



Brexit: Potential Impact on VAT in the UK Higher Education Sector

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This document was drafted in response to a request from HEFCE for information on the likely impact of Brexit on VAT in the UK higher education sector. It is based on views within the HE sector itself, as well as informal discussions with advisers (undertaken prior to receiving the request from HEFCE). It is not intended to represent the views of HMRC or government, with whom BUFDG has not yet commenced discussions on this topic.

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Abbreviations:

BUFDG	British Universities Finance Directors Group
CGS	Capital Goods Scheme
CJEU	Court of Justice of the European Union
CSE	Cost Sharing Exemption
ECJ	European Court of Justice
HE	Higher Education
HEFCE	Higher Education Funding Council for England
HESA	Higher Education Statistics Agency
HMRC	HM Revenue & Customs
IPT	Insurance Premium Tax
RCP	Relevant Charitable Purpose
RRP	Relevant Residential Purpose
VAT	Value Added Tax

Summary

- Most tax commentators do not expect the UK VAT rules to change significantly, if at all, in the immediate post-Brexit period. This is because, while UK VAT legislation is based on EU VAT law, this has been implemented into UK law so the UK has its own VAT legislation which could simply continue post-Brexit.
- Nevertheless, there are certainly areas of both risk and opportunity relevant to the UK HE sector once the UK is no longer obliged to follow EU VAT law post-Brexit. However, as mentioned above, simply due to more pressing issues which must be addressed as part of the Brexit process (e.g. trade deals, and, related to that but in the indirect tax arena, customs laws – see section C.iii below) there is an expectation that changes to VAT rules in the UK will come later.
- BUFDG and other bodies remain willing to discuss possible areas of change in VAT legislation with the UK government either now in the lead up to Brexit, or post-Brexit, as appropriate.
- There are potential tax issues other than VAT which could be created by Brexit which may impact on universities. This document is restricted to VAT and does not cover those, but we would be happy to provide information about these if requested.
- BUFDG has consulted with its Tax Group, made up of Finance Directors and Tax Managers in 16 UK universities, to produce this paper, and will be consulting with its wider membership (made up of 163 UK universities) on these issues shortly.

A. Possibilities re: UK VAT post-Brexit

UK abolishes VAT	1	This scenario is highly unlikely, given that VAT currently raises £115 billion a year in the UK ¹ , and that more countries are introducing VAT and Sales Tax systems throughout the world.
UK reviews & amends the UK VAT system and implements changes immediately post-Brexit	2	As it is largely not necessary to do so, and there has not been any major lobbying to do so, it is highly unlikely that wholesale changes will be made to UK VAT law immediately post-Brexit while there are many other more pressing matters to resolve in the lead up to Brexit.
UK continues to follow the EU VAT model permanently, despite not being bound by it	3	It is unlikely that the UK would continue to follow the EU model in its entirety in future, when it is no longer bound to do so, as there are likely to be at least some parts of the UK VAT system that the government would like to amend.
UK continues to follow the EU VAT model temporarily after Brexit², and then reviews and amends specific areas of the UK VAT system over time	4	<p>This is the most likely, and, many would say, most sensible, scenario.</p> <p>For example, there are areas of UK law which were ‘grandfathered’ into the current VAT law when the UK joined the EU and which do not form part of EU VAT law but are permitted derogations from it. As such, the UK has been unable to amend or update them since 1973, and many need updating to account for changes over the last 40+ years, so it is likely that these would be reviewed as part of any changes to the UK VAT system.</p>

¹ UK Trade Statistics, July 2016: <https://www.uktradeinfo.com/Statistics/Pages/TaxAndDutybulletins.aspx>

² Although some aspects of the legislation which refer specifically to EU vs. non-EU customers or suppliers may have to be amended prior to Brexit – see section D.ii below.

B. Opportunities for UK HE sector in post-Brexit VAT

Brexit provides the opportunity to review, amend and update UK VAT legislation when it will no longer be bound by the EU VAT system and the 'standstill' effect of having derogations from EU legislation which date back over 40 years which could not be updated under EU legislation.

The summary below explains some of the opportunities this provides, split into the type of legislative change that would be required.

B.1. Updating the current UK derogations from EU VAT law:

These parts of pre-EU UK VAT legislation which have been maintained as derogations from the EU VAT system have had to remain unchanged while the UK is a member of the EU. However, this means there has been no opportunity to amend or adapt the legislation in order to account for updates in technology or modern practices for over 40 years. These derogations are therefore out of date in many areas and too restricted. Brexit provides the opportunity to bring the legislation in these areas properly up to date for use in the 21st century.

