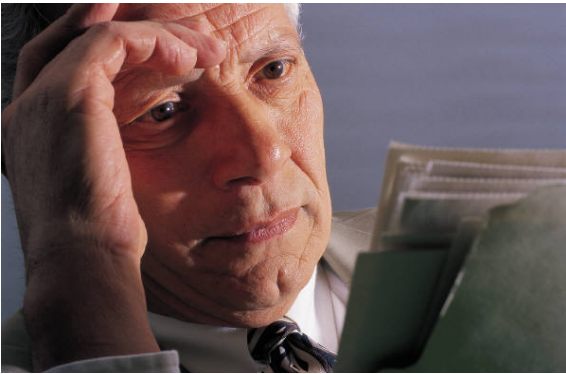


New Legal Challenge Over VAT On Investment Management Services



In June 2007, the European Court of Justice ('ECJ') concluded in the case of HM Revenue and Customs v JP Morgan Fleming Cleverhouse Investment Trust Plc that Investment Trust Companies ('ITCs') should be exempt from VAT on investment management services. A further challenge arguing that the exemption should also be extended to pension and endowment funds has been highly anticipated ever since.

Just eleven months on and a joint legal action is being taken against HM Revenue and Customs ('HMRC') by the National Association of Pensions Funds ('NAPF') and Wheels Common Investment Fund, an £8b multi-employer scheme covering Land Rover, Jaguar Cars Limited and Ford Motor Company Limited .

The Issue

Under Article 13B(d)(6) of the Sixth Directive, Member States are to exempt from VAT the 'management of special investment funds as defined by the Member States'. The UK government took the view that this should be interpreted so as to give them full discretion to define 'special investment funds' and therefore, when incorporating

the provision into national law, limited the exemption to unit trusts and open ended funds such as Open Ended Investment Companies ('OEICs'), Authorised Unit Trusts ('AUTs') and some Trust Based Schemes ('TBSSs').

It was this narrow interpretation that led to the JP Morgan case, which argued firstly, that ITCs should be included within the exemption and secondly, that the phrase "as defined by Member States" should not allow Member States to select some "special investment funds" to benefit from the exemption whilst excluding others.

When considering the issues, the ECJ held that there was no relevant difference between open ended investments, currently benefiting from the exemption, and closed end investment trusts, and that there was therefore no justification to preclude their classification as 'special investment funds'. It further went on to say that although the wording of the exemption did provide the Member States with the discretion to define 'special investment funds', they must do so having respect to the fundamental principal of the EU VAT system of fiscal neutrality.

This was the result that the Association of Investment Trust Companies had been hoping for and following the decision, HMRC eventually conceded that investment management services supplied to ITCs would benefit from the exemption. They are however still unwilling to concede that the judgement has any relevance to the investment management services supplied to pension funds on the basis that they use segregated investments managed through assets managers as opposed to investment management services provided through pooled funds.

As the JP Morgan case concerned itself specifically with ITCs, the ECJ did not explicitly state whether pension funds should fall within the definition of 'special investment funds'. With HMRC determined not to extend the exemption any further, the only way to determine the issue was to raise a fresh challenge.

The New Challenge

The NAPF claim that this interpretation is still too narrow and that the UK Government continue to fail to respect the principal of fiscal neutrality. They argue that as a result of the JP Morgan judgement, no investment management services should carry VAT and that Member States cannot distinguish between one type of investment undertaking

that allows investors to invest and another.

Currently, larger pension plans in the UK typically have segregated mandates with several asset managers. This allows them to have management mandates tailored precisely to their needs. However, by adopting this approach, they pay VAT at 17.5% on the fees charged and miss out on the tax relief which is available under pooled investment structures, such as unit trusts or OEICs.

Therefore, despite offering a similar service as that of OEICs and ITCs, pension schemes are subject to different VAT treatment. It is argued that this puts pension schemes at a competitive disadvantage compared to OEICs and ITCs, as the additional cost incurred by the pension schemes is borne by the members. This of course, is against the fundamental principal of fiscal neutrality.

The NAPF hope that the ECJ will follow the same rational as they did in coming to the JP Morgan judgement, and hold that pension funds should be defined as a 'special investment fund' and therefore benefit from the exemption

How Could You Benefit?

It is thought that 650 private-sector UK schemes could benefit. It is possible your scheme may be one. The pensions industry currently pays £100m a year on VAT for investment management services. If the challenge is successful, not only will the pension industry save £100m a year, under UK tax laws, you are also currently entitled to claim back-payments for the past three years, amounting to £300m. In addition, the Association of Investment Companies is currently seeking to have the three year time limit ruled illegal. If successful, VAT refund claims could date as far back as 1991. The ultimate amount that could be recouped could potentially reach £1b.

Pension schemes should now consider talking to their investment managers about submitting protective claims if they have not already done so. If you are unsure of your position we will be more than happy to discuss this, or any other issue, with you. If they have already submitted a claim and this has been rejected, the NAPF are urging them to ask for their appeal to stand behind their current challenge.

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