VAT focus

VAT and the management of Special Investment Funds: the last six years

Speed read

The application of the VAT exemption for the management of Special Investment Funds (SIFs) remains both complex and uncertain, having been subject to numerous interpretations by the CJEU, particularly regarding the definitions of 'management' and 'SIF'. The UK Government's decision to maintain the status quo on the VAT exemption reflects a cautious approach, preserving continuity over innovation. However, by failing to broaden the exemption to include both alternative investment funds and securitisation vehicles, the Government misses the opportunity of giving the UK funds industry a clear advantage over its European competition.

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Article 135(1)(g) of the Principal VAT Directive exempts the 'management of special investment funds as defined by Member States'. The provision appears straightforward, but it is anything but. Every key phrase in this ten-word sentence – 'management', 'special investment funds' and 'as defined by Member State' – has been the subject of consideration by the CJEU at least once. We discussed these foundational concepts in 2018 and 2019 (in articles in this journal that are summarised below). In this article, we review noteworthy developments in this area in the intervening years.

2018

In this journal in November 2018 ('VAT and the evolution of the special investment fund', *Tax Journal*, 16 November 2018), we discussed the limits on the 'as defined' concept, and explored the scope of what constitutes a Special Investment Fund (or SIF). Key points noted in relation to the latter include:

- how an Undertaking for Collective Investment in Transferable Securities (or UCITS), regulated under the UCITS Directive, is by definition a SIF (as the CJEU confirmed in *Wheels* (Case C-424/11));
- how the definition of a SIF is wide enough to extend beyond UCITS and encompass investment funds that are not UCITS – a closed-ended fund, for example, or (provided certain conditions are satisfied) a fund investing in land (neither of which falls within the definition of a UCITS) (see *Claverhouse* (Case C-363/05) and *Fiscale Eenheid X* (Case C-595/13) respectively);
- the characteristics of a SIF, as summarised by the CJEU in *ATP* (Case C-464/12) – namely, (i) the fund being funded by the persons to whom the benefit of the investment is to be paid, (ii) the funds being invested under a risk-spreading principle, and (iii) the funders bearing the investment risk;
- the importance in this area of the EU legal principle of fiscal neutrality;
- the relevance of 'specific state supervision'; and
- why the authors considered certain Alternative Investment Funds (or AIFs), regulated under the Alternative Investment Fund Managers Directive (or the AIFMD), to be SIFs.

2019

In January 2019 ('VAT and SIFs: what does "management" mean?', *Tax Journal*, 25 January 2019), we discussed the meaning of 'management' for the purposes of the exemption, noting:

- how the term is an autonomous concept under EU law (as the CJEU ruled in *Abbey National* (Case C-169/04));
- how the exemption may apply to a service that is not in itself 'management', but is a component comprised in 'management', provided that, when viewed broadly, it forms a distinct whole, and is specific to, and essential for, the management of a SIF (see *Abbey National*); and
- in relation to such a component service, how the EU legal principle of fiscal neutrality:
  - applies to exempt its provision to a SIF, to ensure parity between a SIF that is managed in-house or by several managers and one whose manager has to buy in services from a third party outsource service provider (see *GfBk* (Case C-275/11); but
  - not where the comparison is between an individual investing directly (where the provision of such services may be taxable) and an individual investing through a SIF (where it is exempt) (see *Deutsche Bank* (Case C-44/11)).

BlackRock

As if to highlight the pace of development in this area, just a year and a half after the 2019 article was published, the CJEU released its ruling in *BlackRock* (Case C-231/19) (a case considered by one of the authors in the article '*BlackRock*: single supply, dual use – apportionment?', *Tax Journal*, 8 July 2020)).

There, the taxpayer used the same services to manage both SIFs and investment funds that were not SIFs. The question was whether any part of the services fell within the exemption for SIF management. The CJEU ruled that the supply was a single composite supply that was either taxable or exempt – it could not be both. But how would one determine whether it was taxable or exempt? The CJEU ruled against using the nature of the majority of the managed funds as the deciding factor – in other words, even if the vast majority of the managed funds were SIFs, that would not bring the services within the exemption. Indeed, if any of the managed funds was not a SIF, the services would fall outside the exemption. This is because if the services:

> 'may be used in the same way for the management of special investment funds as for the management of other funds … [they] cannot be regarded as specifically for the management of special investment funds … [and consequently, their supply] does not meet the conditions to benefit from the exemption'.

