The HFMA's response to the *VAT and the public sector: reform to VAT refund rules*

About the HFMA

The Healthcare Financial Management Association (HFMA) is the professional body for finance staff in healthcare. For 70 years, it has provided independent and objective advice to its members and the wider healthcare community. It is a charitable organisation that promotes best practice and innovation in financial management and governance across the UK health economy through its local and national networks.

The association also analyses and responds to national policy and aims to exert influence in shaping the wider healthcare agenda. It has particular interest in promoting the highest professional standards in financial management and governance and is keen to work with other organisations to promote approaches that really are 'fit for purpose' and effective.

The HFMA offers a range of qualifications in healthcare business and finance at undergraduate and postgraduate level and can provide a route to an MBA in healthcare finance. The qualifications are delivered through HFMA's Academy which was launched in 2017 and has already established strong learner and alumni networks.

Summary

This submission is based on the views of our members, particularly informed by the views of the HFMA's VAT Sub-committee (the Committee) that is made up of finance staff from across the UK who are responsible for managing VAT issues as part of their role.

The Committee welcomes the reform and acknowledges that the contracted out services (COS) system is both complex and not fit for purpose. The time and effort required by NHS staff, consultants and Her Majesty's Revenue and Customs (HMRC) to effectively operate the system and interpret the guidance has raised questions by many individuals for many years. A simpler VAT recovery system for the public sector is a positive development and its introduction is supported by our members. We acknowledge that, but it will require careful planning and implementation as there are many ramifications, not just for the NHS and other public sector bodies, but for the contractors or commercial providers of similar services. We believe these ramifications can be addressed and/ or mitigated and would welcome continued engagement in the ongoing process.

Detailed response

Background

Organisations that fall under section 41 of the VAT Act 1994 ('the Act') can generally only recover the VAT they incur on services they buy in for their non-business activities if those services fall within one or more of 76 COS headings published under the HM Treasury direction.

The Committee agrees with the conclusion reached by HM Treasury (HMT) and HMRC that section 41 in its current form is unduly complex, administratively burdensome and a barrier to effective financial planning. This is borne out by the onerous workload placed on HMRC regarding claims made by NHS bodies based on interpretation of the COS headings.

The policy paper states that it is solely concerned with addressing the issues present within the section 41 regime and therefore focuses only on those bodies currently within the scope of section 41 and non-business activity. The Committee acknowledges this and that NHS bodies, which it represents, are included within the spectrum of suggested reform.

The preferred full refund model would see the end of the COS regime. It would allow section 41 organisations to recover all VAT on goods, as well as services, incurred for non-business use. But this increased VAT recovery would likely see a commensurate drop in government top up funding to cover VAT recovery shortfalls.

Our response covers the following points:

