

The Association of Investment Companies ('AIC') Guide to the accounting treatment of Back VAT

Background

Fund management fees (including performance fees) charged by third party fund managers to investment trust companies ('ITCs') have been treated as subject to VAT since 1990. The AIC believes that such fees should be exempt from VAT (as are similar fees charged to unit trusts and OEICs) and consequently, in conjunction with a Member company, took a case to the VAT Tribunal which eventually ended up at the European Court of Justice ('ECJ').

In June 2007 the ECJ delivered its judgement and supported the view that management fees charged to investment trusts should be exempt. HM Revenue & Customs ('HMRC') is currently considering the verdict and we hope that the VAT Tribunal will confirm the exemption within the next month or so. Assuming the case is won, VAT will not be charged on management fees going forward.

In addition, many ITCs will be able to reclaim some of the VAT they have paid over to their managers, potentially since 1990 ('Back VAT'). The legal position with regard to claiming Back VAT has been the subject of several papers and notes issued by the AIC and is not discussed further in this paper.

The purpose of this paper is primarily to provide guidance to Members as to when they should recognise Back VAT in their financial statements, including the various stages of recognition that might apply and the disclosures that might be made. However, the paper also considers a number of other issues, such as the need for market announcements and corporate tax issues (including section 842 implications).

This paper must be considered to be general guidance and is for use by the AIC's Members only. Members in any doubt over if or when to recognise Back VAT should take professional advice.

VCTs and other non ITC investment companies

The case was taken with respect to ITCs specifically (i.e. those qualifying under section 842) and not VCTs or other investment companies. A recent Business Brief from HMRC (<http://www.hmrc.gov.uk/briefs/vat/brief5807.htm>) suggests that HMRC will be taking a very strict line on this case, and that they will take the view that the ECJ judgement only applies to ITCs, and not VCTs.

It should therefore be assumed for the time being that VCTs will not benefit from the outcome of the case and therefore that issues relating to Back VAT do not arise.

Asset recognition and disclosures

A refund of Back VAT, perhaps covering a period of many years, may be a significant sum for some ITCs. If so, it will be a figure that shareholders and other industry stakeholders would like to see published and recognised in financial statements as soon as possible. The right to receive Back VAT is clearly an asset of an ITC. However, where there is uncertainty as to the quantum of the asset or whether it is actually due, then accounting standards set out the rules and circumstances regarding when disclosure and recognition should be made.

These accounting rules are set out in IAS 37 (for those ITCs reporting in accordance with IFRS) and FRS 12 (for those reporting in accordance with UK GAAP). The two standards are effectively identical as far as the position of Back VAT is concerned.

In general terms, accounting rules require a higher degree of certainty before an asset is recognised than a liability. The basic rules for assets are that:

- Where the inflow of economic benefits is virtually certain, then the asset (i.e. the Back VAT in this case) should be recognised as appropriate.
- Where the inflow of economic benefits is probable, but not virtually certain, the asset is said to be contingent and is not recognised, though certain disclosures are required.
- Where the inflow is not probable, then no recognition or disclosure is required.

Given the significant publicity regarding Back VAT, and the requirement for financial statements to give a true and fair view, it is considered that, generally speaking, some form of disclosure might need to be made even where the asset is not considered to be contingent.

IAS 37 also makes it clear (paragraph 90) that it is important that disclosures of contingent assets avoid giving misleading indications of the likelihood on income arising.

Quantification of Back VAT

The quantum of Back VAT due will depend on an ITC's historical VAT position and negotiations with its manager. These negotiations may take several months, with some elements likely to be agreed quicker than others, although it may be that nothing is formally signed-off until everything is agreed. In addition, it may be extremely difficult (or impossible) to determine precisely the potential size of

the refund due for some time as a result of records having been lost or destroyed.