Zero-rating of e-Publications should be introduced in parity with hard copy books

- i. The zero-rating of books is intended to relieve the dissemination of knowledge from the cost burden of VAT. However, as the 40 year old language of the legislation refers to 'printed matter' it differentiates between hard copy publications (goods) which can be zero-rated and electronic publications (services) which cannot.

This is clearly out of date, and has a significant impact on university budgets as books, journals, periodicals etc. in both hard copy and increasingly in electronic format are a large cost to all students, scholars and universities (as well as schools and colleges).

Provisions for the zero-rating of the construction of buildings used for non-business purposes and for student accommodation are currently too restrictive to be utilised as effectively as they could be

- ii. The current VAT rules for constructing so-called ‘Relevant Charitable Purpose’ (RCP) and ‘Relevant Residential Purpose’ (RRP) buildings are too restrictive.

This results in either stifling the freedom of some research undertaken by universities, undertaking research in older, out of date buildings, or increasing the costs of research, as well as making constructing financially-viable student accommodation extremely difficult. It also provides a disincentive to construct buildings that could be used for multiple purposes by multiple community stakeholders – an issue that impacts on developments that are part of the local growth agenda.

The RCP issue affects the wider charitable sector, not just universities.

Please see Appendix A for a previous paper outlining the RCP issue (drafted prior to the Brexit vote), and section B.4.i below regarding an issue related to RRP.

The zero-rating of certain equipment purchased to undertake medical or veterinary research and training should be simplified and clarified as well as expanded to other products purchased for use in medical/veterinary research. The relief should also be extended to certain other types of research

- iii. For the UK to become a powerhouse for technological and medical advances, this relief should be widened to include other types of purchases outside the existing restricted ‘qualifying items’ and to areas of research and training beyond medical and veterinary.

For example, providing zero-rated relief for purchases used in high end technological research and engineering research would reduce the cost of undertaking such research and could increase funding at a time when research funding from the EU will become unavailable (valued at £836m in the UK HE sector in 2014/15³).

Additionally, reliefs for research into social issues that the UK is facing should also be considered e.g. social care and how we are going to care for an aging population. This research cannot usually be classified as “medical” as it is actually looking at how people can be dealt with on a practical level, so it cannot benefit from the existing relief.

³ HESA data: <https://www.hesa.ac.uk/data-and-analysis/providers/finances>

Zero-rating reliefs for disabled and older people are complex and seemingly arbitrary in some areas, and could do with being fully overhauled

- iv. Parts of this legislation apply to individuals purchasing and/or installing aids and assistance and parts apply to charities (which includes universities) doing so. Confusingly, the reliefs are not the same in both areas.

The reliefs should be widened to allow the elderly and infirm access to all the reliefs that are available (currently this is restricted).

The emphasis of the legislation should be changed to concentrate on and consider the purpose of work/purchases e.g. to make a building more accessible or to enable the disabled to get out and about rather than on the specific use of the building.

For example, there are only very limited circumstances when lifts (and even then, only very specific kinds of lifts) in academic buildings can be zero-rated even if the purpose is to make the upper floors of a building more accessible to disabled students/users. Lifts are a very expensive part of construction/improvement/accessibility projects and expanding this relief would help universities pursue their accessibility agendas considerably.

There are many other anomalous and unhelpful areas within the legislation for these reliefs and we would be happy to supply more details or engage in further discussions on this.

B.2. Changing areas of UK VAT law currently based on EU VAT law:

<i>Reviewing the fundamental exemption from VAT of education</i>	<p>i. Whilst we are not advocating that education should be subject to the standard rate of VAT, there are other possibilities to explore to further relieve/reduce the burden of VAT on education. As income received for supplies of education is currently 'exempt' from VAT, this means that universities, unlike most 'taxable' businesses, are unable to recover VAT incurred on any associated costs, and have to undertake complex 'partial exemption' calculations to determine how much VAT on overhead costs can be reclaimed.</p> <p>Potential alternatives include:</p> <ul style="list-style-type: none"> • Applying the zero-rate of VAT to supplies of education (which allows recovery of VAT on associated costs); • Extending the 'section 33' VAT recovery regime for certain public bodies and certain charities to universities. The section 33 regime applies to local authorities, the police, the BBC, certain museums and galleries, and more recently has been extended to academies, hospices, air ambulance charities, medical courier charities, and search and rescue charities. Similar provisions apply to government departments and the NHS under section 41 of the VAT Act 1994. A similar regime to one of these could be applied to universities. 	<p>There is also a risk that the exemption could be removed and replaced with the standard rate of VAT</p>
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In order to drive further efficiencies within universities and groups of universities the Cost Sharing Exemption could be amended so that it becomes much more workable so universities can actually use it

