Briefing on tax policy concerns in the science and engineering sector

This briefing outlines three issues that CaSE has been made aware of during conversations with the science and engineering community (see annex 1 for groups consulted). There is strong evidence that the application of VAT is negatively impacting research collaboration between academia and industry due to cost and bureaucracy. This runs contrary to government aims to promote innovation to drive economic growth.

Summary of policy concerns highlighted by these issues:

1. There is general confusion within the research community and their finance offices on how to interpret VAT rules. This may be leading to an over-cautious approach to classification within finance offices, which may be wasting money.
2. There are increased costs and perverse incentives discouraging academia-industry research collaboration and co-location, which runs contrary to the aims of the Science and Innovation Strategy to promote growth-friendly innovation through collaboration[1]
3. There is increased bureaucracy and inefficient accounting systems resulting in poor use of public money

For more information please contact Dr Martin Turner, Policy Advisor, CaSE (martin@sciencecampaign.org.uk).

1- Zero-rate VAT on new build costs

Issue: The application of VAT on the building costs of research institutes is creating perverse incentives that reduce industry-academia collaboration and co-location.

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).[2] 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.[3] Therefore institutions like the Crick and Imperial West development are severely restricted in the amount of business collaboration that can happen on their premises. This is a key obstacle to increasing the permeability between the academic and industry sectors.

[1] https://www.gov.uk/government/publications/our-plan-for-growth-science-and-innovation
[2] https://www.gov.uk/government/publications/vat-notice-708-buildings-and-construction/vat-notice-708-buildings-and-construction
[3] 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.

Institutions can designate areas of the building that will be used for commercial purposes and pay VAT on these parts, and they must also pay VAT on communal areas such as corridors and shared services. This designation must then be monitored for 10 years, which is a very bureaucratic process. 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 future demand may be for commercial activity.

If having built the building and not paid VAT, the institution decides to collaborate on site with commercial partners, it must pay back a proportion of the VAT saved. This creates a financial disincentive to collaboration.

Alternatively, if the institution opts to pay VAT on the whole build, it must charge VAT to any supplies it makes to users, including on rent. 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.

Case study 1: As a single physical 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.

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 HEFCE. 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 will house life-changing research into 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 at Imperial West 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. Academic researchers wishing to rent space or use the facilities are also charged VAT as a result of this, which raises their costs.

Recommendations:

1. Reassess how EU (and UK derogated legislation) is interpreted to ensure it is in line with government science and innovation policy. For example, increase the 5% threshold or create more favourable apportionment rules where it is exceeded, potentially proportionate to business use.
2. Produce clearer guidance for institutions on how to interpret the current VAT regulations

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2 - VAT-exemption for collaborative research

Issue: In the past few years, there have been a number of changes to VAT law and a tightening of interpretation by HMRC that have resulted in increased burden upon public research institutions collaborating in research.

Following changes enacted in August 2013[4], the supply of research services between universities (or other eligible bodies) is subject to VAT.[5,6] This raises the costs and bureaucracy of collaborative research. As a result there is a disincentive for collaboration between academic institutions, running contrary to the government's aims of promoting innovation-based economic growth and an efficient higher education sector.

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 consultation[1], 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 2 for more detail). However, there is confusion within the research community and its finance departments over exactly what can be classed as collaborative research. 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).

[4] 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.

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

[6] https://www.gov.uk/government/consultations/consultation-on-the-withdrawal-of-the-vat-exemption-for-research

‘Pre-competitive collaboration’ involving academia and industry is also a growing phenomenon that current tax definitions are not well drafted to accommodate for. With the growth of innovation funding to businesses through government agencies like Innovate UK, companies are often the majority beneficiary of 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.

Recommendations:

1. Review HMRC guidance for institutions on how to interpret the current VAT regulations to ensure that it takes into account the modern research funding ecosystem.
2. Reassess how EU (and UK derogated legislation) is interpreted to ensure it is in line with government science and innovation policy.

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3 – Cost Sharing Groups

Cost Sharing Groups (CSG)[7] can be established between universities to avoid the application of VAT for either the supply of research or the sharing of large pieces of equipment paid for by multiple institutions. However, universities report that HMRC’s current inflexible view of the legislation means that in practice a CSG creates an unmanageable administrative burden on the parties, incurring unnecessary costs, and negating the available VAT benefit (see case study 4). If current problems are not solved, CSGs may not be widely adopted.

Case study 4: Polaris, a High Performance Computing (HPC) cluster, serves HPC needs across the eight universities represented within N8 Research Partnership[8]. It is physically located at Leeds but used by all universities.

It was anticipated that the facility would be a test bed for the N8 Cost Sharing Group model. The original HPC financial model was put in place as an “equal shares” model. Each university is charged for one eighth of the total cost of running the facility in return for which they are entitled to one eighth of the compute-time[9]. In reality, it is unreasonable to expect spare capacity on such a valuable facility to go to waste and so if a member has not used their full allocation it is made

[7] http://www.hefce.ac.uk/pubs/rereports/year/2013/csgexemption/#d.en.83022
[8] The N8 Research Partnership was setup to allow more efficient sharing of research infrastructure across the north of England. It includes the universities of Durham, Lancaster, Leeds, Liverpool, Manchester, Newcastle, Sheffield, and York.
[9] The equal shares model is an attractive option for first-time collaborations as it limits the risk to the hosting institution and fixes the costs for the users of the facility for budgeting purposes. If use by universities of the facility is low they do not bear the full cost and it enables data to be collected to build a robust charging model for future refreshes of the facility.

available to the other members without further charge or refund. This supports the Higher Education sector's commitment to efficient use of resources[10].

It is N8's understanding from discussions with HMRC that this common collaborative approach to sharing research assets, as illustrated by the current N8HPC model, does not meet condition 4 of the CSG requirements[11] as the exact reimbursement does not equal the cost of an individual member's use.

It may be possible, in future iterations of the HPC and other facilities, to include an adjustment to charges over time, based on actual usage once that is known but this causes difficulties in the drafting of agreements for sharing assets and introduces the need for complex adjustments over time and financial uncertainty.

More particularly this does not remove the fundamental problems for using the CSG rules for the HPC (and potentially other shared facilities). An equal-shares model remains a straightforward approach for promoting sharing of research assets because it fixes the liability for the university incurring the initial investment and the cost for those sharing the asset which gives absolute certainty to the members of their financial commitment.

Recommendations:

1. HMRC should relax its interpretation of the Cost Sharing Exemption legislation to accommodate the realities of collaborative research.

[10] http://www.universitiesuk.ac.uk/aboutus/AssociatedOrganisations/Pages/EfficiencyExchange.aspx
[11] http://www.hefce.ac.uk/pubs/rereports/year/2013/csgexemption/#d.en.83022 (page 9)

Annex 1 – organisations consulted during the preparation of this document

Association of Medical Research Charities (AMRC)
British Universities Finance Directors Group
Francis Crick Institute
GlaxoSmithKline
Imperial College London
Medical Research Council
N8 Research Partnership (Universities of Durham, Lancaster, Leeds, Liverpool, Manchester, Newcastle, Sheffield, and York)
University College London

Annex 2 – extract from HMRC briefing on research services

HMRC has produced a briefing[12] 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 application[13]
- 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.

[12] 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
[13] 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.