Response to consultation on VAT treatment of fund management services

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 270 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £10 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 46% of this is for overseas clients. The UK asset management industry is the largest in Europe and the second largest globally.

Executive summary

We have set out our key observations below with responses to specific questions provided later in this document:

1. **Limited scope.** As noted in the Consultation, at Budget 2020 a wide-ranging review of the UK Fund Regime was announced targeting merited tax changes that could help to make the UK a more attractive location for investment managers to domicile funds, including specifically a review of VAT treatment of fund management services. It is disappointing that the opportunity for a wider VAT reform has been minimised in favour of removing reliance on retained EU law through a technical consultation in a very specific and narrow area of VAT in fund management.

    - **Definition of 'management'.** Even with its retained EU law objective, the Consultation is solely focussed on the definition of what is a Special Investment Fund ('SIF') and does not address other more problematic and widely litigated parts of fund management VAT where loss of Retained EU Law would have significant impact, such as what constitutes the term 'management'. With significant case law over the years on this issue expanding the scope of the definition of 'management', it is critical that at the very minimum these principles are codified in UK law to maintain and protect the current position alongside the SIF definition.

    - **Wider policy areas.** The Consultation states that other options for policy reform in relation to fund management services will not fall within its scope. This approach ignores the feedback provided to HMT and HMRC in the intervening period through the bulk of responses to the UK Fund Regime review and informal feedback offered as part of the Policy Lab interviews. The feedback we understand was almost unanimous in its support for a future consultation on VAT zero-rating of UK management of all funds, which would level the inconsistent VAT treatment of management of UK and non-UK funds, and benefit the UK economy through increased activity, growth, and jobs.

      Whilst we welcome the chance to help contribute to crafting new legislation to improve policy clarity and certainty, this task is made difficult when the overarching policy objectives have not been reaffirmed since the UK's exit from the European Union. It is imperative and critical that Government should, first, take this opportunity to plot a new, independent course and set its own clear VAT policy for fund management.

2. **It does not meet its stated objectives.** We agree and support the broad objectives stated in the Consultation, however the proposal set out in the Consultation does not meet these objectives for the reasons set out below:

a. **Objective: The consultation is not intended to result in significant policy change.**

- **Impact on current exempt funds.** The Consultation proposes to introduce a principles-based definition of SIF using criteria that are vague and although considered by the EU VAT Committee, were never formally adopted by the EU Commission. The proposed criteria are not consistent with the list of funds already considered as exempt under UK VAT law (Items 9 & 10 of the Value Added Tax Act 1994, Schedule 9, Group 5) ('Items 9 & 10 list').

  By way of example, the following types of funds currently fall under the UK VAT exemption by virtue of being explicitly covered in the Items 9 & 10 list, would not meet one or more of the proposed principles-based criteria:

  - Investment Trust Companies and qualifying pension funds as these will likely not meet condition (a) of the proposed SIF criteria of being a 'collective investment'.
  - Non-UCITS OEICs/AUTs/ACS funds including the recently introduced Long Term Asset Funds due to the UCITS-like and retail requirements of the proposed condition (d).

  Please also see our detailed comments regarding the limitations and difficulties associated with conditions (a) and (d) as well as **Annex A** for a non-exhaustive list of entities showing inconsistencies between the proposed and current exemption.

- **Impact on non-UK funds.** The proposed principles-based definition also does not distinguish between UK and non-UK funds (unlike that in Note 6A to Item 9) possibly erroneously but dangerously risking a fundamental change to the UK VAT treatment of management of non-UK funds that are not marketed to UK investors. In the event that the Items 9 & 10 list is not maintained, this would lead to a fundamental change in the UK VAT policy for UK based fund managers managing non-UK funds, putting at risk UK's position as a leading exporter of fund management services. We would welcome clear clarification to confirm that this is not the intention as well as commitment to ensure that any legislative changes will clearly maintain the current position.

b. **Objective: Legal clarity and certainty**. The current Items 9 & 10 list is a culmination of case law principles set over the last few decades. The list provides a definitive and unambiguous answer re the VAT treatment of funds covered by it.

   We strongly disagree with the Consultation suggesting that there has been a '*proliferation of fund types'*. As is clear from the relatively short list of funds set out in the Items 9 & 10 list which currently contains 8 items, only 2 of which were added in the last 10 years, this statement is factually incorrect. On the contrary, other aspects of the fund management VAT exemption, i.e., what constitutes 'management' have increasingly been litigated due to the lack of a clear definition and the industry evolving through the use of outsourcing and technology.

