- General pool £4,227.8M
- Special pool £1,443.5M
- Short life asset pool £156.7M

These are the amounts of unclaimed capital allowances available for a tax deduction in future periods.

4. Deferred revenue (capitalised) expenditure £11,793M

This should be available for tax deduction as it is depreciated for accounting purposes.

Forecast period CP5

The table below summarises the forecast headline current tax charge for CP5 as provided by NR in their addendum to SBPT3242. We have subsequently revised this for 2015/16 following our discussions with Management. These numbers supersede those in the Model. However, we understand from NR that the Model has been finalised and will not now be updated for the revised numbers below.



CORPORATION TAX

£'M	2014/15	2015/16	2016/17	2017/18	2018/19
Corporation tax charge	10.08	1.54	0	0	0

The reason for a forecast tax charge in 2014/15 is because NR is projecting a total taxable profit in that year of approximately £71M with income due from non-trading sources (mainly comprising non-trading profits such as chargeable gains on disposals and rental income) and other group profits not being offset by carried forward tax losses as these losses are trade losses and cannot offset non-trading income e.g. property income or other group income.

The reason for a forecast tax charge in 2015/16 is because the losses projected for that year of approximately £38M are not sufficient to offset the non-trading profits and other group profits fully.

The company is not forecasting a current tax charge in the next three years in CP5 due to the availability of tax losses which are generated in those years that are in excess of the non-trading profits and other group profits and therefore offset these fully.

As noted above, a current tax charge is expected in the first two years of CP5 due to the fact that NR is expecting to make taxable profits comprising non-trading profits and other group profits which cannot be fully offset by tax losses. For the future three years in CP5, NR is anticipating generating taxable losses which will be sufficient to fully offset taxable profits.

Deferred tax

We understand from Management that within the overall context of the funding requirements, the focus of the tax forecasts compiled have been on current tax (cash tax) that may become payable. Consequently, we have not reviewed the deferred tax balances in detail. However, we have the following high level comments on the deferred tax balances for CP5.

According to the balance sheet in the statutory group consolidated financial statements for the year ended 31 March 2012, the deferred tax balance comprised a liability of £3,070M as follows:

Description	Deferred tax (asset)/liability in £'M
Accelerated capital allowances	3,246
Revaluation of network	1,357
Short term timing differences and derivatives	(418)
Tax losses	(1115)
Total deferred tax liability	3,070

The net deferred tax liability relates to accelerated capital allowances because the tax depreciation i.e. capital allowances claimed have been greater than the accounting depreciation. This should reverse over time as the relevant assets are depreciated for accounting purposes.



CORPORATION TAX

Key findings

We have set out below our comments on key findings from our review.

Enhanced Capital Allowances (ECAs)

A 100% first year allowance (ECA) can be claimed on qualifying capital expenditure which meets certain criteria for example energy saving plant and machinery (Section 45A, Capital Allowances Act 2001 (“CAA 2001”). The qualifying energy saving products and technologies have to be included on the relevant lists compiled by the DEFRA.

Since the introduction of this incentive in 2001, railway assets were excluded under Section 46, CAA 2001. However, this has been changed in Budget 2013 and railway assets can now qualify for ECAs (Clause 69, Finance Bill 2013). Qualifying expenditure incurred on or after 1 April 2013 should qualify for ECAs subject to meeting the normal criteria.

The current tax legislation also allows for first year tax credits (Schedule A1, CAA 2001). Where a company claims ECAs and incurs a tax loss, it can surrender such a loss in return for a cash tax credit paid by HMRC. The credit payable is 19% of the lower of the ECAs claimed and the tax loss in the accounting period. Repayments are then limited to the greater of the company’s total PAYE and NIC liabilities for payment periods ending in the accounting period or £250K.

In the case of NR, we understand that the total of PAYE and NIC liabilities in a given year are in the region of £500M. Therefore, the £250K limit will be irrelevant. However, NR cannot at this stage estimate the level of capital expenditure which will qualify for ECAs. Management has informed us that since this is only a very recent change, there are a number of areas that need to be reviewed including procurement procedures and systems, suppliers, documentation, etc.

