

Pension schemes and VAT: where are we now?

December 2017

Pension briefing

HIGHLIGHTS

In a welcome announcement, HMRC has confirmed that existing arrangements enabling employers to reclaim VAT in respect of pension scheme administration costs borne by scheme trustees may continue. This development followed a long period of uncertainty, during which it was expected that the favourable VAT treatment of current arrangements would cease at the end of a transitional period – most recently extended to 31 December 2017.

HMRC will also accept a number of other arrangements enabling employers to recover VAT on pension administration costs and, to some extent, VAT on investment expenses as well. Each arrangement has advantages and disadvantages.

In a separate development, HMRC has announced that the VAT exemption for fees on pension fund management services carried out by insurers will cease from 1 April 2019. This will affect defined benefit (DB) schemes holding insurance company managed funds, though the particular impact is likely to depend on the terms of the individual contracts.

This note sets out the various options available to trustees and employers, plus the factors to consider when deciding on the optimal arrangement for your scheme.



EXISTING ARRANGEMENTS

HMRC divides the services received by occupational pension schemes into:

- administration services (which includes legal and actuarial fees for example); and
- investment services (principally investment management fees).

Historically, HMRC has allowed sponsoring employers of pension schemes to recover VAT on administration services but not on investment services. VAT on administration costs could be recovered by the employer, even where the service was contracted and paid for by the trustees (provided that an invoice was made out in the name of the employer).

Where contracts covered both administration and investment services, HMRC has allowed a notional split of 70/30 (with 30% of the invoice being attributed to "administration" and VAT recoverable on that part).

HMRC confirmed in November 2017 that employers may continue to recover VAT on administration costs, even where the trustees contract and pay for the services. In addition, the 70/30 split for combined contracts may still be used.

This decision was very welcome. What it essentially means is:

- if employers are only concerned about ensuring they continue to be able to reclaim VAT on administration services, there is no need to take any further action; however

- if employers wish to reclaim at least some of the VAT on investment services (perhaps given the insurance company changes mentioned below), then they should consider implementing some of the alternative options.

In terms of the alternative options, two of them produce similar results (full recovery on administration services and – if HMRC agrees – 50% of investment services), but one of them potentially allows full recovery on both administration and investment services. This last option, however, is the most complex to implement and administer.

INSURANCE COMPANY MANAGED FUNDS

The assets of many pension schemes are invested through insurance policies. The trustee enters an insurance contract with a regulated insurer and the value of the trustee's rights under the policy is linked to the investment performance of one or more funds managed by the insurer. The trustee does not have any rights in the underlying fund: its rights are to money paid under the terms of the insurance policy.

EU law exempts insurance services from VAT. HMRC has historically allowed pension fund management services provided through an insurance policy to be exempt from VAT, even where the insurance policy does not include an element of risk borne by the insurer.

HMRC announced in November this year that the VAT exemption for insurance company managed funds will end from 31 March 2019. The impact on pension schemes will depend on the wording of their particular insurance policy,

including whether there is any risk cover written into the policy and what, if anything, the terms say about liability for VAT.

Trustees who invest through insurance company managed funds should be aware that the cost of doing so may increase from 1 April 2019. In advance of this date, trustees may be approached by their insurers asking to discuss terms of their existing policy and, in particular, who should be liable for any new VAT charge.

The future VAT position of insurance company managed funds may influence employers' and trustees' decision-making on the most optimal arrangements for recovering VAT on pension scheme running costs going forward.

BACKGROUND: WHY DID HMRC CONSIDER OTHER VAT STRUCTURES?

Two decisions of the Court of Justice of the European Union (called "PPG" and "ATP", decided in 2013 and 2014 respectively) prompted HMRC to rethink its position regarding occupational pension schemes and VAT.

Defined contribution (DC) arrangements

In relation to DC arrangements, it became clear that services of managing the DC funds fall within the EU VAT exemption for special investment funds (SIFs), so the question of recovering VAT for DC fund management should not arise.

The boundary between exempt DC fund management and administration services relating to DC schemes, which are subject to VAT, is not entirely clear. It is therefore likely that some VAT on administration services will be payable in relation to DC schemes. Although HMRC does not say so explicitly, employers should be able to recover VAT on VATable administration services associated with a DC arrangement in the same way as for DB schemes – that is, even where the trustee contracts and pays for the administration service.

