

CaSE submission to the Dowling Review

Summary of key points

The UK has a strong and highly productive research ecosystem. Collaboration between universities, charities, and industry is at the heart of the UK's success in science and engineering and is a highly attractive feature for public and private researchers when deciding where to base their research. It is also increasingly recognised that future scientific and technological breakthroughs will come from the collaboration of specialists from a range of disciplines and sectors. It is therefore vital that government policy promotes collaboration.

Academic and industry CaSE members have highlighted the UK's VAT system as a current and significant barrier to research collaboration, particularly co-location within research institutes. Publicly-funded research institutes are restricted to 5% commercial activity if they opt not to pay VAT or face costly tax bills to co-locate their researchers with industry colleagues. The complicated nature of the UK tax system and inflexible interpretation by HMRC is creating unnecessary cost and bureaucracy, and stifling research collaboration. It is important that policies are aligned across government to ensure the efficient use of public funds within the higher education sector and that public investment is optimised to promote economic growth. Successive governments have sought to encourage business R&D through tax-incentives such as R&D tax credits and the Patent Box. CaSE believes there are further steps that can be taken by the government to promote and facilitate research collaboration between academia and industry to drive economic growth.

Introduction

The Campaign for Science & Engineering (CaSE)¹ is a membership organisation aiming to improve the scientific and engineering health of the UK. CaSE is funded by around 750 individual members and 100 organisations including industry, universities, learned and professional organisations, and research charities that recognise the importance of science and engineering for the UK. CaSE welcomes the opportunity to feed in to this review.

Collaboration is at the heart of the UK's strong and highly productive research and innovation ecosystem. By working together, universities and businesses can share ideas, skills, and approaches to catalyze innovation. This leads to new products, services, and policies that improve the lives of citizens and generate economic growth. There is an increasing trend towards collaboration across the science and engineering disciplines and how universities and businesses work together has changed dramatically over the past ten years. But there are still further ways the government can promote this activity.

Working with our members, CaSE has identified a number of areas where UK tax rules are having a negative impact on research and innovation by creating unnecessary bureaucracy, raising costs, and stifling collaboration. UK tax law is based on European Union (EU) Legislation but EU Member States are allowed a degree of flexibility in how they interpret the law. We believe that the UK could improve the current tax framework through more flexible interpretation of legislation to better

¹ www.sciencecampaign.org.uk

incentivise research collaboration in line with government science and innovation policy promoting research collaboration and making the UK the “best place in the world for science and business”.²

VAT rules for new buildings restrict research collaboration

The construction of public and charity research institutes is subject to zero-rate VAT due to it being for a ‘Relevant Charitable Purpose’ (i.e. grant-funded non-business research activities).³ This is on the condition that a minimum of 95% of the activities undertaken within the new building are for non-business research. This means that only 5% of activities within the building can be for commercial purposes, including research collaboration with industry.⁴ Therefore institutions like the government-, university-, and charity-funded Francis Crick Institute and the Imperial West development by Imperial College London are severely restricted in the amount of business collaboration that can happen on their premises if they are to benefit from VAT-exemption. This is a key obstacle to increasing the permeability between the academic and industry sectors.

Institutions can designate areas of the building that will be used for commercial purposes. In doing so they elect to pay VAT on these parts but they must also pay VAT on communal areas such as corridors and shared services, which can be significant in some cases. This designation must then be monitored for 10 years, which is a very bureaucratic and costly process for university finance offices. Furthermore, the dynamic nature of higher education and scientific research makes such apportionment very difficult and in some cases risky, as universities may not know what the future demand for commercial activity may be. If, having built the building and not paid VAT, the institution decides to collaborate on site with commercial partners within the ten year period, it must pay back a proportion of the VAT saved. This creates a financial disincentive to collaboration during the first ten years of a building’s life.

Alternatively, if the institution opts to pay VAT on the whole build, it must add VAT when invoicing the users of its services, including on rent, as it is considered a commercial enterprise. This does not negatively impact businesses, which can reclaim VAT from HMRC but raises costs by 20% for academic tenants, who do not have the ability to reclaim VAT from HMRC. Thus opting in to VAT on a research building raises the costs and adds a perverse disincentive for academic collaborators to work in the building alongside businesses.

