By email
HMTVATandExcisePolicy@hmtreasury.gov.uk

MACFARLANES

2 February 2023

Our ref CCEM/TAX_POLICY_WORKSPACE

HM Treasury
For the attention of: Rachel Stirrat

HM Revenue & Customs
For the attention of: David Fitzgerald and Russell Langford-Smith

Dear Rachel, David and Russell

Macfarlanes LLP's response to HMT and HMRC consultation on the VAT treatment of fund management services

We welcome the opportunity to comment on the consultation titled "VAT Treatment of Fund Management Services" (the "**consultation**") published on 9 December 2022.

We understand that the consultation is not intended to result in any significant changes to the VAT treatment of fund management services but instead aims to improve the clarity of government policy and reduce reliance on retained EU law.

In our view it is debatable whether the proposal set out in the consultation achieves those aims. However, we think it is possible to clarify the current legislation and remove most or all references to retained EU law while achieving the same policy outcome as the current legislation. This response contains proposals to this effect.

We have provided our response to the questions presented in the consultation as an appendix to this letter. Please contact Rhiannon Kinghall Were, Head of Tax Policy using the following contact details (rhiannon.kinghallwere@macfarlanes.com or 020 7791 4131) if you have any questions.

Yours faithfully

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APPENDIX

1 **Question 1:** Do you agree that the proposed approach to refine the UK law covering the VAT treatment of fund management achieves its stated aims?

1.1 Agreeing and documenting the features which should lead to a fund qualifying as a SIF would potentially be of benefit. CJEU case law has evolved over the years in a manner intended to ensure that funds with similar features, and which are in competition with one another, have the same treatment for VAT purposes. Without recourse to the principles established by the CJEU, the purely list-based approach adopted in the VAT Act runs the risk of producing arbitrary results and distorting competition, particularly as and when new types of fund vehicles are brought to the market.

1.2 However, any form of principles-based definition will not give taxpayers the certainty provided by the current list-based approach and may in some cases lead to future tax disputes. Model portfolio services and unit-linked life funds are each the subject of opposing views and consequent uncertainty. We would welcome HMRC's views on whether each falls within the proposed SIF definition and suggest that such a discussion might serve to test how effectively the principles-based definition might address policy uncertainty.

1.3 In the absence of a principles-based definition, each time a new type of fund is conceived a decision must be taken as to whether to add it to the list of SIFs in the VAT Act (if it does not already fall within one of the descriptions listed in items 9 and 10 of Group 5 of Schedule 9). That currently gives rise to purposeful engagement between industry and government, resulting in a clear 'yes' or 'no' answer. We are concerned that the introduction of a principles-based definition might, at least in some cases, serve to disincentivise the parties from taking part in this valuable engagement and might deprive both government and industry of the benefit of a clear outcome.

1.4 For these reasons, if a principles-based definition is introduced in legislation, it would in our view be more appropriate to legislate in such a way that the government is required to add funds meeting the principles-based definition to the list of SIFs in Group 5 of Schedule 9. Funds meeting the definition would not automatically be VAT-exempt, but taxpayers could take a position (and if need be, litigate) to ensure the inclusion of a fund in the list as currently contained in Items 9 and 10, which would result in it becoming VAT-exempt. Such an approach would maintain the situation that long-existed while the UK was a member of the EU, whereby both government and industry benefited from the certainty of the list-based approach, but taxpayers were protected by judicial oversight against arbitrary results.

1.5 Turning to the principles-based definition which has been proposed, we note the following points:

1.5.1 Several types of funds which are currently listed in Items 9 and 10 of Group 5 would not qualify as SIFs under the proposed principles-based definition, suggesting that the definition (at least insofar as it pertains to UK funds) is too narrow. We understand that other responses to the consultation provide further details and examples, which we do not intend to repeat in our response.

1.5.2 Determining whether a fund is subject to the "same conditions of competition" and "appeals to the same circle of investors" as a UCITS would be difficult in practice and is likely to lead to disputes over interpretation. The definition should not cross-refer to UCITS; if there are particular features of a UCITS that HMRC and HMT think should be incorporated in any SIF definition then those features should be identified and defined in as clear and objective a manner as is possible.

1.5.3 The definition does not distinguish between UK and non-UK funds. At present, legislation and HMRC policy are such that, broadly speaking, non-UK funds do not qualify as SIFs for UK VAT purposes unless they are actively marketed to UK retail investors. As such, and as is the case in almost all other industries, UK asset managers competing on the global stage are not generally impeded by

irrecoverable VAT on their costs. Insofar as any principles-based definition takes account of the target investors, it should continue to exclude from exemption those non-UK funds that are not marketed to UK retail investors. Indeed, as the UK moves from UCITS passporting to the Overseas Funds Regime for the marketing of EU funds, there may be opportunities to introduce a more clearly defined test with less scope for disagreement over whether a fund is to be taken as being marketed to UK retail investors.