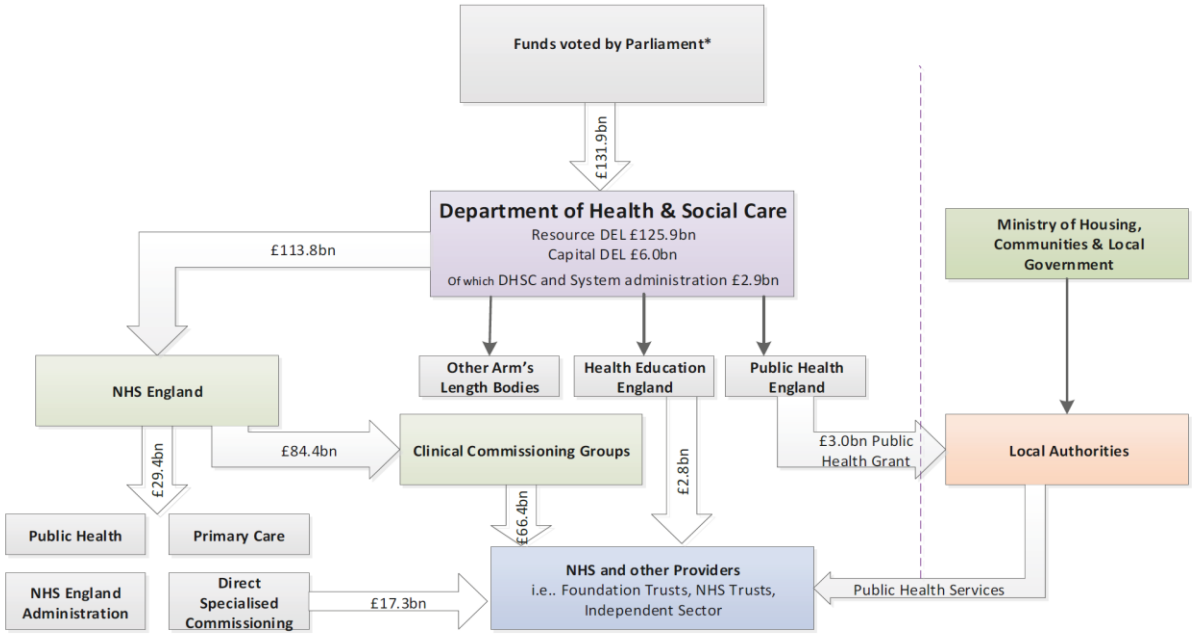
- fiscal neutrality and how that will be achieved in the NHS
- the impact of the proposals on NHS bodies' wholly owned subsidiaries
- the effect of the proposals on contracts between NHS bodies and those outside of the divisional registration
- partial exemption
- the timing of the implementation of the proposed changes and unintended consequences
- the possible changes in supplier behaviour as a result of the change in regime.

Fiscal neutrality

The Committee agrees that the basis of the reform should be fiscally neutral but acknowledges that there are significant issues in achieving this that require careful consideration before any final decision is made.

The Department of Health and Social Care (DHSC) is made up of over 450 health and social care organisations that are mostly within the VAT divisional registration but, nonetheless, manage their own VAT and submit their own claims. The complexity of the system is reflected in the extract below from the DHSC's 2018/19 annual report and accounts.

Figure 1: Flow of funding in the health and care system, 2018-19 (Budgeted Position)



Each of the 450+ bodies will have taken different decisions in relation to how they operate which will have implications on their VAT efficiency.

How the impact of this change will flow through the DHSC's funding system without having a financial impact on individual NHS organisations is of concern to our members. The impact on the DHSC at the departmental/ group level may be neutral, but each of the group's bodies is assessed on its own financial performance so it will be important that that the neutrality flows through the system or, if not, the impact of this change is recognised as being outside of each body's control. Different NHS bodies have taken, or are able to take, different approaches to manage their VAT recovery.

Examples of the types of issues that will impact on an individual NHS body's VAT efficiency include:

- whether they have a PFI scheme or not
- whether they have subsidiary bodies or not, and if so, the size of those subsidiaries and their operations
- the number and type of managed service contracts the NHS body has.

Some of our members have started to assess the impact of this proposal on their financial position and it is material, £10-14m for some. It is vitally important that the impact of moving to the full recovery model is considered at the NHS body level as well as the departmental level.

The Committee acknowledges that the local authority VAT refund mechanism (under section 33 of the Act) is referred to in the consultation paper, and it is implied that this is the type of mechanism that HMT would prefer. Our members are concerned that there is a lack of detail about how this type of system would operate in practice. The Committee would like to offer its support as a sounding board as the further detail is developed once representations by the NHS and wider public bodies to this call for evidence have been considered. The Committee and the HFMA are in a position to gather case studies and information from NHS bodies to help assess the impact of the proposals as they are developed.

The Committee also notes that the paper does not comment on divisional registration which the NHS is managed under for VAT and the effects of the reform on this process.

Subsidiary bodies within the NHS

Some subsidiary bodies have been setup within the NHS to provide non-healthcare services back to the NHS. Such efficiencies were encouraged to improve and develop new ways of working and promote commercial best practice. It should be noted that only NHS foundation trusts have the legal power to establish subsidiary bodies, so this opportunity was not available to all NHS bodies.

