MiFID II - watch out for the VAT implications

3 January 2018

In brief

The revisions to the European Union (EU)'s Markets in Financial Instruments Directive (MiFID II) finally came into force on 3 January 2018, a year later than originally planned.

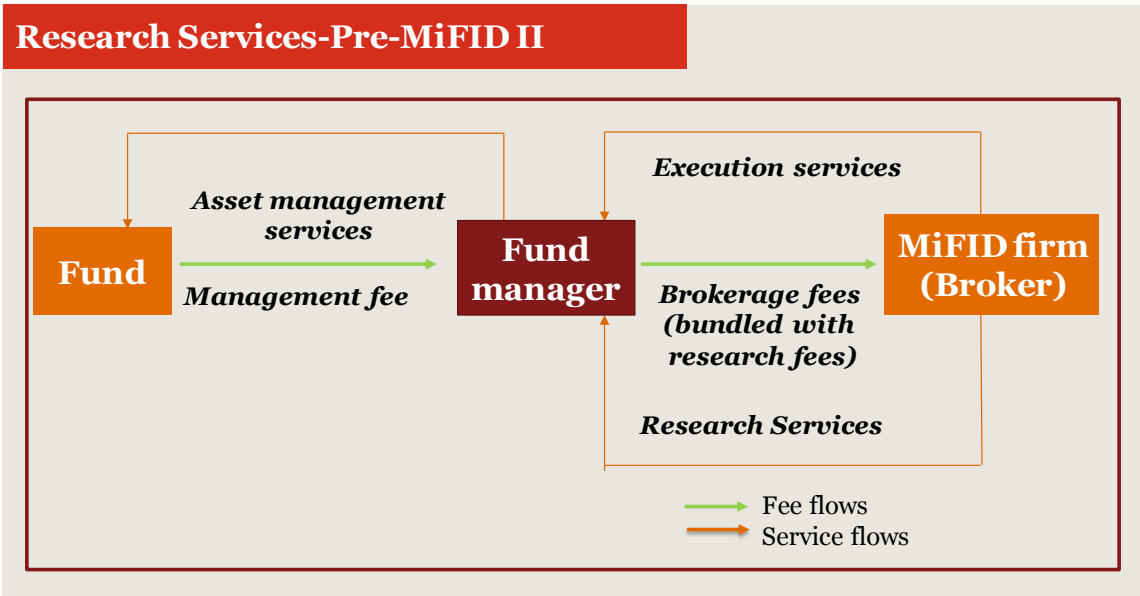
MiFID II, amongst other changes, impacts the inducement regime and how the investment research costs are charged thus having an effect on the payments to be made to asset managers and independent advisors. This publication focuses on the possible VAT implications deriving from the inducement ban and on the unbundling of investment research and brokerage costs in the investment funds sector only.

Whilst MiFID II is not tax driven, it is one of the areas where the collective asset management industry will also feel an indirect impact, particularly with regard to VAT that may now arise on research costs and any new enhanced services that may be introduced to comply with the new rules.

