VAT focus

VAT and the evolution of the special investment fund

Speed read

Article 135(1)(g) of the Principal VAT Directive (PVD) exempts the 'management of special investment funds as defined by member states'. There is a lack of consistency at both national and EU levels as to how the exemption is interpreted and applied, leading to ongoing litigation. The Undertakings for Collective Investment in Transferable Securities (UCITS) Directive was introduced to harmonise the regulation of UCITS across the EU, leading to the question of whether a UCITS was by definition a special investment fund (SIF). In *Claverhouse*, it was ruled that the concept of a SIF went beyond UCITS, leading to a series of cases testing the extent of this judgment. In the most recent case, *Fiscale Eenheid X*, the investment fund was clearly not a UCITS as it invested in land, not securities, raising the question of whether it should nevertheless be a SIF by virtue of the principle of fiscal neutrality.

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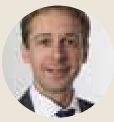

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Article 135(1)(g) of the Principal VAT Directive (PVD) exempts the 'management of special investment funds as defined by member states'. Tax authorities and taxpayers have clashed repeatedly over the exemption – specifically, over what amounts to 'management', and what precisely 'special investment funds as defined by member states' means – and litigation continues. There is no better illustration of the confusion that pervades than the UK legislation, taking over 500 words to implement a ten word exemption. This reflects the 'band-aid' style approach the UK has been taking, reacting to each judicial decision as it comes, rather than coming to grips with the underlying concepts. To be fair, the problem is not confined to the UK. There is a general lack of consistency in how the exemption is interpreted and applied across the EU.

In this article, we examine what 'special investment funds as defined by member states' means; what amounts to 'management' is worthy of its own focus (for another day).

Special investment funds

A key question is whether a member state has the power to select certain investment funds within its jurisdiction for the purposes of exemption while excluding others. The Court of Justice (CJEU) said it did not, which means that a member state simply cannot select from among investment funds those which are eligible for the exemption and those which are not. All it has power to do is to identify, through its national law, those investment funds that it considers 'special'.

This means that although, on its face, the exemption may appear to confer a discretion on member states to define the scope of the exemption, it does not in fact do so. What it does is to confer exemption on the management of a particular type of creature. It is up to each member state to name that creature in its own jurisdiction. Even that overstates the member state's actual power, however. This is because any investment fund designated as 'special' by a member state would only be a 'special investment fund' (SIF) for VAT purposes – i.e. a creature that benefits from the exemption – if that were consistent with the purpose of the exemption.

That the exemption has an identifiable purpose implies it is intended to benefit creatures of a particular stripe, but there is little clue in the PVD as to what those creatures are. When member states are asked to define them, therefore, it is a little like asking them to define a pink elephant when the words 'pink' and 'elephant' do not exist.

UCITS

In 1985, the first Undertakings for Collective Investment in Transferable Securities Directive (UCITS Directive) was introduced. The purpose of this Directive was to harmonise the regulation of UCITS across the EU. A UCITS (at a high level) is a regulated investment fund that can be marketed and sold to retail investors in the European Economic Area.

The significance from the VAT perspective is that the Directive introduced for the first time a creature – the UCITS – that could found an EU-wide concept for a SIF. That a UCITS was by definition a SIF was expressly confirmed in *Wheels* (Case C-424/11).

The UCITS Directive did not, however, seek to regulate all forms of collective investment undertakings; nor did it apply to other forms of investment vehicles that could be sold to retail investors. Specifically, it did not extend to 'closed-ended' funds (its scope was limited to 'open-ended' funds). The question arose as to whether, if a UCITS was by definition a SIF, the converse was also true; i.e. that an investment fund that was not a UCITS was by definition excluded from being a SIF.

Non-UCITS

This was considered in *Claverhouse* (Case C-363/05), a seminal case on the exemption. The investment fund in that case was 'closed-ended' – and so not a UCITS; and the challenge by the taxpayer was that it should nevertheless be a SIF.

The CJEU ruled that 'the provisions of the UCITS Directive cannot be relied on to derive a restricted interpretation of the term "special investment funds" from [PVD article 135(1)(g)]'. The taxpayer prevailed. The concept of a SIF was broader and went beyond UCITS.

How far beyond remains a mystery. It is, in principle, still up to each member state to decide what is (or is not) a SIF in its own jurisdiction, but that discretion must be exercised with regard to the principle of fiscal neutrality inherent in the common VAT system.

This principle precludes economic operators carrying out the same transactions from being treated differently for VAT purposes. Where similar goods or services are supplied, and are in competition with each other, the principle requires that they must be treated in the same way for VAT purposes, and the principle is breached where a service is standard rated while a similar service in competition with it is exempt.

The investment fund in *Claverhouse* was, as the CJEU observed, a '[form] of special investment which spread risk'. In this respect, it shared the same characteristics as the investment funds that were actually SIFs under the UK legislation applicable at the time. Because of this, the CJEU considered that excluding the 'closed-ended' fund from the exemption would be a breach of the principle of fiscal neutrality.

In contrast, treating it as a SIF for the purposes of the exemption would be consistent with the purpose of the exemption. Such purpose was identified by the CJEU as the facilitating of investment in securities through an investment undertaking (such as an investment fund) by excluding the cost of VAT, so as to ensure that the VAT position is neutral as regards a person's choice between a direct investment in securities and an investment in the same through an investment undertaking.

