

THE VAT EXEMPTION FOR THE MANAGEMENT OF SPECIAL
INVESTMENT FUNDS: A REVIEW OF THEIR DESIGN, IMPACT AND
ALTERNATIVES

by

DAVID CURRIE

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School of Business

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ABSTRACT

The Value Added Tax (“VAT”) treatment of investment management services is one of the most challenging areas for policymakers, tax administrators and taxpayers alike. In both the European Union (“EU”) and the United Kingdom (“UK”), a particular set of investment funds – referred to as Special Investment Funds (“SIFs”) – qualify for VAT exemption on investment management services provided to them whilst other funds – non SIFs – do not. The VAT exemption for the management of SIFs is a mechanism to deliver a particular policy aim of the UK and the EU: to remove the VAT cost on collective investment by retail investors. This dissertation reviews the current definition and VAT treatment of SIFs across the UK and the EU; considers their design, practical and economic impact; analyses the challenges with this definition; and considers alternatives to the current position. I will set out why the best way to fully and properly achieve the UK and EU’s policy aim is to have investment management fees subject to VAT at a zero rate. I will also set out why the definition of a SIF on a principles basis with specific reference to the regulation which governs products intended for retail investors is most appropriate.

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ABBREVIATIONS

AG	Advocate General of the European Union
AIF	Alternative Investment Fund
AIFMD	Council Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010
AUT	Authorised Unit Trust
B2B	Business to business
B2C	Business to consumer
CDC	Collective defined contribution
CIS Act	Collective Investment Schemes Act of 23 rd June 2006
CJEU (also “the Court”)	Court of Justice of the European Union
CSSF	Commission De Surveillance Du Secteur Financier – the Luxembourg financial markets regulator
DC	Defined contribution
DB	Defined benefit
EC	European Commission
EIOPA	European Insurance and Occupational Pensions Authority
ELSA	English Longitudinal Study of Ageing
ELTIF	European Long Term Investment Fund
ESMA	European Securities and Markets Authority
EU	European Union
EuSEF	European Social Entrepreneurship Fund
EuVECA	European Venture Capital Fund
EU VAT Directive	Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax
EY	Ernst & Young
FAT	Financial Activities Tax
FCA	Financial Conduct Authority
FCP	Fonds Commun de Placement

FINMA	Swiss Financial Market Supervisory Authority – the Swiss financial markets regulator
FSMA 2000	Financial Services and Markets Act 2000
FTT	Financial Transaction Tax
G20	Group of Twenty. The G20 is the premier forum for its members' international economic cooperation and decision-making. Its membership comprises nineteen countries plus the European Union. ¹
GST	Goods and Services Tax
HMRC	His Majesty's Revenue and Customs – the tax administration of the United Kingdom (Her Majesty's Revenue and Customs prior to 9 th September 2022)
IMF	International Monetary Fund. The IMF is an organization of 190 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world. ²
IORP I	Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision
IORP II	Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs)
ISA	Individual Savings Account
ITC	Investment Trust Company
KIID	Key investor information document
MiFID I	Council Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC
NFT	Non-fungible token
OECD	Organisation for Economic Co-operation and Development. The OECD provides a forum in which governments can work together to share experiences and seek solutions to common problems, particularly with a view to improve the economic and social well-being of people around the world. ³

¹ G20. 2018. *About G20* [Online]. Available: <http://g20.org.tr/about-g20/> [Accessed].

² INTERNATIONAL MONETARY FUND. 2018. *About the IMF* [Online]. Available: <https://www.imf.org/en/About> [Accessed].

³ OECD. 2018. *About the OECD* [Online]. Available: <http://www.oecd.org/about/> [Accessed].

OEIC	Open Ended Investment Company
ONS	Office for National Statistics
PwC	PricewaterhouseCoopers
RITC	Reduced input tax credit
SEC	Securities and Exchange Commission – the US financial markets regulator
SI	Statutory Instrument
SICAV	Société d'Investissement à Capital Variable
SIF	Special Investment Fund
Solvency II Directive	EC Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)
TCA	Tax Calculation Account
UCITS	Undertaking for Collective Investment in Transferable Securities
UCITS Directive	Council Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)
UAE	United Arab Emirates
UK	United Kingdom
USA	United States of America
VAT	Value Added Tax
VATA 1994	Value Added Tax Act 1994

INTRODUCTION

The Value Added Tax (“VAT”) treatment of financial services, and investment management services in particular, is a topical and challenging issue for policymakers, governments and taxpayers alike. European Union (“EU”) law provides for an exemption from VAT for the provision of investment management services to certain types of investment funds⁴. These funds are referred to in EU tax legislation as Special Investment Funds (“SIFs”). Whilst the United Kingdom (“UK”) is no longer a member of the EU, it also continues to have a VAT exemption available for the management of SIFs⁵. Over the last twenty years, there has been a significant number of cases referred to the Court of Justice of the European Union (“CJEU” or “the Court”) – the ultimate arbiter on EU VAT law – by the national courts of EU Member States on the VAT treatment of SIFs and, whilst each of these cases have helped to shape the current legal framework, the regular and recurring involvement of the Court highlights the significant complexity and uncertainty surrounding this matter. This complexity and uncertainty has been further compounded by the fast-paced modernisation of the investment management industry, in particular through developing technologies and service delivery models. VAT law has at best struggled, and at worst failed, to keep pace with the industry. In 2020, two⁶ of the twenty-three cases referred to the CJEU were in respect of the VAT treatment of investment management, highlighting the continuing challenges on this matter.

In 2007, the European Commission (“EC”) announced a review of the VAT treatment of financial services which was ultimately withdrawn in 2016, with no meaningful results, after Member States failed to reach agreement on a number of politically sensitive issues. Of particular issue was the VAT exemption for the management of investment funds⁷. In 2019, the EC announced its intention to revisit this project by conducting a study to evaluate the functioning of the VAT treatment of financial services with a view to developing future policy and legislation in this area⁸. The output of this review was expected in the fourth quarter of 2021, although nothing as yet has been published. Additionally, in its 2020 budget, the UK government also announced that it would establish an industry working group to review the VAT treatment of financial services⁹, although there is no timeline for this review at the time of writing.

A supply which is VAT exempt is not subject to VAT, however, exemption also has the effect of the restricting the recovery of input tax incurred by the supplier of the exempt activity and this input tax, therefore, becomes a cost component of the supplier’s business. VAT exemptions are generally considered to be distortive¹⁰ and it is widely agreed amongst tax professionals, tax administrations and academics that the most effective consumption tax systems are designed to have a wide tax base with minimal, if any at all, exemptions¹¹.

⁴ Article 135(1)(g) of 2006d. Council Directive 2006/112/EC - The Common System of Value Added Tax. *2006/112/EC*. European Union.

⁵ Schedule 9, Group 5, Items 9 and 10 of 1994. Value Added Tax Act 1994. United Kingdom.

⁶ Cases C-58/20 K v Finanzamt Österreich, anciennement Finanzamt Linz and C-59/20 DBKAG v Finanzamt Österreich, anciennement Finanzamt Linz.

⁷ EUROPEAN COMMISSION 2019. GFV No 087 - Update on the state of play of financial and insurance services and their VAT treatment. P.5.

⁸ Ibid.

⁹ HER MAJESTY’S TREASURY 2020. UK Budget 2020. P.57.

¹⁰ The distortive effect of, and problems with, VAT exemptions are discussed in detail at chapter five of this dissertation.

¹¹ See, amongst others: INSTITUTE OF FISCAL STUDIES & MIRRLEES, J. 2011. Tax by Design, DE LA FERIA, R. & KREVER, R. 2013. VAT Exemptions: Consequences and Design Alts. *EUCOTAX Series on European Taxation*, Volume 37, HENRY, K., HARMER, J., PIGGOTT, J., RIDOUT, H. & SMITH, G. 2009. Australia’s Future Tax System: Report to the Treasurer - Part Two. In: TREASURY (ed.). www.taxreview.treasury.gov.au: Australian Government.

Despite this, VAT exemptions are widely applied in traditional VAT systems, such as those in the UK and the EU. VAT exemptions have a distortive effect on market pricing, with suppliers of exempt services incurring additional VAT costs themselves which, in theory, will impact on the pricing of their services. The extent to which this VAT cost is passed on indirectly to the end consumer will be dependent on other market and economic factors.

In financial services, VAT exemptions are typically utilised by governments and tax administrations due to the complexity in calculating the value of a service to which VAT would need to be applied. However, from a VAT perspective, such complexity does not exist for investment management services as the value of an investment management charge is, in the vast majority of cases, explicit. The VAT exemption for SIFs is, instead, legislated for to remove the cost of VAT for investors and to ensure that direct investment – that is investment made by an individual on their own account – and collective investment are treated equally for VAT purposes. This is, in effect, a social exemption which seeks to influence, or assist with, the consumption of a particular good or service and the behaviours of the general public.

When we consider that 30%¹² of the value of invested assets in the EU comes from retail, or household, investors and a further 53%¹³ from pension schemes and insurance companies, who ultimately act on behalf of millions of households, the significant impact that this social VAT exemption has on the financial wellbeing of the public at large is clear to see. At a time when the effects of the global financial crash of 2008 are still being felt by households across the globe, and with policymakers increasingly focussed on ensuring that individuals save sufficiently for their retirement, the removal of the VAT exemption on investment management services would be both socially damaging and politically challenging. This issue is only further exacerbated by the current economic downturn and high inflationary environment caused, at least in part, by the Covid-19 pandemic with increased numbers of households reliant on savings to be able to continue to make ends meet.

Enabling retail investors to access collective investment schemes is a vital part of helping individuals save. Collective investment delivers a wide variety of benefits to investors, including: access to professional investment managers which ensures the better management of assets; ease of access to investments which would not, typically, be available for retail investors investing on their own account (e.g., commercial real estate); diversification of investment risk, or at least better access to diversified investment strategies; better investment protection; access to appropriate long-term investment vehicles necessary to meet the aging population and cost of retirement; and reduced transaction costs. With an estimated pensions saving gap – that is how much more individuals need to save in order to achieve an adequate standard of living in retirement – of EUR 2 trillion per year¹⁴ across Europe, the importance of facilitating access to collective investment, and enabling these investor benefits, is clear.

The interaction of tax policy, economics and the political environment is complex. Tax policy which plays negatively from a political perspective, even where the policy is well intended and will achieve its aim, inevitably becomes a difficult proposition. This is often due to the public perception of a particular measure which, due to the complexities of the tax policy and implementing tax legislation, and the application of this to complex commercial scenarios, is in many cases not fully understood. Changes to tax policy, as a result, not only require political will, but invariably also involves a trade-off between a variety of competing factors, including the public's view of the measure.

The aim of this study is to review the current definition and VAT treatment of SIFs across the UK and the EU; consider their design, practical and economic impact; analyse the challenges facing policymakers and legislators with this definition; and consider alternatives to the current definition and VAT treatment. This

¹² EUROPEAN FUND AND ASSET MANAGEMENT ASSOCIATION 2019. Asset Management in Europe: An overview of the asset management industry. P.5.

¹³ Ibid.

¹⁴ AVIVA 2016. Mind The Gap - Quantifying the pension savings gap in Europe. P.3.

study will also consider the potential VAT treatment of the management of SIFs in both the UK and the EU following the UK's formal departure from the EU on 31st January 2020.

There are limited academic contributions on the topic of VAT and investment management, and little which specifically considers the definition of a SIF or the VAT treatment of investment management services more generally. The majority of research and existing literature on VAT and financial services is focussed on the industry in general or banking and the investment products themselves. There is, as a result, a gap in the existing literature on this topic which this dissertation aims to, in part, fill. There are also a number of unresolved challenges with the definition of a SIF, primarily arising due to differing approaches by Member States, including the UK when it was a member of the EU, to interpreting the jurisprudence of the CJEU in defining a SIF. This dissertation will also, therefore, seek to address these unresolved challenges and offer tax policy suggestions which aim to better serve the overarching policy aims of both the EU and the UK. SIFs are critical to successfully delivering on these policy aims, as evidenced by the current reviews being undertaken by the EC and the UK government, and this dissertation is intended to be both an academic and industry contribution on this topic to help shape the policy debate.

In this dissertation, I will set out why the best way to fully and properly achieve the UK and EU's policy aim – that is to remove the VAT cost of collective investment by retail, or household, investors – is to have investment management fees subject to VAT at a zero rate. Zero rating ensures that there is no VAT cost embedded within the supply chain of investment management services which, as I will show later in this dissertation, is not the case for exemption or full taxation¹⁵. The introduction of a zero rate of VAT will reduce the overall tax collection by governments, through the removal of irrecoverable VAT costs on these services by investment managers, and the need for governments to fund their expenditures, support the public welfare and manage the economic cost of the Covid-19 pandemic must be borne in mind. The question for policymakers and governments is, therefore, which is the greater priority: enabling the policy aim of encouraging “small” investors to access collective investment schemes and ensuring that this is put on parity with direct investment; or protecting the current levels of tax collection and avoiding any possible political fallout that would inevitably come from such a change.

With the UK no longer a member of the EU, zero rating the investment management of a SIF is a possibility under UK VAT law. From an EU perspective, however, a zero rate of VAT is not possible under current EU VAT law and a change to this approach seems unlikely given the EC's clear dislike for a zero rate of VAT and the need for consensus across all twenty-seven EU Member States to enact such a change. I will also show why, based on empirical economic research, VAT exemption for the management of SIFs remains strongly preferable to full, or even reduced, taxation should zero rating not be viable across the EU.

The same economic outcome as zero rating could be achieved by taxing investment management, at either the full or a reduced rate, and allowing SIFs to recover the VAT charged. In my view, however, this approach is hugely problematic, both legally and administratively. Any such approach would also shift the burden of VAT onto Member States in which funds are established and would, by extension, have a disproportionate impact on traditional investment fund locations.

I will also review, analyse and show why defining a SIF on a principles basis with specific reference to the regulation which governs investment products which are intended for retail investors is entirely appropriate and one which I would continue to advocate for.

I will discuss why the option to tax regime for the investment management of SIFs only serves to achieve the EU policy aims in limited circumstances and, outside of these limited scenarios, has the effect of frustrating the stated policy of the EU by increasing the overall cost for the consumer. In order for an option

¹⁵ A full discussion of exemption, zero rating, reduced and full taxation for the management of SIFs is covered at chapter eleven of this dissertation.

to tax to achieve the policy aims of the EU, it requires the ability for it to be applied on a on a selective, case-by-case basis and also requires a wider application of the option to tax across more Member States.

My research will look at what lessons can be drawn from the approach of modern VAT systems¹⁶ in dealing with the VAT treatment of investment funds and conclude that, irrespective of the maturity of a tax regime, the challenges across both modern and traditional VAT systems on this particular matter are similar.

This dissertation will also review the EC's conclusions that it is not possible to apply a single VAT treatment to all Alternative Investment Funds ("AIFs") and that, instead, a case-by-case analysis should be carried out for each fund considering the principles based approach and tests which have been set out by the CJEU. I will show, in agreeing with the position of the EC, that a single VAT exemption for AIFs would contradict previously settled CJEU jurisprudence.

I will discuss why harmonising the approach to the treatment of offshore funds across the EU would be beneficial and why the UK's 'active marketing' policy for offshore funds, including non-domestic UCITS, best achieves the policy aims of the EU, specifically when dealing with offshore funds. I will also offer an alternative, less complex approach to the treatment of offshore funds based on the Swiss system, where foreign funds which are registered with the Swiss financial markets regulator for distribution in Switzerland are treated as SIFs.

My research will also discuss, in detail, the VAT treatment of investment management services provided to defined contribution, defined benefit and hybrid pension funds. I will, in particular, discuss the key question for pension funds in determining whether they are a SIF: who bears the investment risk, to what extent, and how does this translate into the criteria set out by the CJEU?

Throughout this dissertation references to VAT should be read to include VAT, Goods and Services Tax ("GST") and other consumption taxes.

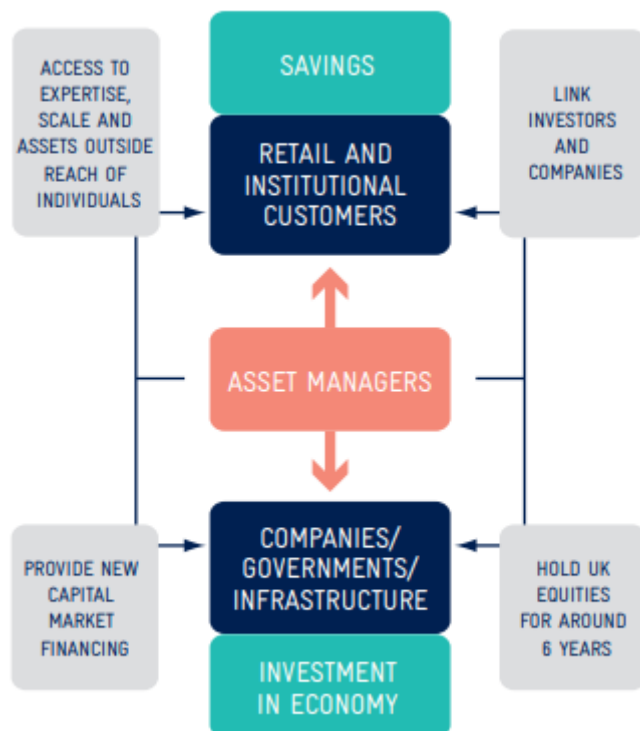
¹⁶ A modern VAT system typically has a single positive rate and minimal, tightly targeted exemptions. See: KREVER, R. 2008. Designing and Drafting VAT Laws for Africa.

CHAPTER 1: AN OVERVIEW OF THE INVESTMENT MANAGEMENT INDUSTRY

1.1 THE ROLE OF THE INVESTMENT MANAGEMENT INDUSTRY

The investment management industry plays a central role in the economy by channelling savings into investment and in ensuring, together with other financial services businesses and financial market regulators, that capital markets operate properly and efficiently.

The role of an investment manager, or asset manager, is summarised in the below diagram¹⁷:



Investment managers play a vital role in supporting households to save efficiently and effectively to enable a prosperous retirement or facilitate a life changing decision such as buying a new home. In the UK, for example, 75% of households use the services of an investment manager, directly or indirectly, mostly through pensions and individual savings accounts (“ISA”)¹⁸.