- ii. The Cost Sharing Exemption (CSE) is based on EU legislation and it took 30 years to implement it into UK legislation. Even now that it has been implemented in the UK, it is overly restrictive and very difficult to put to practical use in the HE sector. Additionally, there are several EU cases currently being heard by the CJEU regarding the operation of the CSE in different Member States, further confusing the picture.

As well as not having the restraints of the EU Directive and CJEU judgements post Brexit, we understand that HMRC might find it easier to relax/amend the CSE were the legislation to be restricted to the not-for-profit sector – it currently applies to all exempt businesses which includes the insurance and banking sectors. Improving the CSE to allow the HE sector to make better use of it doesn't just remove the VAT cost, it also removes this as a barrier to collaboration and closer working between universities and encourages the sharing of facilities and the general 'efficiency' agenda set out by the Diamond report⁴ etc.

There is also a risk that the Cost Sharing Exemption could be removed once the UK exits the EU – see section C.ii below

B.3. Reversing changes made to UK VAT law due to EU infraction proceedings etc:

Re-introduce reduced rating (or zero-rating) on energy saving products in domestic or non-business buildings– and also extend this relief beyond installation to the purchase of the products themselves

- i. The UK was threatened by infraction proceedings from the EU a few years ago so had to remove and restrict the use of the reduced rate of VAT for the installation of energy saving materials in non-business and domestic buildings.

This could be re-introduced post Brexit and better scoped to really encourage the use of green energy solutions in homes, universities, and other charities.

⁴ <http://www.universitiesuk.ac.uk/policy-and-analysis/reports/Pages/report-by-efficiency-and-modernisation-task-group.aspx>

Consider re-instating the exemption for research services between eligible bodies, and possibly widen the scope to encourage and simplify collaboration and closer working between universities

- ii. HMRC did manage to delay the UK removal of the exemption for the supply of research from one 'eligible body' (like a university) to another, but again, the EU Commission made it clear this had to be changed.

As HMRC were not keen to withdraw the exemption, we hope they would consider reinstating the exemption – we also hope they would consider extending it to more supplies connected with research projects when supplied by one 'eligible body' to another in order to provide a real benefit to university research.

At present, research funding applications are increased by the cost of the additional VAT so reinstating the exemption would reduce research council funding, reduce the complexity for researchers and reduce university concerns regarding compliance.

B.4. Legislate for removed concessions:

There will be an opportunity to review concessions which have been withdrawn due to the combination of a UK court ruling and the fact that certain concessions had no basis in EU VAT law so could not be legislated in the UK.

- i. In recent years HMRC has been forced by a court ruling to review its concessions and either put them on a legislative footing or, where this is not possible (for example because they were VAT concessions and there was no basis in EU law) to remove some altogether.

We would like to see HMRC take the opportunity presented by Brexit to legislate for some concessions which have been removed, such as the 'vacation lettings' concession which enabled universities to construct new student accommodation and use them in a way that was financially viable.

B.5. Opportunities to improve UK VAT unrelated to Brexit:

<i>The current VAT Act 1994 is now 22 years old and its operation could be simplified and improved by a thorough review, update and 'tidy up'</i>	i.	<p>Whilst it is not necessary to review the UK's VAT legislation in light of Brexit, it would be a great opportunity to do so.</p> <p>The 22 year old legislation is outdated and its construction has developed to be quite tortuous in parts - for example it includes:</p> <ul style="list-style-type: none"> • exceptions to exemptions; and • children's clothing is zero-rated with some exceptions, one of which is around fur or animal skin items, with certain exceptions including goat skin/fur except from Yemen, Tibetan or Mongolian goats. 	<p>Some specific areas to review/update which would benefit universities are shown below</p>
<i>Reintroduce zero-rating for supplies of domestic fuel & power</i>	ii.	<p>Whilst the introduction of reduced rate VAT on supplies of 'domestic' fuel and power in 1994 had nothing to do with the EU, a general review of the UK VAT system due to Brexit could encompass consideration of reinstating the previous zero-rate of VAT for supplies of fuel and power for domestic and non-business use.</p> <p>This would benefit universities significantly as a large proportion of their fuel and power usage relates to residential or non-business use.</p>	
<i>Simplify the reduced rating of building conversions to domestic use (or introduce zero-rating)</i>	iii.	<p>This area is complex and confusing and would benefit from clarification and better construction.</p> <p>In addition, this would be an opportunity to consider introducing a zero-rate for these supplies/projects as new zero-rates will be possible post-Brexit.</p>	