2 **Question 2:** Do the proposed legislative reforms present any issues for your business?

N/A

3 **Question 3:** Do you currently rely on Items 9 and 10 of Group 5, schedule 9 of VATA or exempt any transactions using that law?

N/A

4 **Question 4:** Would the legal definition for 'Collective Investment' in FSMA 2000 meet the intended aim of providing much greater certainty over correct application of the associated qualifying criteria?

4.1 The definition of collective investment scheme at section 235 FSMA 2000 is well understood and commonly used in a tax context. We note that this definition is intentionally very broad, so it is primarily the nature of the fund's investors that will limit the extent of the fund management exemption.

5 **Question 5:** If the answer to 4 is no, how might the government improve the definition to attain that aim?

N/A

6 **Question 6**: Are there any further VAT related modifications the government might introduce under these or future reforms to improve the fund management regime for taxpayers?

6.1 In our experience the most common complaints about the fund management VAT exemption concern the definition of "management" and "tainting" issues where management services relate to both SIFs and non-SIFs, or where a single fund meets the definition of a SIF in respect of some of its assets but not others.

Definition of management

6.2 The proposal as drafted does not achieve its objective of removing retained EU law from the UK's fund management VAT exemption because the definition of management will remain and will presumably continue to be informed by EU case law such as *GfBk* and *Abbey National*.

6.3 In common with most other types of financial services businesses, asset managers have in recent years increasingly sought to increase efficiency by outsourcing to third parties, a move which has been driven in large part by technological advancements. The extent to which outsourced fund management services, and particularly technology-enabled activities, qualify for VAT exemption has given rise to disputes in both the UK (e.g. the *Blackrock* case and the debate over research fees following MiFID II) and EU (e.g. the joined cases of *K* and *DBKAG*). The CJEU has gone some way in explaining the criteria which must be fulfilled for an outsourced service to fall within the fund management VAT exemption – most notably in the case of *GfBk* – but questions remain and disputes arise over how the test laid down in *GfBk* should be applied in practice.

6.4 A holistic policy-driven discussion between government and industry of how far the fund management VAT exemption should extend to outsourced services in the context of fund

management is long overdue. In the absence of a such a discussion it seems inevitable that case law will evolve in a piecemeal and unpredictable manner in response to disputes as and when they arise over the coming years. It is regrettable that the opportunity has not been taken to have that discussion as part of the present consultation.

Subcontracted services used in relation to both SIFs and non-SIFs

6.5 In 2020 the CJEU gave judgment in the *Blackrock* case. The case concerned management services provided in relation to both SIFs and non-SIFs. The CJEU concluded that such services should not qualify for the fund management exemption. We understand that in HMRC's view subcontracted fund management services do not qualify for VAT exemption if they are performed by way of a single supply and are used to any extent for the management of non-SIFs.

6.6 The current position - whereby managers of both SIFs and non-SIFs may incur VAT on services relating to their SIFs, which will not be incurred on the same services received by SIF-only managers - is clearly irrational. It introduces an arbitrary cost to outsourcing depending on the manager's fund range and therefore has the potential to interfere with the efficient organising of business.

6.7 Allowing for an apportionment so that VAT only applies to a reasonable proportion of the fees paid to the service provider in such circumstances would be simple to achieve and would remove VAT as a disincentive to the efficient structuring of business. It would meet the objectives of the fund management VAT exemption, being the removal of VAT as a cost of collectively investing via a SIF.

Mixed asset funds

6.8 A similar issue has arisen in relation to pension funds, where managers of funds comprising both defined benefit and defined contribution scheme assets have been required to charge VAT on their management fees, whereas managers of funds containing only defined contribution scheme assets are not required to charge VAT. Whether or not a beneficiary of a defined contribution pension scheme ultimately bears the cost of VAT may therefore depend on whether their assets are pooled with the assets of defined benefit schemes.

6.9 Again, this is an irrational result which contradicts the purpose of the fund management VAT exemption. It could quite easily be addressed by allowing an apportionment of the fund management fees to reflect the fund's assets.

6.10 Similar issues arise where a non-UK fund is marketed in the UK in such a manner that it is a SIF, despite many of the investors being outside the UK. The UK fund manager's supplies will often largely benefit, and are largely paid for by, non-UK investors and yet the manager bears the burden of irrecoverable VAT in relation to the whole of the fund (in contrast to the usual position for exported services). Again, it seems that allowing a reasonable apportionment would solve the issue.