N8 RESEARCH PARTNERSHIP

Implementation of Cost-Sharing Exemption in Universities

Executive Summary

N8 universities have been working towards utilisation of the VAT Cost-Sharing Exemption (CSE) for sharing of equipment through the development of an approved Cost Sharing Group (CSG) model, legal agreements to implement a model and the practical demonstration and dissemination of learning from utilising the model.

By utilising N8 HPC as a model facility for implementing a Cost-Sharing Group we hoped to demonstrate the value and viability using an existing shared asset. The main findings of this work are:

1) HMRC ruling that a Cost Sharing Group cannot exist within a university VAT group means that a CSG has to be formed outside of a university's VAT group and any equipment leased to that CSG would incur a VAT charge. *This negates the benefit of the CSG model and moves the VAT charge to elsewhere in the supply chain*.
2) Whilst there is interest in the CSG model from the university sector there is also an aversion to risk in the current climate and the current risks, uncertainties and costs of using the CSG model far outweigh the benefits of using the model. *Without clear and approved models the risk is too great for the benefit.*

It is therefore recommended that for successful implementation of the Cost-Sharing Exemption, the UK Government should work with HMRC and HEI-representative organisations to identify an acceptable templated process or identify other incentive schemes that encourage facility sharing.

Introduction

N8 Research Partnership is a not-for-profit collaborative organisation, established and funded by the eight research intensive universities of the North of England – Durham, Lancaster, Leeds, Liverpool, Manchester, Newcastle, Sheffield and York. N8 Research Partnership, with colleagues at the University of Sheffield, has undertaken a project, with financial support from HEFCE, to explore and review appropriate methodologies that may be used to maximise relevant VAT exemptions

The drive towards greater efficiency in Higher Education has intensified in the last few years with the recommendations of the Wakeham and Diamond Reviews. Whilst formal equipment sharing as a benchmark or assessment criteria for funding may be relatively new, sharing of equipment is a regular part of research activity for many academics; with collaborative research providing the clearest example of existing mechanisms for sharing.

Professor Luke Georghiou (University of Manchester, and N8 Executive Management Group) outlined the most common existing sharing mechanisms, as well as the barriers to and benefits of equipment sharing, in a report for the N8 Research Partnership and wider sector in 2012.[1] Subsequently, N8 continued to work to identify processes for reducing the operational and administrative barriers to sharing equipment, culminating in a comprehensive set of recommendations, guidelines and documents which were published as the N8 Equipment Sharing Toolkit in 2014.[2]

[1] http://www.n8research.org.uk/economic-impact/n8-efficiency/policy-reports/sharing-for-excellence-and-growth/
[2] http://www.n8research.org.uk/economic-impact/n8-efficiency/equipment-sharing-toolkit/

Through the development of the Equipment Sharing Toolkit, regional and the national equipment databases and other activities in the sector there has been a change in patterns of equipment usage. However, these tend to be towards boosting productivity and utilisation within university systems e.g. through moving towards centralised facility models, rather than through sharing between institutions.

One major barrier that still exists to sharing between institutions is the requirement for VAT to be charged for sharing assets between universities; a charge that will be, at best, only partly reclaimable by the recipient. This requirement thereby introduces a worst case 20% additional cost to asset sharing, which could in many cases negate the financial efficiency reasons for sharing.

Programme

N8 has undertaken a project, with financial support from HEFCE, to explore and review appropriate methodologies that may be used to maximise relevant VAT exemptions. The project has focussed on the N8 HPC shared computing facility as a case study.[3]

N8 HPC (High Performance Computing) is a shared research facility, which is hosted by the University of Leeds and administered by the University of Manchester on behalf of the N8 universities. N8 HPC was established through an EPSRC grant in 2012, to support regional HPC needs, with recurring costs shared and supported by the N8 universities. As N8 HPC has substantial experience of collaborative activities across HEIs, and is currently exposed to VAT costs in its operation, it was identified as a strong test case.

N8 sought to create a framework that would enable HEIs sharing equipment to meet the terms of the VAT Cost Sharing Exemption (CSE), while ensuring any additional bureaucracy incurred was set at a manageable level.

As previously described in the N8 Equipment Sharing Toolkit each N8 university would need to establish a company as a cost sharing group (CSG) itself, and to have a membership/shareholding in each of the other CSGs set up by the remaining N8 member universities. Each N8 university would also be required to lease equipment capacity to its CSG; and in order to access the asset, the accessing University will need to purchase use from the relevant CSG. Additionally, each the CSG would be required to have a clear membership structure in place.