The Model does not include any provision for ECAs for CP5. Management can only provide a rough estimate of qualifying expenditure for CP5 which they estimate to be around £2M per year based on work NR carried out at the time of lobbying for the policy change.

Based on a £2M estimate of qualifying expenditure, the maximum first year tax credit that could be claimed in CP5 (until the current statutory time limit of 31 March 2018) assuming tax losses higher than this amount would be £1.5M. This could be higher if the qualifying expenditure is more than £2M per annum.



CORPORATION TAX

Research & Development (R&D)

Tax relief is available for qualifying R&D expenditure. Large companies can get an additional deduction of 30% of the qualifying expenditure (Chapter 5, Part 13, CTA 2009). We understand that historically NR have been claiming this tax relief where possible. Management has informed us that NR's qualifying R&D expenditure ranges between £1M and £5M per annum and averages out at around £2M. The relevant R&D that NR pays for is mainly conducted by universities and research institutions such as RSSB.

The Model does not include any R&D tax relief for CP5. We have discussed this with Management and understand that currently it is not possible to estimate the level of qualifying R&D for CP5. Management has informed us that a R&D budget of around £500M to £600M is being requested for CP5.

Assuming the qualifying expenditure is £2M per annum as a minimum for CP5, the additional tax deduction available would be £3M (30% of £10M for CP5).

A change in law has been proposed for R&D tax relief with the introduction of an Above the Line Credit ("ATL") (Schedule 14, Finance Bill 2013). Large companies will now be able to claim a 10% ATL cash tax credit on qualifying expenditure which will be claimable from HMRC, subject to the relevant conditions, and treated as additional taxable income.

Companies can claim ATL credit on or after 1 April 2013. The scheme will initially be optional and companies will be required to elect for the ATL credit. From 1 April 2016, the ATL credit will become mandatory.

Depending on the level of qualifying expenditure, the ATL credit could have a material impact on the taxable profits of NR for CP5. We understand from Management that most of the R&D expenditure is currently capitalised and R&D allowances claimed as appropriate. Such allowances would decrease taxable profits or increase tax losses without a cash tax credit being available. If any of the qualifying R&D expenditure is expensed through the profit and loss account, then NR may be able to claim the ATL credit in CP5. In the absence of further information on estimated qualifying expenditure, it is difficult to estimate the cash impact of the ATL credit at this stage but could be significant subject to the amount of qualifying expenditure. An ATL credit should be offset by available tax losses or carried forward tax losses in CP5 and there should be no additional cash tax impact based on the forecast numbers in the Model.

There are a number of steps that need to be followed in order to calculate the ATL credit, as set out in Finance Bill 2013. This will need to be worked through in detail and Management has informed us that they will continue to review R&D expenditure on an on going basis with a view to maximising any potential tax relief for CP5.



CORPORATION TAX

Initiatives

NR have provided us with a note of key initiatives that the company is currently contemplating. We have set out below our comments on these initiatives.

Research & Development ("R&D")

NR intends to expand its R&D program in CP5. We have covered this above and understand that NR will review R&D expenditure in order to optimise available tax relief.

British Rail Board (Residuary) Limited ("BRBR")

NR will receive approximately 50 sites from BRBR. The sites which primarily include war memorials, bridge foundations, and tunnels will be transferred under a Statutory Transfer Order and a Treasury Order, which we understand should provide for the transfers to take place in a tax neutral manner.

Management expect the tax impact of the acquisitions to be immaterial as most of these sites will not qualify for capital allowances and will be transferred free of VAT and SDLT. We consider Management's conclusions to be reasonable.

Project Dime and Network Rail Consulting

We understand that Project Dime was a wide ranging review of how the company conducts its business. There were two primary outcomes of the project being, (i) the formation of a new business unit which will deliver infrastructure projects and (ii) the creation of a small consulting business which will pursue international railway consulting work.

We understand from Management that the new business unit does not cause any change to the nature of the underlying historical trade. On this basis, this should not cause the carried forward tax losses not to be offset against future trading profits from this initiative, but should be kept under review.

With regard to the international consulting business, a new company has been set up and we understand that at present the business activities are still in their early stages and it is difficult to make an assessment of the tax position. However, a material cash tax impact is not projected for CP5 in respect of this initiative.

