

How changing VAT rules can promote innovation

R&D is a central part of the Government's ambitions to build back better and level-up opportunity across the regions. University-business collaborations will be key to realising these ambitions, accelerating innovation by translating cutting-edge research into innovative new products and services that benefit British consumers and citizens, create high-value jobs across the UK and establish new export markets.

The application of VAT rules around capital investment for the purposes of R&D act as a barrier to university-business collaboration, crucial for innovation diffusion and R&D led growth. These rules, deriving from EU application of VAT rules, stifle collaborative R&D. Now the UK has left the EU, we invite Government to take advantage of the opportunity to reform VAT rules by introducing an exemption for new capital investments that are for the purpose of R&D activities.

Supercharging business R&D investment and innovation

Legislation allows the construction costs of buildings used solely for a relevant charitable purpose to be zero-rated for VAT. Under the legislation, publicly funded or charitable research qualifies for VAT relief, as long as the building is used for this purpose for at least 10-years after its construction. HMRC define 'solely' as meaning 95% of the use of a building, with a 5% allowance for commercial activities. Now the UK has left the EU, there is an opportunity to align VAT rules with Government's ambitions for UK R&D.

Current rules hold back business innovation, acting as either a disincentive for business to engage in R&D or resulting in business/university R&D occurring in buildings which are more than 10-years old, rather than state-of-the-art facilities. **We invite the Government to consider reforming VAT rules for new university buildings that will be used to undertake collaborative research projects with businesses.** This could build on the current HMRC guidance, which states that research falls outside the scope of VAT if it is in the public good. This would:

- **Incentivise university-business collaboration, by reducing costs associated with capital investment for collaborative R&D**, specifically on new state-of-the-art buildings designed to host innovative collaboration with businesses.
- **Provide additional confidence to business to return to high risk, high reward areas of research as we emerge from the pandemic**, since the research business conducts with our universities is often world-leading and can lead to significant breakthroughs if business is willing to invest.
- **Increase the impact of public investment in new R&D facilities**, avoiding a significant chunk of this investment simply being returned in VAT receipts rather than providing value in terms of research and innovation impact.

To address this issue, we suggest a solution whereby **new buildings built or acquired by universities for charitable purposes are zero-rated in the first instance**. Universities could then submit an **annual VAT self-charge adjustment – reporting and paying VAT on any commercial or non-research use of the building each year up to 10 years**. This would be consistent with other existing VAT schemes used by HMRC, such as the Capital Goods Scheme adjustment.

This adjustment could be based on the following formula: $(\text{cost of the building} \times \text{VAT})/10 \times \text{business use percentage}$ (above 5% allowable use), allowing VAT to be paid on the percentage of the building used for business R&D each year.

This would increase the impact of public investment in new R&D facilities. For example, one of our member institutions built a **£140m research hub in 2016, with £35m in Government grants** used to support the project. As the whole development was liable for VAT, **£24m was returned to the Treasury in VAT** (equivalent to almost 70% of the total investment by the Government) – meaning the true government contribution was a net £11m, and therefore provided significantly less value in terms of research and innovation impact.

If the proposed annual VAT self-charge assessment had been used for this project, this would have allowed VAT to be applied to only those parts of the building used for commercial R&D activity.

For example, if 15% of the building was used for business collaboration in Year 1 and 20% of the building was used for business collaboration in Years 2 and 3, with Years 4-10 used for publicly funded R&D only, the VAT charged would have amounted to **£1.12m as opposed to £24m** using this formula:

$(\text{Cost of building} \times \text{VAT})/10 \times \text{business use percentage}$ (above 5% usage)

$(£140,000,000 \times 0.20/10 \times 10\% = \text{Year 1 charge of } £280,000$

$(£140,000,000 \times 0.20)/10 \times 15\% = \text{Year 2 charge of } £420,000$

$(£140,000,000 \times 0.20)/10 \times 15\% = \text{Year 3 charge of } £420,000$

= £1.12m total