Defined benefit (DB) arrangements

For DB arrangements, HMRC and the pension industry engaged in lengthy discussions about alternative structures which would allow employers to recover some or all of the VAT on the costs of running their occupational pension schemes. The more thinking that was done by HMRC and industry stakeholders, the more potential difficulties arose with the proposed "solutions". Implementing any of the possible alternative structures would involve additional expense – the value of doing so will involve a cost/benefit analysis for the particular scheme.

ALTERNATIVE ARRANGEMENTS ALLOWING SOME VAT RECOVERY ON INVESTMENT COSTS FOR DB SCHEMES

HMRC will accept the following arrangements enabling the employer to recover all or some of the VAT incurred on investment services (as well as full recovery on administration services):

- paymaster (or "on supply") arrangements;
- VAT grouping; and

- hybrid arrangements (combining paymaster and tripartite contracts (see the box for an explanation of tripartite contracts)).

The rest of this note sets out the different alternative arrangements and explains the advantages and disadvantages of each.

As administration costs will continue to be 100% recoverable under previous arrangements, we anticipate that employers and trustees will only want to consider an alternative structure where the VAT incurred on investment costs is significant, or where there are material investments in insurance policies which, from 1 April 2019, will cease to be exempt from VAT.

PAYMASTER ARRANGEMENTS (ALSO KNOWN AS "BACK TO BACK")

What is a paymaster arrangement?

Under a paymaster arrangement, the trustee enters into a contract with the employer to provide the services of running the pension scheme. The trustee registers itself for VAT and invoices the employer for its services as trustee (adding on VAT). The employer pays the invoice and, providing it is making VATable supplies, recovers the VAT charged from HMRC.

The trustee contracts with various service providers (legal, actuarial, administration, etc) and pays VAT, where applicable, on their fees. The trustee can then offset the VAT it pays on service providers' fees against the VAT it charges the employer. For services where both the employer and the trustee have full VAT recovery, the trustee and the employer will end up in the same position as if the employer had contracted directly with the service provider and had recovered the VAT on the provider's fees.

Please see the diagram below which explains paymaster arrangements visually.

What services does paymaster work for?

A paymaster arrangement will allow the trustees and employer full VAT recovery in respect of administration services.

A paymaster arrangement will also allow **some** VAT recovery in respect of investment services. HMRC considers that the investment services relate partly to the trustee's "investment activities" and partly to its supply of running the pension scheme for the employer. To the pensions industry, this is a strange position as it is difficult to understand what investment activities the trustee might carry out that are not related to its supply of running the pension scheme.

HMRC will only allow a trustee to recover the part of the VAT it is charged on investment management fees that relate to the trustee's service of running the pension scheme on behalf of the employer, and not that part relating to the trustee's investment activities.

In earlier discussion with the industry, HMRC indicated that allowing 50% recovery of VAT on the trustee's investment costs would be likely to be fair (ie a notional 50/50 split between the investment activities and the supply of running the scheme). Unfortunately, this has not been repeated in the recently updated guidance.

We therefore suggest that before implementing a paymaster arrangement trustees and employers engage with HMRC to

confirm what particular percentage of the investment costs could be recovered.

Paymaster arrangements: advantages

- The trustee contracts with the providers – no need to renegotiate contracts (in contrast to tripartite contracts necessary as part of a hybrid arrangement).
- No conflict of interest issues (the trustee contracts direct with the providers).
- Full recovery of VAT on administration fees and partial recovery of VAT paid on investment fees.