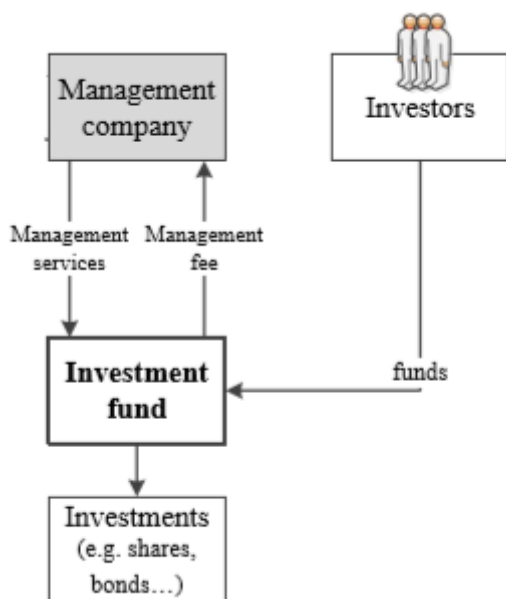
Investment managers also support economic growth by channelling investors savings into businesses and infrastructure programmes. Investment managers have a responsibility not only to invest savers’ money in the way that will produce the best possible returns, but also to act as stewards for the investments that they make¹⁹. Asset managers will develop investment funds, which are products created with the sole purpose of gathering investors' capital and investing that capital collectively through a portfolio of financial

¹⁷ THE INVESTMENT ASSOCIATION 2018. Asset Management in the UK 2017-2018: The Investment Association Annual Survey. P.15.

¹⁸ THE INVESTMENT ASSOCIATION 2019. A Manifesto for Investment Management - Plans to Power the Economy. P.4-5.

¹⁹ Ibid.

instruments such as stocks, bonds and other securities²⁰. The interaction of the asset manager, investment fund and investor is detailed in the below diagram²¹:



Each of these are discussed in more detail below.

1.2 MARKET PLAYERS AND TYPES OF INVESTMENT MANAGEMENT

Investment management services are commonly provided by asset managers, banks and insurance companies, with each offering a range of services and products to meet the needs of their clients. It is important to note that, in this respect, asset managers, banks and insurance providers are, therefore, in competition with each other.

The nature of these asset management services and products can, broadly, be separated into three distinct categories:

1.2.1 TRADITIONAL ASSET MANAGEMENT

Traditional asset management involves the investment of pooled money from multiple investors into specific securities, such as stocks, bonds and money market instruments, with the aim of achieving a pre-determined investment objective.

²⁰ EUROPEAN COMMISSION. 2018b. *Investment Funds* [Online]. Available: https://ec.europa.eu/info/business-economy-euro/growth-and-investment/investment-funds_en [Accessed].

²¹ EUROPEAN COMMISSION 2017. VAT Committee Working Paper 936 - Scope of the exemption for the management of special investment funds. P.5.

To achieve this investment objective, traditional asset managers will organise securities into specific funds and each investor will own units or shares in the fund. The investor's return, in absolute terms, will depend on the number of units they own, the performance of the fund and its overall value.

Investor assets are typically invested across various asset classes, which will depend on the investor's required level of risk and return and their investment objectives.

1.2.2 ALTERNATIVE ASSET MANAGEMENT

Alternative asset management includes a broad range of non-traditional asset classes, such as real estate, infrastructure, private equity and hedge funds.

As with traditional asset management, alternative asset managers will also be seeking to achieve a pre-determined investment objective. Alternative asset classes typically carry higher investment risk and are typically less liquid than traditional asset classes.

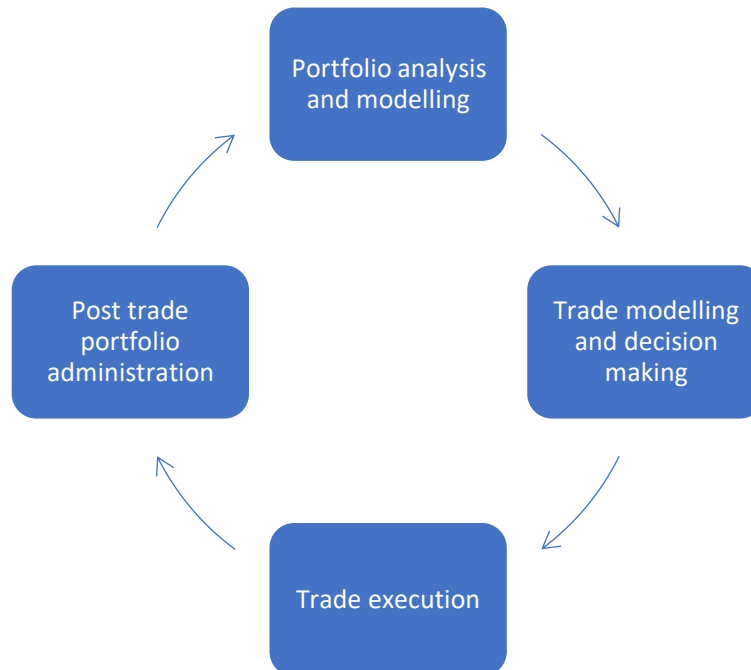
1.2.3 RISK MANAGEMENT AND ADVISORY SERVICES

Asset managers will also provide clients with risk management and advisory services including, amongst others:

- The development and deployment of technology solutions to enhance the client's investment cycle, risk management and/or investment reporting processes;
- Data and financial modelling;
- Financial analytics;
- Capital management advice;
- Stress testing of balance sheets;
- Regulatory advice;
- Strategic advice in respect of distressed assets.

1.3 THE INVESTMENT MANAGEMENT CYCLE

The investment management cycle can be summarised as:



Portfolio analysis and modelling

The asset manager will continually review the composition and performance of an investment portfolio against the pre-determined investment objectives.

Trade modelling and decision making

After reviewing the composition and performance of the portfolio, the asset manager will consider and analyse the impact on the portfolio of buying and selling particular assets and securities. This analysis will be used to inform the asset manager's decision to buy and/or sell specific assets or securities and decisions will be made to better meet the portfolio's investment objectives compared to its current position.

Trade execution

Asset managers will ensure that the buying and selling of assets and securities is undertaken in the most efficient and cost-effective manner to ensure that the value of the portfolio is not adversely affected by any trading. Trading will usually be conducted by a dealing team which is separate to the investment management team responsible for the overall management of the portfolio. The dealing team will ensure the required trades are carried out within the relevant regulatory frameworks and will also ensure that each trade obtains the best possible outcome for the investors.

Post-trade portfolio administration

After a trade has been executed, there are a number of administrative tasks which must be completed. These are:

- Trade settlement – the asset or security being bought or sold must be legally transferred and financially settled. This process will usually be carried out by the custodian²² of the portfolio;
- Updating the portfolio to reflect the trade – this ensures that the asset manager can analyse and model, as described above, based on the most up-to-date portfolio information;
- Post-trade portfolio reconciliation – the asset manager will reconcile the balances in the portfolio after the trade has been executed to ensure it has been correctly reflected in the portfolio.

1.4 TYPES OF INVESTOR

Investors can be categorised as either retail or professional – each is described in more detail below.

1.4.1 RETAIL INVESTORS

Article 4 of Council Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (“MIFID I”) describes a retail investor as one which is not a “professional investor”²³. Professional investors are considered at 2.4.2 below.

A retail investor will typically buy and sell securities for their own personal account and not for, or on behalf of, another organisation. Retail investors will normally buy securities in smaller quantities and will often prefer to invest in pooled investment vehicles. Investing in pooled funds allows retail investors to diversify their risk and access asset classes (e.g., commercial real estate) which they would not be able to access on their own account due to the cost barrier.

Retail investors will usually invest through fund distributors, such as banks or independent financial advisors, or distribution platforms. Distribution platforms, which bring together product offerings from a wide variety of investment managers, are often referred to as mutual fund supermarkets. The mutual fund supermarket format provides numerous advantages to retail investors, including: more choice; the flexibility to switch between products on the same distribution platform; and lower transaction costs. Distributors will earn commissions from the investment managers based on products sold to their clients. As a result of this distribution model, investment managers will often not have any direct contact with retail investors. Instead, investment managers will seek to place their products with distributors to access the retail market, ensuring that each distributor understands the investment objectives, profile and suitability of the product for investors. This will usually be achieved through a continual process of training and relationship management between the asset manager and the distributor.

²² A custodian is a financial institution that holds customers securities for safekeeping in order to minimize the risk of their theft or loss.

²³ 2004c. Council Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC. 2004/39/EC. European Union.

Investment products aimed at retail investors are highly regulated. An overview of the regulatory framework within which asset managers operate is set out at 1.5 below.

1.4.2 PROFESSIONAL INVESTORS

Annex II of MiFID I sets out the categories of clients who will be considered as professional investors²⁴. Professional investors are also referred to as ‘institutional’ investors – these terms are used interchangeably.

Professional investors include, amongst others, pension funds, insurance companies, banks, trusts, large businesses, businesses whose main activity is to invest in financial instruments, not for profit organisations and official institutions (e.g., central banks, sovereign wealth funds, etc.).

Due to their increased size and complexity, institutional investors often require specialist and sophisticated investment policy advice and customised investment strategies to meet their investment objectives.

1.5 REGULATION OF THE INVESTMENT MANAGEMENT INDUSTRY

A high-level overview of the key regulatory frameworks within which asset managers and investment funds operate is set out below²⁵. Each of these regulatory frameworks, and their interaction with the VAT treatment of SIFs, will be discussed in more detail throughout this dissertation.

1.5.1 EU DIRECTIVE 2009/65/EC – UNDERTAKINGS FOR COLLECTIVE INVESTMENT IN TRANSFERABLE SECURITIES (“THE UCITS DIRECTIVE”)

The UCITS Directive was launched in 1985 and has been updated several times since, most recently in 2014. The Directive’s aims are:

- To ensure harmonisation of the conditions of competition between collective investment funds within the EU;
- To facilitate cross-border investment in collective funds;
- To ensure effective and uniform protection for investors across the EU;

²⁴ Ibid.

²⁵ EUROPEAN SECURITIES AND MARKETS AUTHORITY. 2022. *Fund Management* [Online]. Available: <https://www.esma.europa.eu/regulation/fund-management> [Accessed]. EUROPEAN COMMISSION 2017. VAT Committee Working Paper 936 - Scope of the exemption for the management of special investment funds. P.6.

- To provide for common rules for the authorisation, supervision, structure and activities of collective funds and the information that they are required to publish.

Where an investment fund meets the criteria to be considered a UCITS fund, both the fund and the investment manager will be required to comply with the requirements of the Directive. The supervision of UCITS funds and investment managers is provided by the national supervisory body of each Member State.

A history of the UCITS Directive, and its relevance to this study, is considered in more detail at chapter two.

1.5.2 EU DIRECTIVE 2011/61/EU – ALTERNATIVE INVESTMENT FUND MANAGERS (“AIFMD”)

AIFMD was introduced into EU law in 2011 and applies to managers of funds that do not fall within the UCITS Directive. Taken together, therefore, the UCITS Directive and AIFMD provide for a comprehensive set of rules for fund management activities in the EU.

The main objectives of the Directive are:

- To provide a harmonised regulatory framework for the activities of non-UCITS investment managers;
- To improve investor protection;
- To foster cross border investment.

The AIFMD aims to improve the stability within the financial markets and to increase transparency and investor protection by closing the regulatory gap for investment funds which fall outside of the UCITS Directive.

Only the investment manager is subject to the regulations imposed by AIFMD. Any investment funds being managed are not subject to the Directive.

We also consider AIFMD, and its relevance to this study, in more detail at chapter ten.

1.5.3 EU DIRECTIVE 2016/2341 – ACTIVITIES AND SUPERVISION OF INSTITUTIONS FOR OCCUPATIONAL RETIREMENT PROVISION (“IORP II”)

IORP II has four key objectives:

- To ensure sound workplace pensions and better protection for members and beneficiaries;
- To ensure better information for members and beneficiaries (primarily through the Pension Benefit Statement);

- To remove certain obstacles to cross-border provision of services;
- To encourage long-term investment in employment enhancing activities.

The rules in the Directive are intended to ensure a high degree of security for future pensioners through the imposition of stringent supervisory standards of the occupational pension fund itself, which will be established as a separate legal body from the employer.

1.6 FEES EARNED BY INVESTMENT MANAGERS

For the most part, asset managers will charge an explicit fee for their services. For both traditional and alternative asset management, asset managers are typically remunerated by:

- Management fees – calculated based on the assets under management within a particular investment fund or by a particular institutional investor;
- Performance fees – earned based on the performance of the investment against the risk and return profile.

Fee terms will be set out in the fund documentation or the investment management agreement.

For risk management and advisory services, fees payable to asset managers will be set out in the contractual agreement governing the services. Fees will be dependent on the nature of the risk management or advisory agreement but will almost always be explicitly charged.

CHAPTER 2: THE DEFINITION OF A SPECIAL INVESTMENT FUND (“SIF”) – HISTORY AND CURRENT APPROACH OF THE COURT OF JUSTICE OF THE EUROPEAN UNION (“CJEU”)

The VAT exemption for the “*management of special investment funds as defined by Member States*” was first conferred by Article 13(B)(d)(6) of the original EU Directive on the common system of value added tax²⁶. The wording of this exemption remains unchanged today, prescribed for in Article 135(1)(g) of the current EU VAT Directive²⁷.

Whilst EU Member States have the authority to define a SIF, this power is limited by the requirement to ensure that any definition is consistent with the intention of EU legislature, the EU VAT Directive, and the principle of fiscal neutrality as an inherent part of the common system of VAT across the EU²⁸.

At the time of the original VAT Directive entering into force in 1977, there was significantly less cross border trading and investment when compared to today. There was, therefore, no EU wide regulation or supervision of investment funds. Instead, Member States regulated, licenced and supervised investment funds at a national level. Referring to the national law of the Member States for the definition of a SIF enabled the VAT exemption to be applied to investments that were subject to specific state supervision, ensuring that similar domestic funds were subject to the same conditions of competition and would appeal to the same circle of investors²⁹.

Since the early 1980s, however, there has been a significant increase in market integration and trade openness³⁰, with hyper-globalisation occurring since around 1990³¹. This has had a marked impact on the development of the fund industry and has resulted in a significant increase in the scale with which products have been marketed and distributed on a cross border basis. The creation of the EU single market in January 1993 had a particularly significant impact on the globalisation of trade³². According to a report by the Association of the Luxembourg Fund Industry, EU cross border funds increased in absolute terms by 157% between 2001 and 2011³³. The investment environment today is, therefore, clearly different from that in existence in 1977 when the VAT exemption for SIFs was originally constructed.

²⁶ 1977. Council Directive 77/388/EEC - SIXTH COUNCIL DIRECTIVE of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes — Common system of value added tax: uniform basis of assessment. 77/388/EEC. European Union.

²⁷ 2006d. Council Directive 2006/112/EC - The Common System of Value Added Tax. 2006/112/EC. European Union.

²⁸ This limitation was noted by the CJEU in its judgment: 2015. C-595/13 - Staatssecretaris van Financiën v Fiscale Eenheid X NV cs. Court of Justice of the European Union. Paragraph 33.

²⁹ KOKOTT, J. 2015. Opinion of Advocate General Kokott in case C-595/13 Staatssecretaris van Financiën v Fiscale Eenheid X NV cs. Court of Justice of the European Union. Paragraph 27.

³⁰ Trade openness is the ratio of exports and imports to national income.

³¹ BROADBENT, B. & BANK OF ENGLAND 2017. Winners from globalisation. P.3.

³² EUROPEAN COMMISSION & INSTITUTE FOR FISCAL STUDIES 2011. A retrospective evaluation of elements of the EU VAT system.

³³ ASSOCIATION OF THE LUXEMBOURG FUND INDUSTRY & SPENCE JOHNSON LTD 2012. Trends in Cross Border Distribution. P.6.

As a result of this environmental change, the EU has sought to harmonise the rules relating to the authorisation and supervision of investment funds, which was formally established with the adoption of the first UCITS Directive on 20th December 1985³⁴. The Directive's aim was to:

- Create a unified regulatory framework for mutual funds across the EU, ensuring no distortion of competition between similar funds in different Member States;
- Facilitate cross-border offerings of investment funds to retail investors;
- Ensure that EU citizens receive similar levels of investment protection across all EU Member States.

To achieve these aims the Directive allowed any fund authorised as UCITS in its home country to market its units in other EU Member States by simply notifying the host Member State of the intention to market the fund's units or shares on its territory. The fund would no longer have to go through a process of registration in each country of sale, as was previously required. The Directive also introduced common rules for mutual funds and standardised protections for investors.

The UCITS Directive has been updated on several occasions since its adoption in 1985 – each update was introduced to ensure that the Directive continued to meet its original aims. The updates to the Directive are summarised below.

- **2001/107/EC** – detailed minimum standards with which a UCITS management company should comply in terms of capital and risk control, rules of conduct and conditions relating to technical and human resources;
- **2001/108/EC** – widened the investment possibilities of UCITS to include new instruments (money market instruments, units of other collective investments, bank deposits and financial derivatives) and eased investment restrictions for index tracker funds;
- **2009/65/EC** – introduced, amongst other measures: a passport allowing a UCITS fund to be managed by a management company authorised and supervised in a Member State other than its home Member State; a simplified notification procedure for the marketing of fund units or shares in another country by introducing a regulator-to-regulator approach; the requirement to have a key investor information document ("KIID"), which was designed to provide the investor with important information about the fund in non-technical language;
- **2014/91/EU** – introduced: additional requirements in respect of the role and responsibility of UCITS depositaries³⁵; a requirement for UCITS management companies to adhere to certain remuneration principles based policies; and the harmonisation of the administrative sanctions that must be available to EU regulators for breaches of the UCITS Directive.

According to the EU, investments in UCITS funds account for 75% of the total investments by "small" investors in Europe³⁶. Given that, as I will explain in more detail later in this dissertation, one purpose of the SIF VAT exemption is to facilitate collective investment by these so called "small" investors, an interaction of this exemption with UCITS was inevitable.

³⁴ 1985. Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS). *85/611/EEC*. European Union.

³⁵ A depositary is an independent third party that is responsible for the safekeeping of the assets of a fund.

³⁶ EUROPEAN COMMISSION. 2018b. *Investment Funds* [Online]. Available: https://ec.europa.eu/info/business-economy-euro/growth-and-investment/investment-funds_en [Accessed].

In the period from 2004 to date, there has been a number of CJEU judgments relating to the definition of a SIF, all of which have, unsurprisingly, made reference to the UCITS Directive. As CJEU judgments are binding on Member States, these rulings have, to some extent, harmonised the definition of a SIF across the EU. This attempted harmonisation has been possible due to the introduction of the UCITS Directive which provided regulation and supervision of investment funds at EU level and, by extension, limited the discretion of Member States to define a SIF.

