

# Contracted-Out Services Heading 14

## Application in Practice

### Paper for Discussion

#### Overview and Purpose

On 16 June 2017 HM Revenue & Customs ("HMRC") published revised guidance on the application of Contracted-out Services ("CoS") heading 14. That revised guidance is reproduced in Appendix A to this paper.

However, the revised guidance has made the position on VAT recovery under this CoS heading unclear and has raised many questions about how it should be applied. It has also created a significant amount of uncertainty about the recovery of VAT on IT projects which is unwelcome given that this is an area where there is significant and increased spending by the NHS.

At the HfMA VAT committee it was agreed that a paper would be put together setting out some questions about the revised guidance and some example scenarios of IT projects and how the committee believes the revised guidance should be applied to those scenarios. Some scenarios are set out below together with the committee's view on the VAT treatment that should be applied. These scenarios do not relate to any specific NHS body and are intended to be general in nature. It is recognised and acknowledged that the VAT recovery position of any project must be considered on its own particular facts.

#### Key questions about the revised guidance

Before considering some examples it is worth noting the key areas of uncertainty that appear to exist in the guidance. We note these for discussion purposes and with the aim of seeking to agree whether there is scope to make some changes to the wording of the guidance to increase clarity.

1. We note that in HMRC's current guidance the wording for the title of Heading 14 omits the words "*.....including the provision of a fully managed and serviced computer infrastructure*". As these are the official words as per the list of CoS headings as published in the London Gazette it does not seem appropriate for these words to be omitted. Comment on this would be welcome.
2. We are aware that some HMRC Officers are asserting that an IT system must be designed to meet the particular NHS organisation's specifications. In the past it was accepted that a system should be specific to the NHS and this is underscored by the use of the words "to specifications dictated by the government or NHS" in the opening paragraph of the guidance. However, given that it appears that some HMRC Officers are now giving a different view it would be appreciated if this point could be confirmed – see also scenario 5 below.
3. The definition of an "IT System" makes reference to a "tower IT system". This term is not itself defined but there is a concern that this is not something that is typically used in IT parlance – and where the word "tower" is used it is more likely to refer to hardware and not a system. Do HMRC have a description of what is meant by a "Tower IT System"?

4. The definition of an IT System would benefit from some clarity. For example, the definition starts by saying:

*"An IT system itself can be made up of several packages which could be provided by different suppliers, however as long as the packages, when linked together form an entire IT system that has been built to the recipient's specifications, this would still qualify for recovery under this Heading."*

Arguably this definition could be read as making reference to all of a Trust's IT given that generally speaking most systems will be linked together to "...form an entire IT system".

In the paragraph that then follows in the guidance there is reference to "... a larger IT system to be linked with the ..... NHS body's overall network". Again, this suggests that an IT system would be all IT applications that are linked into the Trust's IT network. It would also be helpful to confirm whether HMRC regard a "computer infrastructure" as being essentially the same as an "IT System" or whether different meanings should apply. Clarity over this aspect would be very welcome as this is crucial to the interpretation of other aspects of the guidance.

5. Under the section headed "includes" the guidance states: "Software support which forms part of an IT system package". Could it be confirmed what is meant by a "system package"? This sentence seems to conflate two terms – "package" which tends to refer to an individual piece of software, and "system" which would tend to refer to hardware and software that has been integrated.
6. With regard to software being "substantially modified" in order to be bespoke, what supporting evidence would HMRC expect to be present in order to provide support that this criterion is met and hence is "unrecognisable" from the original? In addition, for how long should such supporting evidence be retained in order to demonstrate that the software was bespoke, particularly having regard to the fact that's some IT contracts can run for many years?
7. In the 3<sup>rd</sup> paragraph of the guidance it is stated that:

*"What is important is that the department or NHS Trust requires an IT system designed to its specifications (or to specifications dictated by the government or the NHS) and this is **mainly** provided through outsourcing". [Emphasis added]*

What is meant by the use of the word "mainly" in this context? For example, if a system is 51% outsourced and 49% provided internally (e.g. service integration and management services, staff costs) would this qualify as "mainly outsourced" and therefore any VAT incurred would be reclaimable, subject to the system fitting under the heading in the first place? If not, what would HMRC accept as a "mainly outsourced" system and should this be determined by reference to costs or some other measure?