This is clearly wider than the facilitating of 'investment in common funds for small investors', which advocate general Kokott identified as the purpose of the exemption in her opinion on *Abbey National* (Case C-169/04). Ten years later, in her opinion on *Fiscale Eenheid X* (Case C-595/13), she adopts the CJEU's wider formulation, even adding that 'the Court of Justice expressly does not view this objective, which relates only to transferable securities, as exhaustive'.

Elephant

What followed after *Claverhouse* was a series of cases testing the extent to which the definition of a SIF went beyond UCITS. *Wheels*, *PPG Holdings* (Case C-26/12) and *ATP* (Case C-464/12) all concerned pension funds. With these cases, the CJEU finally addressed the (pink) elephant in the room: what exactly are the characteristics of those investment funds the exemption was designed to benefit? These were identified by the CJEU in *ATP* as:

- the investment fund being funded by the persons to whom the benefit of the investment is to be paid (i.e. the investors);
- the funds being invested using a risk-spreading principle; and
- the investors bearing the investment risk.

The most recent EU case on the exemption is *Fiscale Eenheid X*. This case is important primarily because until this point, all the EU cases on the exemption concerned investment funds that invested in securities. In *Fiscale Eenheid X*, the investment fund invested in land.

As a UCITS can only invest in securities, the investment fund in *Fiscale Eenheid X* was clearly not a UCITS. The question was whether it should nevertheless be a SIF by virtue of the principle of fiscal neutrality. The CJEU ruled that: 'In so far as investments, whether composed of transferable securities or immovable property, are subject to comparable specific state supervision, there is direct competition between those forms of investment.' This meant that the investment fund may be a SIF provided that: it is a vehicle in which capital is pooled from several investors and (broadly) has the characteristics identified in *ATP*; and 'the member state concerned has made [companies such as the investment fund] subject to specific state supervision'.

Specific state supervision

The reference to specific state supervision is important. This is because it clarifies that what makes investment funds 'special' is the imposition of specific state supervision. Before the UCITS Directive, these would have consisted only of investment funds that were 'regulated at national level and subject, therefore, to licensing and oversight rules, namely authorisation by the public authorities and control, with the aim particularly of protecting investors'. The reason why the exemption (as drafted) looks to each member state to define what is a SIF in its own jurisdiction is because, at the time it was introduced, legislation on VAT was harmonised across the EU but legislation on the authorisation and supervision of investment funds was not. The exemption could not refer to a community concept for a SIF because there was no community concept for a SIF.

In light of this, specific state supervision can be summed up in one word: regulation. If this is right (and the authors consider it is), then any regulated investment fund in the UK would (in principle) be a SIF, irrespective of the nature of its investment or whether it is (or is not) a UCITS.

In any event, the UCITS Directive is only the beginning of the journey and (by no means) the end. The Directive is significant because it introduced 'the first measures to regulate the supervision of investment funds'. In other words, the Directive brought with it a community concept for a SIF. As far as the investment funds it regulated, i.e. UCITS, were concerned, the member states' discretion to designate them as 'special' was supplanted. The arrival of the community concept made such discretion otiose (at least to that extent).

Harmonisation is not, of course, a one-off; the process is ongoing and still continues today. As the CJEU noted in *Fiscale Eenheid X*, 'the coordination of legislation in relation to supervision is intended to cover not only UCITS but also other collective investment undertakings'.

Fiscale Eenheid X concerned a payment made in 1996. While the case was under appeal, the EU introduced more measures to regulate the supervision of investment funds; namely, the Alternative Investment Fund Managers Directive (AIF Managers Directive), which, the CJEU observed, 'represents a further step in the harmonisation of specific state supervision of investment'. The AIF Managers Directive applies to real estate funds, and this was one reason why the CJEU was comfortable in ruling that the exemption applied to investment funds investing in land.

If the reason why UCITS are by definition SIFs is because the UCITS Directive introduced a community concept for a SIF, should the fact that the AIF Managers Directive has introduced another community concept for a SIF not mean that AIFs are also by definition SIFs? Until this point, AIFs have largely been ignored for the purposes of the exemption – at least in the UK (unlike in many other member states such as Ireland, Italy, Luxembourg and the Netherlands, which recognise that AIFs are generally SIFs). AIFs include not only real estate funds, but also commodity funds, private equity funds, infrastructure funds, funds of funds and real estate investment trusts. If an AIF is indeed a SIF (and the authors consider that it is), the exemption is considerably wider than historically thought.

Conclusion

In short, therefore, an investment fund is a SIF if:

1. it is a vehicle in which capital is pooled from several investors;
2. it has the characteristics identified in *ATP*; and
3. it is a UCITS; or
4. it is not a UCITS but:
   (i) it has been designated as 'special' in the relevant member state *and* it being a SIF is consistent with the purpose of the exemption;
   (ii) it not being a SIF would be in breach of the principle of fiscal neutrality; or
   (iii) (in the authors' opinion *but not necessarily HMRC's*) it is an AIF. ■

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- Wheels: specified investment funds (H Sharkett & R Louden, 21.3.13)
- VAT on pension fund costs: has the European Court made life easier? (G Salmond, 12.12.14)