VAT focus

Consultation on the VAT treatment of fund management services

Speed read

The rules for the VAT treatment of fund management fees are unclear and incentivise UK fund managers to establish non-UK funds or add complexity to their arrangements. The proposals in the government's long awaited consultation document do not intend radical reform. Instead, they aim to give more legislative clarity to the fund types to which the fund management exemption applies, by codifying the government's view of the current EU law position. This lack of ambition may reflect the fact that there is no obvious straightforward, politically acceptable solution. However, the consultation appears to leave the door open for creative ideas.

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The VAT treatment of fund management services is a complex area. There is an exemption for the management of certain types of fund but its exact scope is uncertain. In addition, the current rules generate a policy anomaly under which UK fund managers are incentivised, by the VAT consequences, to use non-UK fund vehicles. With Brexit giving the UK the opportunity to depart from the EU based position, many in the asset management sector see reform of the UK VAT rules for fund management services as an opportunity for the country to give itself a competitive edge over rival European fund jurisdictions (in particular, Luxembourg).

Hopes were therefore high when, in March 2020, the government announced that it would undertake (during 2020) a review of the UK funds landscape and that, as part of this, the VAT treatment of fund management fees would be considered. However, although other aspects of the review made good process (such as the development of the qualifying asset holding company (QAHC) regime), there were no substantive public announcements on the VAT on fund management fees issue until February this year. At that time, the government confirmed that a consultation would be published 'in the coming months' but that it would not consider zero-rating fund management fees. Despite that announcement, there were rumours that perhaps zero-rating was not completely off the table.

On 9 December last year, as part of the 'Edinburgh reforms' package of documents, the consultation document (condoc) was published (see bit.ly/vatonfunds). In the accompanying consultation description, the government said that its proposals are 'not intended to result in policy change but are intended to improve the legislative basis of the VAT treatment of fund management.' In this article we will explain the current position and the government proposals, before considering both whether the proposals do what the government intends and whether they should be seen as a missed opportunity for substantive and positive reform.

The current position

The uncertainty

The UK VAT rules relating to fund management services are part of retained EU law and the EU position is therefore key.

Fund management services are standard rated unless an exemption applies. The crucial exemption can be found in article 135(1)(g) of the VAT Directive (2006/112/EC) which simply says that member states shall exempt 'the management of special investment funds as defined by Member States.' However, rather fundamentally, the meaning of 'special investment funds' (SIFs) is far from clear, with different member states taking different views on its scope. What constitutes 'management' is also uncertain, especially in the context of outsourcing arrangements.

> Many in the asset management sector see reform of the UK VAT rules for fund management services as an opportunity for the country to give itself a competitive edge

In 2017, the EU's VAT Committee provided some guidelines on the scope of the exemption ('the guidelines'). The VAT Committee is an advisory committee (set up under article 398 of the VAT Directive) consisting of representatives of member states and the Commission. Its guidelines do not constitute an official interpretation of EU law and member states are free not to follow them. The Committee was not able to get to complete agreement amongst its members, but 'almost unanimously' confirmed that, in line with (its view of) EU case law, the fund management exemption applies to funds which constitute undertakings for collective investment in transferable securities (UCITS) within the meaning of the UCITS Directive (2009/65/EC) and to funds that display characteristics identical to those of a UCITS and therefore carry out the same transactions or, at least displays features that are sufficiently comparable for them to be in competition with such undertakings.

There was less agreement among Committee members as to what are the characteristics that make a fund sufficiently comparable to a UCITS. By a 'large majority' the Committee thought the characteristics were:

(a) the fund must be a collective investment;
(b) the fund must operate on the principle of risk-spreading;
(c) the return on the investment must depend on the performance of the investments, and the holders must bear the risk connected with the fund;
(d) the fund must be subject to state supervision; and
(e) the fund must be subject to the same conditions of competition and appeal to the same circle of investors as UCITS.

Despite the lack of full agreement and the fact that the guidelines are not binding, it is clear from the condoc that HMRC sees these characteristics as embodying the current EU caselaw position as to what constitutes a SIF.

Layered on top of the EU caselaw derived position is the UK law implementing the exemption. This can be found in items 9 and 10 of VATA 1994 Sch 9 Group 5. The UK legislation does not use the term 'special investment fund' or seek to set out characteristics by which such a fund can be identified. Instead, it specifically lists fund types to which the exemption applies. Like the VAT Directive, the UK legislation applies the exemption to 'management' but does not define the term.

An advantage of the UK statutory approach to the types of fund covered by the exemption is that it gives certainty for entities on the list. However, this has come at the expense of flexibility, something which has given rise to complexity when the Court of Justice of the European Union (CJEU) has held that the scope of the exemption extends beyond the funds on the UK list. This has happened both specifically in the context of particular UK fund types (in the case of UK investment trusts (*JP Morgan Fleming Claverhouse Investment Trust plc v HMRC* (Case C-365/05)) and more generally in respect of foreign fund types with a UK equivalent (such as in the case of defined contribution pension schemes (*ATP Pension Service v Skatteministeriet* (Case C-464/12)).