At a time when the scope of the exemption for SIF management was thought to be expanding, the CJEU's ruling in *BlackRock* reinforced its boundaries. For fund managers employing integrated systems, the ruling introduces operational complexity, as they must now bifurcate services between SIFs and investment funds that are not SIFs. And even then, if the nature of the services is such that they 'may be used in the same way for the management of special investment funds as for the management of other funds', would that mean they are not 'specific' to the management of a SIF, and thus outside the exemption even where they are used exclusively to manage SIFs?

The problem that lies at the heart of the exemption [is that an] exemption is meant to have defined borders, but the services in question ('management') are constantly evolving, and the intended beneficiary of the exemption (SIFs) seems incapable of precise definition

K & DBKAG

As mentioned above, in *Abbey National*, in a key decision for outsource service providers in the fund management space, the CJEU ruled that the exemption for SIF management may apply to a component service comprised in management, provided that, when viewed broadly, it forms a distinct whole, and is specific to, and essential for, the management of a SIF. In *K & DBKAG* (Cases C-58/20 & C-59/20), the CJEU elaborated on this:

- confirming (in relation to the meaning of the term 'distinct') that it is not necessary for a service that is specific to, and essential for, the management of a SIF to be outsourced in its entirety; and
- ruling that services would be regarded as 'specific' and 'essential' for these purposes if they are (i) intrinsically connected to the activity of managing a SIF and (ii) provided exclusively for the purposes of managing such a fund, even where such services are administrative or accounting in nature (such as carrying out tax-related calculations for unit-holders) or provided via a 'system of information technology' (such as risk management software).

The CJEU's ruling in *K & DBKAG* expands the potential for cost savings through outsourcing and, in contrast to its decision in *BlackRock*, offers fund managers flexibility in structuring their operations. It also underscores how, with 'management', the CJEU often views the concept not just from a technical perspective, but with an eye on practical (or real world) applicability as well.

The 'pension cases'

As mentioned above, in *ATP*, the CJEU ruled that in order to be a SIF, the persons to whom the benefit of the investment(s) made by the fund is to be paid must bear the investment risk of the investment(s). In the 'pension cases' (Cases C-639/22 to C-644/22), the question was what that meant in the context of occupational or sector-specific pension funds.

The CJEU ruled that the risk that members of a pension fund must bear must be comparable to that borne by the holders of units in a collective investment undertaking. In practical terms, this means that performance of the investments made by the pension fund must have a significant impact on the amount of the member's pension entitlements or retirement benefits. This in turn means that those entitlements and benefits cannot be guaranteed or predefined (such as by reference to the duration of the member's career or their salary); they must depend primarily – positively or negatively – on the performance of the investments made by the pension fund.

Brexit

So far, the focus of this article has been on EU case law, as it was in the 2018 and 2019 articles. Of course, between then and now, Brexit happened. Why then do we still look to EU case law?

A full explanation of the continuing relevance of EU law to UK VAT is beyond the scope of this article. Suffice it to say that (very broadly), by virtue of the combined effect of (primarily) the European Union (Withdrawal) Act 2018 and FA 2024 s 28, CJEU cases (such as *Wheels, Claverhouse*, *Fiscale Eenheid X*, *Abbey National*, *GfBk* and *BlackRock)* that predate the so-called IP completion day (meaning 11 pm on 31 December 2020) remain binding (save in certain specified circumstances none of which has yet to materialise). As for post-IP completion day CJEU cases (such as the 'pension cases'), while they are no longer binding on any UK court or tribunal, they may nevertheless still be taken into consideration. For the foreseeable future, the authors expect UK courts and tribunals to continue to align with CJEU jurisprudence, for consistency and legal certainty if nothing else, but UK policy in this area is under scrutiny, and may eventually shift, leading to divergence.

The UK Government's consultation

In 2020, in anticipation of the IP completion day, the Government announced in the Budget that it would carry out a wide-ranging review of the UK fund regime. This included looking at the VAT exemption for SIF management. A technical consultation (or the SIF consultation) was launched in December 2022. The Government's proposal was to codify the CJEU case law at the time in a legislative 'SIF' definition while also retaining the list of exempt fund types then set out in VATA 1994 Sch 9 Group 5 items 9 and 10.

