

VAT exemption for management services

The European Court of Justice ('ECJ') has recently published its judgement in the case of HM Revenue and Customs v JP Morgan Fleming Claverhouse Investment Trust Plc ('JP Morgan'). The judgement is a significant step forward in extending the exemption for management services supplied to Investment Trust Companies ('ITCs') in the UK.



Background

JP Morgan is an ITC, which used the services of a third party to manage its investment portfolios. Under the current UK VAT rules, JP Morgan was charged standard rate VAT on the services.

JP Morgan was not entitled to reclaim this VAT as it did not make any taxable supplies for VAT purposes. Consequently, the irrecoverable VAT was an absolute cost (approximately £2.7 million in this case).

JP Morgan challenged the UK's treatment of investment management services as being subject to VAT, which resulted in the matter being referred to the ECJ. The ECJ's judgement was published on 28 June 2007.

VAT Exemption

The EU VAT Directives, from which the UK VAT legislation is derived, state that EU Member States must exempt the 'management of special investment funds as defined by Member States'.

The key issue in the JP Morgan case was therefore the extent to which EU Member States could include some types of investment funds and exclude others from the definition of 'special investment funds'.

When drafting the VAT legislation, the UK government took the view that 'special investment funds' should be defined as including Open Ended Investment Companies (OEICs), Authorised Unit Trusts (AUTs) and certain Trust Based Schemes (TBSs) and nothing else.

Accordingly, the UK VAT legislation only provides exemption for management services where they are supplied to OEICs, AUTs or TBSs.

The thrust of HMRC's case in the ECJ was that the EU Directive gave EU Member States the discretion to define 'special investment funds' and therefore it was entirely within the UK's rights to limit the exemption to OEICs, AUTs and TBSs.

The ECJ agreed with the UK, but said that the UK had to respect the fundamental principles of the EU VAT system, when exercising that discretion.

JP Morgan argued that the UK's interpretation was too narrow and offended the fundamental principle of the EU VAT system, namely that there should be fiscal neutrality. That is to say, similar types of services should have the same VAT treatment, so as to provide a level playing field for suppliers competing in the same market.

The deciding factor was therefore whether excluding the management of ITCs from the exemption would offend the principle of fiscal neutrality, therefore creating a distortion of competition. In other words, would the imposition of irrecoverable VAT on ITCs put them at a competitive disadvantage compared to OEICs, AUTs and TBSs?

The ECJ decided that it would and concluded that the management of ITCs should be included within the scope of the exemption.

Implications

The ECJ's judgement is clear that the scope of the UK's exemption is too narrow and should include the management of ITCs. HMRC have yet to publish a full response to the ECJ's judgement, but it seems that a change of legislation and policy is unavoidable.

In the meantime, HMRC have published a briefing paper (58/2007 dated 24 August 2007) which invites businesses to submit 'protective' claims, pending the outcome of the litigation.

Many managers of ITCs are now submitting claims to HMRC for the overpaid VAT, so that these amounts can be passed back to the ITCs. Due to the fact that VAT claims are limited to a 3 year period in the UK, it is advisable for claims to be submitted to HMRC as soon as possible.

Businesses submitting claims need to take into account the fact that, by recategorising services as exempt, input VAT previously reclaimed on business expenditure will become repayable (in part or in full) to HMRC and this needs to be incorporated into any claim that is submitted.

What Next?

The JP Morgan case has confirmed what many have thought for some time, that the UK's exemption is too narrow. It is likely that there will be further litigation on this subject, concerning whether the exemption should also include the management of other types of funds, such as pension funds.

It should also be remembered that the EU is currently carrying out a wide ranging review of the VAT treatment of financial services, which is expected to result in some significant changes.

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