



HM Treasury

VAT and the Public Sector: Reform to the VAT refund rules

Response paper

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Chapter 1

Introduction

- 1.1 Section 41 of the Value Added Tax Act 1994 (VATA) allows public bodies falling within the scope of the legislation to claim a refund of VAT incurred on the procurement of a limited list of services as outlined in the Contracted Out Services (COS) Direction published by HM Treasury (HMT).¹ The list of COS is colloquially referred to as “the COS Headings”.
- 1.2 Section 41 applies to certain public bodies, including those listed below. Throughout this response document, the following bodies may be referred to as public bodies, central government organisations, Section 41 bodies, or government departments.²
- UK government departments;
 - NHS England & its bodies;
 - Scottish Government;
 - NHS Scotland & its bodies;
 - Welsh Government;
 - NHS Wales & its bodies;
 - UK Parliament;
 - Health and Social Care in Northern Ireland (HSCNI) & its bodies;
 - Highways England;
 - Some Crown Non-Departmental Public Bodies (NDPBs), for example the Advisory, Conciliation and Arbitration Service (ACAS).
- 1.3 The purpose of the refund scheme is to make sure that public resources are used in the most efficient way possible, by ensuring VAT costs are not a disincentive for public bodies to implement approaches to policy delivery that represent the best value for

¹ Latest up to date HMT Direction can be found on <https://www.thegazette.co.uk/notice/3665219>

² The full list can be found on <https://www.gov.uk/hmrc-internal-manuals/vat-government-and-public-bodies/vatgpb9720#qualifying-bodies>

money. However, a number of issues have been identified with the current refund system, including the potential for high administrative burdens, productivity inefficiencies, policy delivery challenges, legal disputes and reduced flexibility in responding to a national crisis.

- 1.4 The government published a Policy Paper on the 27 August 2020 entitled 'VAT and the Public Sector: Reform to VAT refund rules'³ ('the Policy Paper') which explored the issues affecting both private sector and public sector organisations in their interactions with Section 41, and set out a proposed reform. Alongside this, the government sought views on the advantages and disadvantages of reforming the way in which VAT incurred on non-business activities related to their public body functions is refunded to the public sector, and the options for implementation of any reform.
- 1.5 The Policy Paper set out a Full Refund Model (FRM), which would extend the current scope of Section 41 to permit full refunds of the VAT incurred on all goods and services in the course of non-business activities for those organisations currently falling within the scope of Section 41.
- 1.6 The deadline for the submission of responses to the Policy Paper was 19 November 2020. The government received over 60 responses from government departments, NHS Trusts, non-departmental public bodies and other interested parties. Stakeholders were overwhelmingly in favour of reform to the Section 41 refund scheme, with the majority of respondents supported the FRM as the model for reform. However, the responses also identified a number of specific areas that would need to be considered in the design of a potential reform.
- 1.7 This document summarises the views received from respondents on the potential implementation of FRM. Whilst FRM remains our preferred option for reform, responses highlighted certain areas that require further consideration. The government will consider these in detail, including through further engagement with stakeholders, before a final decision on whether to implement FRM is made.

³ The Policy Paper can be found on <https://www.gov.uk/government/publications/vat-and-the-public-sector-reform-to-vat-refund-rules>

Chapter 2

Areas highlighted in response to the Policy Paper

Funding implications

- 2.1 Stakeholders have challenged our previous assessment of government accounting and Section 41, and the section below clarifies the current treatment.
- 2.2 HMT sets departments' budgets as part of the Spending Review process. Departmental budgets are set net of recoverable VAT and include irrecoverable VAT charges.
- 2.3 Responses to the Policy Paper have highlighted a need to ensure that the government considers the implications that reform of Section 41 will have on the funding of public bodies. In particular, responses highlighted the complexity of VAT refunds and institutional structures within the NHS, and expressed concerns that it would be challenging to ensure the budget adjustments coinciding with Section 41 reform were fiscally neutral overall.
- 2.4 As previously outlined in the Policy Paper, we are committed to ensuring that, if the government decides to implement FRM, the delivery of any reform is fiscally neutral. The government will continue to refine the design of the scheme to best reflect the aims and objectives for FRM, building on the responses to the Policy Paper and through further engagement with interested stakeholders.