Paymaster arrangements: disadvantages

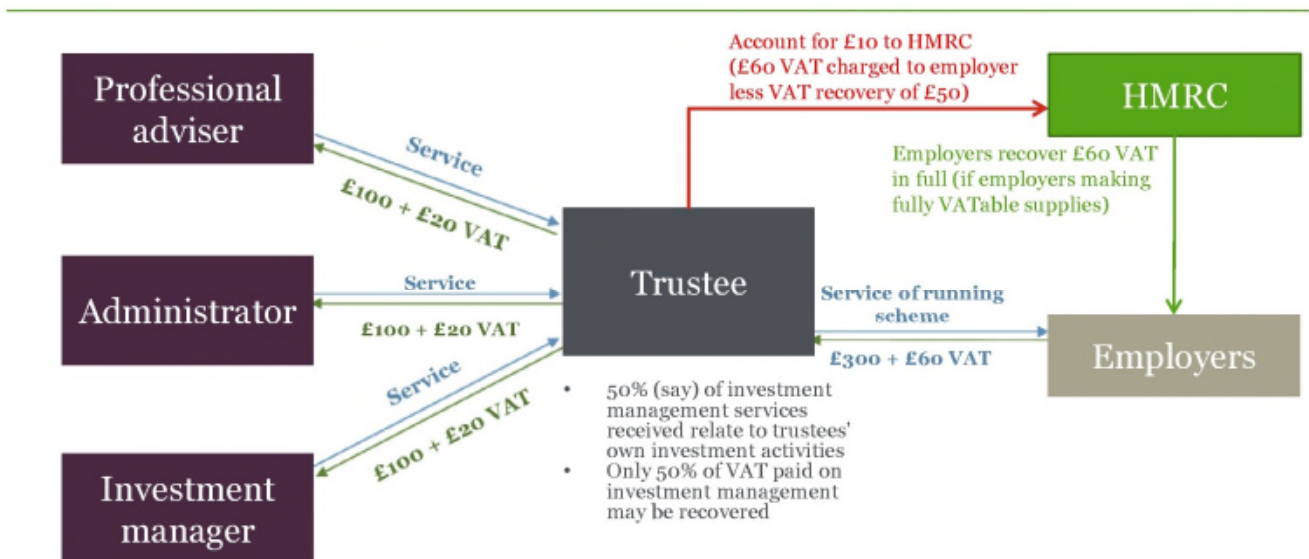
- The trustee will need to register for VAT and will need to submit VAT returns. Whilst it is possible for individual trustees to register (collectively) for VAT, the process is much simpler for a corporate, so it may be necessary to incorporate the trustees if they are not already a corporate.
- Only partial recovery of VAT will be allowed in relation to investment services.
- Potential loss of dormant company status for the trustee company, with consequent potential obligations to file accounts and returns with Companies House.

- The employer and trustee will each need to arrange their cashflow so that the trustee can pay the providers' fees when due and the employer can pay the trustees.

How to set up a paymaster arrangement?

Various steps would be needed:

- The trustee should register for VAT (and consider incorporation).
- Scheme rules should be checked and, where necessary, amended to allow the new arrangement.
- Processes, and cash flow arrangements, should be set up for the trustee (rather than the employer) to pay the providers of services to the trustee.
- A written contract will be needed between the trustee and the employer for the provision of services by the trustee.
- The trustee will need to submit VAT returns and comply with any other requirements for being VAT registered.



The example above illustrates how a paymaster arrangement might work. In this example, the trustee pays fees to service providers totalling £300 (plus £60 VAT) and charges the employer £300 (plus £60 VAT) for the service of running the pension scheme. The trustee does not add a profit element to the fee it charges the employer and will not, we understand, be treated as "trading" for corporation tax purposes.

In our example we assume that 50% of the investment consultant's services provided to the trustee relates to the trustee's investment activities, with 50% related to the service of running the scheme for the employer. Although the trustee charges £20 VAT to the employer that (effectively) relates to the investment services provided, the trustee may only offset £10 (50%) of the VAT it incurs on the investment manager's services against the VAT it must account for to HMRC on its service of running the scheme, and so must account to HMRC for the remaining £10 (50%).

This means that there is a tax leakage of £10, but this is a higher effective overall rate of VAT recovery than under the 70/30 split currently allowed.

VAT GROUPING

What is VAT grouping?

VAT grouping involves adding a corporate trustee as a member of the employer's wider VAT group. This enables employers to recover the VAT paid by the trustee – although care is needed because including the trustee in the VAT group could adversely impact the overall VAT recovery of the group as a whole.

VAT grouping allows full VAT recovery for administration services. Partial recovery of VAT on investment services should now be possible, although as with a paymaster arrangement, HMRC considers that the investment costs relate partly to the trustee's "investment activities", as well as to the provision of benefits which have a direct link to running the employer's business.

Again, as with paymaster (i) HMRC indicated in earlier discussions that it would accept a 50/50 split, allowing trustees to recover 50% of the investment services VAT; but (ii) no actual figure is given in the recently updated guidance. Again, our recommendation is that clients confirm with HMRC in advance what percentage of investment costs can be recovered before implementing VAT grouping.