Research services

Situation before MiFID II

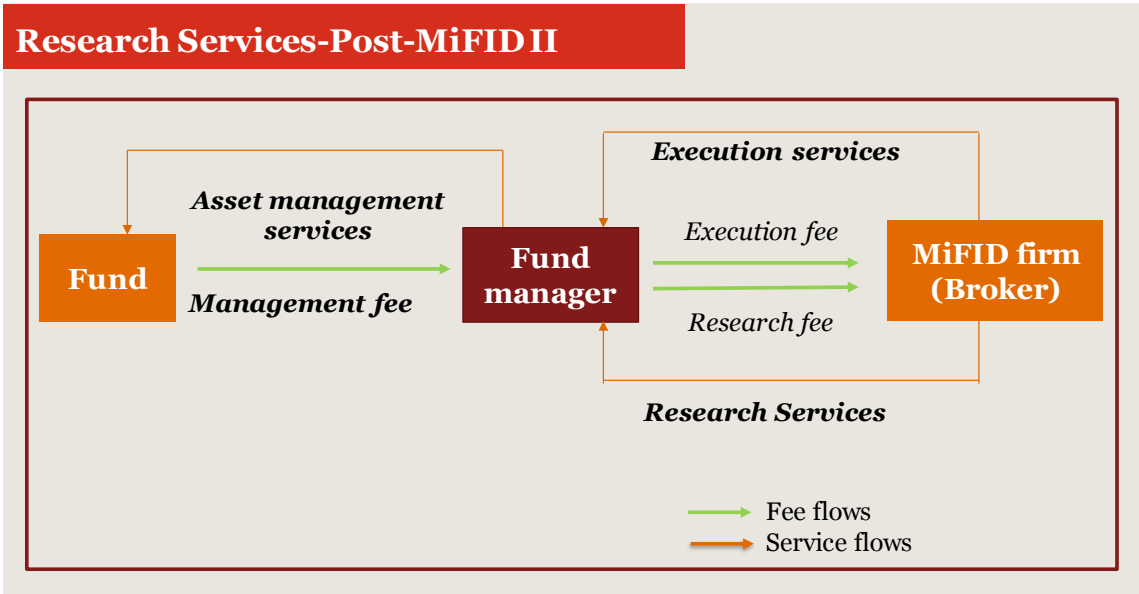
The diagram below shows the current situation with regard to research services procured by a fund manager from a MiFID firm (pre MiFID II).



For decades, asset managers receiving research services from an investment bank or broker in exchange for using them to carry out trades have lumped together trading and research costs into a single execution fee and billed to the investor. Since execution fees are normally VAT exempt, the unbundled research costs have been treated as merely ancillary to an execution service thus benefiting from the exempt VAT treatment afforded to the execution service. However, MiFID II requires that research fees are unbundled and we discuss below a possible scenario.

Possible scenario Post MiFID II

The diagram below shows a possible scenario in connection to research services supplied to a fund manager by a MiFID firm post MiFID II:



MiFID II requires under certain conditions that MiFID firms unbundle the research and trading costs and charge them separately. Charging for research services separately may expose research fees to be accorded a separate VAT treatment than the execution services. In theory, the VAT treatment of the research services would primarily depend on whether the research services form part of a single supply, are ancillary to the main supply or are a distinct and independent supply.

In light of the above, a supply would be regarded as a single supply where two or more elements or acts supplied by the taxable person are so closely linked that they, objectively, form a single, indivisible economic supply, which it would be artificial to split. In this case, the qualifying research services should be accorded the same treatment as the main supply. Alternatively, the research services could also be viewed as ancillary to the main supply if they do not constitute for the asset manager an end in itself but a means of better enjoying the principal supply. If a supply is seen as insignificant or incidental or ancillary to the main supply, then for the purposes of VAT it is usually ignored – the liability is determined by the VAT treatment applicable to the main supply (or supplies). Conversely, where research services are considered a distinct and independent supply, they will be accorded their own VAT treatment (potentially subject to VAT at a 17% rate when the place of taxation is in Luxembourg). The qualification of a given scenario as a single, ancillary or multiple supplies must be done on a case-by-case basis taking into account the circumstances at hand.

In practice, while there is room to argue that research services still constitute a single supply with execution services or research services are “ancillary” to execution services and hence are VAT exempt, this argument is yet to be fully tested and the answer would vary depending on the exact circumstances and potentially from one country to the other.

Where VAT is charged on research costs post 3 January 2018, the asset manager may suffer from increased costs of doing business, in particular where VAT is irrecoverable.

The wider VAT impact on the asset managers will be influenced by whether the asset managers elect to meet the research costs from their own resources or pass this cost on to their clients. In the last months, many asset managers grappled with this big question of who will pay for research costs. However, irrespective of the “option” selected, all players should consider how to capture, process and

account for any VAT incurred on external research costs and, where irrecoverable VAT costs will arise, assess the impact that will be felt on research budgets.