Full Refund Model and the private sector

- 2.5 Some responses to the Policy Paper have highlighted concerns that the adaptation of FRM poses some risks of commercial distortion. The concern was that Section 41 bodies could have a VAT advantage over private sector providers and would have a disincentive to outsource certain services.
- 2.6 For instance, if a service was put out to tender which was exempt from VAT, a private sector provider would be unable to recover VAT on their costs in respect of the supply. However, if the service was

performed in-house and the Section 41 body is able to claim a refund on the VAT costs, this would reduce the relative cost of that service.

- 2.7 Another example cited was that FRM could discourage Section 41 bodies from outsourcing entire services, including services such as building repairs (where a large element of the overall cost is in respect of goods) and serviced administrative or operational functions (where it may be more cost effective to procure supplies of staff, rather than the overall service).
- 2.8 On the other hand, several respondents also argued that FRM would improve fair competition between different suppliers. Since the present system only allows non-business VAT recovery for a limited number of services, it was argued that the COS refund system actually fails to act as an incentive to procure certain services externally where VAT recovery would not be available. In contrast, since FRM involves the considerable widening of the scope for VAT recovery by public bodies, it may become more cost effective to contract third parties to carry out a wider range of services.
- 2.9 The government remains of the view that FRM offers the greatest flexibility for bodies to manage their affairs, however these views have been noted.

Partial exemption

- 2.10 Taxable supplies are goods or services which are subject to a VAT rate (i.e. charged at a standard rate of VAT of 20 per cent, a reduced rate of VAT of 5 per cent or a zero rate of VAT of zero per cent). Taxable persons can generally recover the VAT on the costs incurred directly in the course of making these supplies.
- 2.11 Exempt supplies are supplies that are not subject to VAT and on which VAT is not charged. VAT incurred directly in making exempt supplies generally cannot be recovered.
- 2.12 Partial exemption allows taxable persons to recover a proportion of the VAT incurred on costs which are attributable to both taxable and exempt supplies to the extent that they relate to taxable supplies and other supplies that carry the right to deduct. All taxable persons, including Section 41 bodies, are subject to partial exemption rules where they make, or intend to make, both taxable and exempt supplies and incur VAT on costs which relate to both.¹
- 2.13 The responses to the Policy Paper have noted that the partial exemption treatment of certain bodies listed under Section 33 VATA, namely local authorities, is generous compared to the treatment given to public bodies listed under Section 41 VATA (and the private

¹ Notice 706 (<https://www.gov.uk/guidance/partial-exemption-vat-notice-706>)

sector). Section 33 bodies can recover their input tax attributable to exempt supplies provided it falls below a certain de minimis threshold and is therefore 'insignificant'. VAT attributable to the exempt activities of Section 33 bodies is insignificant only if it amounts to less than either £7,500 per annum or 5 per cent of the total VAT incurred on all purchases in a year².

- 2.14 It was proposed in several responses that Section 41 bodies should be given the same partial exemption treatment as Section 33 bodies. One of the reasons this was suggested was that making the VAT treatment of Section 41 and Section 33 bodies more consistent would make the tax implications of collaborative projects between NHS bodies and local authorities easier to administer. It was also argued that equity of partial exemption treatment would allow certainty for such bodies when budgeting for the costs of collaborative projects.
- 2.15 The government will carefully consider the points made on the case for aligning the partial exemption treatment of Section 41 and Section 33 bodies.