It should also be remembered that HMRC has not, at the time of writing, formally agreed that management expenses are indeed exempt from VAT, and HMRC might still fight the case at the VAT Tribunal. Also, it is not clear on what basis HMRC might refund to managers the VAT paid to HMRC (will, for example, HMRC require managers to re-work their own partial exemption calculations?). There is also the question of whether interest will accrue on any refund. The final complication is that the length of the potential back period is the subject of an appeal to be heard by the House of Lords.

Management fees vs management expenses

The case will determine whether ITCs are entitled to a VAT exemption on their 'management expenses'. This term is potentially broader than just the management fee. For clarification, it is assumed that a performance fee will be treated in the same way as a management fee, as the payment relates to the same service provided.

However, aside from performance fees, it is unclear as yet which other classes of expense, in addition to management fees, should be included within the term management expense and therefore benefit from a VAT exemption. Although there has been a case heard before the ECJ on this point, this case was taken in respect of open-ended funds, and made specific reference to the UCITS Directive. It is difficult to draw any firm conclusions as to the implications of this case on the other expenses incurred by ITCs.

The AIC expects to discuss this matter with HMRC once it has been finally determined that ITCs should be exempt from VAT on their management expenses.

Recognition and Disclosures – general issues

(Illustrative examples are set out in Appendix 1)

1. Future invoices

For future invoices issued without VAT, once it has been finally determined that management expenses should be treated as exempt, there is nothing particular for an ITC to do other than account for the invoice in the normal way (albeit without VAT). Apart from a mention in the notes in the first accounting period that management fees are exempt, no additional disclosures are required in the financial statements.

2. Outcome of case

Until the Tribunal has finally determined that management expenses of ITCs should be treated as exempt from VAT, the receipt of Back VAT is not considered to be virtually certain and therefore it should not be recognised as an asset in the accounts. However, subject to the specific circumstances of an ITC, it is possible for an ITC, relying on the ECJ judgement, to conclude that the receipt of Back VAT is probable and therefore that certain disclosures are required.

3. Length of Back VAT claim

The Government has restricted the time period for a refund of Back VAT to a period of three years before the date of the claim. However, a recent case has found this restriction to be invalid and claims can now include a period from 1 January 1990 to 4 December 1996 (please see the AIC's note issued on 26 October 2006 for full details). HMRC has appealed against this ruling to the House of Lords and, until the outcome of the appeal is known, an ITC's manager cannot be certain how far back it can claim. In such circumstances, the manager may find it impossible to agree the amount (or even the basis) of any refund it might wish to agree with its ITC clients, which in turn means that the ITC will be unable to quantify the total refund.

4. Agreement with fund manager

The ITC's manager will be paying any refund of Back VAT to its client ITC and therefore the ITC will be negotiating the quantum of Back VAT due with its manager (and not with HMRC). Consequently, until the basis of the Back VAT refund is agreed, it will not be possible for the ITC to finally determine the amount of Back VAT refund due. It is therefore considered that, until the basis of the Back VAT refund is agreed, the receipt of Back VAT cannot be virtually certain. However, depending on the state of the negotiations between the manager and the ITC, the Back VAT refund could be classified as probable. However, even in these circumstances, a cautious approach may be desirable.

It may be that an ITC's manager has agreed with its ITC client that certain elements of the VAT paid to it (say, any and all VAT which the manager succeeds in reclaiming from HMRC) will be paid to the ITC despite the fact that no conclusion has yet been reached concerning the remaining elements.

In such circumstances the agreed element, subject to point 2 above, becomes virtually certain, although it will be necessary to examine the strength of the agreement and whether, for example, the manager is legally committed to refunding that element of the Back VAT regardless of the outcome of the remaining negotiations. Until a decision is reached by the House of Lords (see point 3 above), the 'virtually certain' element cannot include any Back VAT

reclaim relying on an HMRC refund earlier than three years before the claim was made or protective notice given.