Case study 1: As a single building facility founded by three universities and three major funders (MRC, CRUK, Wellcome Trust, UCL, King’s and Imperial), the Francis Crick Institute recognises the importance of fostering a collaborative approach.

² <https://www.gov.uk/government/publications/our-plan-for-growth-science-and-innovation>

³ <https://www.gov.uk/government/publications/vat-notice-708-buildings-and-construction/vat-notice-708-buildings-and-construction>

⁴ If the 95% ‘Relevant Charitable Purpose’ proportion is not achieved and sustained for a 10-year period, the construction cost would become standard-rated (20%), and the full VAT cost on construction would become payable. Where qualifying non-business activities exceed the 5% threshold, it is still possible to obtain zero rating on those parts of the building which are used solely for qualifying non-business activities but the method of calculating this apportionment is somewhat cumbersome and where any space (eg corridors or other facilities) is used for both qualifying and non-qualifying activities then this must be treated as non-qualifying space so does not benefit from zero rating – and so the overall result can seem unfavourable.

Due for completion in 2015, the construction costs for the new building are charged at zero rate VAT due to it being for a 'Relevant Charitable Purpose'. In the case of the £600m Francis Crick Institute facility, the ramifications of a standard 20% VAT rate being imposed would be significant. Consequently, the extent to which industry partnership can be truly integrated in the new building are significantly impacted, arguably to the disadvantage of the Institute, its founders and UK science and research.

Case study 2: The £140 million Research and Translation Hub being built in the Imperial West innovation district in White City provides the physical environment to enable world-class research and knowledge transfer at scale – driving innovation and growth. It received £35 million from the government through the UK Research partnership investment fund (UKRPIF) administered by the Higher Education Funding Council for England. Housing academics and companies side-by-side to foster innovation means that the development is liable for VAT. Of the £35 million received from the government, £24 million will be returned to the Treasury in VAT, meaning the true government contribution through UKRPIF is a net £11 million.

Case study 3: The Uren Centre at the Imperial West development will support the translation of fundamental research into life-changing new and affordable medical technology, helping people affected by a diverse range of medical conditions. Imperial College London's world-class engineers, scientists, and clinicians will work together in the new space and facilities alongside spin-out companies, helping to create a vibrant innovation district in White City. The Hub will also incorporate clinical areas, providing patients with direct access to innovations in healthcare.

Unsure of exactly how much of the building would be used for commercial purposes in the future, Imperial elected to pay VAT on the building costs, thereby greatly increasing their capital expenditure.

Recommendations:

1. The government should reassess how EU (and UK derogated legislation) is interpreted to ensure it is in line with government science and innovation policy in promoting collaboration. For example, increase the 5% threshold or create more favourable apportionment rules where it is exceeded, for example, not to include communal spaces.
2. HMRC should produce clearer guidance for institutions on how to interpret the current VAT regulations

VAT-exemption rules for collaborative research are not clear and can result in over-cautious behaviour

In the past few years, there have been a number of changes to VAT law and, according to finance officers that we have spoken to, an over-cautious approach to interpretation by HMRC. These developments have resulted in increased burden upon public research institutions collaborating in research with both academic and industry partners.

Following changes enacted in August 2013⁵, the supply of research services between universities (or other eligible bodies) is subject to VAT.^{6,7} This raises the costs and bureaucracy of collaborative research. As a result there is a disincentive for collaboration between academic institutions.

Research services could include, for example, collaborative research where one academic research group provides funds to another to conduct a particular experiment, or where a researcher uses a large piece of equipment at a different university and is required to pay for that use.

Following consultation¹, HMRC conceded that despite the August 2013 change, ‘collaborative’ research should legitimately fall outside the scope of VAT if it is for the public good with no commercial gain (see annex 1 for more detail). However, there is confusion within the research community and its finance departments over exactly what can be classed as collaborative research, especially when commercial partners are involved. This is confounded by the fact that even public and charitable funders can place terms on awards that would gain them some IP rights emanating from the research (which could count as a taxable business service).

