

Does investment fund VAT exemption match the modern world?

The evolution of financial markets and the complexity of transactions have called into question the relevancy of the VAT exemption applicable to investment funds, explain **Christophe Plainchamp** and **Nicolas Devillers** of **Atoz – Taxand**.

Since the implementation of the VAT system in the late 1970s, most financial services, including investment fund management, have been exempt from VAT. In the investment fund sector, the exemption is based on a specific provision included in the European VAT legislation stating that member states shall exempt the “management of special investment funds as defined by Member States”.

Financial markets have however been evolving significantly since the introduction of the VAT system. Transactions have become more complicated and require the involvement of specialists, leading to the outsourcing of certain functions and raising the number of participants to a transaction. Where the aim in the investment world is obviously maximising return by carefully selecting the right products, external factors must be taken into consideration to avoid ruining efforts. Tax, particularly VAT, is one of them.

The evolution of financial markets led to different interpretations of the rules initially laid out in the VAT legislation. Disparities arose first between the member states and then between types of funds. This has sometimes endangered the principle of fiscal neutrality, but has also led to distortions of competition between taxable persons performing the same activity.

One should remember that one of the purposes of the VAT exemption was to treat the management of special investment funds similarly to the investment decisions private individuals could make with respect to their own portfolios. In essence, considering small investors do not always have the required understanding of financial markets to make sound investments, receiving assistance from qualified people for the management of personal funds should not lead to a VAT cost.

Jurisprudence of the ECJ

The European Court of Justice (ECJ) has given three major decisions in cases dealing with VAT in investment funds over the last years. These decisions have been widely commented on when they were released. Considering this, it does not seem necessary to give a full description of these decisions. A short summary should be sufficient.

In the *Banque Bruxelles Lambert SA (BBL)* case against the Belgian State, released on October 21, 2004, the ECJ mainly had to deal with the issue whether a Luxembourg SICAV (a Luxembourg regulated investment vehicle) had to be given the status of taxable person for VAT purposes. The court stated that transactions performed by SICAVs consist of the collective investment in transferable securities of capital raised from the public. With the capital provided by investors when they subscribe for shares, SICAVs assemble and manage, on behalf of the subscribers and for a fee, portfolios consisting of transferable securities. The court considered that such

an activity goes beyond the mere acquisition and sale of securities and seeks to produce income on a continuing basis. Therefore, these SICAVs perform an economic activity and are to be treated as taxable persons for VAT purposes.

The Abbey National case

In the *Abbey National* case, the ECJ brought some clarity and consistency to the scope of the VAT exemption applicable to the management of investment funds. The ruling can be summarised as follows:

- The court confirmed that the concept of “management” of investment funds has its own independent meaning in Community law that member states may not alter. The answer of the court is in line with jurisprudence which states that VAT exemptions must be given a Community definition to avoid divergences in the application of the VAT system from one member state to another.
- The court then clarified the concept of “management” of investment funds. The court considered that the VAT exemption must be understood as covering transactions that are specific to the business of investment funds. Consequently, the court ruled that tasks of portfolio management but also tasks of administering investment funds, which are functions specific to investment funds, come within the scope of the VAT exemption. The court however considered that the functions of depositary cannot benefit from that VAT exemption because they do not fall under the management of investment funds but under the control and supervision of activities of investment funds.
- Outsourced functions can be VAT exempt under certain conditions. Concerning the services performed by a third-party manager in respect of the administrative and accounting management of the funds, the court stated that, viewed broadly, these services must form a distinct whole and be specific to and essential for the management of those funds to benefit from the exemption.

The conclusions of the Court were in line with the principle of VAT neutrality, which avoids divergences in the application of VAT from one member state to another and potential distortion of competition in the same sector of activity.

JP Morgan Fleming Claverhouse Investment Trust Plc

Further to the *Abbey National* case, the ECJ was questioned on the interpretation of the VAT exemption’s scope applicable to fund management services under the angle of the type of investment fund whose management is exempt.

More specifically, in this case the question was raised whether the UK was entitled to refuse the VAT exemption for the management of investment trust companies (closed-ended funds with their own legal personality) while giving it in respect of authorised unit trusts and open-ended investment companies.