The statutory list has been updated periodically, but this approach has, as the condoc explains, 'struggled to keep pace with the evolution of the industry and proliferation of fund types.'

The fact that the statutory list may not accord with EU caselaw has actually given some fund managers an element of choice as to whether to apply the exemption to a fund type. This is because the fund management exemption has been held (*Claverhouse)* to have direct effect, meaning that it can be relied on by a taxpayer notwithstanding the terms of the relevant member state's implementation in its own domestic law. This direct effect still applies post-Brexit under s4 of the European Union (Withdrawal) Act 2018. This has led to fund managers being able to choose whether or not a supply of their services should be exempt when dealing with a fund not on the statutory list but within the definition of SIF derived from EU caselaw. HMRC accepts that fund managers have this choice, but, as the Condoc makes clear, takes the view that the direct effect works by reference to the characteristics in the guidelines. The benefit for fund managers of having this optionality to charge or exempt their services has, however, come with the cost of the uncertainty that arises from the difficulties in ascertaining the precise boundaries of the EU caselaw concept of a SIF, especially as, to the authors' knowledge, prior to the publication of the condoc, there was no public guidance confirming that HMRC considered that the guidelines represented the EU law position.

A consequence of the UK following the position in the guidelines is that supplies of management to most alternative investment funds (AIFs), such as typical private equity funds, will not fall within the exemption.

The authors consider that there are good arguments that EU caselaw permits a wider interpretation of the fund management exemption than the approach taken in the guidelines, and it is important to note that some EU jurisdictions take a wider view, for example, treating AIFs as SIFs. However, we will not be discussing further here the correct scope of what constitutes a SIF. (For more insight on that issue, see 'VAT and the evolution of the special investment fund' (Etienne Wong & Alex Tostevin), *Tax Journal*, 16 November 2018 and 'The UK fund management VAT exemption' (Ian Zeider & Rob Smith), *Tax Journal,* 19 June 2020.)

The anomaly: supplies of management to non-UK funds

Managers are unable to recover their own input VAT to the extent that it is attributable to exempt supplies of fund management. Therefore, for a fund manager, a supply falling within the exemption is something of a double-edged sword. No VAT is chargeable on the supply but the manager cannot recover its own input VAT, leaving it the choice of having a reduced (or extinguished) margin or pushing the cost onto the fund by increasing its (exempt) fees.

However, VATA 1994 s 26(2) allows a taxable person to recover input tax attributable to supplies made outside the United Kingdom which would be taxable supplies if made in the United Kingdom. Fund management supplies to a fund with a place of belonging for VAT purposes outside the UK (and the Isle of Man) should be deemed to be made where the fund belongs (VATA 1994 s 7A for funds that are 'relevant business persons' and VATA 1994 Sch 4A para 16(2)(e) for funds that are not), and therefore outside the scope of UK VAT.

The anomaly is one of VAT policy in respect of an internationally mobile and competitive industry

This means that a consequence of the UK's relatively narrow interpretation of the fund management exemption is that fund managers can recover their own input VAT relating to supplies they make to many types of non-UK fund (for example, private equity funds) under s 26(2), without having to charge them VAT. In theory this benefit should be eroded where the fund is located in the EU because the fund should have to apply a reverse charge in its domestic jurisdiction. However, where that jurisdiction takes a wider view of the exemption and considers the fund in question to be a SIF, no reverse charge applies. Therefore, supplies of fund management to Luxembourg AIFs often fall entirely outside the scope of UK and Luxembourg VAT, whilst allowing the UK manager full input tax recovery.

It is often possible to mitigate the VAT costs of making fund management supplies to UK AIFs. This is typically, where the relevant fund is an English limited partnership, by including its general partner in the same VAT group as the manager. However, although that prevents the fund management fee being VATable, there is likely to be input tax leakage, and grouping itself adds an extra layer of complexity.

Supplies being outside the scope of UK VAT but with the right of input tax recovery is not, in itself, anomalous. The anomaly is one of VAT policy in respect of an internationally mobile and competitive industry, where it as easy for many fund houses to locate their funds overseas as in the UK, but in relation to which the government is looking to secure the country's status as a global hub. The current UK VAT rules give fund houses a financial incentive to locate their funds in rival fund jurisdictions such as Luxembourg or the Channel Islands.

The proposals

The proposals set out in the condoc have two parts. One is to 'make legislative changes to bring relevant case law and guidance into UK law' and, in doing so, establish

'defined criteria to establish which funds are entitled to the SIF exemption'. The other is to retain, but not update, the statutory list of exempt fund types. This retention is to ensure continuity of treatment for existing funds.