‘Pre-competitive collaboration’ involving academia and industry is a growing practice that current tax definitions are not well drafted to accommodate for. This practice is particularly popular in medical research where academic expertise and curiosity can lead to new medicines with obvious health and financial benefits for the UK. One example of this is when a pharmaceutical company provides compounds that have not proven useful in in-house tests to academic researchers who wish to test them for other indications in a more curiosity-driven process. This could be considered VAT-exempt as there is a clear public-good and no money has changed hands. However, there would be an agreement that if a compound were to be found to be effective then the pharmaceutical company would have the right to develop the compound into a marketable medicine. At this point the earlier curiosity-driven research could be considered commercial and therefore VAT-liable. Paying tax retrospectively could be costly and hugely burdensome on the researchers and therefore may reduce the inclination of researchers to engage in pre- competitive research.

With the growth of innovation funding to businesses through government agencies like Innovate UK, companies are increasingly the majority beneficiary of public grant money with their academic partners receiving smaller proportions of the grant, often channelled through the company. Current HMRC guidance is not clear on how research at the academic-business interface should be classified. There is therefore confusion over whether transactions between the partners should be subject to VAT and academic finance offices are over-cautious as a result and can incur higher tax bills than necessary. This results in inefficient use of public funds and can discourage collaboration due to the difficulty of managing the financial relationships. This is very unwelcome at a time of constrained

⁵ Following challenge by the European Commission, HMRC has accepted that previous arrangements contravened EU tax law and changed UK rules effective as of the 1 August 2013. Previously, money for research, regardless of its original source, passed between universities to cover research was not subject to VAT (it was referred to as “exempt”). HMRC now estimates that the withdrawal of this exemption will lead to increased VAT on these supplies of approximately £10 million in 2013-14 increasing to a maximum of £50m by 2017-2018 as more contracts become taxable rather than exempt. Much of this will be public money.

⁶ <https://www.gov.uk/government/publications/revenue-and-customs-brief-21-2013-withdrawal-of-the-vat-exemption-for-supplies-of-research-between-eligible-bodies>

⁷ <https://www.gov.uk/government/consultations/consultation-on-the-withdrawal-of-the-vat-exemption-for-research>

public finances when universities are trying to improve efficiency and open up new opportunities for co-funding with industry.

Recommendations:

1. The HMRC should review its guidance for institutions on how to interpret the current VAT regulations to ensure that it takes into account the modern research funding ecosystem.
2. The government should re-assess how EU (and UK derogated legislation) is interpreted to ensure it is in line with UK government science and innovation policy to promote collaboration.

Research collaboration is highly beneficial to both the public and business as it leads to innovative new products, services, and policies that improve people's lives and the environment in which we live. Successive governments have sought to encourage business R&D through tax-incentives such as R&D tax credits and the Patent Box. CaSE believes there are further steps that can be taken by the government to promote and facilitate research collaboration between academia and industry.

Annex 1 – extract from HMRC briefing on research services

HMRC has produced a briefing⁸ attempting to add clarity to what research falls outside the ‘scope of VAT’:

- research which is funded for the ‘general public good’ and there is no direct benefit for the funding body
- research which is funded for the general public good and is either not expected to generate any intellectual property (IP), or if it does then any reports or findings will be freely available to others
- where there is a ‘collaborative’ agreement between different research institutions where all parties to the grant are named on the application⁹
- where the funding flows through one named party - and they act purely as a conduit passing on the funds to others involved in the research project - the funding remains outside the scope of VAT

Where funding is provided to a named party for research that will either generate IP to be exploited by the funder and/or is not for the public good and they subsequently decide to sub-contract some of the research to an eligible body (for example a university), the initial funding to the named party (assuming an eligible body) will be taxable consideration for a supply.

⁸ <https://www.gov.uk/government/publications/revenue-and-customs-brief-10-2013-withdrawal-of-the-vat-exemption-for-supplies-of-research/revenue-and-customs-brief-10-2013-withdrawal-of-the-vat-exemption-for-supplies-of-research>

⁹ However, the briefing also elsewhere says that institutions can be added retrospectively to an agreement on a case by case basis as assessed by HMRC.