The judgments of a number of cases presented before the CJEU in respect of the definition of a SIF³⁷ were most recently consolidated in case C-595/13 (*Staatssecretaris van Financiën v Fiscale Eenheid X NV cs*, hereinafter “*Fiscale Eenheid*”), which provided the following definition of a SIF³⁸:

1. Funds which constitute UCITS within the meaning of the UCITS Directive; or
2. Funds which, without being collective investment undertakings within the meaning of the UCITS Directive, display characteristics identical to theirs and thus carry out the same transactions or, at least, display features that are sufficiently comparable for them to be in competition with such undertakings. An investment fund is comparable to collective investment undertakings as defined by the UCITS Directive if:
 - a. The fund is a collective investment of capital raised from the public; and
 - b. The fund must operate on the principle of risk-spreading; and
 - c. The return on the investment made by each participant is dependent on the performance of the investments over the period in which they are held. In this respect, the participants are entitled to the profits and bear the risk connected with the management of the fund; and
 - d. The fund is subject to specific state supervision; and
 - e. The fund must be subject to the same conditions of competition and appeal to the same circle of investors as UCITS.

These criteria were also set out in the EC VAT Committee’s Working Paper No 936³⁹, which specifically addressed questions raised by the Netherlands and Denmark on the scope of the VAT exemption for pension funds and Alternative Investment Funds (“AIFs”), respectively.

I will come back to consider the appropriateness of the VAT exemption and the above definition of a SIF later in this dissertation.

³⁷ Namely: C-169/04, *Abbey National plc*; C-363/05, *JP Morgan Fleming Claverhouse Investment Trust and The Association of Investment Trust Companies*; C-44/11, *Deutsche Bank*; C-424/11, *Wheels Common Investment Fund Trustees and Others*; C-464/12, *ATP Pension Service*.

³⁸ 2015. C-595/13 - *Staatssecretaris van Financiën v Fiscale Eenheid X NV cs*. Court of Justice of the European Union. Paragraphs 29-64.

³⁹ EUROPEAN COMMISSION 2017. VAT Committee Working Paper 936 - Scope of the exemption for the management of special investment funds. P.20-27.

CHAPTER 3: THE DESIGN OF A CONSUMPTION TAX SYSTEM – A GENERAL OVERVIEW

It is widely agreed amongst tax professionals, tax administrations and academics that the most effective consumption tax systems are designed to have a wide tax base with minimal, if any at all, exemptions. Indeed, even the original proposal to harmonise the EU VAT system in 1973 noted the “*need to keep the number of exemptions as small as possible. This need reflects a concern to keep exceptions to the minimum in a general system of taxation of consumption, but also reflects a desire to avoid the inconveniences which such exemptions cause, mainly by reason of the fact that, unless the transaction exempted forms part of an international trading operation, taxes paid on inputs will not be deductible*”⁴⁰. Gale, in proposing a new progressive consumption tax for the United States of America (“USA”), proposed that a USA VAT should apply to “*a broad base, including essentially all consumption that is associated with explicit payments*”⁴¹; Mirrlees advocated for the “*wholesale removal of most of the exemptions*” from the UK VAT system⁴²; Henry concluded that “*the consumption tax base be spread across most forms of consumption*” for the purpose of Australian GST⁴³; Charlet and Owens, in referencing Mirrlees as well as various Organisation for Economic Co-operation and Development (“OECD”) reports, commented that “*other things being equal, a broad base, single-rate VAT is ideal*”⁴⁴; and de la Feria and Krever stated that “*VATs applied around the world are – to different degrees – imperfect with exemptions*”⁴⁵. Gottfried and Wiegard took this principle to its ultimate conclusion, stating that “*contrary to common belief, VAT no longer equals a consumption tax when exemptions are granted*”⁴⁶.

The consensus towards this model is further evidenced by almost all new consumption tax systems being designed with a wide tax base and few exemptions. Such systems include those in New Zealand (1986), Japan (1989), Australia (2000), Malaysia (2015)⁴⁷, The Gulf Cooperation Council (2018) and the majority of African countries⁴⁸.

Richard Krever, in his paper ‘Designing and Drafting Tax Laws for Africa’, describes this most effective consumption tax system as “modern”⁴⁹. European VAT is not, however, considered to be a modern

⁴⁰ EUROPEAN COMMISSION 1973. Proposal for a sixth Council Directive on the harmonization of Member States concerning turnover taxes, Common system of value added tax: Uniform basis of assessment. *In*: 11/73, B. O. T. E. C. S. (ed.). P.15.

⁴¹ GALE, W. 2020. Raising Revenue with a Progressive Value-Added Tax. P.54.

⁴² INSTITUTE OF FISCAL STUDIES & MIRRLEES, J. 2011. Tax by Design. P.193.

⁴³ HENRY, K., HARMER, J., PIGGOTT, J., RIDOUT, H. & SMITH, G. 2009. Australia's Future Tax System: Report to the Treasurer - Part Two. *In*: TREASURY (ed.). www.taxreview.treasury.gov.au: Australian Government. P.277.

⁴⁴ CHARLET, A. & OWENS, J. 2010. An International Perspective on VAT. *Tax Notes International*, Volume 59, P.943-954.

⁴⁵ DE LA FERIA, R. & KREVER, R. 2013. VAT Exemptions: Consequences and Design Alts. *EUCOTAX Series on European Taxation*, Volume 37. P.4.

⁴⁶ GOTTFRIED, P. & WIEGARD, W. 1991. Exemption versus zero rating: A hidden problem of VAT. *Journal of Public Economics*, 46, P.307-328.

⁴⁷ Malaysia's consumption tax system was revoked in September 2018 due to its unpopularity. Its original design did, however, follow this model. See: AVALARA VATLIVE. 2018. *Malaysia launches Sales and Service Tax Sep 2018* [Online]. Available: <https://www.vatlive.com/vat-news/malaysia-launches-sales-tax-sep-2018/> [Accessed].

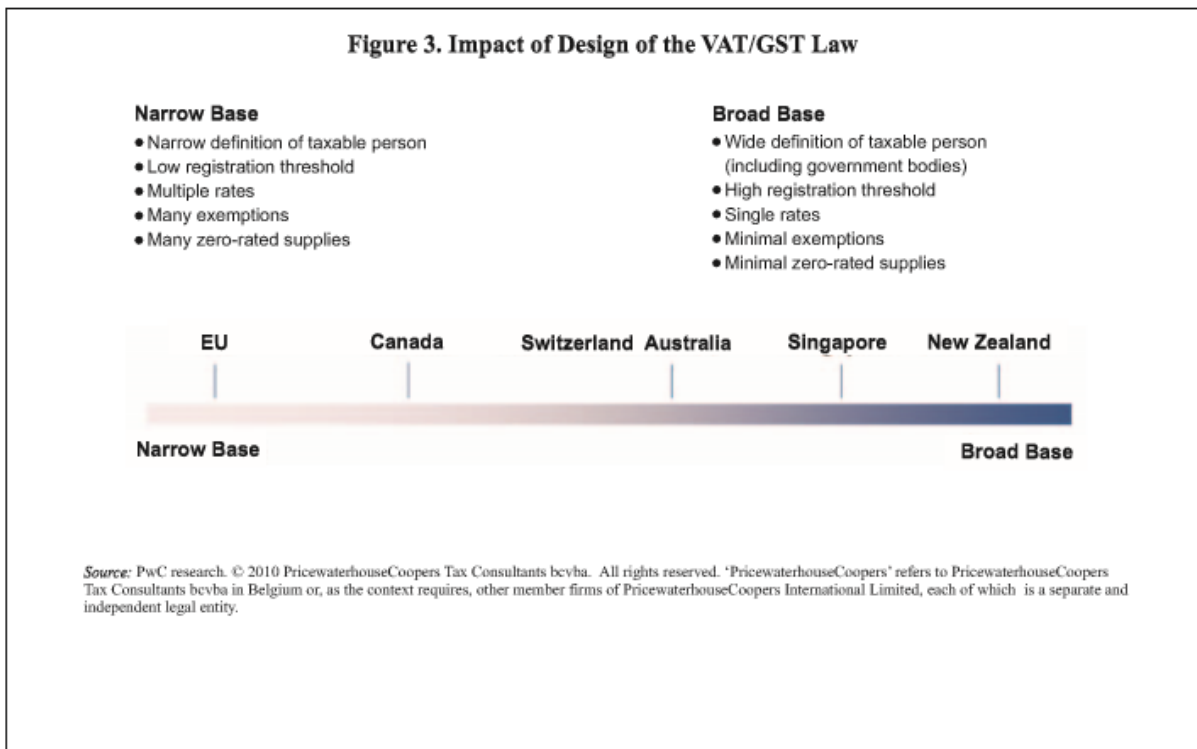
⁴⁸ CHARLET, A. & OWENS, J. 2010. An International Perspective on VAT. *Tax Notes International*, Volume 59, P.943-954, DE LA FERIA, R. & KREVER, R. 2013. VAT Exemptions: Consequences and Design Alts. *EUCOTAX Series on European Taxation*, Volume 37.

⁴⁹ KREVER, R. 2008. Designing and Drafting VAT Laws for Africa. P.14. Also see: CHARLET, A. & OWENS, J. 2010. An International Perspective on VAT. *Tax Notes International*, Volume 59, P.943-954.

consumption tax system, but rather a “traditional”⁵⁰ consumption tax system. Krever describes the differences between both VAT systems as:

*“Traditional VAT systems generally have multiple positive rates while the modern VAT has a single positive rate. Traditional VAT systems often contain multiple exemptions while the modern VAT has far fewer and much more tightly targeted exemptions.”*⁵¹

Krever’s analysis is supported by Lejeune, who set out the below overview of consumption tax system designs, with traditional systems reflected on the left of her analysis and modern systems to the right⁵²:



Despite modern consumption tax systems being the preferred model, at least ideologically, amongst tax administrations and academics due to their undoubted improvement from traditional consumption tax systems, they remain imperfect. de la Feria and Krever note, in particular, that it is unclear whether the modern approach has solved for all the challenges of traditional systems or to what extent they have given rise to new problems⁵³.

⁵⁰ KREVER, R. 2008. Designing and Drafting VAT Laws for Africa.

⁵¹ Ibid. P.13-14.

⁵² LEJEUNE, I. 2011. The EU VAT Experience: What Are the Lessons? *Tax Analysts*, P.257-282. P.281.

⁵³ DE LA FERIA, R. & KREVER, R. 2013. VAT Exemptions: Consequences and Design Alts. *EUCOTAX Series on European Taxation*, Volume 37.

CHAPTER 4: APPLICATION OF TRADITIONAL VALUE ADDED TAX (“VAT”) IN EUROPE, INCLUDING THE PROVISION OF EXEMPTIONS UNDER EUROPEAN LAW

For all Member States of the EU, EU law is supreme⁵⁴. Member States must, therefore, enact legislation within the confines set by EU Directives and EU Regulations, and apply the jurisprudence of the CJEU. Failure to do so will result in infringement proceedings being brought against the Member State by the EC⁵⁵.

EU VAT law, in following a traditional VAT model, provides for a number of exemptions from the taxable base⁵⁶. VAT exemptions can be categorised as either social or technical⁵⁷.

Two principal reasons have been offered for a social exemption being granted:

1. To address vertical equity

The first reason offered for a social exemption being provided is to act as a mechanism in addressing vertical equity concerns which will arise within a consumption tax system⁵⁸. Vertical equity is the principle that people at different levels of income should be taxed based on their ability to pay.

Many have argued that a consumption tax system with a broad tax base does not adequately deal with the issue of vertical equity, with consumption taxes considered to be “regressive”⁵⁹. Others have argued that, whilst a consumption tax system is inherently regressive, using tax as a mechanism to address vertical equity issues is inefficient, due to the fact that this, in essence, equates to indirect government expenditure⁶⁰. The alternative proposal is that vertical equity should be addressed by direct, targeted government expenditure, which would achieve a more transparent, efficient and fairer re-distribution of wealth – this was the approach taken by New Zealand on its implementation of GST in 1986⁶¹. One reason offered for VAT systems including exemptions as a social redistribution mechanism is that, particularly in developing countries, governments may lack the necessary capacity to administer a comprehensive income tax and welfare system – in such cases the VAT system becomes a necessary instrument for administering

⁵⁴ See judgment in 1964. C-6/65 - Costa v ENEL. Court of Justice of the European Union. For an academic contribution on the supremacy of EU law, see: ALTER, K. J. 2003. House of Lords Select Committee on European Union: Memorandum by Karen J Alter, Associate Professor of Political Science, Northwestern University, Evanston, Illinois. <https://publications.parliament.uk/pa/ld200304/ldselect/ldecom/47/47we02.htm>.

⁵⁵ EUROPEAN COMMISSION 2018a. EU Infringement Procedure. In: COMMISSION, E. (ed.). https://ec.europa.eu/info/law/law-making-process/applying-eu-law/infringement-procedure_en.

⁵⁶ See Title IX of 2006d. Council Directive 2006/112/EC - The Common System of Value Added Tax. 2006/112/EC. European Union, LEJEUNE, I. 2011. The EU VAT Experience: What Are the Lessons? *Tax Analysts*, P.257-282.

⁵⁷ DE LA FERIA, R. & KREVER, R. 2013. VAT Exemptions: Consequences and Design Alts. *EUCOTAX Series on European Taxation*, Volume 37.

⁵⁸ WISE, K. & BERGER, N. 2010. Understanding our Tax System: A Primer for Active Citizens. DE LA FERIA, R. & KREVER, R. 2013. VAT Exemptions: Consequences and Design Alts. *EUCOTAX Series on European Taxation*, Volume 37.

⁵⁹ WISE, K. & BERGER, N. 2010. Understanding our Tax System: A Primer for Active Citizens. P.7.

⁶⁰ CHARLET, A. & OWENS, J. 2010. An International Perspective on VAT. *Tax Notes International*, Volume 59, P.943-954, DE LA FERIA, R. & KREVER, R. 2013. VAT Exemptions: Consequences and Design Alts. *EUCOTAX Series on European Taxation*, Volume 37, INSTITUTE OF FISCAL STUDIES & MIRRLEES, J. 2011. Tax by Design.

⁶¹ JAMES, S. & ALLEY, C. 2008. Successful tax reform: the experience of value added tax in the United Kingdom and goods and services tax in New Zealand.

redistribution⁶². The case for using the VAT system to redistribute is that the developing country's social protection schemes are less well-developed and less effective⁶³. Crawford, Keen and Smith described the case for using preferential rates of VAT to address vertical equity as weak however concluding that, from a UK perspective:

“ending all current zero and reduced rates....while increasing all means-tested benefit and tax credit rates by 15% would leave the poorest 30% of the population better off, on average, and raise £11 billion that could be used to help them further or for some other purpose”⁶⁴

It cannot be ignored however, irrespective of any purist tax policy views, that the granting, or removal, of social exemptions will only proceed on a case-by-case basis, with significant attention being paid by policy makers and governments to the political saleability of any such measure⁶⁵.

2. As a mechanism to influence, or assist with, the consumption of a particular good or service

A number of VAT exemptions are mandated by EU VAT law to influence the public's consumption of certain goods and services which are considered to be in the public interest⁶⁶. In such cases, the exemption is intended to reduce the cost of these supplies to the final consumer, thus making them more likely to be consumed.

Whilst this type of exemption is numerous in traditional VAT systems, it has been argued that the rationale for this exemption is flawed due to the pressure to increase efficiency in the provision of public services which has resulted in an increase in subcontracting and outsourcing, and competition for the provision of public interest services by both public and private bodies⁶⁷. This view is shared by Gendron, who notes:

“there are no convincing conceptual or practical arguments to remove the activities of the non-profit and public sectors from the VAT base. Arguments concerning income distribution, social objectives, or the difficulty of taxing the sectors don't survive scrutiny when it comes to VAT. From the perspectives of efficiency, equity, and simplicity, the argument for full taxation is strong.”⁶⁸

An alternate view on the merits of VAT exemptions for public interest supplies, specifically where provided by a non-governmental organisation, is provided by Herouy who advocates for a VAT exemption or, at least, a favourable and beneficial VAT treatment⁶⁹.

Social exemptions are found regularly in traditional VAT systems, but due to the imperfections detailed above, rarely in modern VAT systems⁷⁰.

⁶² MACKENZIE, G. A. & INTERNATIONAL MONETARY FUND 1991. Estimating the Base of the Value-Added Tax (VAT) in Developing Countries: The Problem of Exemptions.

⁶³ INSTITUTE FOR FISCAL STUDIES, ABRAMOSKY, L., PHILLIPS, D. & WARWICK, R. 2017. Redistribution, efficiency and the design of VAT: a review of the theory and literature.

⁶⁴ INSTITUTE FOR FISCAL STUDIES 2010. *Dimensions of Tax Design: The Mirrlees Review*, OUP Oxford. P.277.

⁶⁵ BIRD, R. M. & GENDRON, P.-P. 2006. Is VAT the Best Way to Impose a General Consumption Tax in Developing Countries?

⁶⁶ Article 132 of 2006d. Council Directive 2006/112/EC - The Common System of Value Added Tax. 2006/112/EC. European Union.

⁶⁷ DE LA FERIA, R. & KREVER, R. 2013. VAT Exemptions: Consequences and Design Alts. *EUCOTAX Series on European Taxation*, Volume 37.

⁶⁸ GENDRON, P.-P. 2011. VAT Treatment of Nonprofits and Public-Sector Entities. *Tax Analysts*, P.239-247. P.240.

⁶⁹ HEROUY, B. 2004. The VAT Regime Under Ethiopian Law with Special Emphasis on Tax Exemption: The Ethiopian and International Experience. P.46-47.

⁷⁰ DE LA FERIA, R. & KREVER, R. 2013. VAT Exemptions: Consequences and Design Alts. *EUCOTAX Series on European Taxation*, Volume 37.

A technical exemption is provided where establishing the value of a supply, to which VAT would be applied, is considered to be too complex⁷¹. A technical exemption cannot, therefore, be derived from political or social policy, but rather exists to facilitate a simplification of taxpayer compliance with VAT law. This reasoning was confirmed in the proposal for the original EU VAT Directive⁷².

The provision of financial services are, generally, exempted from VAT on a technical basis due to the practical difficulties that exist in determining the value added, and therefore taxable, component of these services⁷³. In expanding on this point, Tait argued that *"little seems to be lost and much gained in terms of simplicity if the sector is exempted from VAT"*⁷⁴. de la Feria and Krever conclude, however, that *"the logic for retaining all exemptions supposedly needed for technical reasons is no longer convincing"*⁷⁵.

The removal (or, indeed, addition) of VAT exemptions from EU law is a difficult process – primarily as it requires the unanimous consent of all Member States⁷⁶. As noted above, changes to VAT exemptions require careful political consideration, and individual Member States will have their own political concerns and over-arching aims – obtaining consensus is, therefore, often challenging. Despite this, and the imperfections of VAT, Bettendorf and Clossen conclude that *"one must be careful not to let the desire for a level of perfection seldom obtainable in this world to blind one to the considerable merits of VAT as method of imposing a general consumption tax"*⁷⁷.