Research Undertaken

N8 Research Partnership selected four main objectives for the programme:

- **Objective 1:** Finalise the complex (and new) legal agreements required.
- **Objective 2**: Obtain approval of CSG model by HMRC.
- **Objective 3**: Implement the CSG model across the eight universities.
- **Objective 4**: Develop a case study and disseminate to the wider sector

Objective 1 – Finalise legal agreements for HEI CSGs

To utilise the CSG VAT exemption, N8 prepared, in partnership with legal representatives, template agreements to reflect the need for each University to set up a separate company

[3] http://n8hpc.org.uk/

with membership from Universities who wish to use their equipment. This work built on the existing framework established in the N8 Equipment Sharing Toolkit.

The agreement models which N8 created in this work strand are:

- Agreement 1: This can be used to establish a Cost Sharing Group (CSG) at an HEI.
- Agreement 2: This facilitates membership to a CSG and allows a member to take advantage of a cost sharing VAT exemption.
- Agreement 3: This is for use with members of the CSG and will allow the transaction to be VAT exempt.
- Agreement 4: This is for use with non-members of the CSG who will incur a VAT charge.

These agreements are available for download.[4]

Objective 2 – CSGs Obtain approval of CSG model by HMRC

The N8 Equipment Sharing Toolkit identified a potential model for utilising the Cost Sharing Exemption. N8 intended to deliver a practical case study utilising the N8 HPC.

Concerns around failing to meet HMRC specific requirements for CSGs, notably HMRC's strict interpretation of 'direct reimbursement', and consequent negative consequences for the hosting university, have restricted the number of HEIs willing to establish CSGs to date. The time, effort and risk required to establish a CSG must not outweigh the financial benefits.

To address HMRC's requirements for a CSG, N8 developed a number of potentially workable CSG scenarios, which were presented to HMRC for discussion and approval. These scenarios covered Medium and Small Scale Facilities (with N8 HPC as the worked example), and included different costing/charging arrangements. A CSG within a VAT group structure was used for all examples but with different methods under the "direct reimbursement of costs" condition. The methods consisted of:

1. An equal share of all costs – as per the current model for the HPC
2. An equal share of half the costs at the outset and the balance adjusted for actual utilisation time at the year-end
3. For an MRF an initial Members Access Fee (MAF) to cover the Fixed Costs divided by number of members and adjusted based on use at year end. Plus a Members Utilisation Fee (MUF) on an estimate of the remaining operating costs to create a pence per minute rate and charged quarterly or annually.
4. For a SRF as per method 3 with a MAF plus a MUF on a cost per minute based on TRAC estimates

HMRC responded that they were satisfied with all but the first method, whilst raising a point of concern about having the CSG in a VAT group and its interaction with the 'Host' University.

HMRC suggested that the Host University cannot receive 'qualifying services' from the CSG so therefore could not be a CSG member. This point seemed to challenge the University/CSG structure. If the Host University could not be a member of the CSG it cannot control the CSG which is a requirement for the CSG to be included in the Host University VAT group.

[4] http://www.n8research.org.uk/economic-impact/n8-efficiency/equipment-sharing-toolkit/legal/

Further clarity was sought on two key areas where certainty was not provided:

I. As supplies between VAT group members are disregarded for VAT purposes, can a Host University receive 'qualifying services' from a CSG within its VAT group?
II. If HMRC agreed point one, N8 provided a list of Resource Management Services to query whether they were acceptable as 'qualifying services'.

Further correspondence was sent seeking certainty from HMRC on these two points with HMRC **finally concluding that a university in the same VAT group as the Cost Share Group cannot receive qualifying services, as supplies between members of a VAT group are disregarded for VAT purposes**. Qualifying services are services that the Cost-Sharing Group offers e.g. access to shared equipment.

HMRC suggested that we could consider directly funding a separate CSG entity to enable it to acquire shared research facilities, which would enable the CSG model to work without the need for it to be part of a university's VAT Group. Although this could provide a solution to the VAT group structure not meeting the CSE conditions there are a number of other (non-CSE/VAT) issues with this type of arrangement e.g. willingness of funders to allow capital equipment to be purchased by such an entity, as well as a need to second or hire employees and other value for money considerations.

In ongoing verbal discussions with HMRC, over a period of approximately nine months, we have learned that our proposals and questions had to be considered by the Partial Exemption and VAT Group Anti-Avoidance teams on the two points we have raised.

We have been asked by HMRC to note that other issues have impacted on HEI CSE consideration, including:

- EU infraction proceedings against two other Member States with regards to their interpretation of the EU CSE legislation
- Further guidance due to be published by the EU commission on the CSE which may lead to changes in the UK's current interpretation
- Ongoing review of EU VAT law and member states subsequent interpretation which may impact our scenarios that include a VAT group structure
- Other sectors are covered under the CSE legislation and HMRC are mindful of providing a ruling in the HEI sector that may have a distortive advantage in another.