A number of thresholds used in the UK VAT legislation are long overdue for increase

- iv. The Capital Goods Scheme (CGS) threshold, whereby the use of a building or refurbishment must be reviewed every year for ten years and any VAT reclaimed on the cost of construction/refurbishment adjusted accordingly.

The threshold for items to be included in the CGS has not been updated for 26 years and is set at a mere £250,000 – a level which now includes almost any building, massively increasing the compliance burden on taxpayers. Universities have large capital programmes including new buildings and many refurbishments and some universities have CGS calculations involving over 100 ‘items’ each year.

Other VAT related thresholds which seem particularly low include the business gifts threshold (again, rarely uplifted) and the registration and de-registration thresholds which, while uplifted each year, are quite low.

A suggestion would be to legislate for certain thresholds (such as the CGS) to be reviewed/amended every, say, 5 years and possibly index linked.

C. Risks for UK HE sector in post-Brexit VAT

<i>Removal of exemption of education as a fundamental part of VAT</i>	i. Whilst we would appreciate a review of the education exemption to a more favourable VAT recovery position, without the EU Directive there is a risk it could be removed altogether and without any specific replacement, education would fall to be standard rated.	However, a review of the education exemption is also an opportunity if replaced with more favourable treatment (see B.2.i above)
<i>Removal of Cost Sharing Exemption</i>	ii. Given it took HMRC 30 years to implement the Cost Sharing Exemption, and it has only recently been introduced into UK legislation, there is a risk it could be removed post-Brexit once there is no obligation to have it.	However, the removal of EU restrictions on the CSE provide an opportunity to improve the UK's CSE legislation for non-profit making bodies (see B.2.ii above)
<i>An entirely new statute for Customs Duties would have to be implemented as the UK has no Customs laws of its own – this area is governed entirely by EU law.</i> <i>Import VAT and Customs Duties are also likely to be levied on purchases from the EU, which will increase the cost base of universities</i>	iii. As well as the need to create an entire customs statute for the UK (unless a Customs Union with the EU is possible), the cost of purchasing goods from the EU will increase for UK universities. As well as the cost of import duty (not currently levied on purchases from the EU), there may be additional costs such as increased import guarantees. On a practical level, having to undertake import procedures for purchases from the EU will delay obtaining the goods which can cause problems for universities importing time sensitive items (such as chemicals and biological materials) – there are already numerous incidents of items having to be disposed of without being used due to customs delays for goods imported from outside the EU, and this will only increase if import and customs procedures are required when goods arrive from the EU.	

<i>UK businesses, including universities, have the highest take up in the EU for the 'Mini One Stop Shop' (MOSS) central VAT registration for making certain supplies to consumers across the EU, and would no longer have access to this after Brexit.</i>	<p>iv. The EU system for accounting for these supplies by non-EU businesses is more complex, and presumably is what UK businesses will have to use in future.</p> <p>Conversely, EU businesses making these supplies to UK consumers will no longer be able to use the MOSS system and without a replacement, may have to register for VAT in the UK (resulting in increased administration and compliance checking for HMRC).</p>
<i>The introduction of new turnover taxes which are currently prohibited in the EU</i>	<p>v. The EU turnover tax system is VAT and no additional turnover taxes are allowed. Without the constraints of EU law, there is no guarantee on this.</p>
<i>The removal of the right to appeal or refer questions to the Court of Justice of the European Union</i>	<p>vi. The CJEU will become only a persuasive court which UK courts can choose to consider, but its decisions will not be binding on UK courts.</p> <p>In addition, the UK courts will have no right or opportunity to refer questions regarding the operation or interpretation of EU VAT law to the CJEU, despite the fact that it may well be that, if the UK VAT system remains largely unchanged, it will still be based on EU law. And the UK will have no right or opportunity to make submissions in cases referred by other Member States, which it does now.</p>
<i>Insurance Premium Tax (IPT) on travel insurance costs will increase</i>	<p>vii. While not related to VAT, IPT is an indirect tax.</p> <p>When students/staff go overseas they rely, as do all UK citizens, on the European Health Insurance Card (EHIC) to cover medical costs rather than always going through an insurance policy. If all those medical costs now have to be paid by insurers, travel insurance policy prices will increase and given that IPT has just increased to 10% this will also add a considerable amount to that cost.</p>