NHS divisional registration

- 2.16 Bespoke VAT divisional registration arrangements apply to NHS bodies in Great Britain. The NHS in Northern Ireland obtains VAT refunds through a separate legislative mechanism and is not included in the NHS divisional registration.
- 2.17 The NHS in Great Britain is divided into three divisions for VAT purposes to account for NHS England, NHS Scotland and NHS Wales. In total, over four hundred NHS bodies account for their VAT under these divisional arrangements.
- 2.18 Some responses highlighted the possible effects of FRM on supplies made and received by NHS bodies and bodies outside of their divisional registration and questioned whether there were plans to alter the current divisional registration arrangements following reform.
- 2.19 The government will carefully consider the effects of NHS divisional registration on supplies between health bodies.

² More information can be found in VAT Notice 749 'Local authorities and similar bodies'.

Alternatives to the Full Refund Model

2.20 The majority of responses HMT has received have indicated that implementing FRM will simplify the way non-business VAT is refunded to government departments. However, a handful of responses have suggested solutions for HMT to consider as an alternative to FRM: the removal of the Section 41 refund model, the simplification of the list of Contracted Out Services on which VAT can be recoverable, and a system of zero rating services supplied to public bodies. HMT's position on each of the suggested alternative options is outlined below.

A. Removal of the Section 41 refund model

2.21 A very small number of responses have recommended the complete removal of the Section 41 refund scheme, which would result in Section 41 bodies being subject to broadly the same VAT recovery treatment as other taxable persons. This option, which was explored in the Policy Paper, would require government departments to fund their VAT liabilities directly from their budgets by increases in their DEL to account for their cost increase. The removal of Section 41 would address many of the concerns that have been highlighted in the Policy Paper and significantly simplify the VAT system for government departments and the NHS.

2.22 However, removal of the VAT refund system would distort government departments' decision making, by further incentivising public bodies to choose to save on VAT costs by carrying out services in-house, rather than choosing on the basis of efficiency and cost effectiveness. Moreover, this would have impacts on resource sharing and collaboration amongst government departments. Therefore, HMT does not consider that abolishing the Section 41 refund system altogether is an appropriate solution and believes it is unlikely to be welcomed by most Section 41 bodies.

B. The simplification of the COS list

2.23 Another suggestion is the simplification of the current list of COS Headings. This is an option that has been considered previously. It would ensure that the budgets of Section 41 bodies are minimally affected as well as ensuring that changes to the system will be quicker than undertaking long-term reform through FRM.

- 2.24 However, as technologies evolve and the way in which Section 41 bodies carry out their services continues to change, the adaptation and simplification of the current COS list has been found to be a difficult and time consuming process for both public bodies and HMT/HMRC, which in turn carries a resource cost to the Exchequer.
- 2.25 Simplifying the COS list would therefore be an ongoing exercise that would need to be undertaken on a regular basis. The view of the government is that it would not provide a more permanent solution to the concerns raised in the Policy Paper, such as the issues of interpretation and legal disputes. However, the government will continue to work to simplify COS Headings where possible.

C. Zero rating supplies to public bodies

- 2.26 Another suggestion was to zero rate any supplies made to central government organisations. This option would help to remove the cost of VAT for government departments and the NHS and provide a cost saving solution for the procurement of public body services.
- 2.27 A significant number of respondents noted that a zero-rate solution would not be their preferred option. One reason for this was that it would introduce administrative complexity for the recipient of the supply and the contractor. A majority of respondents also expressed a preference for FRM solution. Given this, HMT does not consider the zero-rate option to be an appropriate solution and will not examine it further.

Legal disputes

- 2.28 As highlighted in the Policy Paper, the complexities with the interpretation of the list of services under the COS Headings have resulted in considerable legal risk for public bodies and HMRC. Public bodies, including HMRC, continue to commit substantial resource to advice on the interpretation of COS Headings and incur professional and legal costs associated with this.
- 2.29 The government considers that these risks will be significantly reduced with the introduction of the FRM by removing the need for the interpretation of COS Headings.
- 2.30 Some stakeholders have raised queries around the treatment of ongoing legal disputes between Section 41 bodies and HMRC following FRM reform. It is HMT's position that any reform would not be applied retrospectively and the current rules under Section 41 would apply. This ensures certainty of tax treatment for affected parties.

