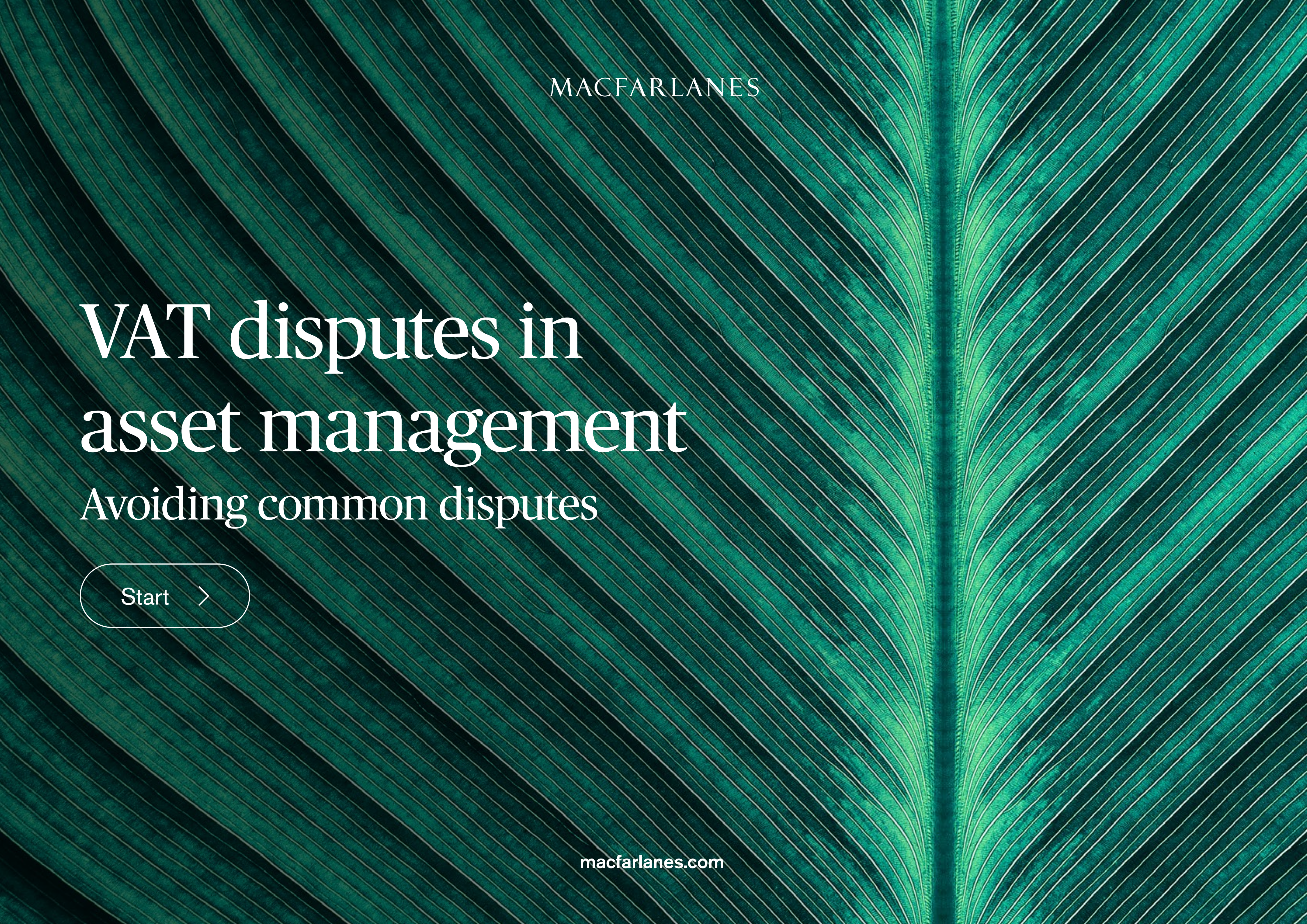

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VAT disputes in asset management

Avoiding common disputes

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Introduction

This is the first in a series of notes on handling VAT disputes in the asset management industry, intended primarily for alternative fund managers.