⁷¹ DE LA FERIA, R. & WALPOLE, M. 2009. Options for Taxing Financial Supplies in Value Added Tax: EU VAT and Australian GST Models Compared. *International and Comparative Law Quarterly*, 58, P.897-932, DE LA FERIA, R. & KREVER, R. 2013. VAT Exemptions: Consequences and Design Alts. *EUCOTAX Series on European Taxation*, Volume 37.

⁷² EUROPEAN COMMISSION 1973. Proposal for a sixth Council Directive on the harmonization of Member States concerning turnover taxes, Common system of value added tax: Uniform basis of assessment. *In: 11/73*, B. O. T. E. C. S. (ed.). P.15.

⁷³ See, amongst many other contributors, PODDAR, S. & ENGLISH, M. 1997. Taxation of Financial Services Under a Value Added Tax: Applying the Cash Flow Approach. *National Tax Journal*, 50, P.89-112, DE LA FERIA, R. & WALPOLE, M. 2009. Options for Taxing Financial Supplies in Value Added Tax: EU VAT and Australian GST Models Compared. *International and Comparative Law Quarterly*, 58, P.897-932, KERRIGAN, A. 2010. The elusiveness of neutrality – why is it so difficult to apply VAT to financial services, HUIZINGA, H. 2002. A European VAT on financial services? *Economic Policy*, 17, P.497-534, MERRILL, P. R. 2011. VAT Treatment of the Financial Sector. *Tax Analysts*, P.163-185.

⁷⁴ TAIT, A. A. 1988. *Value Added Tax: International Practice and Problems*. P.99.

⁷⁵ DE LA FERIA, R. & KREVER, R. 2013. VAT Exemptions: Consequences and Design Alts. *EUCOTAX Series on European Taxation*, Volume 37. P.33.

⁷⁶ BETTENDORF, L. & CLOSSEN, S. 2014. The Long Arm of the European VAT, Exemplified by the Dutch Experience. *CESifo Working Paper No. 4730*. P.2.

⁷⁷ BIRD, R. M. & GENDRON, P.-P. 2006. Is VAT the Best Way to Impose a General Consumption Tax in Developing Countries? P.2.

CHAPTER 5: THE PROBLEMS WITH VALUE ADDED TAX (“VAT”) EXEMPTIONS FOR FINANCIAL SERVICES

The EC in their report ‘a retrospective evaluation of elements of the EU VAT system’ commented that:

*“The wholesale exemption (or equivalent) of financial services and of large swathes of public services and the public sector seem likely to be extremely damaging, though quantifying the harm done is difficult”.*⁷⁸

Despite the practical difficulties in taxing financial services, and the resulting exemptions provided for in almost all countries with a VAT⁷⁹, exemptions are widely considered to have a number of detrimental impacts both from a legal and economic perspective. These include⁸⁰:

- Interpretative issues with national and supranational legislation. This is particularly true for financial services exemptions within the EU VAT system, with a significant number of referrals by national courts to the CJEU being in respect of the interpretation of VAT exemptions⁸¹;
- Calculation of recoverable input tax and the apportionment of input tax on mixed use supplies. This is also particularly relevant to financial services businesses given the complex and high-volume transactional nature of their trade;
- Encouragement of aggressive tax planning. In agreeing with de la Feria and Walpole, Senyk highlights that *“VAT planning tools are especially beneficial to taxpayers incurring non-deductible VAT, for example, banks and other financial institutions”*⁸²;
- Cascading VAT charges, especially where businesses provide exempt supplies within the supply chain and not directly to the final consumer;
- Discouragement of outsourcing due to the irrecoverable VAT costs associated with doing so. As a matter of principle, tax should not be a factor in businesses deciding to adopt certain corporate structures and/or operating models – exempting supplies encourages the insourcing of business functions, which is clearly contrary to this principle⁸³;
- Loss of revenue to fiscal authorities. This view is supported by Buettner and Erbe, who conclude from their empirical analysis of the German market that repealing the financial services VAT

⁷⁸ EUROPEAN COMMISSION & INSTITUTE FOR FISCAL STUDIES 2011. A retrospective evaluation of elements of the EU VAT system. P.52-53.

⁷⁹ PODDAR, S. & ENGLISH, M. 1997. Taxation of Financial Services Under a Value Added Tax: Applying the Cash Flow Approach. *National Tax Journal*, 50, P.89-112, DE LA FERIA, R. & KREVER, R. 2013. VAT Exemptions: Consequences and Design Alts. *EUCOTAX Series on European Taxation*, Volume 37.

⁸⁰ DE LA FERIA, R. & WALPOLE, M. 2009. Options for Taxing Financial Supplies in Value Added Tax: EU VAT and Australian GST Models Compared. *International and Comparative Law Quarterly*, 58, P.897-932. BETTENDORF, L. & CNOSEN, S. 2014. The Long Arm of the European VAT, Exemplified by the Dutch Experience. *CESifo Working Paper No. 4730*.

⁸¹ See also: LEJEUNE, I. 2011. The EU VAT Experience: What Are the Lessons? *Tax Analysts*, P.257-282, DE LA FERIA, R. & LOCKWOOD, B. 2009. Opting for Opting In? An Evaluation of the Commission’s Proposals for Reforming VAT for Financial Services.

⁸² SENYK, M. 2011. VAT planning in cross-border service transactions: between fundamental freedoms and economic reality. P.5.

⁸³ This issue was also highlighted by PwC in a report to European Commission – see: PWC 2006. Study to Increase the Understanding of the Economic Effects of the VAT Exemption for Financial and Insurance Services.

exemption would result in a revenue increase of EUR 1.6 billion, or 1.2% of VAT revenues⁸⁴. Huizinga estimates removing VAT exemptions from the EU would generate increased VAT revenues of EUR twelve billion across the Community⁸⁵. Copenhagen Economics concluded that the VAT exemption in Sweden results in a loss of SEK 16 to 18 billion (EUR 1.5 to 1.7 billion) to the Swedish tax authority each year⁸⁶. Lockwood, however, provides an alternative view on whether VAT exemptions in the EU contribute to a loss of revenue to fiscal authorities, concluding that, in the specific case of financial services, the exemptions do not result in under taxation⁸⁷;

- Over-taxation of business and the under-taxation of final consumers⁸⁸. In revenue terms, it is theoretically ambiguous as to whether exemption yields more or less revenue than full taxation – it depends on whether the VAT foregone by not taxing business to consumer (“B2C”) supplies is more or less than the VAT collected on non-reclaimable inputs of the exempt supplier⁸⁹;
- The fostering of indirect fiscal competition among EU tax authorities⁹⁰.

The EC acknowledged a number of these issues in their update on the state of play of financial and insurance services in 2019, which stated that the VAT exemption for financial services had led to “*legal uncertainty, and high administrative and regulatory costs*”⁹¹. The EC also commented that “*such rules are interpreted and applied inconsistently by Member States and this has resulted in tax competition and distortion within the EU*”⁹².

PricewaterhouseCoopers (“PwC”), in their report ‘*How the EU VAT exemptions impact the Banking Sector*’, also highlight a number of the above issues, namely: the impact that exemptions have on legal certainty; the ability of banks to choose corporate structures that best fit their needs; and the challenges faced with the calculation of recoverable input tax and the apportionment of input tax on mixed use supplies⁹³. In this respect, PwC is in agreement with the views of de la FERIA and Walpole and Bettendorf and Cnossen.

Genser and Winker, whilst agreeing with the problems which arise from VAT exemptions presented above, also note an alternate reason for the application of the exemption specific to Germany – “*continuity in tax*

⁸⁴ BUETTNER, T. & ERBE, K. 2012. Revenue and Welfare Effects of the Financial Sector VAT Exemption. P.3.

⁸⁵ HUIZINGA, H. 2002. A European VAT on financial services? *Economic Policy*, 17, P.497-534. P.501.

⁸⁶ NÆSS-SCHMIDT, H. S., HEEBØLL, C., GIØDESEN LUND, C. & SØRENSEN, P. 2016. Effects of VAT-exemption for financial services in Sweden: Impact on Swedish banks and their customers compared to a full VAT system. P.4.

⁸⁷ LOCKWOOD, B. 2011. Estimates from National Accounts Data of the Revenue Effect of Imposing VAT on Currently Exempt Sales of Financial Services Companies in the EU.

⁸⁸ DE LA FERIA, R. & KREVER, R. 2013. VAT Exemptions: Consequences and Design Alts. *EUCOTAX Series on European Taxation*, Volume 37.

⁸⁹ EUROPEAN COMMISSION & INSTITUTE FOR FISCAL STUDIES 2011. A retrospective evaluation of elements of the EU VAT system.

⁹⁰ HUIZINGA, H. 2002. A European VAT on financial services? *Economic Policy*, 17, P.497-534.

⁹¹ EUROPEAN COMMISSION 2019. GFV No 087 - Update on the state of play of financial and insurance services and their VAT treatment. P.4.

⁹² Ibid.

⁹³ PWC 2011. How the EU VAT exemptions impact the Banking Sector. Similar comments were also included in a 2006 PwC report to the European Commission – see: PWC 2006. Study to Increase the Understanding of the Economic Effects of the VAT Exemption for Financial and Insurance Services.

*practices, since many of the exempted goods and services were already exempt under the old turnover tax*⁹⁴. This reason was also highlighted in the preparatory work for the original EU VAT Directive⁹⁵.

PwC, in a report to the EC, also noted an additional problem created by VAT exemptions – *“exempt suppliers of financial services resident in countries with relatively low standard rates of VAT enjoy a cost advantage vis-a-vis those resident in higher-VAT jurisdictions”*⁹⁶. PwC do, however, go on to comment that, specifically for financial services, local market presence is vital and, as a result, the impact of this issue is *“considered small to minimal”*. This issue is expected to exist across other sectors where supplies are VAT exempt and local market presence is not a vital – however, as the focus of this analysis is financial services, this issue is not explored further in this dissertation.

Gale also noted that having exemptions increases the political pressure to generate more exemptions⁹⁷. The impact of exemptions, therefore, becomes compounded over time.

⁹⁴ GENSER, B. & WINKER, P. 1997. Measuring the fiscal revenue loss of VAT exemption in commercial banking. P.3.

⁹⁵ EUROPEAN COMMISSION 1973. Proposal for a sixth Council Directive on the harmonization of Member States concerning turnover taxes, Common system of value added tax: Uniform basis of assessment. *In: 11/73*, B. O. T. E. C. S. (ed.).

⁹⁶ PWC 2006. Study to Increase the Understanding of the Economic Effects of the VAT Exemption for Financial and Insurance Services. P.12.

⁹⁷ GALE, W. 2020. Raising Revenue with a Progressive Value-Added Tax.

CHAPTER 6: ALTERNATIVES TO VALUE ADDED TAX (“VAT”) EXEMPTIONS FOR FINANCIAL SERVICES

In an attempt to address the problems with VAT exemptions, as described at chapter five, a number of alternatives to apply VAT to financial services have been offered, particularly in the last twenty five years. As will be seen later in this dissertation, I do not consider that any of these alternatives are, on their own, appropriate in the context of the management of a SIF and, as a consequence, what follows below is a discursive summary of the proposed alternatives.

6.1 CASH FLOW METHOD – PODDAR AND MORLEY (1997)⁹⁸

Under a cash flow VAT method, financial services receipts and payments would be treated as transactions which are subject to VAT, either at the standard rate for domestic supplies or at the zero rate for non-domestic supplies. Zero rating non-domestic supplies ensures that the destination based taxation principle is applied, as is considered best practice in a consumption tax system and recommended by the OECD⁹⁹.

A simple example which explains the operation of this cash flow method and assumes a VAT rate of 10% is reproduced below from Poddar and Morley’s original paper¹⁰⁰:

⁹⁸ PODDAR, S. & ENGLISH, M. 1997. Taxation of Financial Services Under a Value Added Tax: Applying the Cash Flow Approach. *National Tax Journal*, 50, P.89-112.

⁹⁹ OECD 2017. International VAT/GST Guidelines. P.15-16.

¹⁰⁰ PODDAR, S. & ENGLISH, M. 1997. Taxation of Financial Services Under a Value Added Tax: Applying the Cash Flow Approach. *National Tax Journal*, 50, P.89-112. P.94.

A: Consumer Depositor, Consumer Borrower			
	<u>Bank Inflows</u>	<u>Bank Outflows</u>	<u>Tax/ Credits</u>
<u>Period 1</u>			
Deposit	100		10
Loan		<u>-100</u>	<u>-10</u>
Subtotal	100	-100	0
<u>Period 2</u>			
Loan Repayment	100		10
Loan Interest	15		1.50
Deposit Withdrawal		-100	-10
Deposit Interest		<u>-7</u>	<u>-0.70</u>
Total	115	-107	0.80
Total Value of Banking Services	= 8		
VAT	= 0.80		
No further tax adjustment at the consumer level			

The merits of a cash flow VAT system for financial services are considered at 6.2 below.

6.2 CASH FLOW METHOD WITH TAX CALCULATION ACCOUNT (“TCA”) – Poddar and Morley (1997)¹⁰¹

One of the issues acknowledged by Poddar and Morley with the cash flow method described at 6.1 is the requirement for substantial VAT settlements or refunds at the beginning and end of financial services arrangements. To address this, the cash flow method was developed to include a VAT suspense account to which all financial services transactions are allocated and the net VAT amount settled at the end of the provision of the financial service. Using the same fact pattern as in 6.1 above, the following example of the TCA is, again, reproduced from Poddar and Morley’s original paper¹⁰²:

¹⁰¹ Ibid.

¹⁰² Ibid. P.100.

Illustration		
TCA for loans by a bank		
	Amount	TCA
Loan	(100)	(10)
TCA Indexing	—	(1.2)
Interest	15	1.5
Loan Repayment	100	10
Loan Closing Value	—	—
Net Tax Due	—	0.3

Illustration		
TCA for deposits with a bank		
	Amount	TCA
Deposit	100	10
TCA Indexing	—	1.2
Interest	(7)	(0.7)
Withdrawal	(100)	(10)
Deposit		
Closing Value	—	—
Net Tax Due	—	0.5

It can be seen from both the basic cash flow and the cash flow with TCA methods that the same amount of tax is collected on the same series of transactions. The TCA, however, provides an administratively simpler mechanism to subject the financial services to VAT, as well as removes the significant cash-flow impact that exists with the basic model.

Meakin noted that Poddar and Morley’s approach could be simplified by only applying the cash flow method to retail transitions and thus removing business to business (“B2B”) supplies from VAT. In Meakin’s view, this would retain the tax neutrality of a cash flow VAT system, whilst ensuring that intermediary stages of the supply chain remain untaxed¹⁰³.

¹⁰³ MEAKIN, R. & INSTITUTE OF ECONOMIC AFFAIRS 2016. Taxation, Government Spending & Economic Growth. P.193.

Any cash-flow method would, however, be inherently complex to implement and administer with López-Laborda and Peña describing it as “*unviable in practice*”¹⁰⁴. de la Feria and Lockwood also highlighted the operational challenges of calculating the total margin and, at a conceptual level, that the cash flow method represented a clear departure from the general principle of VAT being calculated on a transaction-by-transaction basis¹⁰⁵.

6.3 ZERO RATING OF BUSINESS TO BUSINESS (“B2B”) FINANCIAL SERVICES – NEW ZEALAND’S GOODS AND SERVICES TAX (“GST”) SYSTEM

On 1st January 2005, New Zealand introduced the zero rating of financial services provided B2B, principally to tackle the issue of cascading VAT charges on services not provided directly to the final consumer. The application of zero rating is contingent on taxpayers obtaining evidence that their customer is registered for GST. B2C financial service supplies continue to enjoy exemption in New Zealand¹⁰⁶.

A zero rated supply, as with VAT exemption, is not subject to VAT. However, unlike exemption, the provider of a zero rated supply is entitled to recover all of the input tax which they incur in making the zero rated supply. The differences between exemption and zero rating are covered in more detail at chapter eleven.

Whilst the zero rating of B2B supplies does resolve the issue of cascading VAT charges, it does not address a number of the other issues with the taxation of financial services – e.g., the calculation of recoverable input tax and the apportionment of input tax on mixed supplies¹⁰⁷. This measure would also, in my view, exacerbate the loss of revenue to a tax authority as a result of the reduced irrecoverable VAT borne by financial services providers at intermediary stages of the supply chain.

One apparent disadvantage of this solution is the administrative burden put on financial organisations to distinguish between businesses and end consumers. Whilst this is true, Huizinga notes that the OECD fight against tax evasion and the international struggle against terrorism have forced financial institutions to know much more about their clients and that, as a result, verifying a client's status should be “*fairly simple*”¹⁰⁸. Additionally, from a European VAT perspective, businesses also have to identify B2B and B2C supplies for the purpose of applying the EU place of supply rules¹⁰⁹, so the requirement to identify the tax status of a client exists currently.

Ernst & Young (“EY”), in a report prepared for the European Banking Federation, concluded in its assessment of alternative approaches to VAT exemptions that “*the approach that appears to have been*

¹⁰⁴ LÓPEZ-LABORDA, J. & PEÑA, G. 2016. A new approach to financial VAT. P.4.

¹⁰⁵ DE LA FERIA, R. & LOCKWOOD, B. 2009. Opting for Opting In? An Evaluation of the Commission’s Proposals for Reforming VAT for Financial Services.

¹⁰⁶ INTERNATIONAL VAT MONITOR & PALLOT, M. 2011. Financial Services under New Zealand’s GST. *International VAT Monitor*, September/October 2011, p.310-315. See also MERRILL, P. R. 2011. VAT Treatment of the Financial Sector. *Tax Analysts*, P.163-185.

¹⁰⁷ MERRILL, P. R. 2011. VAT Treatment of the Financial Sector. *Tax Analysts*, P.163-185.

¹⁰⁸ HUIZINGA, H. 2002. A European VAT on financial services? *Economic Policy*, 17, P.497-534. P.525.

¹⁰⁹ See, in particular, Articles 44 and 45 of 2006d. Council Directive 2006/112/EC - The Common System of Value Added Tax. 2006/112/EC. European Union.

*most satisfactory and given rise to the least amount of concerns is one under which the exemption is limited to margin services, and B2B financial services are zero-rated*¹¹⁰.

This approach was also proposed by an EC consultation paper in 2006 as one of four potential solutions for the amendment of the VAT Directive provisions on insurance and financial services¹¹¹, but only supported by 43% of the respondents as a favourable solution¹¹².

The zero rating of B2B supplies of financial services appears to solve some of the inherent problems with VAT exemptions – namely the cascading VAT issue and the over taxation of financial services businesses, particularly for those businesses that do not provide their services to end consumers. The zero rating of B2B financial services, as part of a wider analysis of the EU VAT treatment of SIFs, is considered in more detail later in this dissertation.