D. Other items:

We don't know what will happen with some of the underlying principles of EU VAT law:

- *Legal certainty;*
- *Fiscal Neutrality;*
- *Distortion of Competition;*
- *Proportionality;*
- *Legitimate expectation.*

- i. In some ways the removal of these principles could be advantageous e.g. the distortion of competition rules currently mean the UK cannot give different treatment to one industry sector/group of taxpayers, but without this HMRC would be able to consider sector-based solutions to sector-specific problems. But this principle is obviously designed for the protection of taxpayers.

This could present risks and/or opportunities for the HE sector

And, for example, no one would want to see the principle of legitimate expectation disappear.

The Place of Supply rules are often dependent on whether a customer is based inside or outside the EU – this will no longer be relevant, so the areas of the legislation where this is mentioned will need to be updated for Brexit to reflect the new position.

In addition, there is a risk of double taxation or non-taxation due to differences in interpretation of VAT place of supply rules, or in fact, different rules

- ii. If the UK amends either its interpretation of the place of supply rules, or the rules themselves, there is a risk that VAT may be due in both the UK and an EU Member State, or indeed in neither, on cross-border transactions.

It is not clear what will happen with existing ECJ/CJEU precedents

- iii. This must be clear to government, HMRC, taxpayers and the UK courts.

Whatever changes are made to UK VAT there WILL be an increased burden on businesses, including universities, around Brexit simply to cope with the changes. Even if the law doesn't change there will be associated systems and data changes required e.g. amending VAT treatment of EU suppliers and customers, increasing provision to process additional imports and exports etc.

- iv. The government should announce changes as early as possible to allow businesses to prepare, and should provide guidance on how to prepare for the changes.

Around the actual time of Brexit it would be appropriate for HMRC to concentrate on educating taxpayers over the new rules or any changes to procedures, rather than compliance.

Appendix 1



VAT obstacles to public/private collaboration in university research buildings

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Executive Summary 1

We understand that BIS has become aware of this issue, and has asked the GLA to uncover examples of this problem in practice, with a view to improving HMRC's guidance. In particular, there is a concern about the construction of research facilities for the joint use of academic/public institutions and business.

1.1 Conclusions

While we have obtained examples from various UK universities (and include some in this document), we would suggest that the issues are more fundamental than HMRC guidance. The guidance reflects HMRC's interpretation of the legislation, and to a very large extent the legislation itself. Improving HMRC guidance does not, of itself, usually mean making it more favourable. So we have given some thought to what changes to policy and legislation might be possible, considering EU constraints on the UK's freedom of action over zero-rating legislation. However, these constraints were called into question as recently as 26 November when the Chancellor announced in his [Autumn Statement](#) that the UK government would make 'the case in the EU for a zero rate of Value Added Tax (VAT) for sanitary products' which had been recently highlighted in the press (the so-called 'tampon tax').

We have suggested some possible solutions (detailed in section 3):

- a. The introduction of a new VAT refund scheme, or
- b. Amending the operation of the option to tax.

1.2 The anomaly – scenarios

It seems useful to set out the problem, and the particular anomaly that limits collaboration. This is best illustrated by way of simple scenarios, in which a university constructs a new building(s) for use as a research facility. We assume the construction cost (excluding any VAT) is £100 million in each scenario:

Scenario	VAT Cost
The building is purely for the university's own occupation in carrying out grant-funded research.	£Nil
The building is purely for occupation by a third party business.	£Nil
If 50% of the building is purely for the university's own occupation in carrying out grant-funded research, and the other 50% is purely for occupation by a third party business. The two halves are occupied and used entirely separately (not a very realistic scenario).	£Nil
If the whole of the building is 50% for the university's own occupation, and 50% for occupation by a third party business, with university and business researchers working side-by-side to work collaboratively, or sharing some spaces within the building.	£17-19 million

This situation clearly discourages collaborative working between university and commercial researchers in new, state of the art buildings. Universities try to work round this by:

- housing research groups which might be affected by this in older, possibly less suitable buildings,
- placing restrictions on how researchers can operate within certain buildings, or
- paying higher VAT costs in order to have full academic freedom to conduct the research as needed.