That this article exists is perhaps all the spoiler needed as to the outcome of the consultation. Despite the push from the sector for reform to leverage the UK's post-Brexit VAT autonomy, the Government decided in December 2023 to maintain the status quo. This can be said to reflect a cautious approach, preserving continuity over innovation, but it can also be said to expose the problem that lies at the heart of the exemption, which is that, by its nature, an exemption is meant to have defined borders, but the services in question ('management') are constantly evolving, and the intended beneficiary of the exemption (SIFs) seems incapable of precise definition. It is like showing Border Control one passport with a fuzzy picture after another. The Government had the right idea for a cure; one can only hope that one day it will have the right tools to deliver it as well.

CCLA Investment Management Ltd

In *Fiscale Eenheid X*, the CJEU ruled that one of the conditions that must be satisfied in order for an investment fund that is not a UCITS (such as an AIF) to be a SIF is that it must be subject to specific state supervision. In *CCLA Investment Management Ltd* [2024] UKFTT 636 (TC), the FTT considered what this meant in the context of UK VAT.

It held that it is not necessary for the fund itself to be directly regulated by the FCA (the UK's national competent authority) – indirect regulation pursuant to the AIFMD (through regulation of the AIF manager, for example) is sufficient.

However, that only answers the requirement for specific state supervision; there are other requirements that must also be satisfied – in particular, the (fiscal neutrality driven) requirement that the fund must be sufficiently comparable to a UCITS and subject to the same conditions of competition and appeal to the same circle of investors who would invest in a UCITS, i.e. retail investors. The FTT observed that:

> 'some of the more esoteric varieties of AIFs (such as commodity funds, hedge funds, infrastructure funds, and private equity funds) are unlikely to appeal to retail investors, and so would not be treated as SIFs. Further, such investments are unlikely to be sufficiently comparable to the investments undertaken by UCITS.'

This was only stated *obiter*, and only by the FTT – and so is not binding precedent – but it is no less significant when considering which breeds of AIFs may be SIFs for the purposes of the exemption.

In its judgment, the FTT found that, with effect from the introduction of the AIFMD, Charities Official Investment Funds (or COIFs) are SIFs, but Church of England Central Board of Finance (or CBF) funds and Local Authorities' Property Funds (or LAPFs) are not.

Real world consequences

When discussing the SIF consultation (mentioned above), we noted the fundamental problem at the heart of this 'difficult' exemption. While technical in nature, this problem has real world impact – arguably the worst type of impact for a tax that is meant to be neutral (with no distortive effect on business):

- **Migration of CLO structure:** A notable development in the Netherlands emerged in April 2019, when the Dutch tax authorities revoked the VAT exemption previously applied to the management of vehicles issuing collateralised loan obligations (CLOs). This decision, which followed a reassessment in light of *Fiscale Eenheid X*, imposed a 21% VAT rate with retroactive effect, significantly increasing costs for CLO managers. The resultant financial burden prompted a swift migration of CLO structures to Ireland, where the VAT exemption for fund management remains intact under a more permissive regime. This underscores how VAT policy can serve as a powerful determinant of fund domiciliation.
- **Strategic expansion of the exemption:** In stark contrast to the Dutch move, Germany implemented the Future Financing Act, with effect from 1 January 2024, which extends the exemption (previously applicable only to UCITS and select venture capital funds) to the management of *all* AIFs. This legislative change broadens the scope of exempt activities, aligning Germany more closely with fund management hubs like Luxembourg. By adopting such a comprehensive approach to AIFs, Germany enhances its competitive position within the EU, potentially attracting a greater share of fund management activities and reflecting a deliberate strategy to bolster its financial services sector in the post-Brexit era.

> Following the SIF consultation, the authors believe that HMRC now accepts that the services can be structured so as to fall within the exemption for financial intermediation (given the 'right' fact pattern), even if not the exemption for SIF management

- **Management of model portfolio services:** The VAT treatment of model portfolio services – where fund managers design standardised portfolios for clients or advisers to replicate – has evolved significantly in recent years, reflecting both market developments and regulatory clarifications. Historically, uncertainty prevailed over whether these services fell within the exemption for SIF management. HMRC often saw them as standard rated advisory services. Following the SIF consultation, the authors believe that HMRC now accepts that the services can be structured so as to fall within the exemption for financial intermediation (given the 'right' fact pattern), even if not the exemption for SIF management. This has led certain firms to remove VAT from their offerings, reducing client costs and enhancing competitiveness. This shows that if a cat cannot be skinned one way because of inherent uncertainty, there are always alternatives.

