VAT recovery and pension schemes: Where are we now?

Speed read

HMRC’s policy on reclaiming VAT on investment management and other costs remains under review in the light of two recent decisions from the Court of Justice of the European Union.

The first of these cases, PPG Holdings, relates to defined benefit schemes. Although the ruling itself appeared helpful for employers, HMRC’s current interpretation of it is restrictive and could effectively increase overall pension scheme costs for sponsors of DB schemes.

The second case, ATP PensionService, relates to the administration of defined contribution schemes. HMRC has yet to respond formally to this case.

Updated guidance on VAT treatment in the light of both judgments is now expected in autumn 2014. Current arrangements where the pension scheme is invoiced for services under HMRC’s previous practice, as expressed in VAT Notice 700/17 (the 70:30 split arrangements) can continue until the new guidance is issued. A further transitional period is likely to be allowed from that point.

This briefing summarises the current position, including areas of uncertainty, and highlights points for schemes and sponsors to consider in advance of new guidance being published.

Are administration and investment management services exempt from VAT?

Recent cases have sought (with mixed success) to establish that administration and investment management costs relating to pension schemes should be exempt from VAT, based on the nature of the fund itself. The table below sets out the current position.

<table>
<thead>
<tr>
<th>CJEU view and case</th>
<th>HMRC position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management services supplied to DB schemes</td>
<td>Not exempt (Wheels CIF). DB arrangements can be treated differently for VAT purposes from other types of collective investment vehicles as they are employment-related, not open to public. No risk is borne by members</td>
</tr>
<tr>
<td>Management services supplied to DC schemes</td>
<td>Costs of administration, investment and payment services are VAT-exempt as a DC scheme is a ‘special investment fund’ under the VAT Directive (ATP PensionService). The decision relates to arrangements where the performance of the pooled fund of beneficiaries’ assets determines the level of pension benefits; beneficiaries bear the investment risk and retain an unconditional legal right to their investment; risk is spread over a range of securities</td>
</tr>
</tbody>
</table>
Can VAT on the cost of management services be recovered?

To the extent that VAT is chargeable, is it recoverable? VAT charged to scheme trustees on the cost of management services (investment or administration) will be recoverable by the trustees subject to normal rules – that is, it can be reclaimed to the extent that trustees themselves make a taxable supply of services. As this is a considerable restriction on the ability of most trustees to reclaim VAT, in practice the biggest question has always been whether the scheme sponsor could recover VAT charged to it in relation to the pension fund, or paid by it on behalf of the trustees.

HMRC accepts that the administration of pension schemes forms part of the overheads of running a business and, therefore, has a direct and immediate link to their business activities. Scheme sponsors are entitled to recover VAT on these costs as input tax.

HMRC has previously considered that investment management costs relate solely to the activities of the pension fund. To the extent that these inputs were deductible, they were deductible by the fund and/or trustees of the fund. However, by way of concession, VAT Notice 700/17 allowed employers to recover a proportion of the VAT charged on services relating to funded pension schemes. Where a single invoice was received covering both the administration of the pension fund and the management of the investments in the fund, HMRC allowed the employer to claim 30% of the VAT as relating to the general management of the scheme and the pension fund to claim 70% as relating to investment management (subject to the normal rules regarding VAT recovery). For this treatment to apply, the invoice had to be addressed to the employer for the input tax to be recoverable, even where the services were actually paid for by the scheme trustees.

In response to the PPG ruling, HMRC issued revised guidance on this issue in February 2014 and has now announced that, following ‘extensive discussions’ with industry representatives, further guidance can be expected in autumn 2014, which could include changes to its most recent position. The table below summarises the current state of play:

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<td><strong>Administration costs (DB scheme)</strong></td>
<td>Recoverable if there is a direct and immediate link between the provision of the scheme and the sponsor (confirmed in PPG Holdings)</td>
</tr>
<tr>
<td><strong>Investment management costs (DB scheme)</strong></td>
<td>Recoverable (PPG Holdings) if there is a direct and immediate link between the provision of the scheme and the sponsor</td>
</tr>
<tr>
<td><strong>DC investment/administration costs</strong></td>
<td>Exempt (ATP PensionService)</td>
</tr>
</tbody>
</table>
Points to consider

Our recent experience is that the 70:30 arrangements are being used by fewer schemes, so VAT recovery may be seen as a less significant issue in practice. Requirements to formalise adviser appointments and demonstrate that conflicts are appropriately handled may also make it more difficult for employers to commission advice required by trustees.