Clearly, none of these options is ideal.

The anomaly & why it arises 2

More detail of the VAT position of the anomaly shown briefly in the Executive Summary is set out here.

2.1 VAT Implications

The building is purely for the university's own occupation in carrying out grant-funded research.	2.1.1	The construction work will be zero-rated, so that there is no VAT cost.	VAT Cost £Nil
The building is purely for occupation by a third party business.	2.1.2	The university can 'opt to tax' the building, i.e. choose to add VAT to the rent. The tenant would normally be able to recover the VAT on the rent, and the option would mean that the university could recover the VAT incurred on the construction costs. Again there is no VAT cost.	VAT Cost £Nil
If 50% of the building is purely for the university's own occupation in carrying out grant-funded research, and the other 50% is purely for occupation by a third party business. The two halves are occupied and used entirely separately (not a very realistic scenario).	2.1.3	The same points can apply – half the construction costs are zero-rated, as at 2.1.1 above, and opting to tax allows VAT on the other half to be recovered, as at 2.1.2. Once again, there is no VAT cost.	VAT Cost £Nil
If the whole of the building is 50% for the university's own occupation, and 50% for occupation by a third party business, with university and business researchers working side-by-side to work collaboratively, or sharing some spaces within the building.	2.1.4	Neither of the points at 2.1.1 or 2.1.2 will apply. The university will incur VAT on the entire construction cost, and will be able to recover a small proportion of it in line with its general VAT position (perhaps 5%, but in a few cases up to 15%, meaning between 85% and 95% of the VAT incurred is a cost).	VAT Cost £17-19 million

The zero-rating at 2.1.1 above is available because the facility is intended 'solely' for the non-business use of a charity.

2.2 Use 'solely' for a non-business purpose

The word 'solely' comes directly from the legislation ⁵	2.2.1	Therefore 'solely' cannot be ignored or amended.	
Rather than interpret 'solely' as meaning 100%, HMRC have found a basis on which to interpret it as 95% ⁶	2.2.2	They have done so in order to be helpful, but this is clearly inadequate for any meaningful collaboration with the private sector.	
Further problems here include the fact that teaching is regarded as a business activity, and there is a VAT liability (a 'change of use' charge) if business use is introduced into the building within ten years of its completion	2.2.3	Therefore, teaching cannot be carried out in the building on any scale, and there is continual uncertainty over the VAT position for ten years as it is very difficult to accurately predict the use of the entire building for the full ten years. <i>It is important to note that we accept that areas of a building used for teaching should incur a VAT cost, while teaching is treated as an exempt business supply (as exempt supplies do not provide a right to recovery of VAT on associated costs).</i>	

⁵ VATA Sch 8 Group 5 item 2(a)

⁶ <http://www.hmrc.gov.uk/manuals/vconstmanual/VCONST18600.htm>

2.3 Lack of flexibility to amend this legislation

EU VAT rules do not contemplate even the existence of zero-rating	2.3.1	The UK has been permitted to retain it, but this is subject to various constraints and the UK is clearly not allowed to extend it. ⁷
Care is needed to ensure this does not result in a general challenge to the UK's zero-rating by the EU Commission	2.3.2	HMRC have a general (and probably valid) concern that any move to apply zero-rating more generously could lead to a challenge from the EU Commission, which could extend beyond the specific zero-rating provision under discussion.

The option to tax at 2.1.2 is ordinarily available, but not if there is any occupation of the area in question by the university itself.⁸

2.4 Option to tax anti-avoidance

Anti-avoidance rules that mean that a university cannot take advantage of the 'option to tax' where it is also in occupation of the area in question	2.4.1	<p>The rules apply despite there being no tax avoidance.</p> <p>This is a complicated issue, but in this present context it means that university staff can visit the area occupied by the business, but cannot (for example) have the use of a desk or a workbench in that area, cannot book a meeting room in it, cannot store papers or equipment in it, and so on. In practice, very tight protocols need to be enforced if the option to tax is to be used.</p>
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⁷ Council Directive 2006/112/EC Article 110

⁸ VATA Sch 10 paras 12-16. Para 15A provides a limited tolerance, but this is never actually applicable in these cases.