Securitisation vehicles

The management of securitisation vehicles (i.e. special purpose vehicles (SPVs) designed to pool debt instruments such as mortgages or loans and issue securities backed by those assets) presents its own challenges. The issue is whether the vehicles are SIFs. This depends heavily on how each relevant country interprets the concept, and for a tax that is meant to be harmonised across the EU (including, for these purposes, the UK), there is significant jurisdictional variation.

In the UK, HMRC adopt a narrow stance, generally excluding securitisation vehicles from the SIF category, thereby denying their management the benefit of exemption. The cat is skinned instead by means of the exemption for 'the granting and the negotiation of credit and the management of credit by the person granting it.'

In the EU, some Member States adopt a broad view of the SIF concept, potentially encompassing certain securitisation structures where they meet criteria such as risk-spreading and investor pooling, while other Member States align more closely with the UK's restrictive approach.

The absence of a harmonised EU-wide SIF definition means that the VAT treatment of management services supplied to these vehicles requires careful, jurisdiction-specific analysis, with practitioners needing to assess both the nature of the vehicle and the applicable national framework to determine the correct VAT outcome.

Comparative analysis

The table opposite illustrates some of the key points mentioned in this article.

There is a potential opportunity for the UK here – a potential Brexit dividend, so to speak. If the SIF definition were broadened to include both AIFs and securitisation vehicles, a lot of uncertainty would dissipate, and that would give the UK funds industry a clear advantage over its European competition

Looking ahead

Back in 2018 and 2019, the hope was very much that the developments our articles were charting would reach an imminent conclusion. Now, six years later, the journey is still ongoing. The future is not so easy to see: the application of the exemption to emerging fund types (such as an investment fund investing in digital assets) is hard to assess. As these structures gain prominence, they may challenge existing definitions even more and prompt further clarification, potentially influencing debates around wrappers and other vehicles.

So the landscape for fund management continues to unfold, and investment vehicles continue to diversify and new asset classes continue to emerge. The interplay between established case law, national policies and market practices will likely muddy rather than clarify, at least in the foreseeable future, and a cure is needed to address unresolved questions and ensure coherence.

In the run up to Brexit, HMRC indicated that it might be easier for all parties concerned to remove the exemption for SIF management entirely. Clearly, this was not the preferred solution for industry (especially in light of the advantage it would have given the EU funds industry over the UK's). The sentiment still appears to be on the table as it was expressed to industry again in 2024, and it led to a number of industry bodies writing to the Treasury in December (possibly, we believe, to positive effect).

There is a potential opportunity for the UK here – a potential Brexit dividend, so to speak. If the SIF definition were broadened to include both AIFs and securitisation vehicles, a lot of uncertainty would dissipate, and that would give the UK funds industry a clear advantage over its European competition, thus potentially encouraging not only the establishment of funds here, but also the domiciliation of management functions in the UK.

This, one would think, the Government would find attractive. We will see.■

Comparative analysis

Country	Change/debate	Impact
UK	Certain AIFs treated as SIFs, but not all; management of securitisation vehicles covered by 'credit' exemption	Eligibility scrutiny required for AIFs; distinct approach to securitisation vehicles
Netherlands	Exemption revoked in relation to CLOs	Prompted migration of structures to Ireland, reflecting cost sensitivity
Germany	Management of all AIFs exempt	Strengthened competitive position as a fund management hub
Ireland	Stable exemption regime	Reinforced status as a destination for CLOs and similar structures
EU (General)	Whether securitisation vehicles are SIFs not harmonised; pension funds may be SIFs	Necessitates case-by-case VAT analysis; potential for expansion of exempt management services

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- *CCLA*: AIFs can qualify for the SIF VAT exemption (C Boyd & L Redhead, 28.8.24)
- Leave means leave, or does it? (J Woolf, 28.2.24)
- News: Treasury confirms VAT treatment of fund management services (12.1.24)
- Consultation on the VAT treatment of fund management services (E Clark & I Zeider, 13.1.22)
- *BlackRock*: single supply, dual use – apportionment? (A Tostevin & E Wong, 8.7.20)
- The UK fund management VAT exemption (I Zeider & R Smith, 19.6.20)
- VAT and SIFs: what does 'management' mean? (A Tostevin & E Wong, 23.1.19)