   Fund types and regimes are driven by active Government policy-making to attract capital and need to be combined with a bespoke consideration of the appropriate direct and indirect tax regime at the time of their introduction**. To genuinely achieve the stated objective of providing clarity and legal certainty, the Items 9 & 10 list needs to be maintained and updated as and when new fund regimes are introduced by the Government.**

   Contrary to its objective, the proposed principles-based SIF criteria are unlikely to reduce litigation and have the potential to cause further litigation over time due to the increased uncertainties brought about through their inconsistencies with the Items 9 & 10 list. Moreover, the criteria are

unclear in terms of whether they would apply to Collective Defined Contribution (CDC) pension schemes, or life funds.

For these reasons, a principles-based approach which remains ambiguous will not meet the objective of clarity and legal certainty. A clear and regularly updated list of qualifying funds (i.e. the Items 9 & 10 list) will provide an unambiguous view of entities that fund management VAT exemption does (or does not) apply to.

c. **Attractive tax environment for fund management in the UK.** For reasons set out above raising uncertainties over the VAT treatment of various UK and non-UK funds, the UK VAT regime is at the risk of being perceived as uncertain, unstable and unfavourable, adversely affecting the UK's attractiveness for funds and fund managers, contrary to the objective of this Consultation.

Our proposal for meeting the sole aim of codifying retained EU law for 'SIF'

Given the timetable for enactment of the Retained EU Law (Revocation and Reform) Bill, to which we now appear to be subject, any legislative change needs to be simple, efficient, and effective to ensure certainty and clarity. **On that basis, introduction of principles-based criteria without extensive consultation on the UK fund management VAT policy is not a suitable approach** and as detailed in our response at odds with the Chancellor's commitment statement to the House that the Consultation does '*not … make policy changes…the consultation seeks input on whether the proposed changes achieve this objective',*'[1]**.**

As an alternative, a relatively quick and less disruptive solution to meet the limited objectives of the Consultation would be:

a. **To adopt the exact wording of the Article 135(g) EU VAT Directive Special Investment Fund exemption into UK statute as follows:**

   In Item 9, after the words, 'the management of' insert '*Special investment funds, which includes Items 9(a) to 9(k) and Item 10';* and

b. **To maintain an updated Items 9 & 10 list to include funds where UK exemption is already currently granted such as Model Portfolio Services**

We acknowledge that this is an imperfect and temporary solution, but it should provide:

- access to a new but identical UK SIF definition in UK VAT law to those existing funds that currently benefit from the SIF exemption in the EU VAT Directive;
- continued uninterrupted SIF exemption to funds that currently rely on UK VAT law through the Items 9 & 10 list; and
- time for the UK Government to consult meaningfully on VAT in fund management, which must include any future UK definition of 'management'.

This would provide the 'clarity and certainty' which both the industry and HMT/HMRC seek and minimise any unintended consequences. This will then allow the UK, when it has available capacity, to craft a new policy framework covering VAT in fund management which makes good on the UK Fund Regime overarching objective to identify those options that will make the UK a more attractive location to set up, manage and administer funds.

[1] https://questions-statements.parliament.uk/written-statements/detail/2022-12-09/hcws425

Our response to Consultation Questions

Q.1 Do you agree that the proposed approach to refine the UK law covering the VAT treatment of fund management, set out above, achieves its stated aims?

Q.2 Do the proposed legislative reforms present any issues for your business?

IA response: For detailed reasons set out below, we strongly disagree with the proposed approach on the basis that it fails to meet the stated aims. We have highlighted key issues that the proposed approach would present.

a. **Lack of alignment with wider Financial Services regulatory reforms.** In the Chancellor's statement, Financial Services is specifically mentioned as one of five industries which will not be subject to the sunset clauses of the Retained EU Law (Revocation and Reform) Bill. The VAT fund management exemption is a fundamental pillar of the UK tax code for the investment management industry and would have been expected to require the same level of careful consideration as financial services regulations. This conflict is heightened when the principles-based test proposed in the Consultation cross-references the EU regulatory concept of UCITS, an EU regulatory regime, where we may not see a bespoke UK equivalent until 2026.

   It also raises questions of overreach given that the Consultation appears to seek to define the term "UCITS-like" in tax statute, a regulatory concept which the FCA as the regulator should be responsible for.

   We also disagree with the notion that the VAT definition needs to be delinked from any regulatory definition. On the contrary, alignment of definitions for tax and regulatory purposes will provide business with more clarity and simplified certainty while considering the VAT position of funds they manage.

b. **Impact on current policy.** As a general rule, any principles need to be underpinned with a wider policy objective which unifies them. We can find no common ground across the proposed principles which would appear to offer the exemption to certain funds prior to UK's exit of the EU, but not after. And yet, the proposed principles-based definition is inconsistent with the list of funds set out in Items 9 & 10 list as exempt as well as the current treatment of non-UK funds that are not marketed to UK investors, which can have a damaging impact on the UK's position as a fund and fund management domicile.