6.4 INPUT TAXING FINANCIAL SERVICES – AUSTRALIA’S GOODS AND SERVICES TAX (“GST”) SYSTEM

Under Australian GST law, financial services are described as ‘input taxed’, which means that “no GST is payable on the supply ...[and] there is no entitlement to an input tax credit for anything acquired or imported to make the supply”¹¹³. This definition can, *prima facie*¹¹⁴, be considered a VAT exemption as defined by any other consumption tax system, albeit the Australian definition more accurately describes the VAT treatment applied to a supply which is exempt of VAT (i.e., that the tax is collected via input tax restriction of the supplier, rather than through a tax levied on the consumer).

Despite this, however, Australian GST law does allow, for certain financial supplies, a reduced input tax credit (“RITC”) of 75% of the total input tax incurred in making the supply. Whilst this alternative method addresses issues with insourcing bias and cascading tax costs which, according to Merrill, was the intent of its application in Australia¹¹⁵, it cannot be considered a perfect solution to taxing financial services in the EU for the following reasons¹¹⁶:

- It would most likely result in complexities with the characterisation of financial services and apportionment of VAT;
- There would almost inevitably be issues with distortion of competition and fiscal neutrality¹¹⁷;
- It would be extremely difficult to arrive at a common recovery percentage due to the wide range of VAT rates, VAT regimes and VAT recovery profiles amongst EU Member States.

¹¹⁰ ERNST & YOUNG 2009. Design and Impact of the 'Option to Tax' System for Application of VAT to Financial Services (report prepared for the European Banking Authority). P.30.

¹¹¹ DE LA FERIA, R. & WALPOLE, M. 2009. Options for Taxing Financial Supplies in Value Added Tax: EU VAT and Australian GST Models Compared. *International and Comparative Law Quarterly*, 58, P.897-932. P.914.

¹¹² EUROPEAN COMMISSION 2006. Public Consultation of Financial and Insurance Services. P.12.

¹¹³ 1999b. A New Tax System (Goods and Services Tax) Act 1999. Australia: <https://www.legislation.gov.au>. Section 9-30(2). P.23.

¹¹⁴ Based on the first impression; accepted as correct until proved otherwise.

¹¹⁵ MERRILL, P. R. 2011. VAT Treatment of the Financial Sector. *Tax Analysts*, P.163-185.

¹¹⁶ DE LA FERIA, R. & WALPOLE, M. 2009. Options for Taxing Financial Supplies in Value Added Tax: EU VAT and Australian GST Models Compared. *International and Comparative Law Quarterly*, 58, P.897-932.

¹¹⁷ See also EUROPEAN COMMISSION 2006. Public Consultation of Financial and Insurance Services.

As with zero rating B2B financial services transactions (see 6.3 above), a RITC was also proposed by the EC consultation paper in 2006 as a possible amendment of the VAT Directive provisions on insurance and financial services¹¹⁸. This was only considered to be a favourable solution by 35% of respondents, with most being “of the opinion that this approach would bring more disadvantages than advantages”¹¹⁹.

6.5 FINANCIAL ACTIVITIES TAX (“FAT”) – KEEN, KRELOVE AND NORREGAARD (2010)¹²⁰

The Financial Activities Tax (“FAT”) was first proposed as a replacement for VAT on financial services in a paper by Keen, Krelove and Norregaard which was included as part of a wider report for the International Monetary Fund (“IMF”) in 2010¹²¹. FAT was proposed as a solution for margin based transactions only – fee based financial services would continue to be subject to VAT under the current system. An implemented FAT would replace VAT on financial services with a tax levied on profit plus wages. Mirrlees¹²² notes that whilst a FAT may be preferable to taxpayers and fiscal authorities due to its similarity to direct tax calculations, there are two unusual features that would exist in developing a functioning FAT in conjunction with the existing VAT system:

1. Any service which would be subject to VAT by the financial services provider would need to be removed from the FAT calculation to avoid double taxation;
2. B2B services would require to be either removed from the FAT calculation or the system would need to allow the counterparty to receive a FAT refund, to ensure that the tax burden rests with the final consumer – a fundamental principle of a consumption tax system.

It could reasonably be expected that both of the above points would be administratively complex to manage, both for taxpayers and taxing authorities, and would also give rise to service characterisation issues.

Despite the FAT receiving significant attention from the UK government and the EC, the IMF concluded that “it should be stressed that it is better to fix the VAT treatment of financial services than to use a FAT as fix”¹²³. Mirrlees agreed with this conclusion, stating “in principle, taxes on profits and wages could replace the entire current VAT structure. But there is no reason for such an upheaval: for the most part, VAT works passably well as it is”¹²⁴. One reason provided for the conclusions of both Mirrlees and the IMF was the successful application of VAT to a much larger population of financial services, including margin based products, by modern VAT systems and, in doing so, removing the need for a technical exemption.

¹¹⁸ DE LA FERIA, R. & WALPOLE, M. 2009. Options for Taxing Financial Supplies in Value Added Tax: EU VAT and Australian GST Models Compared. *International and Comparative Law Quarterly*, 58, P.897-932. P.914.

¹¹⁹ EUROPEAN COMMISSION 2006. Public Consultation of Financial and Insurance Services. P.13.

¹²⁰ INTERNATIONAL MONETARY FUND, CLAESSENS, S., KEEN, M. & PAZARBASIOGLU, C. 2010. Financial Sector Taxation: The IMF's Report to the G-20 and Background Material.

¹²¹ Ibid., INSTITUTE OF FISCAL STUDIES & MIRRLEES, J. 2011. Tax by Design.

¹²² INSTITUTE OF FISCAL STUDIES & MIRRLEES, J. 2011. Tax by Design.

¹²³ INTERNATIONAL MONETARY FUND, CLAESSENS, S., KEEN, M. & PAZARBASIOGLU, C. 2010. Financial Sector Taxation: The IMF's Report to the G-20 and Background Material. P.138.

¹²⁴ INSTITUTE OF FISCAL STUDIES & MIRRLEES, J. 2011. Tax by Design. P.211.

6.6 SUBTRACTION METHOD – KERRIGAN (2010)¹²⁵

Under a subtraction VAT method, the taxable value of a financial organisation's activities would be determined by subtracting total financial expenses from total financial revenues. Financial expenses and revenues are defined for this purpose as fees, commissions and margin income.

If implemented, this method would require a standardised approach to the calculation of a margin, although according to Kerrigan this could be achieved by utilising the numbers declared in a business' financial statements.

The primary benefit of this method is its simplicity, however, there are a number of disadvantages acknowledged by Kerrigan:

- It does not allow the tax base to be calculated on a transaction-by-transaction basis – as a consequence, the recipient of the financial service would have difficulties identifying how much VAT has been charged to them;
- There would be no precise way of identifying the value of exported services, which should be subject to VAT at the zero rate, and thus departing from the destination based principle adopted by both the EU and OECD;
- Should a financial services business have other exempt supplies, challenges would remain with the apportionment of input tax.

6.7 MODIFIED REVERSE CHARGE – ZEE, IMF (2005)¹²⁶

In 2005, Zee proposed a modified reverse charge solution to taxing financial intermediation services. The basis of the proposal was to:

- Treat loans as taxable outputs by the financial intermediary – subject to VAT for domestic customers and zero rated for non-domestic customers;
- Treat deposits as taxable inputs subject to the reverse charge mechanism for the financial intermediary;
- Include all loans and deposits in a franking account, which would track the output tax and reverse charge input tax, to arrive at a net VAT amount due on a specific loan by the financial intermediary.

The operation of the franking account, and calculation of net VAT due is explained by Zee in the below table¹²⁷:

¹²⁵ KERRIGAN, A. 2010. The elusiveness of neutrality – why is it so difficult to apply VAT to financial services?

¹²⁶ ZEE, H. H. & INTERNATIONAL MONETARY FUND 2004. A New Approach to Taxing Financial Intermediation Services Under a Value-Added Tax.

¹²⁷ Ibid. P.14.

Deposit and loan sequence	Deposits			Franking account			Loans				
	Principal	Interest rate (Percent)	Reverse charge 1/	Cumulated unlent deposits	Cumulated unclaimed reverse charges	Unclaimed reverse charge per unit of unlent deposit	Principal	Interest rate (Percent)	Notional VAT 1/	VAT credit from franking account	Net VAT paid by borrowers
1	1,000	4	4								
				1,000	4	0.004					
2	3,000	5	15								
				4,000	19	0.00475					
3							2,000	9	18	9.5	8.5
				2,000	9.5	0.00475					
4	2,000	3	6								
				4,000	15.5	0.003875					
5							1,000	7	7	3.875	3.125
				3,000	11.625	0.003875					
6							3,000	8	24	11.625	12.375
Total	6,000		25	--	--	--	6,000		49	25	24

1/ The VAT rate is assumed to be 10 percent.

This model would allow VAT to be calculated on a transaction-by-transaction basis and, therefore, ensure full compatibility with a traditional invoice-credit VAT system.

There are however some disadvantages to this model. Kerrigan noted that, in practice, this method would be incredibly complex given the substantial number of financial assets that would underlie the range of intermediation services provided by a financial institution. Kerrigan also highlighted that it is not clear how this model would work where intermediation is supplied in addition to other, non-financial services¹²⁸ – this point is particularly relevant in today’s economy, given the emergence of the FinTech market.

6.8 OPTING TO TAX FINANCIAL SERVICES – THE EUROPEAN UNION (“EU”) VALUE ADDED TAX (“VAT”) DIRECTIVE, ARTICLE 137(1)(A)¹²⁹

Opting to tax supplies of financial services which would otherwise be exempt of VAT has been available since the inception of the EU VAT system¹³⁰. Article 137(1)(a) of the EU VAT Directive states “*Member States may allow taxable persons a right of option for taxation in respect of...the financial transactions referred to in points (b) to (g) of Article 135(1)*”.

Effecting an option to tax is, as the name suggests, optional and its application, based on the current legislation, can at best be considered a partial solution which only reflects the uncertainties of the EU about the long term suitability of VAT exemptions¹³¹.

¹²⁸ KERRIGAN, A. 2010. The elusiveness of neutrality – why is it so difficult to apply VAT to financial services?

¹²⁹ Article 137(1)(a) of 2006d. Council Directive 2006/112/EC - The Common System of Value Added Tax. 2006/112/EC. European Union.

¹³⁰ See Article 13(C)(b) 1977. Council Directive 77/388/EEC - SIXTH COUNCIL DIRECTIVE of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes — Common system of value added tax: uniform basis of assessment. 77/388/EEC. European Union.

¹³¹ KERRIGAN, A. 2010. The elusiveness of neutrality – why is it so difficult to apply VAT to financial services?

Due to the optionality of this provision and the vagueness of the implementing guidelines, the scope of application and the method of exercising the option varies considerably amongst Member States¹³². An empirical review of Member States' application of the option to tax highlighted the *"widespread divergence as to both its coverage and manner of application"*¹³³ and that the legislation, in its current form, was *"obviously incompatible with the requirements of the single market in as much as it may cause competitive distortions and loss of neutrality"*¹³⁴. This distortion arises due to Member States being able to choose whether or not the option is available to domestic taxpayers and is exacerbated by the EU VAT rules on input tax deduction for transactions with non-EU counterparts¹³⁵. Furthermore, the option to tax does not eliminate all of the difficulties connected with exemptions: interpretative problems will still exist; depending on the scope of the option, planning and avoidance would remain possible; and high compliance and administrative costs would still be expected¹³⁶. As a result of this, the EC has previously set out its view for how the option should be designed in an optimal manner – according to de la Feria and Lockwood the option *"should apply to both B2B and B2C transactions; be available on a transaction-by-transaction basis; and without being subject to time-limits. Were Member States to follow this design, this would eliminate the potential for national disparities, but of course they are not obliged to do so. In fact, presumably the Commission's vision of how the option to tax should look like is not included in the proposal precisely to give Member States the flexibility to decide on their own design"*.¹³⁷

The option to tax and its relevance and application to the management of SIFs will be considered in greater detail later in this dissertation.

6.9 TAXING EXPLICIT FINANCIAL SERVICES FEES – THE APPROACH OF 'MODERN' VALUE ADDED TAX ("VAT") SYSTEMS

From 1996, five years after the implementation of VAT, South Africa mandated the inclusion of all domestically rendered fee based financial services in the VAT base¹³⁸. In 2018, the United Arab Emirates ("UAE") followed a similar approach on the implementation of its VAT system¹³⁹. Margin based fees in both countries continued to qualify as VAT exempt.

Taxing explicit fees reduces the amount of irrecoverable VAT incurred by financial services providers and promotes economic efficiency by reducing the over taxation of B2B supplies and the under taxation of B2C supplies. It does not however solve for this issue entirely, due to the remaining exemption for margin based

¹³² DE LA FERIA, R. & LOCKWOOD, B. 2009. Opting for Opting In? An Evaluation of the Commission's Proposals for Reforming VAT for Financial Services.

¹³³ ERNST & YOUNG 2009. Design and Impact of the 'Option to Tax' System for Application of VAT to Financial Services (report prepared for the European Banking Authority). P.77.

¹³⁴ Ibid. P.77.

¹³⁵ KERRIGAN, A. 2010. The elusiveness of neutrality – why is it so difficult to apply VAT to financial services, DE LA FERIA, R. & LOCKWOOD, B. 2009. Opting for Opting In? An Evaluation of the Commission's Proposals for Reforming VAT for Financial Services.

¹³⁶ DE LA FERIA, R. & LOCKWOOD, B. 2009. Opting for Opting In? An Evaluation of the Commission's Proposals for Reforming VAT for Financial Services.

¹³⁷ Ibid. P.16.

¹³⁸ MERRILL, P. R. 2011. VAT Treatment of the Financial Sector. *Tax Analysts*, P.163-185.

¹³⁹ FEDERAL TAX AUTHORITY OF THE UNITED ARAB EMIRATES 2017. FTA: VAT treatment of selected industries. In: AUTHORITY, F. T. (ed.).

products, nor does it eliminate the need to allocate input tax on mixed use supplies where businesses provided a range of financial services¹⁴⁰.

In terms of overall tax collection, if there is flexibility regarding the choice of pricing, financial organisations will have an incentive to charge explicit fees only for B2B supplies. It might, therefore, be expected that taxation of explicit financial intermediation fees would raise less revenue than the EU VAT exemption, unless pricing decisions are not impacted by tax considerations¹⁴¹.

6.10 THE MOBILE-RATIO METHOD – LÓPEZ-LABORDA & PEÑA (2018)¹⁴²

This method calculates the taxable financial margin using a so-called “mobile-ratio” approach, whilst also ensuring full taxation of explicit fees and commissions and no input tax restriction for a financial organisation.

An identical ratio is applied to each margin transaction, calculated as the fraction between the financial margin generated and the total value of interests (note the plurality here – both interest paid and interest received are included in the calculation denominator). The VAT liability of an entity is obtained by adding the VAT due on the financial margin, plus the VAT collected on explicit fees and commissions, less input tax incurred. A simple example of the operation of this method is reproduced from López-Laborda & Peña’s original paper¹⁴³:

	Transaction	Deposit- Loan	Life Insurance	Derivative (Future)	Foreign Currency Transaction
	Capital inflows	10,000			
	Capital outflows	10,000			
1	Interest receipts	200	200	20+180	200
2	Interest payments	100	100	10+90	100
3=1+2	Total of interests	300	300	300	300
4	Mobile-Ratio	0.3333	0.3333	0.3333	0.3333
5=3*4	Taxable interest	100	100	100	100
6	VAT rate	0.21	0.21	0.21	0.21
7=5*6	VAT paid	21	21	21	21

According to López-Laborda & Peña, this method completely eliminates over taxation of businesses, under taxation of end consumers, tax cascading issues and avoids any preference, as a result of tax, towards insourcing. As the calculation would be carried out on a transaction-by-transaction basis, it would also be fully compatible with a traditional invoice-credit VAT system.

¹⁴⁰ MERRILL, P. R. 2011. VAT Treatment of the Financial Sector. *Tax Analysts*, P.163-185.

¹⁴¹ Ibid.

¹⁴² LÓPEZ-LABORDA, J. & PEÑA, G. 2018. A NEW METHOD FOR APPLYING VAT TO FINANCIAL SERVICES. *National Tax Journal*, 71, P.155-182.

¹⁴³ Ibid. P.169.

The transaction-by-transaction calculation cannot, however, be considered to be entirely accurate as it does not explicitly take into account pure interest and does not, therefore, exactly allocate the value added between deposits and loans. López-Laborda & Peña conclude however that this method “*results in an acceptable approximation to the correct VAT*”¹⁴⁴ which could be “*applied practically*”¹⁴⁵.

One disadvantage of this estimated VAT calculation is that, for clients of the financial organisation who make onwards exempt supplies (e.g., a healthcare provider), there will be, by virtue of the non-exact calculation basis and the client not being able to recover any VAT charged, either over or under taxation. In addition, it would also appear that Kerrigan’s comments on Zee’s modified reverse charge method equally apply to the mobile-ratio method – in practice, this method would be incredibly complex given the substantial number of financial assets that would underlie the range of intermediation services provided by a financial institution.

¹⁴⁴ Ibid. P.169.

¹⁴⁵ Ibid. P.155.

CHAPTER 7: THE ECONOMIC IMPACT OF VALUE ADDED TAX (“VAT”) EXEMPTIONS AND RATE CHANGES ON BUSINESSES AND CONSUMERS

7.1 THE ECONOMIC IMPACT OF VALUE ADDED TAX (“VAT”) EXEMPTIONS

VAT exemption is not always favourable to a positive VAT rate, with possible adverse impacts on both B2B supplies as well as those to final consumers. The reasoning for this was explained in the EC’s report ‘a retrospective evaluation of elements of the EU VAT system’:

“Although exempt goods and services bear less than the full rate of VAT, exemption is very different from a reduced rate of VAT. For one thing, exemption is not always more generous than taxation. Where exempt goods and services are sold directly to final consumers, this lower effective rate of VAT is payable instead of the standard VAT rate on those sales. But where exempt products are sold to other VAT-registered businesses, the irrecoverable input VAT comes on top of the VAT that will be charged on sales to final consumers by businesses further down the supply chain, so that the final product bears, in effect, a tax burden that is more than the VAT rate applicable to the final sale.

Whether exemption is more or less generous than applying the standard rate thus depends on whether the exempt products are sold to final consumers—in which case the lack of output VAT outweighs the irrecoverable input VAT—or to other businesses—in which case any output VAT would have been recoverable anyway so the irrecoverable input VAT is a pure extra cost.”¹⁴⁶

Tait concurred with this, commenting that *“the VAT borne of the exempt trader’s inputs is built into his price”¹⁴⁷.*

The following analysis by PwC¹⁴⁸ shows the distortion in profit margin where suppliers have embedded VAT costs within their supply. It also highlights, in the context of providing VAT exempt services, the benefit of direct employment rather than outsourcing, which is discussed in more detail at section five of this study.

