

VAT and Pension Fund Management – the new guidance

On 26 March 2015, HMRC published Revenue and Customs Brief 8 (2015), relating to the deduction of VAT on pension fund management costs. The Brief provides new guidance on the conditions in which employers can reclaim VAT charges in relation to pension fund management services provided in respect of defined benefit (DB) pension schemes.

Unfortunately, the guidance does not sit well with the regulatory environment applicable to DB schemes, and complying with it verbatim could have unintended effects. In our view, there are reasonable ways of working within the guidance, but care needs to be taken to ensure that the perspectives of the various interested parties (employer, trustees and investment manager) are considered.

Background

DB schemes in the UK are typically established as trusts, with investment functions being supervised (and paid for) by the trustees out of trust assets. Most trustees are not VAT registered (unlike their sponsoring employers) and HMRC has historically allowed employers to deduct VAT incurred by the trustees in certain circumstances. In broad terms, employers could recover VAT charged in relation to the administration of an occupational pension scheme, but not pure investment management costs. However, HMRC recognised that investment invoices would often

have an administration element, and, as an administrative simplification, allowed employers to claim 30% of such invoices against their own VAT.

However, this treatment has been called into question by the European Court of Justice case of **Fiscale Eenheid PPG Holdings BV cs te Hoogezand (C-26/12) (PPG)** which has cast doubt on the distinction between administration and investment management costs. This opens up the possibility that employers may be able to reclaim VAT on both types of cost or, depending on the precise arrangements between the parties, be unable to recover any VAT at all. However, HMRC has chosen to

Key issues

- New guidance for VAT recovery on pension scheme management fees
- Conflict with regulatory regime
- IMAs need careful redrafting

interpret the decision as meaning that an employer can only recover VAT on either type of cost where there is evidence that the relevant services are provided to the employer and, in particular, the employer is a party to the contract for those services, and has paid for them. If these conditions are not met, then from 1 January 2016, HMRC are likely to deny VAT recovery on both types of costs.

Note that the guidance does not apply to defined contribution (DC) schemes, which are to some extent covered by Revenue and Customs Brief 44 (2014) – the management of some such schemes is exempt from VAT following the European Court of Justice case of ATP Pension Services (C-464/12). However, HMRC is still

considering the position in relation to other DC schemes.

Conditions

In the past, employers would only rarely have been party to pension scheme management agreements, and indeed given the role of trustees, it would not generally be possible for employers and managers to make agreements without reference to the trustees. Brief 8 (2015) recognises that a tripartite agreement between employer, manager and trustees may be sufficient, but sets out conditions that such an agreement would in HMRC's view need to meet. These conditions are set out in full in the Appendix to this note, but include conditions that:

- The employer must pay for the services under the contract;
- The manager must only pursue the trustees where the employer is unlikely to pay;
- Both the employer and the trustees are entitled to seek legal redress in the event of a breach of contract (albeit that the manager's liability need not be increased as a result, and any payments may be payable to the scheme).

While these changes to the traditional approach may seem straightforward on their face, unless handled carefully they could cause concerns for employers, trustees and managers.

Employers

A key concern for employers is whether payments made direct to the manager will be deductible for corporation tax purposes. Under section 200 of the Finance Act 2004, the only sums which are so deductible in connection with the cost of providing benefits under a registered

pension scheme are contributions paid by an employer under that scheme. This could be interpreted as meaning that a contribution to the trustees (which in turn funds investment management fees) is deductible, but a payment direct to the manager is not.

Pending any official clarification from HMRC, employers may want further HMRC guidance on the point – clearly losing a corporation tax deduction in order to achieve a VAT saving could well be a false economy.

Trustees

Trustees have a range of statutory duties when it comes to investment, including a duty to invest assets in the best interests of members and beneficiaries. From a trustee point of view, it is important to ensure that joining the employer as a party does not cut across those duties. Specific language is likely to need to be included in the agreement on this point. They will also want to make sure that any rights of "legal redress" created for employers (see below) do not prejudice their members' interests.

Managers

Investment managers to pension schemes face some of the same concerns as trustees (they have statutory legal duties, and would want to make it clear that these are not affected by the employer's being a party). They may also have some commercial concerns on being paid by employers (for example, how long will they be prepared to wait on payment from the employer before pursuing the trustees?).

However, managers also may have a legal concern around their liability. The HMRC Brief makes it clear that the employer must be able to seek "legal redress" for a breach of the

contract, but that the manager's overall liability need not be increased. However, achieving this (i.e. ensuring that the manager's liability is not increased and that any payments are routed through the scheme) is not straightforward. Under section 33 of the Pensions Act 1995, where a manager is appointed in respect of a registered pension scheme, and fails to perform with reasonable care and skill, it is not generally possible to limit contractually that manager's liability as a result. A simple limitation clause would likely be void. In our view, it is possible to draft language around this issue, but care is needed.

Conclusion

The new HMRC guidance may represent an opportunity for employers to reclaim VAT that would not previously have been reclaimable and employers will need to address it fully if they are not to lose out on the 30% VAT recovery they currently enjoy. Trustees and investment managers should expect to be asked by employers to agree to necessary changes to help the employer and will have their individual interests to protect. However, careful consideration is needed to ensure that the interests of the various parties involved are not inadvertently prejudiced.

Appendix

Conditions for tripartite agreements under new HMRC guidance

- the service provider makes its supplies to the employer (albeit that the contract may recognise that, in the particular regulatory context in which DB schemes operate, the service provider may be appointed by, or on behalf of, the pension scheme trustees)
- the employer directly pays for the services that are supplied under the contract
- the service provider will pursue the employer for payment and only in circumstances where the employer is unlikely to pay (for example, because it has gone into administration) will it recover its fees from the scheme's funds or the pension scheme trustees
- both the employer and the pension scheme trustees are entitled to seek legal redress in the event of breach of contract, albeit that the liability of the service provider need not be any greater than if the contract were with the pension scheme trustees alone and any restitution, indemnity or settlement payments for which the service provider becomes liable may be payable in whole to the pension scheme trustees for the benefit of the pension scheme (for example in circumstance where the scheme is not fully funded)
- the service provider will provide fund performance reports to the employer on request (subject to the pension scheme trustees being able to stipulate that reports are withheld, for example where there could be a conflict of interest)
- the employer is entitled to terminate the contract, although that may be subject to a condition that they should not do so without the pension scheme trustees prior written consent (this can be in addition to any right that the pension scheme trustees may have to terminate the contract unilaterally)

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