NR will need to be aware of the tax laws in the relevant foreign jurisdictions that it proposes to provide consulting services in. Typical tax matters that the company will need to consider include *inter alia* permanent establishment and taxation of profits, tax relief for funding, remittance of profits and related withholding taxes, withholding of employee taxes and VAT requirements.



CORPORATION TAX

Scotland

We note that NR have prepared the tax forecasts based on current tax legislation (subject to tax rate comment below). It is expected that the Scottish Independence Referendum will be held in September 2014.

ORR wanted us to consider the impact on CP5 of a change in tax legislation for Scotland. Clearly this could have a material impact on NR's tax position in particular with regard to its Scottish business. We have considered this but in view of the uncertainty on independence and the introduction of different tax laws for Scotland, it is not possible to estimate the impact if any. Such an attempt would be purely speculative at this stage.

Therefore, in the absence of specific tax proposals that may affect railway businesses in Scotland in the future, we are of the view that basing the CP5 tax forecasts on existing tax laws is prudent and appropriate.

Model review

We understand that the Model is now finalised and it is not intended to be updated. We have the following comments in respect of the Model.

- Tax rate – the corporation tax rate used in the model for CP5 is 22%. The tax rate from 1 April 2014 will be 21% and is proposed to be reduced down to 20% from 1 April 2015. We understand that the Model is not going to be updated. However, given the level of taxable profits for 2014/15 and 2015/16 and the tax losses forecast for the following three years in CP5, we do not expect the rate change to have a material impact on cash tax payable.
- Cash tax paid – the formula for the cash tax paid in the Model needs to be updated as it adds the brought forward balance with 50% of the previous year's tax payable instead of the brought forward balance and 50% of the current year's tax liability. We have discussed this with Management and whilst they agree, they have informed us that the focus of the Model has been on the current tax liability for funding requirements rather than the timing of the tax payments. Therefore, it is not intended to update this.
- Permanent differences – the Model provides for a tax deduction in respect of permanent differences of £5M per annum for CP5. Management has informed us that this is based on an estimate taking into account recent tax returns submitted. However, we note from the submitted tax computations for 2011 and 2012 the adjustment in respect of permanent differences were approximately £1.9M and £7.6M of add backs respectively. We have discussed this with NR and agreed that the £5M estimate should in fact be an add back. Accordingly, we have taken into account the revised forecast taxable profits and losses after making this correction for the purposes of our review.



CORPORATION TAX

- Qualifying capital expenditure – the Model splits the capital expenditure into the following categories for CP5
 - Plant and machinery (special pool)
 - Plant and machinery (general pool)
 - Deferred revenue expenditure
 - Short life assets
 - Non-qualifying expenditure

Management has informed us that the above classification is based on the forecast for 2012. We have compared the proposed classification above to the allocation of capital expenditure in the 2011 and 2012 tax computations and note it is in line with those computations.

The percentage allocation between general and special pools changed in 2011 following a change in law. Effective from 1 January 2011 qualifying expenditure on railway assets was no longer exempted from the long life asset rules. Therefore a significant shift in allocation followed this change in respect of new expenditure after that date.

What this means is that the tax relief on such expenditure is deferred over a longer period of time as the capital allowances rate is lower (currently 8%).

- Accounting tax charge – the historic tax charge in the statutory financials does not reconcile with the sum of the current and deferred tax charge in the “Tax” sheet in the model. As noted above, we understand from Management that a reconciliation has not been performed as the model is a forward looking cash model with the focus being on the current tax liability for CP5. In order to reconcile these amounts, further work will be required and ORR may wish to discuss this further with NR if required.
- Capital gains – The Model calculates the chargeable gain on property disposals at an assumed percentage rate of the net disposal proceeds. This is based on historical percentages that Management has considered between 2003 and 2012. Management consider the current percentage to be a prudent estimate for CP5 and this appears to be reasonable.
- Short term timing differences (“STTDs”) – The Model does not take into account short term timing differences e.g. movement on general provisions for the purposes of the CP5 current tax forecast. We have reviewed the 2012 tax computation and note there was an adjustment of £114.5M in that year. Management has informed us that following a change in accounting policy from 2013 onwards, the majority of these provisions should be specific in nature going forward and consequently should not result in any material STTD adjustments in CP5.