Extending the Full Refund Model to non-departmental public bodies

- 2.31 Section 33E VATA allows named non-departmental public bodies (NDPBs), and similar bodies, to recover VAT incurred on services purchased to support their non-business activities.³
- 2.32 Section 33E was initially introduced to encourage public bodies to enter into shared services arrangements with parent departments. As the majority of NDPBs carry out similar activities to government departments, or on behalf of a government department, where a system of VAT recovery is not allowed for NDPBs, this may result in differential treatment for similar activities carried out by government departments and NDPBs. Therefore, Section 33E is intended to mirror the VAT recovery allowed to public bodies under Section 41 and Section 33E bodies are able to recover VAT incurred on services through the COS Direction.
- 2.33 Some responses to the Policy Paper have asked that changes to the way VAT incurred by bodies within the scope of Section 41 are also extended to NDPBs listed under Section 33E. This would ensure equity in treatment between government departments and NDPBs and avoid the need to have two refund schemes in place at the same time.
- 2.34 Section 33E bodies were not included into the review of VAT refunds. At this time, the focus of the government is to simplify, where possible, the recovery for bodies within the scope of Section 41. The government will not consider reform to Section 33E as part of this work but may review this in due course.

Making Tax Digital

- 2.35 Government departments and NHS Trusts use a bespoke system (known as “GIANT”) to submit VAT returns and additional information to support their VAT refund claims. These bodies are currently deferred from joining Making Tax Digital (MTD) until at least April 2022.

³ More details into Section 33E found in VATGPB9650 on <https://www.gov.uk/hmrc-internal-manuals/vat-government-and-public-bodies/vatgpb9650>

- 2.36 Respondents to the Policy Paper have suggested that, to ensure cost efficiency, mandatory changes to the delivery of VAT returns for MTD are aligned with the implementation of FRM.
- 2.37 HMRC recognises the importance of taking the Section 41 reform timeline into account when determining when and how GIANT users should start using MTD if FRM is implemented. HMRC will update GIANT users in due course. As announced in July 2020, all other VAT customers will need to start using MTD from April 2022, if they were not already required to use MTD from 2019.

Timing of implementation

- 2.38 The government is aware that accounting systems vary between organisations currently within the scope of Section 41 and adapting to reform in this area may pose challenges.
- 2.39 A number of respondents have suggested that changes to Section 41 should be implemented quickly in order to address the concerns identified with the current COS refund arrangements, with some asking for an implementation date of April 2022 or sooner. However, other responses, although keen to see the reform enacted, have highlighted concerns with the budget adjustments that would be required as a result of moving towards the FRM and have indicated a preference for a much longer implementation date to allow enough time for HMT officials to engage with government departments and NHS Trusts.
- 2.40 Based on these responses, the government believes that thorough preparation for the change is more important than quick implementation. The government will therefore carefully consider the implications of reform including potential timescales to minimise any potential delivery risk.

Chapter 3

Conclusion

- 3.1 The government is grateful to those who have contributed their views to the Policy Paper. The responses received from stakeholders have provided us with valuable insights to inform further policy development and decisions in relation to the FRM.
- 3.2 It is the government's objective that any reform would provide public bodies with a more effective and efficient way of carrying out public services, cause minimal disruption to the public sector, and involve minimal administrative burdens.
- 3.3 The FRM remains the government's preferred option. However, the government recognises the complexity of changing the VAT framework for the public sector and is keen to continue working closely with stakeholders on the next stage of policy development and consideration of the areas highlighted in the responses, before making a final decision on whether to implement FRM.

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