Members employed by companies outside the VAT group

If the scheme members include employees (or former employees) of companies which are outside the VAT group, then either:

- the trustee must charge the employer(s) outside the group for the service of running the scheme; or
- the VAT incurred (for both administration and investment costs) must be apportioned so that only VAT incurred in relation to employers in the trustee's VAT group will be recoverable via the group VAT return.

VAT grouping: can trustees be liable for additional VAT?

Members of a VAT group are jointly and severally liable for VAT in respect of all members of the group. This has led to concern that pension scheme trustees would be liable for unpaid VAT liabilities of other members of the VAT group and that HMRC could reclaim this VAT due from the scheme assets. HMRC has been advised that it cannot recover VAT in respect of other entities from pension scheme assets.

Our analysis is that, under general trust law principles, it would be right that assets of the scheme would be safe from claims by HMRC. However, we suspect that HMRC's opinion may not take account of indemnities in pension scheme trust deeds, which commonly indemnify the trustee out of the scheme assets for any liability it incurs as trustee (which would usually include VAT liability).

Clients interested in implementing this option may want to think about amending the trustees' indemnity, so as to exclude an indemnity for VAT liabilities, in order to protect the scheme assets. They might also want to think about obtaining a specific confirmation on this point from HMRC.

Advantages of VAT grouping

- Enables recovery of VAT on pension scheme administration costs and partial recovery on investment management costs.
- Does not require renegotiation of contracts (the trustee contracts with providers).
- No conflict of interest concerns.

Disadvantages of VAT grouping

- Care must be taken that inclusion of the pension trustee in the employer's VAT group does not adversely affect the VAT recovery of the group as a whole.
- Only partial recovery of VAT will be allowed on investment services.
- Reduced VAT recovery if not all scheme employers are members of the trustee's VAT group.
- The pension scheme trustee would be jointly and severally liable for the VAT liabilities of the whole VAT group.
- The trustee must both be a corporate and meet the eligibility (control) requirements for being within the employer's VAT group.

HYBRID STRUCTURE (TRIPARTITE AND PAYMASTER)

HMRC has provided details of a potential hybrid structure for recovering VAT on services to pension schemes. The structure would combine a paymaster arrangement with tripartite contracts with service providers. In essence:

- the employer sets up a service company ("**Serviceco**") which does not employ any members of the pension scheme;
- Serviceco enters into tripartite contracts with the trustee and different service providers;
- Serviceco contracts with the participating employer(s) to provide the service of running the pension scheme;
- Serviceco pays the service providers' fees (plus VAT). It then recharges the amounts it has paid out to the participating employer(s), adding VAT;
- Serviceco offsets the VAT it pays on service providers' fees against the VAT it charges the employer. The employer can recover the VAT it pays in full, provided that it makes wholly VATable supplies of goods and services.

HMRC guidance suggests that a holding company or other member of a corporate group which already provides services to other companies in the group could also be used to run the pension scheme through tripartite contracts with the trustees and service providers. For convenience, in this note we assume that a new service company ("**Serviceco**") is used for this purpose.

Fundamentally, the main advantage of this option is that it allows full recovery of both administration and investment costs. However, it is also the most complex to implement, and so may only be suitable for clients where the investment services VAT is very significant. We understand that the Financial Conduct Authority (FCA) has raised some issues with regulated investment managers entering into tripartite contracts, which will need to be resolved.

Advantages of hybrid arrangements

- Allows full VAT recovery on administration and investment costs.
- The employer should be able to deduct the fee it pays to Serviceco against its corporation tax liability.
- Conflicts of interest between Serviceco and the trustee are less likely to be an issue than with tripartite contracts entered into by the trustee and the employer.
- The trustee company would retain its dormant status (if applicable).

Disadvantages of hybrid arrangements

- Tripartite contracts will need to be negotiated with each supplier.
- The structure is more complex than a simple paymaster arrangement and is therefore likely to result in higher set up and running costs.
- Serviceco will need to be registered for VAT and to submit VAT returns.
- The FCA will need to be comfortable about regulated investment managers entering into tripartite contracts.
- Cash flow will need to be managed to enable Serviceco to pay the providers' fees when they fall due. This may be more difficult than with a simple paymaster arrangement as Serviceco is unlikely to have its own source of funds, other than fees received from the employer.