CORPORATION TAX

- Further work will be required to establish the impact of any STTDs for CP5. However, we would expect an increase in taxable profits to be offset by carried forward losses.
- Other – We have discussed with Management business activities undertaken by other active entities in the NR group. We understand that the activities of some of these entities have not been included in the Model. However, Management do not expect these entities to have a material impact for CP5. The main entities excluded from the Model are as follows:
 - The Station Office Network LLP (a joint venture with The Office Group set up in 2012 to develop serviced offices in stations);
 - Network Rail Development Limited and the Solum sub-group (set up to carry out development work in partnership with Kier on certain sites adjacent to stations and develop them into residential, commercial or leisure facilities);
 - Network Rail Certification Body Limited (set up on request by DfT to ensure and monitor new asset installations comply with relevant EU rules and regulations). The company recharges its costs to NR or other customers like TOCs.



VALUE ADDED TAX

Background and overview of NR's VAT accounting

We have reviewed NR's VAT status through a series of discussions and interviews with several NR staff who are involved in the VAT accounting process. We have also reviewed documents and correspondence that we requested from NR during the course of our review (a list can be found in Appendix B).

Our main points of contact for the VAT review were Stephen Sell, Group VAT and Indirect Tax Manager, and Phil Hughes, Head of Central Accounting Services, whose team is responsible for preparing NR's VAT returns (together referred to as "Management").

NR's VAT repayment position is mainly due to its grant funding; the company incurs more input tax (i.e. VAT on purchases) than the output tax (i.e. VAT on sales) that it declares and thus claims the difference from HMRC. For this reason NR currently submits a VAT return every 28 days which allows it to receive the refund quicker than it would by submitting quarterly VAT returns as is the standard for businesses that are usually in a net VAT repayment position.

NR derives revenue from three main sources:

- Track access fees charged to Train Operating Companies (TOCs) (standard-rated).
- Grant funding received from the Department for Transport (which NR currently treats as outside the scope of VAT) and is currently at a level of approximately £3,800M per annually.

- Real estate rental activities (which is mostly standard-rated, with a small proportion being exempt).

Most of NR's costs are standard-rated with the most significant categories being:

- Track maintenance (standard-rated)
- Equipment purchases (standard-rated)

In terms of its income and expenditure that is subject to VAT, NR is a relatively VAT-neutral business; it is entitled to claim over 99% of the VAT that it incurs on purchases.

In general terms, a business is entitled to recover VAT on purchases of goods or services that it uses to make taxable supplies (i.e. supplies of goods or services that are subject to VAT). By contrast VAT is not recoverable where purchases are used in the supply of goods or services that are exempt from VAT. VAT exemption mainly relates to supplies made in the areas of financial services, insurance, healthcare, education, and some property transactions.

The main areas of expenditure where NR is not entitled to full VAT recovery are areas where the VAT law imposes a specific block on VAT recovery, such as business entertainment and car leasing. The company generates a small amount of property rental income that is exempt from VAT resulting in a relatively small restriction of input tax.



VALUE ADDED TAX

Network Rail Infrastructure Limited is the representative member of a VAT group comprising eight NR companies. As a VAT group, the activities of each member are consolidated into one VAT return that is submitted by the representative member.

This is mainly for administrative convenience, as each trading company would need to register for VAT independently and submit its own VAT returns in the absence of a VAT group. This is common practice for groups with several trading companies.

Areas of focus for our VAT review

In light of the VAT neutral status (whereby NR claims most of the VAT it incurs on its purchases) of NR, our review has focused on the following areas:

- Uncertain VAT positions that NR has already highlighted.
- Opportunities for enhanced VAT accounting identified by NR.
- Additional areas of potential opportunity or risk.

Relationship with HMRC

We have observed a co-operative and effective working relationship between NR and HMRC VAT officers. This is evident from discussions with Management in several pieces of correspondence we have seen from the past two years on a variety of issues including compensation payments, transfers of going concerns, and car purchase restrictions.