In view of the EU constraints on zero-rating, it is unlikely that HMRC would contemplate any relaxation of the 95% interpretation, or any other useful change either on zero-rating itself, or on the associated 'change of use' rules. It seems to us that an alternative solution needs to be found.

3.1 A refund scheme

There is a long history of arrangements for VAT to be refunded outside the normal operation of the tax. The Government has recently introduced a series of new refund schemes⁹, and such schemes are not subject to the same EU constraints or VAT-technical complexities as a solution within the VAT system itself.

We would suggest that this is the best model, which could deal with the problem entirely.

We accept that it may be difficult to scope a refund scheme in a way that achieves the desired result and no more than the desired result. But this has been successfully achieved with the other schemes, and we and other stakeholders would be pleased to help with this work. We would suggest that the key is to identify and ring-fence the circumstances where the VAT rules create an anomalous result, as in the scenarios we have described. The removal of these clear anomalies which are preventing universities and business from most effectively pursuing the collaborative research activities that government desires would also provide the justification for such a scheme.

It would also be important that the scheme was administered fairly. This can be an issue with some existing schemes, where HMRC's understandable instinct as a tax-gathering department is to protect the public purse. This might suggest that the scheme should not be administered by HMRC at all (as with some other existing schemes), or at least that it is administered on the basis of very clear guidelines.

3.2 Option to tax

As shown in 2.4 above, the issue partly arises from the anti-avoidance rules for the option to tax. There is no EU obstacle to these being modified, and this could allow a university to share occupation of premises that were leased to a third party, without a disproportionate VAT cost. This would, however, be a highly technical issue, and whilst we would be happy to advance specific proposals, or to discuss the matter direct with HMRC, we doubt that it is useful to explore options in this paper. There are, in any case, several further obstacles here:

- HMRC are unlikely to have the resource at a policy level to consider any such matter.
- These are anti-avoidance rules, and whilst they mainly apply where there is no actual avoidance, anti-avoidance specialists within HMRC may well resist any dilution of them.
- For most universities, a change on these lines would only be useful if it was accompanied by a more flexible approach to universities' 'partial exemption methods', i.e. the method of calculating what VAT could be recovered where it relates to a mixture of activities.
- Universities would still be nervous of challenges from VAT officers, although it is accepted that this is one point where guidance might possibly change behaviour.

This would, in any case, provide only a partial solution, and hence our preferred option is the more complete solution of a carefully prescribed refund scheme as set out in 3.1 above.

⁹ The new refund schemes benefit charities providing palliative care (such as hospices), search and rescue activities, air ambulance services and medical courier services. Existing schemes allow VAT refunds to central government, the NHS, local authorities, academies, museums and galleries and, in relation to building work, private individuals, churches and others.

Examples of recent problems

We have obtained examples from various UK universities, and we attach details of a selection of these. We found, however, that the list was less full than it might have been, because:

- i) the issues with some projects were too complex;
- ii) universities that had managed to secure a partial solution to the problems were concerned that HMRC's reaction would merely be to challenge them;
- iii) universities are sufficiently aware of the difficulties that collaboration is often not considered in the first place.

All the examples are provided anonymously, but we can discuss permission to identify any specific examples with the university concerned, if required.

Note : RCP = Relevant Charitable Purpose (i.e. the rules regarding the zero-rating of the construction costs for areas of a building used solely for non-business purposes)

1. Example where there is a difficulty in establishing sustainable funding which is hampered by the restriction imposed by these RCP rules constraining the amount of commercial activity

A prestigious building and research collaboration between several universities and research charities due to open shortly, which is already facing difficulties establishing a basis for sustainable funding. This is hampered by the RCP rule restrictions which limits the amount of commercial activity that they can undertake in partnership with, for example, the pharma industry, despite this being a necessary element of the intended research within the building. The cost of the building is £450M.

2. Example where the VAT position has not yet been determined, but shows both the complexity and the size of the problem in reality (building cost £120M before VAT)

Comprising of approximately 12,000sqm across a twelve storey building with one basement level, the majority of the building will consist of research space, as well as a clinical facility on level 1 and an auditorium on level 12. Three of the research floors (9, 10 and 11) are initially planned to be constructed as shell-only floors.