## **Example Scenarios**

### **Scenario 1: An EPR system**

An NHS Trust wishes to implement an EPR system and does so as follows:

- An EPR systems provider provides a licence for the basis modules that have been chosen. Those modules are chosen to enable the EPR providers to build a system that meets the particular needs of the Trust.
- The Trust specifies exactly what it needs the system to do. This will take into account the particular needs of the Trust's clinicians, the Trust's patient pathways and the other systems that it needs the EPR system to integrate with. The EPR system provider will configure the chosen modules to meet this specification.
- The Trust purchases certain hardware that will be needed for the implementation.
- The Trust also pays for costs of agency staff brought in to work on the project. These personnel are under the control of the provider of the EPR system as it is responsible for the implementation.

*VAT Recovery Position:* Our interpretation of the guidance is that the VAT incurred on all costs should be recoverable as this is a system that is bespoke. Hardware forms a part of that system and as staff are under the control of the provider the VAT thereon is recoverable.

### **Scenario 2: Data Lines**

From June 2017 the guidance on what is included reads:

*"Hosting Computing Services, Archiving Communication Services, Data Communications Services, Desktop Communications Services, for example Picture Archiving Services (PACS), Ethernet cable/Data lines and Cloud computing when supplied as part of an IT system." [Emphasis added]*

The words underlined have been added to include the requirement for the recovery of VAT on data lines to be predicated on this being part of an IT system.

HMRC define "IT System" in their revised guidance as follows:

*"An IT system itself can be made up of several packages which could be provided by different suppliers, however as long as the packages, when linked together form an entire IT system that has been built to the recipient's specifications, this would still qualify for recovery under this Heading.*

*HM Treasury's view is that an 'IT system' could be a stand-alone system or equally the system may form part of a larger IT system to be linked with the department's or NHS body's overall IT network.*

*Therefore, VAT refunds under this heading are permitted where the recipient contracts with more than one supplier, provided the services across the contracts join together to provide an IT system. An example of this would be smaller contracts which, when joined together, form a tower IT system. This would also include any costs in relation to the build and support of the bespoke software which is provided as part of the contract.*

*VAT Recovery Position:* It is arguably the case that the VAT on data lines should still be recoverable on the basis that:

- The guidance states that an IT system can be made up of different elements provided by different suppliers.
- The guidance acknowledges that where services join together to form an IT system then VAT is recoverable.
- The data lines are an integral part of an IT system – without them different parts of the system (and different sites) would not be able to be linked.

**Scenario 3: Use outside the NHS**

- A software provider develops a piece of software for a particular NHS Trust's needs. This meets the test of being bespoke and hence the VAT is recoverable.
- The software company begins to make sales of this software to other NHS organisations. As the software is specifically developed for NHS use, this should meet the criterion of being to "specifications dictated by.....the NHS" and the VAT recoverable.
- The software provider recognises that the software developed could have application in the private healthcare market and begins to make sales to private healthcare operators, albeit the software needs to be modified to fit the needs of the private healthcare market which are very different in many respects.

*VAT Analysis:* There are several implications on which HMRC's views are sought, for example:

- Do the sales to private healthcare operators remove all VAT recovery for the NHS? In our view this should not alter the position for the NHS provided that the software was initially developed for NHS use.
- Is the fact that the software is modified to meet the needs of the private healthcare market sufficient to mean that VAT recovery for the NHS is not affected?

**Scenario 4: An IT System**

A Trust purchases the following:

- New PACS software (for medical imaging)
- New hardware that relates to the PACS system
- Handheld devices to be used by clinicians to access the PACS system
- Cloud storage services
- Additional Microsoft Office licences needed for new PCs and other devices that link to the PACS system

*VAT Analysis:* Considering the new guidance it would appear that all of the VAT incurred on these costs would be recoverable on the basis that this forms a "system".

**Scenario 5: Bespoke to the NHS**

There is some confusion over what this means and how it should be applied. For example, if a supplier develops a system for the specific needs of the NHS it would generally be viewed as bespoke and the VAT recoverable under Heading 14.