5. Quantification techniques and estimations

At some point in the future, HMRC may concede that management fees are exempt and agreement will be reached with the ITC's managers regarding Back VAT. Therefore the Back VAT refund becomes virtually certain but it will still be necessary to quantify the amount of the refund. Even where these circumstances do not apply, an ITC may still wish to calculate how much VAT is potentially refundable for other purposes.

Where full records exist this should be a relatively straightforward exercise, although it will almost certainly involve the manager's records and not just those of the ITC. It is possible, particularly if details going back to 1990 are required, that the original records may have been lost or destroyed and therefore estimates will have to be used. Auditors will require calculations to be supported by as much evidence as possible (e.g. returns, partial exemption calculations etc).

Recognition and Disclosures - specific issues

1. Timing and method of recognition

When an asset falls to be recognised it should be treated as a credit in the year of recognition – it should not be treated as a prior period error.

Depending on circumstances, Back VAT may fall to be recognised in two or more different accounting periods.

2. Where recognised

Within the Income Statement the Back VAT refund credit should be disclosed as a negative management fee even if this results in the management fee charge for the year becoming a negative figure overall.

Depending on its significance, details of the Back VAT refund credit should be shown separately on the face of the Income Statement or in the notes to the accounts.

3. Capital or revenue?

Within the Income Statement the refund credit should be apportioned between revenue and capital in the same proportions as the original irrecoverable VAT was expensed. Where the basis of allocation has altered over the period, then the apportionment of the refund credit should reflect this. In some cases, it may

not be possible to demonstrate definitively how the refund relates to VAT previously recognised as irrecoverable. Where this is the case, reasonable assumptions and estimates should be made.

4. Interest on back claims

It is not clear whether interest will be paid by HMRC when a refund is made. The position between the ITC and its manager regarding interest relating to any Back VAT not payable by HMRC will need to be agreed by the two parties.

In any event, if any Back VAT related interest is received by an ITC, it should be credited to the Income Statement and disclosed within income. All such income should be treated as revenue and disclosed within the revenue column.

5. Allocation of tax relief

Within the Income Statement the allocation of tax relief should follow the calculations set out in the SORP. Such calculations should include the Back VAT refund credit and any interest received.

6. Disclosure when not recognised

Where it is not appropriate to recognise an asset, but the flow of economic benefits is probable, it is appropriate to disclose in a note to the financial statements a brief description of the VAT refund including, where practicable, an estimate of the financial effect as set out in paragraphs 89 – 91 of IAS 37.

Even where the flow of economic benefits is not considered probable, and particularly where the amount of Back VAT could be significant, the publicity surrounding this issue means that, if an ITC says nothing, shareholders, and other industry stakeholders, might misunderstand the actual position. Accordingly, an ITC should disclose a brief explanation of the situation, making it clear that the flow of benefits is not yet considered probable.

Even if no Back VAT will ever be payable (perhaps because the ITC has itself already fully recovered the VAT it has suffered, or for some other reason) the ITC should consider making a disclosure to this effect. This is because shareholders, not fully understanding what is a very complicated situation, may be aware of the industry's general position and may expect the ITC to benefit from a refund.

7. Prejudicial disclosures

As set out in paragraph 92 of IAS 37, in extremely rare cases, where disclosure can be expected to seriously prejudice negotiations with the ITC's manager, disclosure should not be made. However, disclosure of the general nature of the

dispute together with the fact that, and reason why, the information has not been disclosed is still required.

Gross Refunds

Due to the way that VAT refunds are made and various legal and procedural complications, it may be possible for an ITC to receive a larger amount of Back VAT than it itself has actually suffered during the relevant period.

For example, an ITC with a high proportion of its portfolio invested in the US typically recovers a very high percentage of the VAT it suffers so that its actual VAT write-offs are negligible. If that ITC reaches an agreement with its manager such that it receives Back VAT higher than the write-offs then, until the position of this 'over refund' becomes clear, the element of the Back VAT refund recognised as income should be restricted to the amount treated by the ITC as irrecoverable.