¹⁴⁶ EUROPEAN COMMISSION & INSTITUTE FOR FISCAL STUDIES 2011. A retrospective evaluation of elements of the EU VAT system. P.68.

¹⁴⁷ TAIT, A. A. & INTERNATIONAL MONETARY FUND 1988. Value Added Tax - International Practice and Problems. P.50.

¹⁴⁸ PWC 2006. Study to Increase the Understanding of the Economic Effects of the VAT Exemption for Financial and Insurance Services. P.11.

Table 2: The Impact of the VAT Exemption (Business to Business)

Input Costs	VAT Exempt		Non-Exempt	
	Supplier A	Supplier B	Supplier C	Supplier D
VAT Exempt	Yes	Yes	No	No
Total Cost of Inputs (VAT Exclusive)	€10,000	€10,000	€10,000	€10,000
Total Cost of Direct Employment	€1,000	€9,500	€1,000	€9,500
Total Cost of Vatable Inputs (VAT Exclusive)	€9,000	€500	€9,000	€500
Rate of VAT	21%	21%	21%	21%
VAT Component of Input Costs	€1,890	€105	€1,890	€50
Net Input Costs	€11,890	€10,105	€10,000	€10,000
Scenario 1 (Embedded VAT Absorbed in Service Price)	Supplier A	Supplier B	Supplier C	Supplier D
Total Revenues (VAT Exclusive)	€13,890	€12,105	€12,000	€12,000
Total Revenues (VAT Inclusive)	€13,890	€12,105	€14,520	€14,520
VAT Component of Revenues	€0	€0	€2,520	€2,520
Net Profit before Tax	€2,000	€2,000	€2,000	€2,000
Scenario 2 (Embedded VAT Absorbed in Profit Margin)	Supplier A	Supplier B	Supplier C	Supplier D
Total Revenues (VAT Exclusive)	€12,000	€12,000	€12,000	€12,000
Total Revenues (VAT Inclusive)	€12,000	€12,000	€14,520	€14,520
VAT Component of Revenues	€0	€0	€2,520	€2,520
Net Profit before Tax	€110	€1,895	€2,000	€2,000

PwC's study also concluded that it was difficult to "provide details of how irrecoverable VAT was distributed between service pricing and overhead allocation"¹⁴⁹.

Copenhagen Economics, in their report 'Effects of VAT-exemption for financial services in Sweden: Impact on Swedish banks and their customers compared to a full VAT system', concurred with the view that irrecoverable VAT incurred by providers of exempt financial services was expected to be passed on to consumers¹⁵⁰. The study drew a comparison to the impact of a Central Bank increasing the lending base rate which is passed onto borrowers and lenders by banks. Irrecoverable VAT becomes part of the exempt business' cost base and, as long as there is tax neutrality and similar service offerings also qualify as VAT exempt, the market pricing and consumer choice will include an embedded VAT cost. The study also concluded that the introduction of VAT on financial services in Sweden would increase the cost of financial services for private households by around 19%. This price increase would, as a consequence, reduced the demand for financial services by private households.

I have found no economic evidence to suggest irrecoverable VAT costs incurred by exempt traders are not incorporated to at least some extent in the price of the traders exempt good or service.

¹⁴⁹ Ibid. P.17.

¹⁵⁰ NÆSS-SCHMIDT, H. S., HEEBØLL, C., GIØDESEN LUND, C. & SØRENSEN, P. 2016. Effects of VAT-exemption for financial services in Sweden: Impact on Swedish banks and their customers compared to a full VAT system.

7.2 THE ECONOMIC IMPACT OF CHANGES TO THE VALUE ADDED TAX (“VAT”) RATE OR TREATMENT OF PARTICULAR SERVICES

The economic impact of introducing VAT on certain goods and services is very difficult to establish. Tait commented:

*“A VAT that simply increased revenue would be potentially deflationary, would reduce consumption, and probably would reduce the profitability of future investment. At the same time, such an increase in revenue could be used to reduce the fiscal deficit, reduce the public sector borrowing requirement, allow interest rates to fall, and thus stimulate investment”.*¹⁵¹

The EC concluded that VAT rate changes have the following impacts on price setting behaviours¹⁵²:

- From a theoretical point of view, the degree to which changes in VAT rates are passed through into consumer prices largely depends on the form of competition in the market and supply and demand behaviour;
- There seems to be evidence that, in line with the theory, more competitive markets more often feature full shifting of taxes, whereas less competitive markets feature both under and over shifting of taxes;
- The impact on prices of a tax reform in a single country may differ from the impact of an EU wide reform;
- Countries may be affected differently by EU wide taxation of a single good or service as a consequence of varying market structures. This may imply a more diverse burden on firms and households in certain Member States than for a broad based VAT as VAT overall seems to be subject to close to full pass-through.

Whilst the imposition of a tax will raise revenues for governments which can be used to improve the welfare of the public, there can also be a negative impact on economic welfare of tax increases. If a tax is levied on earned income, it either becomes less attractive to work and production goes down, or workers have to do more to achieve the same level of disposable income they had prior to the tax increase¹⁵³. If a tax is levied on a good or service it will, all else remaining constant, become less attractive to buy, reducing demand and, in turn, production of the good or service¹⁵⁴. On the contrary, decreasing the tax applied to a good or service will, in theory, increase consumption through either, or both, of the following¹⁵⁵:

¹⁵¹ TAIT, A. A. & INTERNATIONAL MONETARY FUND 1988. Value Added Tax - International Practice and Problems. P.222.

¹⁵² EUROPEAN COMMISSION & INSTITUTE FOR FISCAL STUDIES 2011. A retrospective evaluation of elements of the EU VAT system.

¹⁵³ WHALEN, A., FUSS, J. & FRASER INSTITUTE 2021. INCREASING PRODUCTIVITY THROUGH TAX REFORM, TAX FOUNDATION, BUNN, D., ENACHE, C. & BOESEN, U. 2021. Consumption Tax Policies in OECD Countries. *Tax Foundation Fiscal Fact*, 741, COPENHAGEN ECONOMICS 2007. Study on reduced VAT applied to goods and services in the Member States of the European Union.

¹⁵⁴ COPENHAGEN ECONOMICS 2007. Study on reduced VAT applied to goods and services in the Member States of the European Union.

¹⁵⁵ INSTITUTE FOR FISCAL STUDIES, BLUNDELL, R., LEVELL, P. & MILLER, H. 2020. A temporary VAT cut could help stimulate the economy, but only if timed correctly.

1. The ‘income effect’

A VAT cut which is passed on to consumers reduces costs and allows the saved costs to fund additional purchases which, in turn, stimulates spending and economic activity.

2. The ‘substitution effect’

Households have an incentive to bring forward purchases to take advantage of lower prices when the VAT cut is in effect, leading to a temporary boost in demand.

An efficient VAT system, however, is one which impacts on consumers buying decisions as little as possible. This view was proffered by Tait who commented *“the ideal VAT...does not distort consumer choice”*¹⁵⁶. It stands, therefore, that the impact of changing the rate of VAT applied to a certain good or service will be dependent on the price elasticity of that good or service. When the price elasticity is high, even small price increases as a result of tax imposition will reduce demand significantly and, therefore, impact consumers buying decisions. On the other hand, consumers buying decisions for price inelastic goods and services will be less impacted by VAT rates changes.

Given the difficulty of measuring with any accuracy the required price elasticities and associated VAT rates of individual goods and services, most academics and economists would propose a single uniform VAT rate. As explained at chapter five, a departure from a single rate of tax on consumption can have a distortive effect and gives rise to a number of challenges. Catarino and Moraes e Soares concluded, in their research on the impact of a single VAT rate model in the EU, that applying a single rate is feasible and would both increase tax revenues and simplify the VAT regime. However, they also noted that *“the obstacles to its implementation seem to be social and political in nature”*¹⁵⁷. Copenhagen Economics offer a different view on the use of multiple VAT rates, however – in their ‘Study on reduced VAT applied to goods and services in the Member States of the European Union’ they comment that *“there is little doubt that carefully designed reductions in VAT rates or equivalent direct support schemes for several reasons may improve member state and community welfare”*¹⁵⁸ and, whilst noting that other policy measures can achieve the desired outcome of a reduced VAT rate, that *“where you have strong economic arguments for extending reduced rates, there appear to be no significant problem for the functioning of the internal market”*¹⁵⁹. The economic arguments for removing investment management services provided to SIFs from the tax base are considered at section 7.3.

A single uniform VAT rate assumes that the price elasticities of all goods and services are the same, which is clearly a flawed assumption. To administer VAT rates based on price elasticity would require tax authorities to be able to estimate this for every product on the market on a regular and ongoing basis. Implementing a VAT system along these lines was described by Copenhagen Economics as “gargantuan”¹⁶⁰. The costs incurred by governments in doing so would likely outweigh any benefit derived. Copenhagen Economics also commented in their review:

“It is important from the outset to stress that there is little doubt that permanently lowering the VAT rate on a particular good (or service) sooner or later will lead to a reduction in the price of the good more or less

¹⁵⁶ TAIT, A. A. & INTERNATIONAL MONETARY FUND 1988. Value Added Tax - International Practice and Problems. P.220.

¹⁵⁷ CATARINO, J. R. & MORAES E SOARES, R. 2019. Restructuring the European VAT tax system: advantages and disadvantages of the adoption of a single-rate model - a study based on the Portuguese case. *European Journal of Government and Economics (EJGE)*, 8, P.145-160. P.157.

¹⁵⁸ COPENHAGEN ECONOMICS 2007. Study on reduced VAT applied to goods and services in the Member States of the European Union. P.20.

¹⁵⁹ Ibid. P.35.

¹⁶⁰ Ibid. P.8.

corresponding to the monetary equivalent of the lower VAT rate... There is also little doubt that as prices slide, consumers' demand for this particular good or service will sooner or later expand".¹⁶¹

They also commented that "we conclude that reducing – or increasing – VAT rates for a particular good or service has a notable impact for the sector concerned. VAT changes are likely to pass fully into consumer prices over time in the majority of industries".¹⁶²

The Copenhagen Economics study included eight case studies from six different sectors in individual Member States and considered the impact VAT rate changes had on pricing. The results of each case study, which were summarised in a separate EC study from 2011 – 'A retrospective evaluation of elements of the EU VAT system' – are shown in the table below¹⁶³:

Sector	Country	VAT change (percentage points)	Estimated pass-through
Books	Sweden	-19	82
Footwear	Italy	4	163
Periodicals	Italy	10	134
		-16	0*
Beverages	Portugal	-5	0*
		-7	0*
Restaurants	Portugal	-5	19
Hairdressers	Ireland	-8	46

* The estimated coefficients were zero or even had the wrong sign.

Source: Copenhagen Economics (2007).

Whilst there is a large variation in the pass through of the increased or decreased tax charge, there is some evidence to suggest an asymmetry in the price response to VAT rate changes in that tax increases are more heavily passed onto consumers than tax decreases. The conclusion that VAT rate reductions are not always fully passed onto consumers, albeit to varying degrees depending on, amongst other things, the competitiveness of a particular market, was also supported by this 2011 EC report¹⁶⁴ as well as an earlier report by the EC in 2003 – 'Experimental application of a reduced rate of VAT to certain labour-intensive services' – which concluded that "reduced rates of VAT are never fully reflected in consumer prices. Part of the VAT reduction is used to increase the margins of service providers"¹⁶⁵. Empirical research of VAT changes in the EU from 1996 to 2015 by Benzarti, Carloni, Harju and Kosonen also support this view, concluding that prices respond twice as much to VAT increases when compared to VAT decreases¹⁶⁶.

The IMF, in their paper 'Estimating VAT Pass Through', offered a different view on the impact of rate increases and decreases:

¹⁶¹ Ibid. P.9.

¹⁶² Ibid. P.37.

¹⁶³ EUROPEAN COMMISSION & INSTITUTE FOR FISCAL STUDIES 2011. A retrospective evaluation of elements of the EU VAT system. P.299.

¹⁶⁴ Ibid.

¹⁶⁵ EUROPEAN COMMISSION 2003. REPORT FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT - Experimental application of a reduced rate of VAT to certain labour-intensive services. P.4.

¹⁶⁶ BENZARTI, Y., CARLONI, D., HARJU, J. & KOSONEN, T. 2018. WHAT GOES UP MAY NOT COME DOWN: ASYMMETRIC INCIDENCE OF VALUE-ADDED TAXES. NBER WORKING PAPER SERIES. P.1-2.

*“Contrary, however, to a popular conception, and some previous evidence, there seems no systematic tendency for pass through to be greater for tax increases than for tax cuts”.*¹⁶⁷

They also concluded that the pass through of VAT rate changes was largely dependent on the nature of the VAT rate change, commenting:

*“changes in the standard rate, for instance, the assumption of 100 percent pass through—which has been standard practice, albeit with little empirical basis—appears a reasonable starting point. This is much less true, however, of changes in reduced rates, for which pass through is significantly less than one, perhaps around 30 percent; and for simple reclassifications pass through seems close to zero.”*¹⁶⁸

A separate study by the IMF, which analysed the effect on prices of Mexico’s VAT reforms in April 1995 and January 2014, showed that prices rose by 0.4% and 0.27% respectively for each 1% increase in the VAT rate following the reform¹⁶⁹. Research by the Japan Research Institute also concluded that a one point increase in the consumption tax rate in Japan would increase prices by 0.9% and decrease real consumer spending by 0.6%¹⁷⁰.

Tait also offered another reason for VAT changes being passed through to consumers:

*“VAT is expected to be passed forward fully both because the legislation usually clearly assumes that this will happen and because, as a general sales tax, there is likely to be a general awareness on the part of traders that all will be affected similarly... Moreover, the public is likely to be aware of a major tax change”*¹⁷¹.

In a report¹⁷² in 2014, the Financial Services Consumer Panel¹⁷³ concluded that, specifically for pension funds, the market was not one which works in the consumers best interests. In such a market, it would appear highly likely that any increase in the tax burden would be passed onto consumers and not borne by the businesses providing these services.

What seems clear from the theoretical research and empirical evidence is that the rate of VAT applied to a good or service impacts its price for consumers. It is also clear that an increase in the VAT rate applied to a good or service will increase the cost of that good or service for consumers, at least to some extent.

¹⁶⁷ INTERNATIONAL MONETARY FUND, BENEDEK, D., DE MOOIJ, R., KEEN, M. & WINGENDER, P. 2015. Estimating VAT Pass Through. P.30.

¹⁶⁸ Ibid. P.30.

¹⁶⁹ FUND, I. M., MARISCAL, R. & WERNER, A. 2018. The Price and Welfare Effects of The Value-Added Tax: Evidence from Mexico.

¹⁷⁰ JAPAN RESEARCH INSTITUTE 2006. The Impact of an Increase in the Consumption Tax Rate - The Implications of Past and Overseas Experiences.

¹⁷¹ TAIT, A. A. & INTERNATIONAL MONETARY FUND 1988. Value Added Tax - International Practice and Problems. P.192-193.

¹⁷² FINANCIAL SERVICES CONSUMER PANEL 2015. Investment costs - more than meets the eye.

¹⁷³ The Financial Services Consumer Panel is an independent statutory body, set up to represent the interests of consumers in the development of policy for the regulation of financial services. See <https://www.fs-cp.org.uk/consumer-panel/what-panel>.

7.3 THE CASE FOR NOT INCREASING THE COST FOR INVESTMENT AND SAVINGS

Firstly, it is important to recognise the impact that tax policy has on investment and saving decisions. Mirrlees commented:

*“for individuals, the taxation of savings affects their decisions on how much to save, when to save, and how much risk to take when allocating their savings between assets. It therefore directly affects their welfare and particularly their welfare in periods of retirement or unemployment, when they may need to rely on accumulated savings”.*¹⁷⁴

An Office for National Statistics (“ONS”) survey in 2009 found that 39% of household savings were within private pension funds and a similar amount was invested in property. This trend appears to be continuing, with the ONS reporting for 2018 to 2020 that 42% of household savings were within private pension funds and 36% was invested in property¹⁷⁵. The ONS also reported that there is a trend towards an increase in pensions savings, which now make up the largest component of total wealth, rather than property¹⁷⁶. The English Longitudinal Study of Ageing (“ELSA”) published a study analysing the interaction between wealth and health – with a clear correlation between the wealth of an individual and the health and quality of life they can expect¹⁷⁷. According to an Aviva report from September 2016, the pensions saving gap – that is how much more individuals need to save in order to achieve an adequate standard of living in retirement – was EUR 2 trillion per year¹⁷⁸ across Europe. In a social and welfare context, the importance of wealth and savings is therefore clear to see.

The imposition of VAT to investment management fees for pension funds, and indeed other investment products which pension funds will be investing in, which currently benefit from VAT exemption would only serve to exacerbate this already significant issue. This is supported by the theoretical research and empirical evidence set out at section 7.2 of this study.

In the European Insurance and Occupational Pensions Authority’s (“EIOPA”) report on ‘Costs and charges of IORPs’, it concluded that there was significant variation amongst Member States as to who incurs the cost, including irrecoverable VAT, of operating pension funds:

*“Several Member States...reported that they have no information on which party typically bears this cost, although others indicated that these are generally borne by the IORP itself or the member/beneficiary in the case of DC pension schemes and by the IORP itself or the sponsor, or by a combination of member/sponsor/IORP in the case of DB pension schemes”.*¹⁷⁹

Whether the additional VAT burden is borne by the sponsoring employer or the pension scheme members appears to be of little relevance to the overall economic argument here, however. Where the cost is explicitly borne by the pension scheme, clearly that reduces the overall value of the investment which, by extension, reduces the amounts receivable by members of the pension fund. On the other hand, where the

¹⁷⁴ INSTITUTE OF FISCAL STUDIES & MIRRLEES, J. 2011. Tax by Design. P.284.

¹⁷⁵ THIS IS MONEY.CO.UK 2022. Pensions now a bigger store of wealth than property official stats show, as younger people struggle to afford the homes of mortgage-free older owners.

¹⁷⁶ Ibid.

¹⁷⁷ ENGLISH LONGITUDINAL STUDY OF AGING (“ELSA”) 2020. Socioeconomic Inequalities in Disability-free Life Expectancy in Older People from England and the United States: A Cross-national Population-Based Study *The Journals of Gerontology*, 75.

¹⁷⁸ AVIVA 2016. Mind The Gap - Quantifying the pension savings gap in Europe. P.3.

¹⁷⁹ EUROPEAN INSURANCE AND OCCUPATIONAL PENSIONS AUTHORITY 2015. Costs and charges of IORPs. P.15.

cost is borne by the employer, this will reduce their profitability levels which will in turn impact on the overall employment benefit packages which are able to be offered to employees. In both scenarios it is difficult to see how the employee, past or present, does not suffer economically from any additional VAT burden.