However, the recent letter issued by HMRC to the NHS relating to software called "ScriptSwitch" casts doubt on this. It is understood that ScriptSwitch was developed for the NHS and that HMRC previously gave a non-statutory clearance that the VAT was recoverable. However, the recent letter says that VAT is not recoverable.

Could it be clarified how the term "...to specifications dictated by the government or NHS" should be interpreted and whether the reference to "NHS" means (i) the NHS as a whole; or (ii) each individual NHS body?

**Scenario 6: A Finance System**

- A systems supplier sold a finance system into the NHS
- Over a number of years the supplier customised that system to meet the needs of the NHS in respect of areas such as VAT accounting, budgeting, agreement of balances and the Government banking service.
- This customised system is now only marketed to NHS bodies. The supplier's commercial customers are sold a completely different package.

*VAT Analysis:* All VAT would be recoverable on maintenance and expenditure on upgrades on the basis that the software is now bespoke to the NHS. In addition, VAT would be recoverable on new purchases of the system as it is now bespoke to the NHS.

DRAFT FOR DISCUSSION

## APPENDIX A: HMRC GUIDANCE ON COS HEADING 14

### **Government departments and health authorities: Contracted Out Services (COS) Headings: COS Heading 14 - Computer services supplied to the specification of the recipient**

This heading applies to services supplied to a government department or NHS body in its procurement of an IT system to its own specifications or to specifications dictated by the government or NHS.

The origins of this heading lie in the outsourcing of entire IT systems by central government to the private sector. For this reason, the heading does not cover in isolation the procurement of off-the-shelf software or web design.

Because of the fast pace of technology, this heading is not intended to be restricted to past practices, but instead to include modern methods of supplying an entire IT system. This may not now involve using a single outsourced provider, or outsourcing all aspects of the IT system. What is important is that the department or NHS trust requires an IT system designed to its specifications (or to specifications dictated by the government or the NHS) and this is mainly provided through outsourcing. Whether ownership of the hardware is or is not in the public sector, whether there is one supplier or several suppliers, whether the servers are or are not remote, does not affect this basic position.

When we say “to the specification of the recipient” we mean that the system/software should not be simply designed and built in order to meet certain perceived needs. The specifications must have either been specifically dictated to the supplier, or be of such specific requirements that it would have no application outside of the Government or NHS. For instance, if a system can be used by private healthcare providers, it would not meet the rule and recovery would not be possible. For that reason, many of the patient records systems that are being supplied are unlikely to be recoverable.

Provided that the supply received is an IT system designed to the users specifications, this heading applies even though some components of the package would – if supplied in isolation – be excluded from the heading. Thus, for example, where a department or NHS trust requires such an IT system and outsources its provision to several contractors, possibly retaining the project management in-house, in this situation the contracts and in-house project management are components of the procurement of the IT system. The only exception is telephony, which is always excluded.

The following examples of what is included and what is excluded from heading 14 should be read in conjunction with the definitions, interpretative notes and additional information at the end of this guidance.

#### Includes

- The provision by one or more suppliers of an IT system either using the recipients’ own hardware or hardware provided by a supplier of qualifying services that form a part of the infrastructure. At one time the requirement was for the system to be fully managed by the outsourced provider, but now it is accepted that the management function can be retained in-house (or, in the case of existing contracts, returned in-house)
- Software support which forms part of an IT system package

- The development, implementation and support of bespoke software
- Hosting Computing Services, Archiving Communication Services, Data Communications Services, Desktop Communications Services, for example Picture Archiving Services (PACS), Ethernet cable/Data lines and Cloud computing when supplied as part of an IT system
- Computer consultants and other professionals where they are under the control and management of an outsourced provider and form a part of the overall procurement of an IT system designed to the department's or trust's specifications.
- License fees (including those delivered electronically, or delivered in a package containing a voucher or code to be redeemed electronically):
  - supplied as an integral part of an IT system, whether for bespoke or off-the-shelf software;
  - for bespoke software

The Tax Centre of Excellence (TCoE) has published a joint TCoE, HMRC and HMT "Agreed Principles – IT Licences" document at <http://taxcentreofexcellence.uk/>, which provides examples and clarification.