The outcome will almost certainly be driven by the preferred regulatory position and by the commercial terms. The asset managers can negotiate with the MiFID firms to agree on who bears the economic burden of any VAT cost that could arise. There are additional considerations for the asset managers who have elected to charge research costs to investors/clients, such as how these charges will be practically administered and accounted for and the VAT treatment that should be applied to such charges. The MiFID firms also needs to consider process changes that are necessary to enable the business to properly account for research, and to issue invoices with the appropriate VAT treatment applied, including assessing the amendments to VAT partial exemption methods.

High level VAT treatment of research services in certain countries

A summary of the VAT treatment of research services among certain jurisdictions is set out below:

- In **Luxembourg**, research services are generally considered as subject to VAT at the rate of 17%. However, arguments exist to consider them as falling within the scope of the fund management VAT exemption for qualifying funds if the services include a tailoring advice element that is specific and essential to the qualifying fund and does not amount only to the provision of general financial information. Where bundled with other VAT exempt services, the research fees would qualify as VAT exempt if the fees could be considered ancillary to the provision of a main VAT exempt supply. In this regard, research services might be exempt if ancillary to transactions in shares (including negotiation) or to investment fund management. The application of the VAT exemption is really fact based and depends on the exact nature of the services and related contractual framework. To confirm the VAT treatment, a full analysis would be needed. No guidance or position has been issued by the VAT authority in Luxembourg regarding the treatment of research fees post MiFID II.

- In the **United Kingdom,** discussions have taken place at industry level with HMRC. Through these discussions, HMRC accepts in principle that the exemption for the management of special investment funds could apply, however there are practical issues to consider (e.g. whether the research supply could be split between taxable and exempt elements, and how that could be achieved). Further, the exemption for intermediation in relation to a securities transaction (which has been applied by broker/dealers previously) cannot be applied to supplies of research following the implementation of MiFID II. There could be alternative ways to access VAT exemption in connection to the management of a special investment fund through discussions with HMRC on a case by case basis. HMRC is expected to issue guidelines in this respect.

- In **Sweden, Norway** and **Finland**, research services and investment advice provided with respect to qualifying investment funds should be regarded as VAT-exempt investment advisory services. When provided with respect to discretionary portfolio management, these services should be subject to VAT and this input VAT may be recoverable.

- In **Denmark**, currently research services may be treated as VAT exempt mediation in securities as long as they are aimed at enabling the asset manager to make a decision whether to purchase or sell securities (Danish practice). In the event the Danish VAT authorities change their practice, the research services would as a main rule be subject to VAT unless it can be demonstrated that they form a distinct whole and are specific to and essential for the management of a special investment fund.

- In **Ireland**, if a separate charge was to be made to an Irish fund for research, an argument may be made that it could be considered as “fund management” and therefore, VAT exempt. This would be on the basis that the research services are “intrinsically connected” with the management of the funds. The Irish revenue authority has not issued any guidance yet regarding the treatment of research fees post MiFID II.