   The VAT in fund management exemption has stood for over 40 years with case law slowly and steadily building a picture of what a SIF 'can be'. The 'SIF' criteria proposed in the Consultation are not only vague but also:

   - was first proposed in a draft EU Commission report (issued for discussion purposes only) that contained a number of statements that were demonstrably incorrect;
   - was rejected as flawed by the EU VAT Committee where it was discussed and has not been pursued further by the Commission; and
   - is in parts at odds with the position of a range of existing funds to which the UK has proactively sought to apply VAT exemption.

   We have provided below further details of each of the areas of inconsistency and departure from the current UK VAT policy:

- **Condition a) the fund must be a collective investment.**

  Without seeing what is proposed it is hard to comment on the efficacy of the new definition but it is likely to create uncertainty in comparison to the current definition of collective investment scheme which has widespread application, particularly if the intention is to ensure that the exemption continues to cover a broader class of arrangements such as Investment Trust Companies, Managed Portfolio Services and Pension Schemes, none of which are collective investment schemes from a regulatory perspective. It also creates inconsistency with other areas of the tax code which do rely on the regulatory definition creating inefficiency and complexity. Given the existing scope of the exemption, a definition based on a principle of collective investment will be problematic.

- **Condition d) 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.**

  - Many funds do not exist either for retail or for non-retail – the same fund is often used for both, with different share classes to account for the different investment limits and charging structures. It is essential that the exemption continues to apply to these structures.

  - Existing exemption extends beyond retail to cover funds that are not for retail. One such example is 'Qualified Investor Schemes' which are typically structured as authorised open-ended investment companies. These funds have, since their introduction in 2004, been able to avail of the VAT exemption under UK VAT law and are explicitly prohibited from sale and marketing to UCITS-like investors, thus appear unlikely to meet condition d). We find it hard to believe that this is an intended result.

  - The existing exemption extends beyond funds to cover arrangements that are not necessarily targeting a particular class of investor. For instance, Investment Trust Companies which are listed companies available to anyone.

- **Treatment of non-UK funds.** Prime amongst the unintended consequences is the potential effect on the investment managers who currently export supplies of management services to funds which are not actively marketed to UK retail investors, as the principles-based criteria do not make this distinction.

  Current VAT policy

  - Unlike other VAT exemptions provided for in Group 5 of Schedule 9 to the Value Added Tax Act 1994 ('VATA'), supplies falling within the Items 9 & 10 list do not give rise to input tax recovery for the supplier when the recipient of such supplies is outside of the United Kingdom. Accordingly, where there is a non-UK fund which is actively marketed to UK retail investors (and which would accordingly fall within item 9(c) to 9(f) of Group 5), the supplier cannot recover associated input tax.

  - Conversely, a non-UK fund which is not actively marketed to UK retail investors would currently fall outside of the Items 9 & 10 list by virtue of Note 6A to Group 5. Accordingly, the supply is not subject to UK VAT (as the place of supply will be the location where the fund receives the supply), but that supply would not fall within the UK VAT exemption if made within the UK. This allows the supplier of management to a non-UK fund which is not actively marketed to a UK retail investor to recover input tax incurred on associated costs.

- For UK investment managers, this ensures that VAT is not a cost they bear and allows them to compete for management mandates globally, an activity for which the UK has excelled. Over £4.1 trillion[2] of funds are currently managed here in the UK and 65% of this is in overseas-domiciled funds. This represents tens of billions in fee-based export revenue and billions in tax revenue to the Exchequer.

We are concerned that a crucial element of VAT in fund management, which is so dependent on the intricate mechanisms of VAT legislation, is not addressed within the Consultation.

As currently proposed, the principles-based test could, without detailed review, change the treatment of the management of non-UK funds which are not actively marketed to UK retail investors in a manner which would be detrimental to the UK fund management industry. The formulation of the principles in the consultation document does not include any reference to the geographic reach of the measure, nor of the location of the "retail investors" referenced in condition (d). Indeed, the reference to UCITS, being to a non-UK regulatory framework, carries the connotation that the definition of retail investors for these purposes could extend beyond the UK borders.