Prevention is better than cure; this note therefore sets out what are, in our experience, the most common topics of dispute between fund managers and tax authorities, along with steps for reducing the risk of a dispute arising. Future notes will discuss different types of HMRC enquiries and how to handle them as well as formal dispute processes including litigation.

Occasionally a VAT dispute will arise in relation to a transaction which is in some way novel or because of an unpredictable case law or HMRC policy development. However, that is not usually the case. More commonly, it will have been possible to identify the risk of dispute and to mitigate that risk through appropriate action. Asset managers who are at lower risk of facing a VAT dispute will be those that periodically takes steps to identify potential VAT risks and to address them before they materialise. They will know which types of transactions have the potential to go wrong and will have procedures in place to identify when such transactions occur and to manage the risk.

The following sections set out some common topics of disputes and steps that can be taken to mitigate the risk of dispute.

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Cost recharges

Issue

Costs incurred by the manager, fund or asset holding company might be recharged to borrowers, investee companies and/or other investors.

For these purposes a cost recharge includes one party paying an invoice addressed to another (the person to whom the invoice is addressed having effectively recharged the cost of the invoice to the payor).

Risk

Such recharges will often be a regular occurrence for the firms and funds that make them. However, it is not unusual to find that they are dealt with inconsistently on an ad-hoc basis and with little involvement by the firm's finance or tax teams.

Where invoices addressed to the firm or to the fund are simply paid by another party there is a heightened risk of the transaction being overlooked.

Depending on the arrangements between the parties, the recharge might be consideration for a VAT-exempt supply, which may have a bearing on the input VAT recovery position of the person making the recharge, or for a taxable supply on which output VAT is due.

The risk is not limited to the UK. We are aware of instances in which Luxembourg holding companies have been assessed for Luxembourg VAT on invoices addressed to them but paid by other parties.

Mitigation

A policy should be in place for dealing with cost recharges in a consistent manner and members of the deal teams should be aware of it. The policy should include procedures for:

- identifying cost recharges, particularly where an invoice addressed to the fund or manager is settled by another party;
- assessing the correct VAT treatment of different types of recharge in a consistent manner;
- ensuring that the agreement between the parties for costs recharge is recorded in writing and that the VAT treatment reflects the written agreement; and
- ensuring that whoever is responsible for VAT compliance is aware of the recharges and the correct VAT treatment.

Partial exemption

Issue

Managers of UK-based private equity and credit funds ordinarily operate a partial exemption special method (a PESM) which has been agreed with HMRC.

Risk

In some instances a significant amount of time will have passed since the PESM was agreed with HMRC.

It may be that the way the firm structures its arrangements and conducts is business have not changed materially over the years and that the PESM is still suitable.

However, in many cases the business will have changed and increasingly strained efforts will be required to shoehorn the evolved business into the outdated PESM.

In such cases a VAT exposure may arise if HMRC insist on strict application of the PESM.

Asset managers can find themselves in the unfortunate position whereby, not only does their PESM not enable them to benefit from developments giving the potential for increased VAT recovery, but attempts to apply the PESM to a new business structure not contemplated by the PESM can be challenged by HMRC. It is possible that a firm which has recovered less VAT than it would have if it operated an up-to-date PESM can nonetheless be challenged in respect of the VAT it has recovered.

Mitigation

For dated PESMs, consider whether:

- an updated PESM should be agreed with HMRC; and
- changes to the business mean that there is a gap in the PESM that the firm is entitled to rectify using a fair and reasonable use-based calculation without the agreement of HMRC.

The occurrence of certain events should trigger a review of the PESM. Such events include:

- the launch of a new fund;
- the creation of a new entity or branch in a new jurisdiction;
- use of a new asset holding structure; and
- the introduction of a new type of transaction such as new intra-group service charges or a new advisory mandate where a manager has previously only managed funds in its VAT group.

The annual adjustment calculation also serves as a good fallback opportunity to consider whether the PESM is fit for purpose.

Generally speaking, UK private equity and credit funds have seen their entitlement to input VAT recovery improve over recent years. Since Brexit, loans and disposals of investments to EU counterparties give entitlement to VAT recovery and the use of non-UK holding companies beneath the fund can also give a significant benefit in terms of VAT recovery. Older PESMs will often assume that all investments are held directly by the fund and that investment disposals do not give entitlement to input VAT recovery.