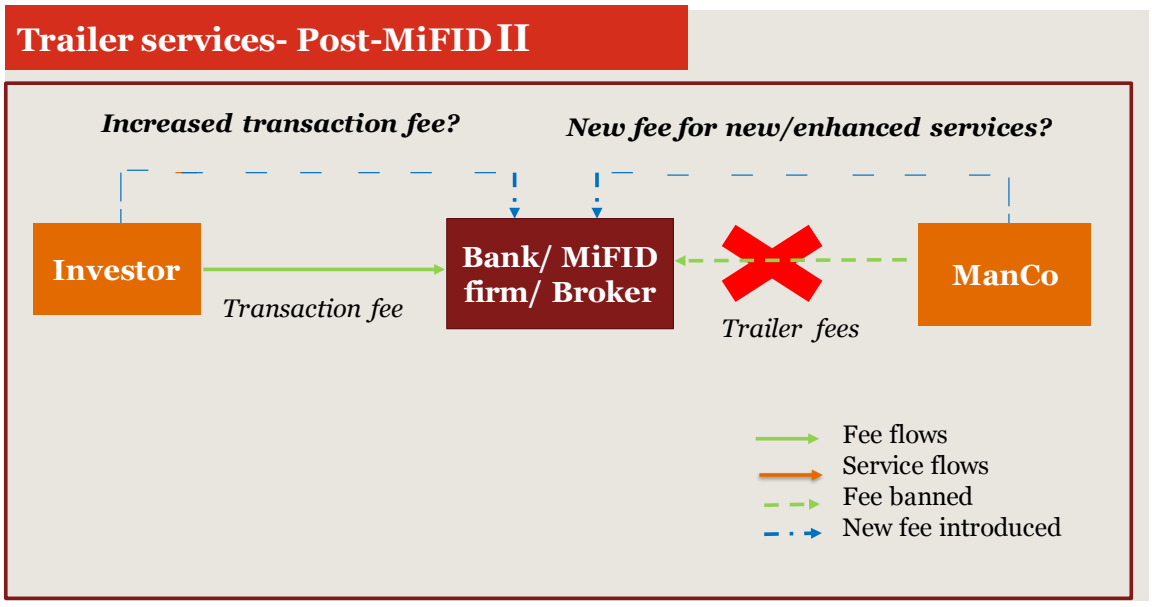
- In **France**, research services provided to a French fund may be considered as qualifying for the management VAT exemption to the extent that the research services are "intrinsically connected" with the management of qualifying funds. It will therefore depend on the nature of the research services provided and whether the research company will issue recommendations on sales or purchase, or not. However, this has not been applied in practice and no guidance is available from the French tax authority.

- **Switzerland** is not a member state of the EU and in principle it may not be bound to implement the MIFID II Directive. However, Swiss financial institutions will also be affected by these rules by virtue of them operating with EU businesses. Consequently, Switzerland has revised its rules to require that Swiss entities providing both execution and research services will have to price and supply these services separately (unbundled). The separately supplied research service will be subject Swiss VAT (now 7.7%) and hence resulting in an increased cost. The affected entities will therefore need to consider the Swiss VAT impact in the pricing of the offered/requested services.

Retrocession/trailer fees

Trailer fees or retrocession are generally defined to constitute commissions (or non-monetary benefits) paid by the fund to a MiFID firm for providing the investor with ongoing investment advice.

A possible scenario in connection to retrocession/trailer fees post MiFID II could be as follows:



With the MiFID II rules, there are instances where retrocession/trailer fees are considered as inducements and are either forbidden or restricted. Consequently, the affected MiFID firms are likely to react by possibly raising current fees charged to investors or introducing new fees to be charged to the Fund for value added or enhanced services. If new fees are introduced, those may be subject to VAT depending on the actual nature of the services remunerated by this new fee. However, there could

also be cases where said fees qualify for a VAT exemption. Therefore, during the implementation of MiFID II's compliant business models, it is important to review the structure to be adopted and confirm the correct VAT treatment while evaluating any possible options to support the application of a VAT exemption where possible.

Next steps

To conclude, the new rules enhance transparency in term of costs incurred by investors. It is important that the funds, asset managers and MiFID firms assess the impact on their operations. They should also identify and prevent potential VAT risks induced by MiFID II during the implementation phase. Where restructuring is considered, it will be important to confirm the way the MiFID II rules have been applied within the various other EU countries and the extent to which the MiFID II rules apply to non EU asset managers or funds that also operate in the EU.

We have a dedicated group advising clients on VAT, Corporate tax, transfer pricing, regulatory and other financial aspects with respect to the implementation of MiFID II. If you experience any challenges, please contact us or your usual PwC contacts or the below contacts.

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