This seems diametrically opposed to the objective of the Consultation and its drive for '*legal clarity and certainty*' and we strongly oppose any change to the VAT regime which does not explicitly protect the existing position for supplies made in relation to non-UK funds.

c. **Lack of clarity and legal certainty**. As the Consultation mentions, currently fund managers can apply the VAT exemption for SIFs, either directly through the Items 9 & 10 list or via the direct effect of the Principal VAT Directive.

One of the reasons that the loss of direct effect of the Principal VAT Directive may have a significantly disruptive effect on the UK fund industry is because UK statute has never sought to replicate the Principal EU VAT Directive. This is not the case for statute applying to other areas of VAT exemption which as a result do not require change ahead of the 2023 sunset clauses.

For other sectors within Financial Services, VATA successfully incorporates the wording which is part of the Article 135 exemptions and while in certain instances the wording differs slightly, in each case the purpose of each exemption remains intact.

Items 9 & 10 lists however are not structured in the same way as set out below showing that the UK VAT legislation does not have the concept of 'SIF' within it and instead only provides a list of funds where the UK fund management VAT exemption applies.

Special Investment Funds			
Article 135(g)		VATA, Schedule 9, Group 5, Items 9 & 10	
	the management of special investment funds as defined by Member States;		9. The management of: (a)an authorised open-ended investment company; or (aa)an authorised contractual scheme; or] (b)an authorised unit trust scheme; or

[2] https://www.theia.org/sites/default/files/2022-09/Investment%20Management%20Survey%202021-22%20full%20report.pdf

			(c)a Gibraltar collective investment scheme that is not an umbrella scheme; or (d)a sub-fund of any other Gibraltar collective investment scheme; or (e)an individually recognised overseas scheme that is not an umbrella scheme; or (f)a sub-fund of any other individually recognised overseas scheme; or (k)a qualifying pension fund. 10. The management of a closed-ended collective investment undertaking

d. Impact on UK's attractiveness. The proposals in this Consultation risk adding an unnecessary and avoidable layer of legal uncertainty and potentially further litigation to the VAT treatment of management of UK and non-UK funds, something that could seriously damage the UK's attractiveness as a leading exporter of fund management services as well as further deteriorate UK's position as a fund domicile.

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

Many of our members rely extensively on Items 9 and 10 Group 5, schedule 9 of VATA and exempt any transactions of management using that law.

Q 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?

Q. 5. If the answer to 4 is no, how might the government improve the definition to attain that aim?

IA response: As stated in our earlier comments, without seeing what is proposed it is hard to comment on the efficacy of the new definition, but it is likely to create uncertainty in comparison to the current definition of collective investment scheme to protect the current policy and exemption. Given the existing scope of the exemption, a definition based on a principle of collective investment will be problematic.

As an example, applying this test to the qualifying pension schemes could add to the dichotomy given that occupational pensions and personal pensions seem to be specifically excluded from the definition of collective investments through articles 19 and 20 of The Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001.

Q 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?

IA response: In addition to our urgent ask of codifying current EU VAT law for the term 'management' into UK law, we reiterate our key messages submitted as part of the IA's response to the HMT UK Fund Regime Call for Input, relayed to the HMRC Policy Lab team as well as various discussions with HMT and HMRC since.

a. **Introduce VAT Zero-rating of fund management.** The IA firmly supports the Government's objective of improving UK's attractiveness as a fund location. The UK management of UK funds currently attracts irrecoverable VAT, an international anomaly which is a major barrier to funds considering domiciling here. For the UK to remain a competitive location for both managers and funds, to protect UK jobs and to capitalise on the UK's current strength in this industry sector and the advantages of the infrastructure in the UK, VAT zero-rating for UK management of UK funds is essential, as it would protect the UK from falling further behind other international fund centres in the race to attract greater and more diverse streams of international capital. VAT zero-rating has the effect of levelling the playing field and brings the VAT treatment of management of UK funds on the same footing as the VAT treatment of non-UK funds. While this opportunity did not exist whilst the UK was part of the EU and hence bound by the EU VAT directive, it now has the perfect opportunity to change its VAT law to benefit economic growth.

   The IA has commissioned an economic analysis to illustrate the macro-economic benefits of such a change through increased business, employment, PAYE and NI in the UK, which will far outweigh the costs of such a measure. We will share this report with HMT and HMRC in short order.

b. **Definition of 'management' to bring the VAT in fund management exemption into the 21st century recognising the different ways in which business is carried out and services are delivered.** The investment management sector has been undergoing a period of significant operational and structural change, driven by a combination of technological development, commercial specialisation and regulatory changes. As such, the scope of operations undertaken 'in-house' by investment managers and outsourced by them to third-party providers has dramatically changed in the last 15 years or so. The current UK VAT rules, that are based on the EU VAT directive, have not kept up to date with this pace of change and do not recognise the evolving ways in which services are delivered.