These subsidiaries are able to employ staff on new terms and conditions outside of the NHS agenda for change pay arrangements. These organisations are therefore more commercial and are able to compete for external contracts which either brings in new income to the NHS or keeps the expenditure within the NHS as external providers do not need to be paid.

Where such a subsidiary provides a service under COS 45 back to an NHS provider that wholly owns it, the subsidiary arrangement will also benefit the NHS provider as a tax efficiency. For example, a healthcare facility contract may see a subsidiary provide services such as an operating theatre which includes:

- the building
- heat and light
- sterility of the air
- operating tables and all subsequent medical machines
- medical gases
- instruments
- consumables
- personal protective equipment (PPE)
- sterility of instruments
- cleaning services
- portering services
- catering
- maintenance of the building
- maintenance of equipment.

This service is provided under a unitary payment arrangement and all the VAT will be recoverable under COS 45. It is often the case that the properties involved in such arrangements have been opted to tax upon inception / initial transfer.

In the example set out above this efficiency gives a benefit to the provider body over one that has not setup a subsidiary company. The full refund scheme will need to acknowledge this efficiency, in the funding regime going forward, to ensure that the agreed benefit continues to be recognised under the reform and the provider body does not suffer a loss.

NHS bodies working with non-NHS bodies

Local government

NHS bodies are seeking to work on an integrated basis both with other NHS bodies, in integrated care systems (ICSs) but also with local authorities. Our members have raised their concerns that VAT is currently a barrier to integration with local authorities and therefore welcome this proposal as it will remove that barrier[1].

[1] HFMA, *Evidence to Health & Social Care Committee's inquiry: NHS legislative proposals*, April 2019

Universities

The proposals may impact on the relationship that NHS bodies currently have with universities particularly in relation to research and development projects. The VAT implications of a project may become a deciding factor in which body takes the lead on the project – this may not necessarily be the most appropriate organisation in terms of project management and research skills. The difficulties with joint working that NHS bodies currently experience with local authorities because of their differing VAT regimes may shift to joint working with the university sector.

The private sector

Under the proposals, NHS bodies will be able to reclaim all the VAT that they incur. Private sector bodies will not – they will only be able to recover VAT on business activities and healthcare is an exempt activity. Therefore, it will be less attractive to sub-contract outside of the NHS.

There will need to be a full assessment of the impact of this proposal on arrangements between NHS bodies and private sector bodies.

NHS bodies providing private patient services may have a competitive advantage over private sector providers under these revised arrangements.

Partial exemption

COS relates to non-business activities, so where NHS bodies undertake business activities they are outside of the scope of these proposals. More detailed work on what the impact on partial exemption and capital goods scheme will be will have to be undertaken as these proposals are developed.

Despite a full refund model being proposed, NHS bodies will still be required to complete and undertake partial exemption calculations and adjustments. This is on the basis that NHS bodies will continue to make taxable and exempt supplies in addition to their core non-business activities.

Over the years, a lot of work has been undertaken with regards to partial exemption, in particular, developing a standard method framework which NHS bodies could use to calculate the adjustments required.

However, due to the varying activities undertaken by NHS bodies, many of them felt the standard method of partial exemption did not give a fair and reasonable result. Consequently, the vast majority of NHS bodies have spent a significant amount of time developing and agreeing with HMRC partial exemption special methods which reflect the complexity and nuances of their business.

The introduction of the full refund model would require every NHS body to review its current partial exemption model and if it no longer gave a fair and reasonable result, a new method would need to be developed and agreed with HMRC.

We note that local authorities are subject to a de minimis where they are engaged in a mix of non-business and exempt business activities and the two cannot be conveniently distinguished. It is not clear whether that would also apply to NHS bodies in the same circumstances under these proposals.