In addition, increases in the tax cost of accessing collective investment funds would potentially push investors into other, more tax favourable asset categories – for example residential property which generally benefits from VAT exemption for policy reasons that are completely removed from investment and saving decisions¹⁸⁰. This would reduce the risk spreading capabilities available to investors and make savings more susceptible to specific markets and their associated risks. Indeed, one of the fundamental purposes of collective investment funds is to enable retail investors to access a spread of markets and assets to achieve the exact opposite of this.

One argument for taxing investment management is that the tax benefit arising from exemption will be delivered more so, in absolute terms, to wealthy individuals who are likely to invest more. The counter argument to this is two-fold.

Firstly, as discussed earlier, there is a clear imperative to enable households to save for retirement and applying to VAT to this investment activity would be regressive – that is any VAT cost would form a higher proportion of households with low income – which, in my view, is a clear justification for exemption or non-taxation. This would be similar to the argument put forward for zero rating children’s clothing, for example.

Secondly, as I will explain later in this dissertation, it must be noted that VAT exemption is only available for funds which are intended for retail investors. Whilst wealthy individuals will undoubtedly invest in collective investment products, the majority of these wealthy individuals will typically have a bi-lateral arrangement with an investment manager or private bank to be provided with discretionary investment management services directly and these services will, in most cases, be subject to VAT¹⁸¹. Given this, it does not appear logical to conclude that wealthy individuals will disproportionately benefit from VAT exemption for the management of SIFs, in the same way that they would for children’s clothing.

¹⁸⁰ The VAT exemption for residential property is a social exemption which is intended to reduce the cost of housing for the public.

¹⁸¹ See judgment of the CJEU in: 2012. C-44/11 - Finanzamt Frankfurt am Main V-Höchst v Deutsche Bank AG. Court of Justice of the European Union.

CHAPTER 8: MANAGEMENT OF A SPECIAL INVESTMENT FUND (“SIF”) – THE PURPOSE AND APPROPRIATENESS OF THE EXEMPTION

It is important to recognise at the outset that the VAT exemptions legislated for in the EU VAT Directive must be interpreted strictly, consistent to the purpose of which they were intended, and not in a way as to deprive the exemptions of their desired effect¹⁸². It is because of this that we must understand the purpose of the exemption provided in EU VAT law for the management of a SIF in order to properly analyse the appropriateness of it.

The purpose of the exemption for the management of a SIF was most recently cited by Judges E. Juhász and C. Vajda of the CJEU who opined the following in case C-595/13:

*“it should be observed that the purpose of the exemption of transactions connected with the management of special investment funds is, particularly, to facilitate investment in securities by means of investment undertakings by excluding the cost of VAT and, in that way, ensuring that the common system of VAT is neutral as regards the choice between direct investment in securities and investment through collective investment undertakings”.*¹⁸³

The intention of the legislature is, therefore, to create parity for investors irrespective of their chosen method of investment. The judges’ reference to facilitating *“investment in securities by means of investment undertakings by excluding the cost of VAT”* has its foundations in another EU VAT exemption, conferred by Article 135(1)(f) of the EU VAT Directive:

*“Member states shall exempt...transactions, including negotiation but not management or safekeeping, in shares, interests in companies or associations, debentures and other securities”*¹⁸⁴ (hereinafter, “the transaction in securities exemption”).

The purpose of the exemption for the management of a SIF was also discussed by The European Insurance and Reinsurance Federation, The European Banking Federation and The European Fund and Asset Management Association in a joint letter to the Polish Ministry of Finance titled *‘Comments of the European financial and insurance sector as regards the VAT treatment of financial and insurance services’* which, in addition to commenting that the exemption seeks to ensure neutrality between direct and collective investment and in this respect fully agreeing with Judges Juhász and Vajda in Case 595/13, also commented that the exemption serves to protect the competitiveness of the EU funds industry against similar non-EU funds¹⁸⁵. In this respect, the joint letter draws a comparison to the USA where no indirect taxes are levied on financial and insurance services¹⁸⁶. The impact that EU VAT has on competition between EU and non-EU funds is considered in more detail later in this dissertation.

¹⁸² VAN, H. 2018. The management of investment funds - under Article 135(1)(g) in VAT Directive.

¹⁸³ 2015. C-595/13 - Staatssecretaris van Financiën v Fiscale Eenheid X NV cs. Court of Justice of the European Union. Paragraph 34.

¹⁸⁴ Article 135(1)(f) of 2006d. Council Directive 2006/112/EC - The Common System of Value Added Tax. 2006/112/EC. European Union.

¹⁸⁵ EUROPEAN FUND AND ASSET MANAGEMENT ASSOCIATION, EUROPEAN INSURANCE AND REINSURANCE FEDERATION & EUROPEAN BANKING FEDERATION 2011. Comments of the European financial and insurance sector as regards the VAT treatment of financial and insurance services.

¹⁸⁶ The USA has no VAT system. Individual states impose single-stage retail sales taxes, however, these are not applied to financial and insurance services. For an alternate comment, with a similar conclusion, on the distortion of competition between EU and US financial services providers which arises due to EU VAT exemptions see: HUIZINGA, H. 2002. A European VAT on financial services? *Economic Policy*, 17, P.497-534.

To consider the appropriateness of the exemption for the management of a SIF we must, therefore, analyse two distinct matters:

1. The appropriateness of the exemption for transactions in securities, as legislated for by Article 135(1)(f) of the EU VAT Directive; and
2. The appropriateness of tax neutrality for investors investing directly in securities and those investing through a collective vehicle.

Each of these are discussed in turn below.

8.1 THE VALUE ADDED TAX (“VAT”) EXEMPTION FOR TRANSACTIONS IN SECURITIES

It is noteworthy that the activities of investment management and buying and selling securities are largely different from the other types of services which are discussed in the majority of academic literature covering VAT and financial services. The literature covers, for example, most services provided by banks and financial intermediaries, and it is these activities to which the alternative VAT methods, as discussed at section six, have been proposed as a mechanism to bring financial services within the scope of VAT.

In considering the appropriateness of the exemption, we must first consider whether or not transacting in a security, in itself, constitutes consumption for the purposes of VAT. The definition of consumption, insofar as it relates to VAT, is not entirely clear and is something which has been subject to numerous judgments by the CJEU over the years. As a result, the scoping and agreement of this definition is considered one of the main challenges of a VAT system design¹⁸⁷. This is particularly true in the context of transacting in shares¹⁸⁸.

The OECD describe VAT as “a broad-based tax on final consumption collected from, but in principle not borne by, businesses through a staged collection process”¹⁸⁹, and Article 1 of the EU VAT Directive states “the principle of the common system of VAT entails the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services”¹⁹⁰. It is clear from the OECD and EU definitions that VAT should only be applied where there is consumption of a good and/or a service. From an economic perspective, investment (and savings) should not be considered consumption because investment (and savings) serves to defer eventual consumption. Based on this economic definition, it stands, therefore, that an investment in a security should not be considered consumption for the purposes

¹⁸⁷ DE LA FERIA, R. & KREVER, R. 2013. VAT Exemptions: Consequences and Design Alts. *EUCOTAX Series on European Taxation*, Volume 37.

¹⁸⁸ DE LA FERIA, R. 2008. When do dealings in shares fall within the scope of VAT? *EC Tax Review*, 2008-1, P.24-40.

¹⁸⁹ OECD 2017. *International VAT/GST Guidelines*. P.4.

¹⁹⁰ Article 1 of 2006d. Council Directive 2006/112/EC - The Common System of Value Added Tax. *2006/112/EC*. European Union.

of VAT – a point which was developed in detail by Chia and Whalley¹⁹¹ and Grubert and Mackie¹⁹², the latter of whom commented:

“Many financial services used by consumers are not consumption...For example, investment services affect the price of buying an investment good, not the price of buying a consumption good. Clearly such services facilitate consumption by allowing the consumer to transfer resources over time, and so smooth his consumption stream. But they are not themselves consumption goods; they are a component of the price of the investment”.¹⁹³

This view is supported by Mirrlees¹⁹⁴ and Poddar and English¹⁹⁵ who, when discussing the application of a cash flow VAT method to financial services, note that the tax base for this method should exclude security based transactions. Poddar and English specifically reference the pooling of investments in their analysis:

*“Taxable persons would not include...pooled investment vehicles making portfolio investments on behalf of fund members. The rationale set out for the exclusion of portfolio investments by individuals applies to the investment activities of persons not engaged in any other commercial activity, and they thus should not be taxable persons for purposes of the cash-flow tax. The mutual fund exemption merely extends the personal level treatment to pooled investment vehicles.”*¹⁹⁶

This approach is also supported by de la Feria and Krever who, in concluding on the VAT treatment of investments, comment:

“In theory, a consumption tax should never be levied on investments; the tax is supposed to fall on consumption and not touch savings”.¹⁹⁷

Despite agreeing that investments should not be included in the taxable base, de la Feria and Krever argue that the VAT exemption for investment in securities is distortive and sits contrary to the very fundamentals of a consumption tax system. One possible solution to address this distortion would be to zero rate investments in securities, although this is not without its own design difficulties, principally in identifying the types of investment that should qualify and how the VAT system would deal with ancillary investment costs. This solution, and the associated difficulties, was also discussed by Grubert and Krever who agreed that investments should not be included within the consumption tax base:

“Under any legal or economic test, there is no consumption character to the acquisition of investment assets and in theory this type of supply should raise few conceptual issues from a VAT perspective”.¹⁹⁸

Gale commented, when discussing VAT exemptions in his proposal for a US VAT, that *“the case for excluding education is that it is an investment and so could plausibly be excluded from a VAT”*¹⁹⁹.

¹⁹¹CHIA, N.-C. & WHALLEY, J. 1999. The Tax Treatment of Financial Intermediation. *Journal of Money, Credit and Banking*, 31, P.714-719.

¹⁹² GRUBERT, H. & MACKIE, J. 2000. Must Financial Services be Taxed Under a Consumption Tax? *National Tax Journal*, 53, P.23-40.

¹⁹³ Ibid. P.24.

¹⁹⁴ INSTITUTE OF FISCAL STUDIES & MIRRLEES, J. 2011. Tax by Design.

¹⁹⁵ PODDAR, S. & ENGLISH, M. 1997. Taxation of Financial Services Under a Value Added Tax: Applying the Cash Flow Approach. *National Tax Journal*, 50, P.89-112.

¹⁹⁶ Ibid. P.108.

¹⁹⁷ DE LA FERIA, R. & KREVER, R. 2013. VAT Exemptions: Consequences and Design Alts. *EUCOTAX Series on European Taxation*, Volume 37. P.29.

¹⁹⁸ GRUBERT, H. & KREVER, R. 2012. VAT and Financial Services: Competing Perspectives on What Should Be Taxed. *Tax Law Review*, 65, P.199-240. P.207.

¹⁹⁹ GALE, W. 2020. Raising Revenue with a Progressive Value-Added Tax. P.56.

EY offered a counter position to this, however, commenting in their report to the EC on 'Methods of Taxing Financial and Insurance Services':

*"once transactions costs are included in such general equilibrium models, there is value-added from the provision of financial services. This can be described in the following fashion...institutions which operate in financial markets create additional value because they control the costs of transacting in financial markets and also because the help to reduce transaction costs in other markets"*²⁰⁰.

The VAT treatment of securities, and in particular whether the buying, selling, holding and issuance of securities constitutes an economic activity²⁰¹ for the purpose of the EU VAT Directive, has been subject to a number of rulings by the CJEU over the past two decades. The CJEU have concluded, and now consider it a matter of settled²⁰² case law, that transacting in securities is not an economic activity as defined by Article 9 of the EU VAT Directive, unless:

1. In the case of shareholdings, the person, natural or corporate, holding the shares is involved directly or indirectly in the management of the company²⁰³; or
2. Where the persons security dealings are part of a commercial security dealing activity²⁰⁴.

It is of particular note that, after issuing a number of previous judgments on this matter, the CJEU issued a court order in case C-102/00 (*Welthgrove BV v Staatssecretaris van Financiën*, hereinafter "Welthgrove") – a referral in respect of the right of a holding company to deduct VAT which is only possible where the holding company carries out an economic activity within the meaning of the EU VAT Directive. A court order will only be issued by the CJEU where the ruling request is identical to a question which the Court has previously ruled upon, or where the answer to the referred question is clear from existing case law. One might consider this to fall within the *acte clair*²⁰⁵ doctrine of EU law. The issuance of a court order in *Welthgrove*, therefore, evidences the extent to which the CJEU believe this matter to be settled²⁰⁶.

The first exception to the CJEU's general view that transacting in securities is not an economic activity, applies to persons owning shares in a company where they participate in the management of that company. The CJEU has been clear that merely owning shares in a company does not, in and of itself, constitute an economic activity – the person must evidence that they are also involved in its management.

²⁰⁰ EUROPEAN COMMISSION & ERNST & YOUNG 1996. Value Added tax: A study of Methods of Taxing Financial and Insurance Services. P.5.

²⁰¹ Economic activity is defined by Article 9 of the EU VAT Directive.

²⁰² See, in particular: 1991. C-60/90 - *Polysar Investments Netherlands BV and Inspecteur der Invoerrechten en Accijnzen* (Inspector of Customs and Excise), Arnhem. Court of Justice of the European Union, 1993. C-333/91 - *Sofitam SA* (formerly *Satam SA*) and *Ministre chargé du Budget*. Court of Justice of the European Union, 1997. C-80/95 - *Harnas & Helm CV and Staatssecretaris van Financiën*. Court of Justice of the European Union, 2001. C-102/00 - *Welthgrove BV and Staatssecretaris van Financiën*. Court of Justice of the European Union, 2004b. C-77/01 - *Empresa de Desenvolvimento Mineiro SGPS SA (EDM)*, formerly *Empresa de Desenvolvimento Mineiro SA (EDM)*, and *Fazenda Pública*. Court of Justice of the European Union.

²⁰³ 1991. C-60/90 - *Polysar Investments Netherlands BV and Inspecteur der Invoerrechten en Accijnzen* (Inspector of Customs and Excise), Arnhem. Court of Justice of the European Union, 1996. C-155/94 - *Wellcome Trust Ltd and Commissioners of Customs & Excise*. Court of Justice of the European Union.

²⁰⁴ 1996. C-155/94 - *Wellcome Trust Ltd and Commissioners of Customs & Excise*. Court of Justice of the European Union, 2004b. C-77/01 - *Empresa de Desenvolvimento Mineiro SGPS SA (EDM)*, formerly *Empresa de Desenvolvimento Mineiro SA (EDM)*, and *Fazenda Pública*. Court of Justice of the European Union.

²⁰⁵ A matter considered to be so obvious as not to require referral to a higher court for interpretation.

²⁰⁶ DE LA FERIA, R. 2008. When do dealings in shares fall within the scope of VAT? *EC Tax Review*, 2008-1, P.24-40. P.29-30.

The second exception, and the reference to a commercial share-dealing activity, was first noted by the Court in C-155/94 (Wellcome Trust Ltd and Commissioners of Customs & Excise, hereinafter “Wellcome Trust”). This term was not, however, defined by the CJEU as part of its judgment in C-155/94, primarily as it was of no relevance to the ultimate conclusions in this specific case²⁰⁷. The judgment in C-77/01 (Empresa de Desenvolvimento Mineiro SGPS SA (EDM), formerly Empresa de Desenvolvimento Mineiro SA (EDM), and Fazenda Pública, hereinafter “EDM”) did, however, consider the conditions required for a person to have a commercial security dealing activity and, in doing so, provided further legal certainty on the second exception listed above²⁰⁸. In EDM, the CJEU ruled that:

“It follows that an undertaking which pursues activities consisting in the simple sale of shares and other negotiable securities, such as holdings in investment funds, is to be regarded, so far as those activities are concerned, as confining itself to managing an investment portfolio in the same way as a private investor...

It is important to observe in that regard that neither the scale of a share sale, nor the employment in connection with such a sale of consultancy undertakings, can constitute criteria for distinguishing between the activities of a private investor, which fall outside the scope of the Sixth Directive, and those of an investor whose transactions constitute an economic activity...

Therefore, it must be held that activities which consist in the simple sale of shares and other negotiable securities, such as holdings in investment funds, do not constitute economic activities.”²⁰⁹

The position of the CJEU, as articulated in EDM, is therefore clear – simply transacting in securities by way of holdings in investment funds cannot be considered an economic activity for the purpose of EU VAT law.

de la Feria offers a challenge to the view of the CJEU, noting a number of inconsistencies and conceptual challenges with its position:

“From a general perspective, having supplies fall outside the scope of VAT as a rule, and only exceptionally subject to the tax, appears to be an inversion of the general principles of the EU VAT system. More specifically, where a sale of shares is undertaken in the course of a business, why would it not be deemed to be a supply by a ‘taxable person acting as such’?”²¹⁰

It is noteworthy, however, that de la Feria’s analysis concludes that it is “most likely correct”²¹¹ that the sale of shares should be VAT exempt, and that she does not advocate for a positive VAT charge on transactions in securities – there does appear to be an acceptance, therefore, that such transactions should be excluded from the tax base, as either outside the scope of VAT, zero rated or VAT exempt²¹². Whilst the distinction between supplies which are outside the scope of VAT, zero rated and VAT exempt is critically important for the operation of a VAT system, for the purpose of considering equivalence between direct and collective investment, the clear conclusion is that transactions in securities should be excluded from the tax base. The method for excluding the management of a SIF from the tax base (i.e., whether it should

²⁰⁷ 1996. C-155/94 - Wellcome Trust Ltd and Commissioners of Customs & Excise. Court of Justice of the European Union, DE LA FERIA, R. 2008. When do dealings in shares fall within the scope of VAT? *EC Tax Review*, 2008-1, P.24-40.

²⁰⁸ DE LA FERIA, R. 2008. When do dealings in shares fall within the scope of VAT? *EC Tax Review*, 2008-1, P.24-40. P.32.

²⁰⁹ 2004b. C-77/01 - Empresa de Desenvolvimento Mineiro SGPS SA (EDM), formerly Empresa de Desenvolvimento Mineiro SA (EDM), and Fazenda Pública. Court of Justice of the European Union. Paragraphs 60-62.

²¹⁰ DE LA FERIA, R. 2008. When do dealings in shares fall within the scope of VAT? *EC Tax Review*, 2008-1, P.24-40. P.38.

²¹¹ *Ibid.* P.40.

²¹² *Ibid.*

be outside the scope of VAT, zero rated or VAT exempt) is considered in greater detail later in this dissertation.