Market Announcements

Boards may need to consider market announcements in respect of Back VAT under the Disclosure and Transparency Rules (DTR) in relation to inside information. Boards may also wish to make announcements for other than regulatory reasons, but this is a matter for them and their advisers. The AIC expects that many Boards will make announcements even though this may not be strictly required.

The disclosure of inside information is covered by DTR 2.2. Broadly speaking, in order for information to be inside information it must (amongst other things) be:

- of a precise nature
- not generally available
- would, if generally available, be likely to have a significant effect on the investment trust's share price

As explained above, the amount of any potential Back VAT is dependent on a range of factors that make quantifying the potential impact on the company's share price extremely difficult.

Factors which may influence whether the Board is in possession of sufficiently precise information include:

- whether HMRC challenges the AIC's view of the ECJ judgement in the Tribunal, and on what basis, and whether they are successful
- uncertainty over the fund manager's own VAT position
- the outcome of pending litigation on the length of the back claims period

- uncertainty over the investment trust's own VAT recovery position in the back claim period
- the existence (or non-existence) of records covering the entire back claim period
- the outcome of negotiations between Boards and managers

All of these factors mean that many aspects of Back VAT, in most cases, are unlikely to be sufficiently precise in nature at this time as to require disclosure.

Even when it becomes possible to quantify some aspects precisely, in many cases Boards may conclude these aspects may well not be 'significant', as defined by the DTR rules. The DTR rules stress (see DTR 2.2.3 - 2.2.8), however, that the question of significance must be judged on a case-by-case basis by reference to the specific circumstances of the investment trust.

Boards may wish to consider specifically how significant Back VAT may be in relation to the NAV of the trust, as well as the impact of Back VAT on dividend distributions (for example, whether a special dividend is likely to be paid and the size of this dividend in relation to typical dividends paid by the company).

Although, in many cases, the AIC expects that Boards will be able to conclude that the impact of Back VAT is not significant in terms of the disclosure rules, this may not always be the case. For example, where an ITC is much smaller today than it was at some point during the period to which the Back VAT applies (perhaps as a result of returning a substantial amount of money to shareholders through a tender offer, or through falls in asset values which have not yet been fully recovered), the total Back VAT could represent a significant percentage of the NAV, and therefore more likely to require disclosure.

In a similar way to the accounting rules, where some aspects of the back claims position are sufficiently precise, and meet the 'significance' test, the AIC considers that these aspects should be disclosed, and the company should not wait until all aspects of Back VAT are finally resolved and make a 'one-off' announcement.

Section 842 and Corporation Tax

A refund of VAT previously treated as irrecoverable in an ITC's accounts should not have any impact on the 'income test' as set out in section 842, as such a refund will not be treated as income for this purpose (section 842 (1AC) ICTA 1988).

If interest on the refund is also received, then this will be considered to be 'bad' income which could, potentially, negatively impact on the income test. Given the possibility of claims for Back VAT extending back to 1990, the scale of interest is potentially much larger than previously anticipated. Nonetheless, the AIC

believes that, except in rare circumstances, the scale of interest due will be unlikely to have a material impact on compliance with the test.

The AIC considers that HMRC should not (and probably could not) withhold 842 status on the basis of income that arises only by virtue of interest on sums which were repaid as a result of the Government incorrectly implementing the Sixth VAT Directive. The AIC will be discussing this issue with HMRC and hopes to be able to confirm that the case could not prejudice an ITC's 842 status.

With regard to the 'retention test', a receipt of income (albeit treated as a negative expense) will boost the 'bottom line' and could, if the ITC wishes to meet the test, force it to pay a larger dividend than it would otherwise have done or even pay a dividend when none would otherwise have been paid. In such circumstances, the ITC might wish to designate the additional element of the dividend as a special payment and explain the circumstances in the notes to the financial statements and the Chairman's Statement and/or Report of the Directors as appropriate.