It may therefore be that re-visiting the PESM is an opportunity to not only mitigate existing risks but also gives the opportunity for improved future VAT recovery.

VAT recovery on deal fees

Issue

The steps required to secure VAT recovery by Bidco are well-tested and in most cases are relatively straight forward. However, unless the firm has procedures in place for determining what must be done on each deal, and (importantly) by whom, mistakes can easily be made.

Risk

Common errors that can lead to loss or reduction of VAT recovery on deal fees include the following.

- Failure to document, at the appropriate time, Bidco's intention to provide taxable services to the target leading to loss of VAT recovery.
- Receipt by Bidco of VAT-exempt loan interest from entities with which it is entitled to join a VAT group. The receipt of such income can reduce Bidco's entitlement to VAT recovery. This typically occurs where debt funding is pushed down via Bidco soon after closing and there is a delay in adding Bidco to the relevant VAT group.
- Failure to implement the service agreement between Bidco and the Target group and, in particular, the failure of Bidco to charge fees to the Target group. This may lead to partial or full loss of input VAT recovery.

Mitigation

VAT recovery on deal fees will usually have been considered well in advance of closing. When things go wrong it is usually because people's minds have moved on from the deal without a plan having been put in place specifying who is to do what in order to implement the agreed steps to support VAT recovery.

There is a heightened risk where members of Target's finance team are responsible for Bidco's VAT affairs but have not been closely involved in the deal.

At the same time that Bidco's VAT recovery is considered in advance of closing, a plan should be drawn up specifying who will be responsible for matters such as execution of the management service agreement by Bidco, any transfers of staff into Bidco, submitting the necessary VAT registration or VAT-grouping application and the charging of fees by Bidco to the Target group. The plan should include the dates by which each step must be taken.

Failure to add a new fund general partner to a VAT group

Issue

Where the GP of a UK limited partnership fund is VAT-grouped with the fund manager, HMRC accept that management fees charged to the fund are outside the scope of VAT.

Risk

If the manager and the fund GP are not VAT-grouped the management fee will be subject to VAT, which will often be largely irrecoverable by the fund. The manager can potentially be assessed for VAT on up to four years' worth of management fees.

HMRC's default position is such that an application to add a GP to an existing VAT group can only be backdated by 30 days, and then only if the effective date requested does not precede the final day of the VAT-group's most recent VAT return period.

VAT legislation affords HMRC discretion to accept belated notifications more than 30 days after the effective date requested in the application and, following criticism from the tax tribunal, their published guidance is now more generous than it once was.

However, we are aware of cases where they have strongly resisted the belated addition of GPs to their managers' VAT groups.

Mitigation

VAT-grouping should be included in the check list of actions to be taken in relation to the launch of any new UK fund. As important as including it in the list is specifying who is to be responsible and the deadline for submitting the application.

Marketing of non-UK UCITS funds

Issue

Where a non-UK UCITS fund such as a Luxembourg SICAV or Irish OEIC is marketed to UK retail investors it may become a VAT-exempt "special investment fund" (a SIF) for UK VAT purposes.

Risk

If the fund becomes a SIF, the manager will not be entitled to recover VAT on its costs to the extent to which that VAT is attributable to the management of the fund. Unlike other financial services VAT exemptions, the management services will not give entitlement to input VAT recovery even if the recipient of the supplies is outside the UK.

If the manager has not agreed a partial exemption special method it will usually be required to apportion its input VAT in accordance with the ratio of taxable to VAT-exempt income, which can result in significant loss of VAT recovery.

Mitigation

This issue occurs most commonly because members of the firm's investment and marketing teams take decisions on marketing strategy without appreciating (quite understandably) that there may be VAT implications.

Any change to the way in which a fund is marketed will require consideration from a regulatory perspective. A simple practical measure would be for members of the finance or tax team to maintain a list of non-UK UCITS funds and to periodically seek confirmation from those responsible for the firm's regulatory compliance that no changes have been made to the way in which the funds are marketed.

If the firm already operates a partial exemption method then the annual adjustment calculation can provide a good opportunity to perform such a review.

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