Timing and cost of implementation

It is not clear when these proposals would come into force, but the DHSC and other national bodies will need time to assess the impact and work out how that would flow through the system – especially to ensure that the impact is smoothed between NHS bodies.

NHS bodies need clarity about any changes to their financial regime and time to implement any changes. Our members have indicated that they would need at least one planning round to implement the changes. This would mean that if the changes were included in the April 2023 Finance Bill then the date of implementation would need to be 1 April 2024 at the earliest as the planning for 2024/25 would start in the autumn of 2023. This would allow the national bodies, DHSC and NHS England and NHS Improvement time to take account of the effect of the change in the VAT regime

and make the necessary amendments to the NHS finance regime, whether that is payment by results or a blended payment arrangement. Sufficient notice would be required by NHS England and NHS Improvement to execute changes to the full planning cycle for NHS funding to take effect after any Finance Bill legislation.

This would also allow the devolved nations time to make the necessary amendments to their financial regime. Their experience is that HMRC usually deal with the impact of any change in England before moving on to Scotland and Wales. For example, guidance on the VAT implications of the changes to the NHS procurement framework for construction projects, P22, has been developed in England before moving on to consider the impact on Design for Life in Wales and Frameworks Scotland.

NHS bodies will need time to amend their accounts payable and financial reporting systems and to train staff in the new arrangements. As well as time, there will be a cash cost attached to implementing the new arrangements – each NHS body will have to assess what that cost is likely to be for them.

Transitional arrangements

Consideration needs to be given to whether there will be 'cliff edges' at the date of implementation of the new arrangements – if VAT cannot be reclaimed in March but can in April then there would be an incentive to delay the purchase until April. However, this could have unintended consequences on the provision of healthcare services. This could also have an impact on manufacturers and suppliers.

It is not clear from the current proposals what the effect on longer term, often capital, projects and contracts would be where those projects span the transition date. The contracts will be agreed on the basis of the VAT regime in place at the time but the change to a full recovery model could have a financial impact for both parties to the agreement that may need to be managed.

Any change in the ability of NHS bodies to recover VAT on non-business activities would have an impact on the capital goods scheme. It is therefore important for NHS bodies to understand whether or not adjustments under the capital goods scheme would be able to be made in relation to projects relating to non-business activities incurred prior to the reforms being enacted. If this is not the case, then this could be an incentive for NHS bodies to defer large capital schemes until after the reforms are enacted to maximise the amount of VAT recoverable. As well as impacting capital projects at a local level, it could also affect the DHSC's performance against their capital departmental expenditure limit (CDEL) in the year before the changes are implemented as well as the year of implementation.

The impact on supplier behaviour

Supplier behaviour needs to be considered. There is the possibility that prices will go up by less than the VAT rate as suppliers will know that the NHS can reclaim the VAT. The NHS body would therefore reclaim the VAT but would pay more for the goods in the first place.

The Committee has identified two potential unintended consequences of the proposal as illustration.

Cost of medicines

The proposal could have an impact on the cost of medicines. Currently, suppliers operate rebate schemes outside of the VAT regime and the change in the VAT regime may impact on those schemes.

NHS Property Services

The impact on those organisations like NHS Property Services that work with NHS bodies but sit outside of the divisional registration needs to be considered. At the moment, NHS Property Services does not opt to tax its premises as the VAT cannot be recovered. If the VAT is recoverable then this may change, and they may opt to tax all properties. The impact of changes in behaviour needs to be assessed to ensure that there are no additional costs introduced anywhere in the system.

Conclusion

Our members are supportive of the proposals in principal. However, they do have concerns about the practical implementation of the changes, particularly in the NHS where the funding flows are complex and there are large numbers of organisations with differing VAT arrangements involved. Therefore, our members and the Committee would like to offer its support as the further detail is developed and would be pleased to help with data collection or worked examples.

If you would like to discuss any of our comments in more detail please contact Debbie Paterson, HFMA policy and technical manager, debbie.paterson@hfma.org.uk.