However, where relevant, schemes and sponsors should:

– consider whether any changes in commissioning/invoicing practices are required for the future; and

– take steps to maximise any possible recovery of VAT incorrectly charged by providers on past supplies of DC-related services.

Changes in commissioning/invoicing practices

DB-related supplies

Where a scheme sponsor commissions and pays for services, it can recover VAT on the associated costs (subject to HMRC’s restrictions) even though the beneficiary of the services is the pension scheme rather than the sponsor.

Where the supply is received by the employer but the costs are recharged to the scheme (by way of reimbursement or a set-off against pension contributions), HMRC will seek to collect output VAT on the amount recharged. This would potentially be deductible by the pension scheme to the extent (if any) that it is able to set off that input tax in relation to its own taxable business activities.

Where the supply is received and paid for by the employer and this is a factor in agreeing a lower overall employer contribution rate, there may be scope for the employer to retain full VAT recovery while covering the relevant costs. This is obviously subject to agreement by the trustees as part of wider negotiations about overall employer contributions required by the scheme; depending on the degree of uncertainty about those future costs and/or the level of materiality involved, this may not be a practical solution. It is also possible that HMRC might look into any reduction in the contribution rate to see if there is scope for arguing that the costs have effectively been recharged to the fund and that output VAT is therefore due.

A further possibility is that the sponsor, scheme and supplier could reach a tripartite agreement under which the employer contracts with the service supplier to provide services to the fund.
For non-VAT reasons, the service supplier would be appointed by the trustees, but would invoice the sponsor which has contracted to pay for those services. This structure, which potentially allows full VAT recoverability, is supported by a June 2013 decision of the Supreme Court. HMRC has not yet expressed a public view on such arrangements, but the potential advantages of this structure should be considered where appropriate for both sponsor and scheme.

Where a scheme has a corporate trustee, the sponsor and trustee may wish to consider the possibility of group VAT registration, if the relevant conditions (for example, GBP10 million annual group turnover, and use of consolidated group accounting) are met. This removes the need to account for VAT on goods and services supplied between group members; VAT on supplies to the corporate trustee can be recovered as if those supplies had been received by the representative member of the VAT group (for example, the scheme sponsor or another group company). From the scheme's perspective, the potential downside is that members of a VAT group are jointly and severally liable for any VAT debts incurred by other group members. Although this is restricted in the case of a corporate trustee, a pre-requisite of this structure would be a guarantee or indemnity from another group company, to ensure that scheme assets are fully protected.

DC-related supplies

Where a service provider supplies services in relation to both DB and DC arrangements, you will need to be able to distinguish between DC-related and DB-related services going forward, on the basis that VAT is not chargeable on services in relation to DC arrangements (following the ATP ruling). You will also need to be able to make this distinction in relation to past invoices to facilitate reclaims, as discussed below.

Recovery of VAT in relation to DC arrangements

In light of the ATP PensionService decision, HMRC is likely to invite claims from service providers seeking to recover any VAT which was incorrectly charged (that is, on services which are now considered exempt) in relation to DC arrangements. The service provider would normally have a right to recover this VAT, for example by issuing VAT credit notes. In theory the benefit of this refund of overpaid VAT should be passed back to the person to whom the supply was made. This could require employers/pension funds to adjust their VAT recovery and where this is not done, HMRC may issue assessments in relation to any VAT incorrectly recovered.

Sponsors and schemes should check the wording of their contracts with relevant providers as a first step, to see whether this indicates that their recovery may be limited to the amount the administrator recovers from HMRC. The latter amount could be reduced, if the provider's services are now VAT exempt. You could consider requiring service providers to confirm that they have made a protective claim against HMRC to maximise any possible recovery, and that they will pass the benefit of any recovery on to you. You should also seek confirmation that VAT is not chargeable on DC-related services going forward, and discuss how DC-related fees can be split out from overall fees on past and future invoices.
Transitional arrangements

HMRC’s new policy applies in principle from 3 February 2014, the date on which the policy currently outlined in VAT Notice 700/17 was withdrawn. However, a six-month transitional period was allowed in cases where the fund has been invoiced for services, while employers and pension funds adapt their arrangements. HMRC has now announced the extension of this transitional period until it issues its full revised guidance later this year.

HMRC will not take any action to correct the position in cases where the employer has deducted a proportion of the VAT under the existing treatment and its new conditions on supply to the employer and mixed administration/investment services were not met.

Further help

The invoicing and VAT recovery arrangements reached in relation to any particular scheme will depend on the specific circumstances of the scheme and sponsor. If you would like to discuss the issues further, please get in touch with your usual Allen & Overy contact and we will happy to explore possible solutions, with input from our VAT experts as relevant.

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