It is proposed that the building contains four types of activity, as described in the sections below.

Research: The majority of the building will consist of research space that is allocated to interdisciplinary research centres and initiatives at the interface of biomedical sciences and engineering. In line with the progressive nature of this research field, it is expected that the research groups within this building will alter regularly over time as the discipline evolves. Whilst the initial occupants of the building will be defined closer to the time of occupation, research topics are expected to include:

- Musculoskeletal Research (including Rehabilitation and Sports Innovation);
- Neurotechnology (including Bioelectronics, Medical Devices and Bio-Inspired Technology);
- Cancer Engineering;
- Cardiovascular Technology;
- Translational Regenerative Medicine and Tissue Engineering;

The XX Research Hub will also operate core facilities, supporting collaboration and servicing the research community through providing access to essential technology, equipment and techniques. These facilities are expected to consist of equipment or techniques that are too expensive or difficult for a single group to maintain and for which the co-location in one building provides significant research advantages (e.g. imaging, biofabrication etc).

A major source of the funding profile of this research is expected to be Charities and Research Councils, although XX Hub research centres will also be expected to attract donations and endowment. These disciplines do not tend to attract significant research funding from industry sources, but it is possible that this would increase.

Clinical facility: A clinical facility with intervention suites will conduct out-patient orthopaedic procedures (e.g. knee/hip operations), enabling translation of clinical research into novel procedures and therapies. The process of an options appraisal to define how this facility would be operated, including whether a third party provider is involved, is currently being undertaken. Located on the first floor of the building, the clinical facility will be accessible via a separate entrance.

Auditorium: The top floor will house an auditorium for the use of research centres to hold scientific seminars and meetings with collaborators from across the world, fostering engagement with the research community, patients and the public. The auditorium will be flat, with the potential to hold 150 people.

Café / reception: A café for predominantly the use of staff will be operated on the ground floor, near to reception. Guests and visitors may use the café, but major external usage is not anticipated.

Comments: The overall cost, including fit out, is expected to be £120M including a major donation of £40M. To potentially lose 1/6th of the donation to VAT (£6.7M or £5.7M after partial recovery) and have an overall additional cost of £24M (£20M after recovery) quantifies the size of this issue.

3. Examples where the configuration and use of the building is being partly driven by the tax rules

- 3.1 One floor of the building had to have key coded doors to prevent anyone else accessing the area to maintain the historic zero rating. There were also some more recent changes to the use of the floor in question which had to be carefully managed in order not to disturb the VAT treatment.
 - 3.2 A large building to house several different medical research departments working in different, but related, areas was constructed. Some groups had commercial funding and others had only research council or charity funding. Although the best science would be created by allowing these groups to potentially mix, the VAT rules dictated that they had to work in separate 'parts' of the building in order for the maximum zero-rating to apply.
 - 3.3 When constructing one building, the department was partly planning which research groups would be in the building not based on those which would benefit most but on whether it would jeopardise the VAT zero-rating of the building.
 - 3.4 An annexe was constructed adjoining an existing building where related research was being undertaken, albeit desk based rather than lab based. Again, although the best science would be created by allowing these groups to potentially mix, key card security access was added in between the two which could not be accessed by all who worked in the buildings, in order to maximise the VAT zero-rating.
 - 3.5 An annexe was constructed where some parts were intended to be used for non-business research immediately, some for teaching and some shell space. When the shell space was utilised this caused change of use charges, which are complex to calculate and are entirely one-sided (i.e. VAT becomes payable if the use changes from non-business to business, but VAT is not refunded if the use changes from business to non-business).
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4. Example where extensive time had to be spent negotiating with HMRC over the VAT position of the building and the result was not VAT-free

A £25M building was constructed with three floors, one of which was let to the NHS with an option to tax in place (thus creating an activity entitled to full VAT recovery), the other two floors were used for the university's own grant funded research (an activity which should allow for zero-rating of the construction costs). Initially, HMRC expressed concern over the attribution to the different parts of the building of some of the fees and costs related to the construction. Once that was agreed, there was then

the matter of determining the extent to which the VAT charged on the construction could be recovered. This involved creating a 'special sector' in the university's business/non-business and partial exemption method (the calculation determining how much VAT a university can reclaim from HMRC), and resulted in a VAT cost, despite the building only housing activities which either entitled it to full recovery of VAT on costs, or to zero-rating of the costs.