We gather that where possible there is a preference within NR as an organisation to seek guidance from HMRC on uncertain VAT matters.

On one hand this provides some comfort that HMRC are aware of uncertain VAT issues which NR has raised. However this approach may not always produce the best result for NR and in general taxpayers should be cautious of over-reliance on HMRC opinions that are not binding.

Accounts payable

We concur that NR appears to have robust VAT accounting procedures in place with knowledgeable and experienced staff responsible for monitoring those procedures. The company's procedures compare favourably with best practice that we have observed in similar large-scale organisations. We have not performed a detailed audit of NR's VAT accounting procedures and our opinion is based solely on interviews with staff to ascertain what procedures are followed and what checks are in place to ensure reasonable care is taken in preparing the VAT returns.



VALUE ADDED TAX

Inevitably in any large organisation that handles a high volume of transactions and accounting documents there is potential for occasional accounting errors. However, we have found no evidence to suggest that NR's assessment in respect of identifying underclaimed VAT is unreasonable.

Hybrid car leases

Generally there is a 50% input tax restriction on car leasing. NR has in the past considered achieving greater VAT efficiency in its vehicle leasing activities by restructuring the existing arrangements.

We gather this area has not been examined further since NR took a decision to purchase the majority of its vehicles rather than lease them. This significantly reduces the potential VAT savings in this area; purchasing vehicles that will be 100% used for business purposes allows for full VAT recovery. There is however a full disallowance of the VAT incurred on purchasing vehicles that will not be used 100% for business purposes (e.g. company cars that employees may use for non-business journeys).

This does not appear to be a significant opportunity for Network to claim additional VAT. In any case, implementation of such a scheme would only benefit NR going forward and does not present an opportunity to reclaim VAT that has been properly disallowed in past periods.

Authenticated receipts

A substantial proportion of the VAT on purchases that NR processes – in the region of three-quarters of all VAT input documents that NR processes – are applications for payment mainly from maintenance contractors. Following the supplier's application for payment, NR makes payment and issues a receipt which the supplier is required to authenticate and return to NR. It is the authenticated receipt that serves as evidence of NR's entitlement to claim input tax in the absence of a VAT invoice issued by these suppliers. This is common practice within the construction industry.

NR claims input tax according to when it makes payment and issues the payment receipt to the supplier. We discussed the likelihood that not all receipts are authenticated and received from suppliers before NR submits each VAT return. This implies NR does not hold the necessary evidence for recovering all input tax stated on its VAT return at the time it is submitted.

We gather that there is a process in place whereby outstanding authenticated receipts are reviewed regularly and if necessary adjustments are made to the input tax claimed. Importantly from a VAT perspective, NR explained that this process has been reviewed and approved by HMRC. We therefore consider this to be a low area of risk in respect of potential HMRC VAT assessments.



VALUE ADDED TAX

Employee expense claims

For a company the size of NR, employee expense VAT claims are inevitably an area that could be prone to VAT accounting errors.

We also observed the operation of NR's online system for recording employee expenses: iExpenses. We have reviewed similar electronic systems and found the system to be an effective and accurate way to process and monitor employee expenses. This system leads us to conclude that employee expenses are a low risk area for VAT errors.

Rental properties

Network Rail has an extensive portfolio of real estate properties which includes not only stations and the railway infrastructure but also property that is let to third-party businesses (for example business premises located under railway arches) and retail units at stations.

Letting commercial real estate is usually, by default, exempt from VAT. Lessors are however able to *opt to tax* commercial real estate for VAT purposes. This results in rental income from real estate, on which this option has been exercised, being subject to VAT. Many lessors of commercial property opt for this treatment so that they are entitled to claim input tax related to expenditure on the real estate – as noted earlier in the VAT section, VAT on expenditure attributable to exempt supplies is not recoverable.

