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VAT and Pensions – the Saga Continues

The circumstances in which VAT can be reclaimed in relation to services provided to a pension scheme are extremely complex, and in recent years have been the subject of a number of European legal cases.

After four years of uncertainty, instead of issuing a promised further briefing, HMRC has published an internal manual on how VAT should be calculated for defined benefit (DB) occupational pension schemes. This manual maintains the status quo and therefore the existing uncertainty indefinitely.

Sponsoring employers and trustees of DB occupational schemes, who have been applying HMRC's old policy on VAT, can continue to do so and don't need to make any changes. Alternatively, they can consider the new suggestions included in the internal manual in respect of investment management services, if they consider this would reduce the ultimate tax bill.

Background

Traditionally, HMRC policy had been to distinguish between costs incurred in relation to the setting up and day to day administration of occupational pension schemes, and the costs incurred in investment management relating to scheme assets.

HMRC allowed employers to deduct VAT incurred in relation to the administration of an occupational pension scheme on the basis these were overheads of the employer and linked to the employer's business activities. However, it viewed investment management costs as relating solely to the activities of the pension scheme. To the extent that these charges were deductible, they were deductible only by the pension scheme. As trustees are not generally registered for VAT the charges were, therefore, usually unrecoverable.

Where a single invoice was issued, covering both administration and investment costs, HMRC allowed the employer to claim 30% of the VAT as being related to the administration of the scheme, and it was left to the scheme to recover the remaining 70% as relating to investment management costs, if the trustees were able to do so (the 30/70 rule).

In the PPG case, the Court of Justice of the European Union (CJEU) found an employer, who set up a DB pension scheme as a separate legal entity, was entitled to deduct VAT it paid on services related to the management and operation of a scheme, provided that the existence of a direct and immediate link was apparent from the circumstances of the transaction in question.

The CJEU noted that the deduction system established by the appropriate EU VAT Directive was meant to relieve the employer entirely of the burden of the VAT paid, or payable, in the course of all its economic activities, provided the goods/services which were produced by the employer were subject to VAT. In other words VAT is payable only once, at the end of the production chain, by the consumer.

The fact that a pension scheme is set up as a legally and fiscally separate entity, in order to safeguard the pension rights of employees and former employees, did not stop the employer deducting the VAT it has paid on services relating to the management and operation of that scheme, provided that the existence of a direct and immediate link is apparent from all the circumstances of the transactions in question. The implication was that VAT on investment management costs incurred in relation to the scheme could be recovered by the sponsoring employer.

HMRC had a problem: VAT is the UK government's third largest source of revenue after income tax and national insurance. To comply with PPG, and say that the running of a pension scheme for employees is part of the employer's process of producing goods/services, and thus directly, and immediately, linked to the provision of those goods/services, would mean they collect less VAT today and face backdated claims of up to four years for the overpayment of VAT.

HMRC's Response

HMRC took some time to respond to the PPG case, and when it issued revised practice in February 2014 it was apparent that the narrowest possible interpretation of the judgment had been taken. This stance has been maintained by HMRC in the subsequent four years. Its internal manual says that for there to be "a direct and immediate link" employers will need to become contractual partners to investment services provided to a DB occupational pension scheme and pay for those services to reclaim VAT. The internal manual notes there will be some VAT bearing costs in relation to pension schemes that the trustees must contract for because of legal requirements. In such cases HMRC is still advocating tripartite contracts or "other contractual arrangements" to provide the necessary link.

The internal manual is silent on the point that even where the difficulties of producing a tripartite agreement were resolved, which meant an employer could reclaim back VAT, this would create an issue for employers in relation to corporation tax. Under the Finance Act 2004 only costs recognised in the Profit and Loss Account and contributions to pension schemes attract a deduction for corporation tax purposes. Payment of pension scheme costs to third party providers is not catered for in the legislation and not strictly contributions to a pension scheme.

The 30/70 Rule

HMRC, as part of their initial response to PPG, also announced the 30/70 rule would be withdrawn after a transitional period. This transitional period was extended on several occasions but was due to expire on

31 December 2017. The internal manual now says that, having undertaken a review, HMRC has decided the 30/70 rule will continue to apply going forward alongside the newer options following PPG.

In Conclusion

Costs incurred by DB occupational pension schemes in relation to the setting up, and day to day administration, of the scheme, can be recovered by the sponsoring employer where it does not directly contract and pay for them.

However, employers will have to become a contracting party to investment services provided to DB occupational pension schemes and pay for them in order to recover any VAT on them.

Where a single invoice is issued, covering both administration and investment costs, the employer can continue to claim 30% of the VAT as being related to the administration of the scheme.

It is surely not best practice for HMRC to rely on publishing an internal manual rather than producing proper guidance for DB occupational pension schemes. It is also concerning that the manual has been published less than 8 weeks before the transitional period for the 30/70 rule was due to expire.

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