#### Excludes

- The supply, license and/or support of off-the-shelf software
- The hire, installation or purchase of hardware alone
- Line rental as a separate supply
- Telephony, which includes Voice Over Internet Protocol (VOIP) and videoconferencing
- Blackberry mobile phones, which are a telephony service
- Hire of computer consultants to add expertise to in-house IT teams and controlled or managed by those teams. This is a supply of staff rather than of IT services.
- Web design where purchased as a stand-alone supply – this may be eligible for recovery under Heading 49

#### Definitions and interpretative notes

##### *'An IT system'*

An IT system itself can be made up of several packages which could be provided by different suppliers, however as long as the packages, when linked together form an entire IT system that has been built to the recipient's specifications, this would still qualify for recovery under this Heading.

HM Treasury's view is that an 'IT system' could be a stand-alone system or equally the system may form part of a larger IT system to be linked with the department's or NHS body's overall IT network.

Therefore, VAT refunds under this heading are permitted where the recipient contracts with more than one supplier, provided the services across the contracts join together to provide an IT system. An example of this would be smaller contracts which, when joined together, form a tower IT system. This would also include any costs in relation to the build and support of the bespoke software which is provided as part of the contract.

VAT on qualifying services received as part of a wider supply that includes non-qualifying services or goods, for a single all-inclusive charge, is not eligible for refund unless the qualifying services are supplied under a separately ordered, negotiated and contracted agreement. The exception to this is where a government department or NHS body receives an IT system which includes telephony; in this instance, HM Treasury (HMT) require the VAT incurred on the contract to be apportioned between telephony and IT services. The VAT which relates to the IT services can be recovered under Heading 14 whilst any VAT incurred on telephony services cannot be recovered.

A VAT refund is permitted where goods are received as an integral part of a supply of qualifying services, are included in the contract for the qualifying services, and are ancillary to the qualifying services supplied.

**\*'Bespoke software' \***

Bespoke software includes the creation of a new software package. This includes research and development, design and consultancy services. It may also include aftercare services such as updates and helpdesk facilities.

It also includes the substantial modification of a pre-existing package of software to meet the needs of the recipient. In such circumstances, the key to qualification for a VAT refund will be to consider the extent of the modification. Substantial modification would require changes that effectively create a product that is unrecognisable from the original. 'Customisation' or 'personalisation' of pre-existing packages are unlikely to be substantial modifications – they tend to be data management/input issues rather than actual remodelling of the software.

Non-qualifying 'off the shelf' software is taken to mean stock software such as "Microsoft Office" packages, Sage accounting software, etc. These generally require minor modification during implementation and would not be eligible for recovery under Heading 14 unless supplied as a minor part of an entire IT system.

**\*'Staff' \***

Where the supplier of IT services also provides staff, and that staff remain under the direction and control of the supplier, the staff are treated as part of the provision of IT services, and costs will be recoverable under this Heading.

In modern contracting situations there are a number of scenarios that can occur. Treasury have therefore considered that the following four situations are likely to occur:

- Where IT services and staff are provided by one supplier, and the staff are under the day to day control of the government department/NHS, this is a supply of staff and VAT is irrecoverable.
- Where IT services and staff are provided by one supplier, the staff are under the day to day control of the supplier, and the activities delivered meet the COS14 criteria, the VAT can be recovered.
- Where the government department/NHS procure an IT infrastructure from one supplier and IT service staff from another supplier, and those staff are under the day to day control of one of the suppliers, the VAT incurred on the supply of staff can be recovered in line with the guidance at 'An IT system' above.

- Where the government department/NHS procure an IT infrastructure from one supplier and IT service staff from another supplier, and the government department/NHS has the day to day control of those personnel, this is still a supply of staff and any VAT incurred is irrecoverable.

The important point to note, therefore, is that recovery is only possible where the staff are not under the control of the government department or NHS body. If they are under the control of any other party, and the supply is an integral part of the overall infrastructure provision, recovery is possible.

'Day to day control': The TCoE has published a joint TCoE, HMRC and HMT "Agreed Principles, guidance and FAQs – COS14 Resource & Digital Expertise" document at <http://taxcentreofexcellence.uk/>, which provides examples and clarification.

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