VAT and fund management costs

Importance: ★★★★☆

In future, employers might be able to recover VAT on the cost of investment management services in relation to their occupational pension schemes.

This new prospect follows the recent decision by the European Court (CJEU) in the *PPG case*.

The next step is for HMRC to say how it will change its stance. We expect it will want to give the case a narrow interpretation.

Actions

HMRC already allows VAT recovery on most categories of expense (subject to billing arrangements) but denies it in relation to investment costs (see VAT Notice 700/17). If, as widely anticipated, HMRC changes its position following the *PPG case*, employers and trustees should review how the services they buy are organised with a view to maximising recovery.

While HMRC is considering its response, employers and any trustees who are registered for VAT should consider making a protective claim now to recover VAT that might have been overpaid in the last four years or so (or reviewing any existing claim).

PPG case

The CJEU held that an employer with a pension scheme that is a separate entity (like a UK occupational pension scheme) "is entitled to deduct the value added tax he has paid on services relating to the management and operation of that fund". The court identified investment management costs among the expenses to which its decision applies.

For VAT to be recovered, the CJEU said there must be a "direct and immediate link" between the expense of running the pension scheme and the price the employer charges for its VATable products. In its usual way, the CJEU confined itself to principles so it is for the national (Dutch) court to decide whether this link exists on the facts of the particular case.

Those facts are that the employer had a legal obligation to set up a scheme and paid all the contributions. It also contracted and paid for all the services the scheme received, including investment services; it did not pass any costs on to the scheme.

UK perspective

The CJEU decision challenges HMRC's long-standing distinction between "management" expenses (eg actuarial work and scheme administration) on which it allows the employer to recover VAT, and "investment" costs on which it denies recovery.

Where a supplier provides investment and related management services and bills them together, HMRC assumes for simplicity that the invoice splits 70/30 and allows recovery on the management element of 30%. It is prepared to consider a different split if the taxpayer presents suitable evidence.

Important points to watch for when HMRC responds include:

- will it try to hold the line that legal and fiscal arrangements for pension schemes in the UK mean there is no "direct and immediate link" between investment expenses and an employer's cost base? This would mean giving a restrictive interpretation to the broad principle the CJEU has set.
- if HMRC accepts that the principle is broad, will it create an evidential hurdle by asking an employer to substantiate the impact of investment expenses on its cost base?
- will it insist that recovery depends on costs being invoiced to the employer and not being passed on to, or paid by, the scheme? Altered billing arrangements might do the trick in many cases, but there might be legal and professional points for some suppliers to consider before settling on a new approach.
- where the employer and scheme members both have legal obligations to contribute, will HMRC allow recovery only in proportion to the employer's share of overall funding? That would be difficult in a DB scheme: for practical purposes, there would have to be a new assumption about the recoverable proportion.

The ball is in HMRC's court.

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