Biography



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Christophe Plainchamp is a partner and the head of the indirect tax practice at Atoz-Taxand in Luxembourg.

Before working with Atoz, Christophe worked for international accounting firms where he gained specialist experience in a wide variety of VAT matters.

Christophe has a strong knowledge in the field of financial services where he solves VAT matters for the accounts of international clients, such as investment funds and asset managers, banks and insurance companies as well as holding companies and private equity structures.

Also, Christophe has been working in close cooperation with key players of the real estate industry for many years. As a result, Christophe is at the forefront of developing structured solutions for the management of the VAT situation of pan-European real estate funds.

Christophe’s experience also includes assistance to the structuring of supply chain transactions for companies in the commercial, retail and distribution sectors.

Christophe is an active member of the Luxembourg Bankers’ Association and the Association of the Luxembourg Fund Industry.

In accordance with the principle of fiscal neutrality which requires that all similar, and therefore competing, special investment funds are treated equally as regards the levying of VAT, the court concluded that the notion of “special investment funds” is capable of including closed-ended investment funds, such as investment trust companies.

The Luxembourg rules

Luxembourg is the second largest fund centre in the world after the US, with more than €2 trillion (\$2.7 trillion) in assets under management. Luxembourg has established a competitive legal framework for Undertakings for Collective Investment in Transferable Securities (UCITS), funds passported within the EU, and non-UCITS funds, to become the largest global distribution centre for investment funds in Europe and the world. It

is therefore important to have a view on the state of Luxembourg VAT rules applicable to investment funds.

Luxembourg VAT legislation includes a provision stating that the management of investment vehicles subject to the supervision of the Commission de Surveillance du Secteur Financier or of the Commissariat Aux Assurances, as well as securitisation vehicle is VAT exempt. This includes typical investment vehicles such as:

- The well known investment vehicles such as FCPs, SICAVs, SIFs, SICAFs, SICARs;
- SEPCAV – Société d'épargne-pension à capital variable (pension savings company with variable capital). This vehicle, which is similar to a regular SICAV, can only be used for defined contribution schemes;
- ASSEP – Association d'épargne-pension (pension savings association). This vehicle is suitable for both defined contribution and/or defined benefit schemes;
- Securitisation vehicles established in Luxembourg.

Services provided in connection with the management of these investment vehicles (management services) are exempt from VAT. The notion of management of investment vehicles is not clearly defined by the Luxembourg legislation. In practice, the daily management of portfolio, research and investment advice as well as accounting and administrative services benefit from the VAT exemption. In accordance with the decision of the ECJ in the Abbey National case, management services rendered by a third party manager may benefit from the VAT exemption provided certain conditions are met. Essentially, the outsourced services must form a distinct whole, viewed broadly, and be specific and essential to the management of the investment vehicle.

In accordance with the decision of the ECJ in the Abbey National case, control and supervision activities performed by the custodian are subject to VAT (12%). Legal, tax and audit services are not covered by the exemption. They are taxable at the standard VAT rate in Luxembourg (15%) when they are deemed to be supplied in Luxembourg.

In Luxembourg, investment funds whose management is VAT exempt are in practice considered as taxable persons for VAT purposes. This is of importance since it brings the place of supply of the vast majority of services received by investment funds to Luxembourg. Luxembourg regulated investment funds may in principle not recover input VAT incurred.

It must however be noted that the exemption does not apply to internal funds of insurance companies. This position is confirmed in the footnotes to the Luxembourg VAT Law where it is expressly specified that the exemption applicable to the management of special investment funds does not apply to internal funds of insurance companies.

Are we all equal in the eyes of the VAT legislation?

The Luxembourg practice detailed above appears to consider the guidelines provided by the ECJ in its various decisions.

Biography



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Nicolas Devillers, is a director in the indirect tax practice at Atoz-Taxand in Luxembourg.

Among the engagements carried out over the years, key projects have included assisting in the management of the VAT situation of several holding companies part of top tier private equity houses, advising on the VAT implications applicable to financial institutions, investment funds and Luxembourg securitisation vehicles. Nicolas has also advised major e-commerce companies in establishing in Luxembourg.