The N8 conclusion is that it does not appear possible to achieve HMRC approval for a working scenario to implement a CSG. This precludes N8 from providing advice on how universities can share assets within a CSG structure and make the necessary VAT saving, without exposure to risk of falling foul of future HMRC determinations.

Put simply, there is no simple, practical, risk-free option in using a CSG structure for HEIs currently.

Objective 3 – Implement the CSG model across universities

N8 initially planned to implement a CSG using the N8 HPC. The access model established in N8 HPC is straightforward– each N8 university pays a standard contribution for and receives an equal share of the facility's compute time.

The charging model is such that University of Leeds, as host, incurs the direct charges for running the facility (mostly utility costs) and invoices the other seven universities on a regular basis an equal share of these costs, plus VAT. These costs are in the order of £40k per annum and thus there is an annual VAT charge of around £8k per university.

However, a number of barriers to utilising the N8 HPC for CSE arose:

- The utility costs for N8 HPC are shared equally, whereas the usage is based on a "fair shares" model where the utilisation is intended to be as close to equal as possible, without wasting 'spare' time should any member not fully utilise their allocated capacity. This was not deemed by HMRC to be meeting the criteria of "direct reimbursement" for a CSG to be used – however following this other models for sharing costs have been agreed (See Objective 2)
- The costs and complexity in initiating the CSG model proved to be a significant barrier – the ratio of risk, resource and cost to overall reward was not deemed substantially attractive.

Alternative facilities were scoped out from across the N8 that could be suitable for CSGs. Whilst in principle facilities were keen not having to charge VAT to partners, in discussions with research facility leads a number of points were raised:

- For any given facility within an N8 university, the value of services that would benefit from a CSG model on an annual basis were limited. An increasingly preferred approach is formal collaborations across institutions.
- A risk of incorrect implementation leading to a potential HMRC Tribunal and penalty charges was a concern. West of Scotland colleges were taken to Tribunal over their 'incorrect implementation'. Commentary on the case indicated that the outcome endorsed HMRC's strict interpretation of 'exact reimbursement'.[5]
- As the Exemption is based on EU law there is the risk that changes at EU level, either in the law or from UK leaving the EU, would render the mechanism useless or would require significant change.
- The cost of ongoing management of a CSG was deemed to be prohibitive for the financial benefit it would bring for most medium scale facilities – running costs for the CSG as a separate company reduces the financial benefit of using the exemption.

The conclusion of these discussions is that there is no appetite amongst N8 facilities to engage with a Cost Sharing Group model under the current restrictions. Direct reimbursement creates a financial situation which would be impossible to administer practically. The current approach to creating and managing a CSE is costly and bureaucratic for HEI-scale facilities.

Findings

Whilst the CSG model outlined by N8 remains a theoretically sound means of utilising the VAT exemption, in realty the challenges of successfully implementing this in practice are manifold.

- Legal
    - Risk of infraction with HMRC and tribunal proceedings
    - Upcoming changes from EU Commission and potential changes in the UK interpretation of the CSE Exemption

[5] http://www.pinsentmasons.com/PDF/Universities-Defeat-for-Colleges-in-first-VAT-Case-to-consider-cost-sharing-groups.pdf

    - CSG not being able to exist in a VAT group negates many of the benefits that the Exemption would provide and would create significant operational difficulties.
- Financial
    - Universities are averse to implementing new tax structures that are not thoroughly tested and accepted by HMRC and may change.
    - Concerns that the financial benefit from using a CSG would not be significant compared to the costs of establishing and running a company.

Therefore, it is the finding of this project that the CSE as implemented in the UK does not currently provide a beneficial method for encouraging facilities sharing across universities. HMRC guidance currently will not encourage uptake of CSEs in HE. This seems to run counter to stated government desires to increase HEI efficiency and to ensure optimised use of high cost equipment that in many cases is taxpayer funded.

Summary and Recommendations

Currently, considering:

- challenges and resource required in developing a working CSG model
- inability to have a CSG in a VAT group
- risk of tribunal associated with not meeting the legal requirements despite best efforts

the benefits of utilising the Cost Sharing Exemption are not seen to outweigh the risks and costs. ***It seems likely that our conclusion will apply to other sectors beyond HE.***

We therefore make the following recommendations:

1. UK Government to work with HMRC and HEI-representative organisations, for example British Universities Finance Directors Group and HEFCE, to identify an acceptable process for which the Cost-Sharing Exemption can be utilised by the Higher Education sector.
    - This should be undertaken with acceptance by all parties that the current CSE terms that are in place, along with existing unresolved issues within HMRC on CSE implementation, do not and will not enable HEIs to make widespread use of CSEs.
2. Alternatively, UK Government to consider and establish alternative financial incentive and/or VAT-compensatory mechanisms that encourage greater facility sharing across HEIs.

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