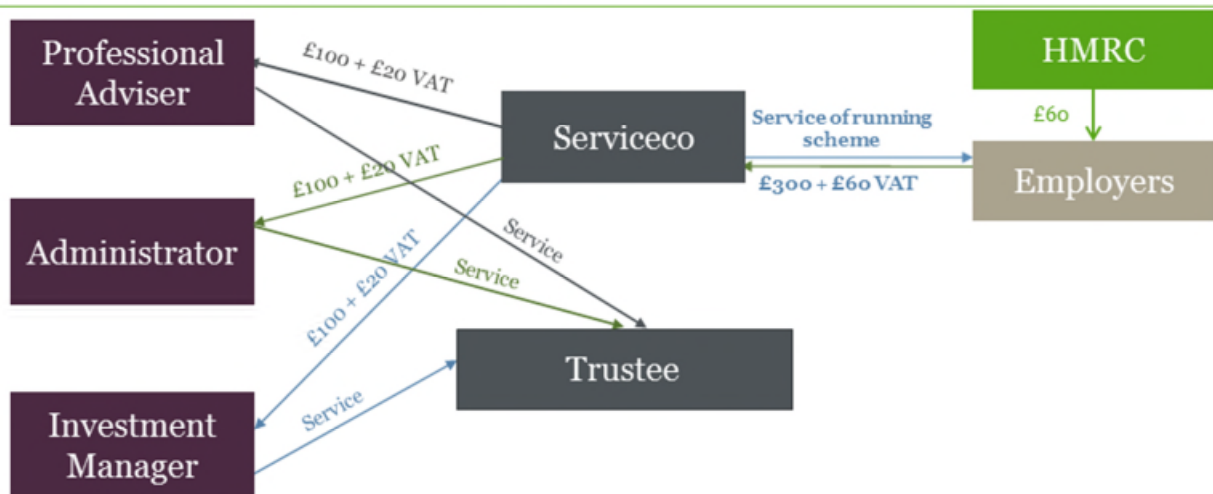
- Investment management costs can be significant (and often vary with the value of the assets being managed). Where investment management costs are included in a hybrid arrangement, the employer must ensure that it (and Serviceco) has sufficient liquidity to pay the fluctuating investment charges.

How would we set up a hybrid structure?

Various steps would be needed:

- The employer would set up Serviceco.
- Serviceco should register for VAT. Serviceco will need to submit VAT returns and comply with any other requirements for being VAT registered.
- Scheme rules should be checked and, where necessary, amended to allow the new arrangement.
- Contracts with service providers will need to be renegotiated to add Serviceco as a party. The contract terms should be drafted to satisfy HMRC's requirements for tripartite contracts.
- Processes should be set up for Serviceco (rather than the trustee or the employer) to pay the providers of services to the trustee.
- A written contract will be needed between Serviceco and the employer for the provision of services by Serviceco to the employer.

Hybrid arrangement example



What is a tripartite contract?

A tripartite contract is simply a contract made between three parties. HMRC has previously suggested that tripartite contracts made between the trustee, the employer and each service provider would be a means of enabling the employer to reclaim the VAT on the provider's fees,

provided that the contract satisfied certain conditions.

HMRC has set out the features that it would expect to see in a tripartite contract with an employer. These include that:

- the service provider makes its supplies to the employer (although the service provider may be appointed by, or on behalf of, the trustees); and

- the employer directly pays for the services supplied under the contract.

We can expect that a tripartite contract used as part of a hybrid arrangement (please see above), and made between the trustee, the service company (Serviceco) and the service provider, would need to meet similar conditions.

NEXT STEPS

- Most employers who make VATable supplies are already offsetting the input VAT incurred on pension scheme administration costs. This may continue, including using the 70/30% split for contracts which combine both administration and investment services.
- Trustees who invest through insurance company managed funds should take advice on the terms of their policy and the likely liability for VAT from 1 April 2019.
- Trustees and employers should assess the level of VAT paid on investment management services. Where this is

significant, they may wish to consider setting up an alternative structure to allow some or all of this VAT to be reclaimed. The analysis should include the future change in VAT treatment of insurance company managed funds.

- Where VAT on investment costs is deemed insignificant, or the employer and trustees prefer not to deal with the complexity of an alternative VAT structure, they need take no further action. Employers may continue to offset VAT on pension scheme administration services (and 30% of the VAT on combined investment/administration contracts).

Hogan Lovells pension team, working with members of our tax and insurance practices, would be pleased to help you assess your position and, where appropriate, to establish a suitable alternative VAT structure for your scheme.

This note is written as a general guide only. It should not be relied upon as a substitute for specific legal advice.

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