Nicolas holds a degree in Finance and Economics from HEC Liège (Hautes Etudes Commerciales), and subsequently post-graduated in tax at the Chambre de Commerce of Luxembourg. Nicolas is a member of the American Chamber of Commerce Luxembourg.

However, a broader view including all member states shows that in practice the current scope of the VAT exemption for the management of investment funds still varies from member state to member state.

The question of equal treatment is however primordial and had been (re)addressed by the ECJ in the JP Morgan decision:

The principle of fiscal neutrality, on which the common system of VAT established by the Sixth VAT Directive is based, precludes economic operators carrying out the same transactions from being treated differently in relation to the levying of VAT. That principle does not require the transactions to be identical. According to settled case-law that principle precludes, in particular, treating similar goods and supplies of services, which are thus in competition with each other, differently for VAT purposes.

The principle of fiscal neutrality includes the principle of elimination of distortion in competition as a result of differing treatment for VAT purposes. Therefore, distortion is established once it is found that supplies of services are in competition and are treated unequally for the purposes of VAT. It is irrelevant, in that connection, whether the distortion is substantial.

The question of neutrality is becoming increasingly important since small investors are likely to invest in funds more than before. The uncertainties created by the financial downturn as well as the change in the population pyramid are likely to drive investors to the investment fund industry. The pooling of investments and the protection offered by risk spreading should be considered by small investors as a way to ensure a safe retirement capital.

Moreover, the question of VAT neutrality must not only be analysed in the light of the different types of investment funds, but also with respect to the development of sophisticated financial products such as those combining private banking with life assurance. Such products may be considered as similar opportunities for sound investment by small investors and should benefit from a similar treatment from a VAT perspective.

Proposition for a Council Directive amending the VAT Directive for financial and insurances services

Being aware that the ageing VAT legislation was increasingly difficult to apply in practice with a risk of unequal VAT treatment for similar transactions, the EU Commission had no other choice but to issue a proposal for amending the EU VAT legislation with respect to the treatment of insurance and financial services.

The European Commission adopted such proposal in late 2007. The aim was to redefine the scope of the VAT exemptions to ensure that the exemptions are better in line with the complexity and diversity of transactions in today's world, but still consider the limitations laid out by the existing provisions.

The Commission had identified three main objectives for this ambitious project:

- Increase legal certainty for businesses as well as national tax administrations and therefore to reduce their administrative burden for correctly applying the VAT exemption for insurance and financial services. Legal certainty will secure the taxing rights of member states and reduce opportunities for aggressive tax planning.
- Ensure a more consistent application of VAT and to deliver a level playing field for VAT in the internal market.
- Allow businesses to manage better the impact of non-deductible VAT on their activities, while ensuring equal access to tax relief across the internal market.

As stated above, modernising the VAT rules applicable to financial and insurance services requires amending definitions of exempt transactions to increase the legal certainty and reduce the need for litigation.

Amending the definition covering the exemption of the management of special investment funds has not been an easy task. In these difficult times where state budgets are tight, the definition of management of special investment funds for applying the VAT exemption is of utmost importance for certain member states. If the wording of the exemption to be included in the recast VAT Directive is important, of even greater importance is a clear and precise definition of what constitutes an investment fund qualifying for the exemption. Such clear definition would allow all member states to have a consistent position. Given the growing number of investors, the different types of funds and the wide range of financial products offered, the new text will be key.

Without surprise, there have been many changes by the different EU presidencies to the draft Directive. Whatever the method and wording adopted, one may however fear that the economic situation faced by the increasing number of member states is likely to bring restrictions to the scope of VAT exemptions rather than extensions.

Issues in court

As for other types of business, the old VAT system is applicable to the investment fund sector and has showed its limits over the last decade. With the demography and global economic environment pushing small investors towards investment funds, the VAT aspects applicable to the fund industry have become an important issue. The ECJ has been asked to précis the scope of application of existing measures but the number of cases brought to it shows that a broader effort is required. The modernisation of the VAT rules applicable to financial transactions is on the way, but it is not an easy task since it brings 27 countries around the table, all in different economic situations. A harmonious application of the VAT system between member states is however required to guarantee the competitiveness of European companies compared with the rest of the world. A cost ranging between 15% and 25% is significant, be it borne by asset management companies or investors.

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