Any refund of VAT (together with any interest received) will be taxable, but ITCs with sufficient surplus management expenses will, of course, not have to pay any corporation tax.

Appendix 1

Example 1: HMRC has conceded that management fees are exempt and the ITC and its manager have reached an agreement that £1m of Back VAT is payable. Of this £1m, £0.6m relates to the period commencing 3 years prior to protective notice having been served by the manager and £0.4m to earlier years.

If it has been agreed that the entire £1m is payable and no other conditions have been set then £1m is virtually certain and should be recognised immediately. If, on the other hand, the £0.4m is subject to HMRC not winning its appeal to the House of Lords then only £0.6m is virtually certain. In these circumstances it is debatable whether the £0.4m can be considered to be probable and disclosed as a contingent asset. It is, in any event, nevertheless recommended that disclosure be made describing the circumstances.

If HMRC subsequently loses the appeal then the £0.4m becomes virtually certain and should be recognised at that time.

Example 2: Same circumstances as Example 1 except the £1m is made up as follows:

	£m
a) Refund due from HMRC to manager in period commencing 3 years prior to protective notice having been served	0.45
b) Element effectively retained by manager relating to manager's input VAT relating to the same period as set out in a) above	0.15
c) Refund due from HMRC to manager in earlier period than in a) above	0.30
d) Element effectively retained by manager relating to manager's input VAT relating to period earlier than set out in a) above	<u>0.10</u>
	<u>1.00</u>

If it has been agreed that the entire £1m is payable and no other conditions have been set then £1m is virtually certain and should be recognised immediately. If, on the other hand, it has been agreed that the manager will repay all of the irrecoverable VAT element and what it recovers from HMRC then, until HMRC loses the House of Lords case, only £0.7m is virtually certain.

If the agreement is that the manager will only repay what it receives back from HMRC then, until the House of Lords case is lost by HMRC, only £0.45m is virtually certain – once HMRC loses the House of Lords case then the £0.3m becomes virtually certain. Until HMRC loses the case it is debatable whether the £0.3m can be considered to be probable and disclosed as a contingent asset. It is nevertheless recommended that disclosure be made describing the circumstances.

It should therefore be noted that it is possible, depending on the circumstances, that Back VAT may fall to be recognised in two or more different accounting

periods. However, as long as adequate disclosure is made at each recognition point (including details, as far as possible, of what has yet to be recognised) shareholders and other interested parties should be able to assess the ITC's position.

Example 3: Negotiations between the ITC and its manager are ongoing:

As no final agreement has been reached it is clear that it cannot be certain that economic benefits will flow and therefore no asset should be recognised. However, depending on the state of the negotiations, the ITC will have to form a view as to how probable the flow of benefits is likely to be.

If, for example, agreement has been reached in principle, but the amount of the Back VAT has yet to be determined then, although it could be argued that it is certain that benefits will flow as it is only the amount that is uncertain, it is considered that disclosure is the most appropriate course of action. Such disclosure should include a statement that the negotiations are ongoing and the amount is uncertain. In accordance with paragraph 90 of IAS 37, it is important that misleading indications of the likelihood of income arising are avoided. It is, however, recommended that disclosure be made even if the ITC concludes that the flow of benefits is not probable.

In extremely rare cases, where disclosure can be expected to seriously prejudice negotiations with the ITC's manager, such disclosure should not be made. However, this should not prevent disclosures in general terms from being made.

Example 4: Negotiations between the ITC and its manager are at a very early stage:

In these circumstances it may be too early to conclude that the flow of benefits is even probable although it may simply be the case that the quantification of Back VAT is the major difficulty. Either way, given shareholder expectations, it is recommended that some disclosure, perhaps in general terms, be made.

In extremely rare cases, where disclosure can be expected to seriously prejudice negotiations with the ITC's manager, such disclosure should not be made. However, this should not prevent disclosures in general terms from being made.