   Due to this, the definition of what constitutes 'management' has been subject to significant amount of litigation and there is an urgent need to address the approach to the provision of services through outsourced as well as technological means so as to cater for current and future delivery mechanisms. It is also crucial to recognise the importance of outsourcing for small and medium-sized investment management firms. The current application of the UK VAT regime results in a perverse outcome of penalising such firms for choosing to outsource certain functions instead of performing them in-house and urgently needs to be reviewed and addressed.

   The UK needs to radically reassess and update its position on the treatment of the evolving investment management supply chain in order to ensure that the UK remains a competitive location for investment managers to establish their operations.

c. **Zero fee share classes –** Legislative certainty and clarity should be provided to confirm that the recipient of the management supply could be the fund or the investor where for example there is a zero-fee share class. HMRC Policy has previously accepted in written correspondence with the IA that where the investor pays the management fee for the management of a special investment fund, the management fee paid is VAT exempt.

Annex A – Illustration of common fund types where the current treatment could be inconsistent with the treatment following the proposed principle based tests

Please note that this table has been prepared on a best effort bases for illustrative purposes only and is based on a very high-level understanding of the proposed criteria. It should not be relied on as a definitive determination of the SIF criteria.

Key	
Y	Yes
N	No
?	Suitable uncertainty exists to the treatment or these criteria may apply to certain funds but not others dependent on other variables

Legal Entity		**Regulatory Regime**	**VATA Schedule 9 & 10**	**Principles Based Test**				**Potential VAT Treatment applying only the principles-based test** *(in red where the current position is not maintained)*
				Conditions				
				(a)	(b)	(c)	(d)	
OEIC		UCITS	Exempt	Y	Y	Y	Y	Unchanged
		NURS	Exempt	Y	Y	Y	?	Unclear
		QIS	Exempt	Y	Y	Y	N	Standard Rated
		LTAF	Exempt	Y	Y	Y	N	Standard Rated
AUT		UCITS	Exempt	Y	Y	Y	Y	Unchanged
		NURS	Exempt	Y	Y	Y	?	Unclear
		QIS	Exempt	Y	Y	Y	N	Standard Rated
		LTAF	Exempt	Y	Y	Y	N	Standard Rated
Unauthorised Unit Trust ('UUT')	Exempt		N/A	?	Y	Y	N	Unchanged
	Non-Exempt		N/A	?	Y	Y	N	Unchanged
	Pension Fund		N/A	?	Y	Y	N	Unchanged
ACS - Contractual		UCITS	Exempt	Y	Y	Y	Y	Unchanged
		NURS	Exempt	Y	Y	Y	?	Unclear
		QIS	Exempt	Y	Y	Y	N	Standard Rated
		LTAF	Exempt	Y	Y	Y	N	Standard Rated
ACS - Partnership		UCITS	Exempt	Y	Y	Y	Y	Unchanged
		NURS	Exempt	Y	Y	Y	?	Unclear
		QIS	Exempt	Y	Y	Y	N	Standard Rated
		LTAF	Exempt	Y	Y	Y	N	Standard Rated
Charity Authorised Investment Fund		CAIF	N/A	Y	Y	Y	?	Unclear
Common Investment Fund		CIF	N/A	Y	Y	Y	?	Unclear

Qualifying Pension Scheme	Trust based - Self Invested Pension Scheme		Standard Rated	?	Y	Y	Y	Unclear
	Insurance based – Self Invested Pension Scheme		Exempt	Y	Y	Y	Y	Unchanged
	DC		Exempt	Y	Y	Y	Y	Unchanged
	Group SIPP		Exempt	Y	Y	Y	Y	Unchanged
	DB		Standard Rated	Y	Y	N	Y	Unchanged
	Small Self Administered Scheme (SSAS)		Exempt	Y	Y	Y	Y	Unchanged
Closed-Ended Collective Investment Schemes	Investment Trust Companies ('ITC')	AIFMD (LSE)	Exempt	?	Y	Y	?	Unclear
	Investment Trust Companies ('ITC')	AIFMD (AIM)	Standard Rated	?	Y	Y	N	Unchanged
	UK REIT	AIFMD	N/A	?	Y	Y	N	Unchanged
Model Portfolio Services			Exempt	?	Y	Y	?	Standard Rated
Luxembourg SICAV	Recognised Overseas Scheme		Zero-Rated	Y	Y	Y	Y	Exempt
Irish ICAV	Recognised Overseas Scheme		Zero-Rated	Y	Y	Y	Y	Exempt