The defined criteria that HMRC proposes be used to establish whether a fund is a SIF are very similar to those in the guidelines but with two changes. The first is that limb (d) has been dropped (the requirement for state supervision), with the condoc explaining that that requirement is unnecessary as a result of the last limb. The second change is that more detail is added to that last limb:

> 'the fund must be subject to the same conditions of competition and appeal to the same circle of investors as a UCITS (Undertakings for Collective Investment in Transferable Securities), *that is funds intended for retail investors*.' (our emphasis)

There is little detail in the condoc on the proposed criteria, but we are told that the intention is that the legislation will contain a clear definition of 'Collective Investment' that will 'broadly mirror that provided within the Financial Services and Markets Act 2000, an area of regulatory law the government understands that the industry is familiar with'. In the authors' view, the term 'a collective investment' requires some clarification, but it may be that HMRC is envisaging at least some form of requirement for investments by investors to be pooled and then managed as a whole.

The deadline for responding to the condoc is 3 February 2023.

Comment

Under the proposals, the government is, in effect, seeking to freeze the range of funds to whom the fund management exemption can apply, in what it considers to be the current EU-law based position. However, as it is new post-Brexit legislation under consideration, the government has the freedom to choose the width of the exemption and depart from the EU position. Therefore, whether or not the government has the correct view under EU law of what constitutes a SIF is arguably academic. It is unlikely that we will get a completely definitive CJEU judgment on the issue in the near future and, even if we did get one before the government seeks to legislate for the proposals, if the proposals represent the position the government is happy with, there is nothing to stop it sticking with that position.

Will the proposals do what the government intends?

As discussed above, one of the government's stated intentions is that the proposals do not involve any policy change. Although that may be correct, retaining its current policy position is itself a real policy choice. The government is making a decision to have a narrower fund management exemption than Luxembourg and certain other EU jurisdictions.

Another of the government's stated intentions is to improve the legislative basis of the VAT treatment of fund management. The proposals should be able to succeed here, but only in part, as they only deal with the types of fund to which the exemption can apply, and do not seek to address the lack of certainty surrounding the concept of management.

A statutory characteristics based test combined with a list of existing fund types in relation to which the exemption would apply should give managers more certainty than currently, when, in difficult cases, reference may have to be had to various UK and EU resources. However, with no clear list of exempt entities to which new fund types can be added, uncertainty will still be possible. In this regard, the drafting of the legislation will be key. (A particular issue may be the express 'intended for retail investors' requirement. As, as the government and industry seek to increase the 'retailisation' of investment funds, the distinction between retail and non-retail funds may be harder to make out.) A possible solution could be to update, on an ongoing basis, the current list of fund types but to also have a characteristics based test available for funds that (i) the statutory process for getting on the list has not caught up with, or (ii) otherwise have not made it onto the list.

A missed opportunity?

Even if the proposals do give the UK a clearer and more user-friendly fund management exemption, there is still the question of whether the government is missing a chance to more significantly reform and improve the UK VAT treatment of fund management and give the country a boost in a competitive and important sector.

The fact that the UK's fund management exemption looks set to continue to be narrower than that of rival European fund jurisdictions can be seen as a mixed blessing for the asset management sector. For UK fund managers with significant non-UK client bases, of which there are many, the status quo works well, effectively giving them zero-rating. If the government had proposed extending the exemption to all AIFs, those managers' supplies to non-UK AIFs would have remained outside the scope of UK VAT, but they would have lost their right to input VAT recovery.

Even if zero-rating is off the table, that does not prevent the government at least considering more creative approaches

However, reducing the scope of the exemption so that it covered fewer fund types would have increased the costs of many UK funds. This is because supplies of management to them would now become standard rated, and investment funds are commonly unable to recover much (if any) of their VAT (although this will depend on the sector in which they operate).

Zero-rating of fund management services, accompanied by a wide (and clear) definition of the funds in scope and of the concept of management, would, unsurprisingly, be very much welcomed by the UK asset management sector and would be an issue in relation to which it would have a competitive edge over rival jurisdictions. However, in the current economic and social climate it is perhaps understandable that a government engaged in pay disputes with many public sector workers has steered clear of providing what could (with some justification) be characterised as a tax break for the fund management sector.

Of course, even if zero-rating is off the table, that does not prevent the government at least considering more creative approaches, and if the proposals mean that that is unlikely to happen, that could be seen as a missed opportunity. Here the condoc leaves the door slightly ajar, with the final question asking whether there are 'any further VAT related modifications the government might introduce under these or future reforms to improve the fund management regime for taxpayers?' ■

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- Taxation of funds: has 2021 lived up to its promise? (B Coleman, 7.12.21)
- VAT and the evolution of the special investment fund (E Wong & A Tostevin, 16.11.18)
- The UK fund management VAT exemption (I Zeider & R Smith, 16.6.20)