NR has a policy of opting to tax each real estate property in its possession. HMRC must be notified of each option and in a few cases HMRC's permission may be required for the option to take effect. A minor number of NR real estate properties may not be subject or wholly subject to the option to tax because they may for example be partly used for residential purposes which is always exempt regardless of any option to tax that has been made.

uses a system called Horizon which is designed specifically for managing a portfolio of commercial real estate. The information held on each item of real estate includes whether the real estate has been opted to tax. Although we have not audited this area in any detail, we consider that the use of the Horizon real estate management software, regular monitoring of property transactions by the VAT team, and the default policy of opting to tax all real estate minimises the risk of VAT accounting errors in this area.

Input tax accrual

Many large companies have agreed a VAT accrual percentage with HMRC as a proxy for claiming input tax that has been invoiced by suppliers but not processed in time to be included on the VAT return for the relevant period. This gives the business a cash flow advantage by effectively eliminating the delay in processing accounts payable invoices.



VALUE ADDED TAX

We discussed the potential for an input tax accrual with Management. NR has considered the possibility but in their view the accounts payable processing time is short enough that the cashflow benefit of agreeing an estimated accrual with HMRC would be negligible. Therefore, no VAT accrual percentage has been agreed with HMRC.

Further remarks on VAT

Structural reform in the industry

As a largely VAT neutral business (whereby NR claims most of the VAT it incurs on its purchases) structural reform is unlikely to have a significant impact on NR's VAT accounting unless there is a material change to the way NR conducts its activities or how it is funded. Notwithstanding our comments earlier in the report about the VAT treatment of grant funding received from the Department for Transport, NR is likely to remain in a VAT repayment position as long as its expenditure on maintaining and investing in the rail network exceeds the taxable revenue it receives from the TOCs.

Potential Scottish devolution and UK withdrawal from the European Union

The UK's VAT rules are based on the European Union VAT Directives that require each member state to adopt a VAT system and direct how member states must implement their domestic VAT legislation. A potential UK withdrawal from the EU may allow the UK more flexibility to adapt the functioning of the VAT system or restructure it.

Two countries in mainland Europe that do not belong to the European Union – Norway and Switzerland – both operate a VAT system similar to those observed in EU member states with standard rates of 25% and 8% respectively. Given these precedents, and a general move towards VAT systems by developed and developing economies, in the event of the UK withdrawing from the EU we do not foresee the UK government immediately making changes to the operation of VAT that would significantly affect NR.

Similarly, with potential Scottish devolution, we do not foresee significant changes to the operation of VAT in an independent Scotland particularly if it remains a member of the European Union and therefore obliged to continue observing the EU VAT directives. No doubt there would be some disruption to VAT accounting owing to re-allocation of assets and responsibilities.

A change in the VAT rate

The UK increased its standard VAT rate to 20% from 17.5% in January 2011. There is certainly scope for another change to the UK standard rate over CP5. VAT rates within the EU currently range from the minimum allowed of 15% (Luxembourg) to 27% (Hungary).

In practice, a further VAT rate change would affect Network Rail mainly to the extent the company would need to alter its invoicing processes and VAT accounting processes. It should not have a significant impact to the company's overall finances as it is entitled to reclaim virtually all VAT that it incurs on expenditure.



APPENDIX A – INFORMATION RECEIVED FOR CORPORATION TAX

1. Strategic Business Plan (SBPT3242) received on 6 March 2013 from ORR and addendum to SBPT3242 received from NR on 2 April 2013
2. Tax commentary paper on “Major and potential major initiatives in CP5” received from NR on 2 April 2013
3. Tax forecast sheet (SBP CT Model 020413) received from NR on 2 April 2013
4. Forecast Model Version v3.45 T4
5. Final tax computations for NRIL for the years ended 31 March 2011 and 2012
6. Schedule summarizing the property proceeds chargeable to corporation tax from years 2003/04 to 2011/12
7. Email from Pippa Johnson dated 21 March regarding Enhanced Capital Allowances in light of the recent change announced in Budget 2013.



APPENDIX B – INFORMATION RECEIVED FOR VAT

1. Summary details of NR monthly VAT declarations for the past two years.
2. Recent correspondence between NR and VAT officers at HMRC over the past two years.
3. Calculations relating to NR's VAT partial exemption calculations.
4. A schedule of uncertain VAT positions and VAT opportunities.
5. NR's general conditions of contracts for suppliers.