Even if we were to assume that investments in securities can be considered consumption and, therefore, potentially subject to VAT, there is a strong argument to have investments in securities exempted on a technical basis. It has been argued that the application of VAT to investments is “*administratively impossible*”²¹³, for three principal reasons:

1. The majority of investors are not registered for VAT and, by making these transactions taxable and bringing them into the scope of VAT, would require fiscal authorities to register, administer, audit and process an unmanageable number of input tax claims²¹⁴;
2. Difficulties in distinguishing between business and consumer investors, giving rise to challenges with compliance and tax authority enforcement;
3. Difficulties in identifying the value of each supply, as highlighted when discussing technical exemptions earlier in this dissertation. It is acknowledged, however, that some of the VAT system design alternatives set out at chapter six would be able to successfully address this particular issue.

Furthermore, and despite there being a differing approach to modern and traditional consumption tax systems as discussed earlier in this dissertation, as of 22nd October 1998, all OECD member countries, with the exception of Mexico, had removed “*dealings in financial instruments and shares*” from the consumption tax base²¹⁵. Since this OECD report was published, Mexico has since legislated for a VAT exemption for dealing in “*local and foreign currency and credit instruments (including shares)*”²¹⁶.

The academic contributions in this area are, on the whole, aligned with both the EU and OECD legislative frameworks, including the settled case law of the CJEU – investments in securities should be excluded from the tax base.

I have also considered, in the Appendix to this dissertation, the merits of other indirect taxes – specifically Financial Transaction Taxes (“FTT”) – to investments in securities. It is clear from the research that FTT is not intended to be a tax on consumption and should not therefore, in my view, be considered as an alternative to a VAT. Even if it were to be considered as an alternative, it is clear from the research that FTT is less preferable to VAT²¹⁷.

²¹³ DE LA FERIA, R. & KREVER, R. 2013. VAT Exemptions: Consequences and Design Alts. *EUCOTAX Series on European Taxation*, Volume 37. P.29.

²¹⁴ See also GRUBERT, H. & KREVER, R. 2012. VAT and Financial Services: Competing Perspectives on What Should Be Taxed. *Tax Law Review*, 65, P.199-240.

²¹⁵ OECD 1998. INDIRECT TAX TREATMENT OF FINANCIAL SERVICES AND INSTRUMENTS.

²¹⁶ ERNST & YOUNG 2018. *Worldwide VAT, GST and Sales Tax Guide*. P.757.

²¹⁷ INTERNATIONAL MONETARY FUND, CLAESSENS, S., KEEN, M. & PAZARBASIOGLU, C. 2010. Financial Sector Taxation: The IMF's Report to the G-20 and Background Material.

8.2 THE NEED FOR TAX NEUTRALITY FOR PERSONS ENGAGING IN THE SAME ACTIVITIES

The principle of fairness and neutrality is well established in the development of tax systems. Originating in the Wealth of Nations in 1776, economist Adam Smith set out his four maxims of taxation²¹⁸:

1. Neutrality/fairness – *“the subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities”*;
2. Certainty – *“the tax which each individual is bound to pay ought to be certain, and not arbitrary”*;
3. Convenience – *“tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it”*;
4. Economy – *“tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state”*.

Noah and Berger, in agreeing with the principles set out by Smith and in considering fairness as a specific principle, commented that *“one important criterion for a tax is that it should be fair”*²¹⁹.

The views of both Smith and Noah and Berger are also reflected in the OECDs International VAT/GST Guidelines. When setting out the principles of tax policy, the Guidelines state that *“taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation”*²²⁰.

Furthermore, EU VAT law applies a principle of fiscal neutrality, which is consistent with the OECD principle set out above. The principle of fiscal neutrality, in so far as it relates to EU VAT, was articulated by Judges C.W.A. Timmermans, C. Gulmann and R. Schintgen in joined cases C-453/02 (Finanzamt Gladbeck v Edith Linneweber) and C-462/02 (Finanzamt Herne-West v Savvas Akritidis)²²¹:

“the Member States must respect the principle of fiscal neutrality. According to the case-law of the Court of Justice, that principle precludes, in particular, treating similar goods and supplies of services, which are thus in competition with each other, differently for VAT purposes...”

It is clear from that case-law and from the judgments in Case C-216/97 Gregg [1999] ECR I-4947, paragraph 20, and Fischer, that the identity of the manufacturer or the provider of the services and the legal form by means of which they exercise their activities are, as a rule, irrelevant in assessing whether products or services supplied are comparable.”

It is clear, therefore, that economists, academics, legislators and taxing authorities are all in agreement that the same taxes, both in type and proportion, should be applied to persons engaging in the same activities. I have found no evidence to the contrary of this principle of taxation.

²¹⁸ SMITH, A. 1776. *Wealth of Nations 1776 Book V, Chapter II.*

²¹⁹ WISE, K. & BERGER, N. 2010. *Understanding our Tax System: A Primer for Active Citizens.* P.6.

²²⁰ OECD 2017. *International VAT/GST Guidelines.* P.18.

²²¹ 2005. *Joined Cases C-453/02 Finanzamt Gladbeck v Edith Linneweber and C-462/02 Finanzamt Herne-West v Savvas Akritidis.* Court of Justice of the European Union. Paragraphs 24-25.

8.3 THE NEED FOR TAX NEUTRALITY BETWEEN DIRECT AND COLLECTIVE INVESTMENT

With agreement that tax should be applied fairly and consistently to the same activities, we must now consider whether or not direct investment and investment through a collective vehicle should be considered the same activity for the purpose of applying the same tax treatment.

The CJEU has been consistent in its stated intention that both direct investment and investment through collective vehicles should be VAT neutral²²². The basis for this view was originally set out in AG Poiares Maduro's opinion in case C-8/03 (Banque Bruxelles Lambert SA (BBL) v Belgian State, hereinafter "BBL")²²³:

"BBL submits that it is necessary to consider, in the analysis, the ratio legis of the provision, that is, the reasons of general policy common to Member States which justify the exemption. It is clear that such reasons existed when Article 13 was drafted. They doubtless reflect, within the framework of Article 13, the overall intention, pointed out by BBL, to promote access by savers to collective investment."

In addition to commenting that the overall intention of the exemption is to facilitate investment in collective investment funds, AG Poiares Maduro also noted a second reason for the VAT exemption:

"However, there is a more practical basis for the exemption, which is to avoid subjecting contract-based funds to a tax burden which self-managed investment undertakings which are legal entities do not have to bear, by reason of the exemption under Article 13(B)(d), point 5. According to this last provision transactions, including negotiation, excluding management and safekeeping, in shares, interests in companies or associations, debentures and other securities, excluding documents establishing title to goods, and the rights or securities referred to in Article 5(3) of the Sixth Directive are exempt from VAT."

AG Poiares Maduro's view was referenced, and expanded on, in AG Kokott's opinion on CJEU case C-169/04 (Abbey National plc, Inscap Investment Fund v Commissioners of Customs & Excise)²²⁴:

"The remuneration for the management of a common fund is exempt from VAT. This is intended in particular to facilitate access by small investors to this form of investment. Because of the small volume of investment available to them, they have only a restricted opportunity of investing their money directly in a wide spread of securities. In addition, they often do not have the necessary knowledge for comparing and selecting securities."

The exemption also serves to avert distortions of competition between common funds managed by others and investment companies managed by themselves. Because they do not have legal personality, common funds cannot manage themselves and have to make use of an external management company. The services the management company provides to the common fund would as such be taxable under the general rules. For a self-managed investment company, on the other hand, there are as a rule no taxable transactions within the meaning of Article 13B(d)(6), since the management activity does not involve the provision of services between two independent taxable persons. Without the exemption in point 6 of that provision,

²²² See, for example, 2006a. C-169/04 - Abbey National plc, Inscap Investment Fund v Commissioners of Customs & Excise. Court of Justice of the European Union, 2015. C-595/13 - Staatssecretaris van Financiën v Fiscale Eenheid X NV cs. Court of Justice of the European Union.

²²³ POIARES MADURO, M. 2004. Opinion of Advocate General Poiares Maduro in cas C-8/03 - Banque Bruxelles Lambert SA (BBL) v Belgian State. Court of Justice of the European Union. Paragraph 26.

²²⁴ KOKOTT, J. 2005. Opinion of Advocate General Kokott in case C-169/04 - Abbey National plc, Inscap Investment Fund v Commissioners of Customs & Excise. Court of Justice of the European Union. Paragraphs 28-29.

common funds managed by third parties would thus be burdened with an additional cost element and would thus be at a disadvantage compared with self-managed investment companies.”

This view was also reaffirmed by the Court in the most recent judgment regarding the definition of a SIF – case C-595/13.

Based on the findings of the CJEU, reflecting the opinions of, amongst others, AG Poiares Maduro and AG Kokott, it would appear that there are two reasons for a VAT exemption being provided for the management of a SIF.

1. Ensuring neutrality between direct and collective investment: facilitating investment in collective investment funds by “small” investors

Based on the opinions of AG Poiares Maduro and AG Kokott, as well as the findings of the Court in case C-595/13, we can conclude that EU policy intends to facilitate investment by so called “small” investors in collective investment funds. To achieve this aim, there is a clear need for neutrality between direct investment and collective investment. Any incremental cost of collective investment would, undoubtedly, deter investors from such an approach, in favour of direct investment.

This would appear, *prima facie*, to be a social VAT exemption – aiming to encourage investment behaviours through tax law. The merits of social exemptions are discussed at chapter four of this dissertation.

It is also of note that Poddar and English, in their commentary of a cash flow VAT method for financial services, arrive at the same conclusion – “*the mutual fund exemption merely extends the personal level treatment to pooled investment vehicles.*”²²⁵

Collective investment has a number of economic benefits to investors which influences the EU’s policy in this area. These include:

- Access to professional investment managers, ensuring the better management of assets;
- Ease of access to investments which would not be available for retail investors investing on their own account – e.g., commercial real estate;
- Diversification of investment risk, or at least better access to diversified investment strategies;
- Investment protection;
- Access to appropriate long-term investment vehicles necessary to meet the aging population and cost of retirement;
- Reduced transaction costs.

2. Adhering to the principle of fiscal neutrality: ensuring VAT equivalence irrespective of the legal form of investment vehicles

Absent of the SIF VAT exemption, there would be distortion of competition between investment vehicles with legal personality and those without, which would breach the EU principle of fiscal neutrality. In case C-216/97 (*Gregg and Gregg v Commissioners of Customs & Excise*), the Court

²²⁵ PODDAR, S. & ENGLISH, M. 1997. Taxation of Financial Services Under a Value Added Tax: Applying the Cash Flow Approach. *National Tax Journal*, 50, P.89-112. P.108.

clearly articulated its view that the legal form by which an activity is carried out should not affect the VAT position of the activities:

“The principle of fiscal neutrality precludes, inter alia, economic operators carrying on the same activities from being treated differently as far as the levying of VAT is concerned. It follows that that principle would be frustrated if the possibility of relying on the benefit of the exemption provided for activities carried on by the establishments or organisations referred to in Article 13A(1)(b) and (g) was dependent on the legal form in which the taxable person carried on his activity.”²²⁶

This principle was again reiterated by the Court in Joined Cases C-453/02 and C-462/02²²⁷.

If no VAT exemption was available, a distortion would arise as a result of potentially different VAT applications to investment management services provided to collective investment funds depending on the legal form of the fund, as explained below:

- A fund with no legal personality does not have the capacity to enter into legal contracts or employ staff – it cannot therefore manage its own affairs and must engage an external management company to manage its investments.

A fund with no legal personality would, in most cases, be constituted as a contractual common ownership entity, where investors will be a member of the co-ownership, but have no rights related to a shareholder. The governance body of a fund with no legal personality will typically be the board of the management company. Examples of such investment vehicles would include UK Unit Trusts and Luxembourgish Fonds Commun de Placements.

Absent of a VAT exemption, the management charges from the external investment manager would be subject to VAT. Even where the fund has a commercial dealing activity²²⁸, its outputs will be VAT exempt and its ability to recover any VAT will be limited²²⁹. The VAT charged on the fund’s management fees, therefore, becomes a real cost to the fund and its investors.

- This position can be contrasted against a fund with legal personality which can legally manage its own assets without paying an external manager giving it the opportunity to avoid a VAT cost on the management of its investments. This would be done by employing an investment manager or team of investment managers, the payments to whom would fall outside the scope of VAT²³⁰.

Funds with legal personality will typically be constituted as an entity recognised by local law. This entity will have its own legal responsibilities – e.g., those conferred by its constitution and local corporate law compliance requirements. Investors will typically be shareholders, with a right to share in the profits and gains of the entity. The governance body of fund with legal personality will be the board of the fund itself. Examples of such

²²⁶ 1999a. C-216/97 - Gregg and Gregg v Commissioners of Customs & Excise. Court of Justice of the European Union. Paragraph 20.

²²⁷ 2005. Joined Cases C-453/02 Finanzamt Gladbeck v Edith Linneweber and C-462/02 Finanzamt Herne-West v Savvas Akritidis. Court of Justice of the European Union.

²²⁸ See section 8.1 for a discussion on what constitutes a commercial security dealing activity.

²²⁹ A fund may recover input tax which relates to transactions in securities for which the customer is established outside of the EU, as conferred by Article 169(c) of 2006d. Council Directive 2006/112/EC - The Common System of Value Added Tax. 2006/112/EC. European Union.

²³⁰ By virtue of employees not being ‘taxable persons’ – see Article 10 of *ibid*.

investment vehicles include UK Open Ended Investment Companies (“OEICs”) and Luxembourgish Société d’Investissement à Capital Variable (“SICAV”).

CHAPTER 9: CONSIDERING THE APPROPRIATENESS OF THE COURT OF JUSTICE OF THE EUROPEAN UNION’S (“CJEU”) APPROACH TO DEFINING A SPECIAL INVESTMENT FUND (“SIF”)

As discussed at chapter two, and following the judgment in *Fiscale Eenheid*, the CJEU has provided clearer guidance on the criteria for an investment fund to be considered as a SIF – exempting funds which are within the scope of the UCITS Directive as well as those that are in competition with UCITS funds, and providing a set of principles to establish when a fund will be considered as being in competition with UCITS.

Despite this, the way in which each EU Member State applies these rules varies widely, particularly in terms of which domestic and overseas funds are in scope for the SIF VAT exemption and what special VAT recovery rules apply to funds and asset managers²³¹. Certain jurisdictions, where investment funds are a significant part of their overall economy, have widely drawn definitions of SIFs to encourage collective funds to setup in their territory – e.g., Luxembourg and Ireland²³². Other countries apply a narrower definition and, as a consequence, achieving consensus on the scope and application of the SIF VAT exemption at an EU level has proved difficult. Challenges therefore remain in aligning EU VAT rules for the management of SIFs and ensuring that fiscal neutrality is achieved.

I will now analyse the criteria for exemption, as defined by the CJEU, as well as consider the appropriateness of the principles based approach developed by the Court to determine when non-UCITS funds will qualify as a SIF. This review will make particular reference to the current regulatory framework for capital markets, the differing interpretations of the SIF exemption amongst Member States, and the remaining challenges and unintended consequences of the current definition.

9.1 THE APPROPRIATENESS OF THE EXEMPTION FOR FUNDS WHICH ARE UNDERTAKINGS FOR COLLECTIVE INVESTMENT IN TRANSFERABLE SECURITIES (“UCITS”)

UCITS funds are defined by the UCITS Directive as *“an undertaking...with the sole object of collective investment in transferable securities or in other liquid financial assets referred to in Article 50(1) of capital raised from the public and which operate on the principle of risk-spreading”*²³³. The UCITS Directive also excludes *“collective investment undertakings which raise capital without promoting the sale of their units to the public within the Community or any part of it”*²³⁴.

It is clear from this definition that UCITS funds are intended to be marketed to the public. It would also appear a reasonable conclusion that “small” investors, as referenced regularly by both the CJEU and the

²³¹ KPMG 2018. Brexit's hidden tax questions for asset managers.

²³² THE INVESTMENT ASSOCIATION 2017. Brexit - Tax Issues for Investment Managers.

²³³ Article 1(2)(a) of 2009a. Council Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS). 2009/65/EC. European Union.

²³⁴ Article 3 of *ibid*.

EU, would primarily include members of the public. This is evidenced by the level of investment in UCITS funds by “small” EU investors²³⁵.

As a result of UCITS funds being aimed at members of the public, and particularly in response to the Madoff Ponzi fraud and the collapse of Lehman Brothers in 2008²³⁶, the UCITS Directive provides for a detailed set of investor protections, all of which are intended to ensure effective and uniform protection of the investors in collective investment schemes²³⁷.

Given that one of the stated intentions of the VAT exemption for the management of a SIF is to facilitate investment in collective funds by small investors, it would appear sensible that UCITS funds should be considered SIFs, given that their specific and stated intention is to be marketed to same group of investors that the VAT exemption serves to benefit.

Additionally, it is noteworthy that UCITS funds may be constituted in accordance with contract law (as common funds managed by management companies), trust law (as unit trusts), or statute (as investment companies)²³⁸. The ability to structure a UCITS fund as a vehicle with or without legal personality means that, absent of an exemption, there would be distortion of competition²³⁹ amongst UCITS funds, which would be counter to the stated aims of the UCITS Directive²⁴⁰.

9.2 THE APPROPRIATENESS OF THE COURT OF JUSTICE OF THE EUROPEAN UNION’S (“CJEU”) PRINCIPLES IN EXEMPTING FUNDS WHICH ARE NOT UNDERTAKINGS FOR COLLECTIVE INVESTMENT IN TRANSFERABLE SECURITIES (“UCITS”)

For a non-UCITS fund to be considered a SIF, it must meet the five principles laid down by the CJEU which are set out at chapter two of this dissertation.

To ensure fiscal neutrality and fairness, it is important to allow exemption for investment funds which are in competition with UCITS to ensure a level playing field and the equal treatment of funds which are targeted at members of the public, irrespective of whether the fund falls within the UCITS Directive or not. Case C-595/13 (Fiscale Eenheid) specifically addressed this issue – ruling that a retail fund which was

²³⁵ EUROPEAN COMMISSION. 2018b. *Investment Funds* [Online]. Available: https://ec.europa.eu/info/business-economy-euro/growth-and-investment/investment-funds_en [Accessed].

²³⁶ Although both Madoff and Lehman Brothers were US domiciled, the effects of the respective fraud and bankruptcy were felt severely across the EU. See: ALSHALEEL, M. K. 2016. Undertakings for the Collective Investment in Transferable Securities Directive V: Increased Protection for Investors. *European Company Law*, 13, P.14-22.

²³⁷ See the preamble to EUROPEAN COMMISSION 1976. Proposal for a Council Directive for the coordination of laws, regulations and administrative provisions regarding collective investment undertakings for transferable securities.

²³⁸ Article 1(3) of 2009a. Council Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS). *2009/65/EC*. European Union.

²³⁹ For a detailed commentary on distortion of competition in this respect see section 8.3.

²⁴⁰ See the preamble to EUROPEAN COMMISSION 1976. Proposal for a Council Directive for the coordination of laws, regulations and administrative provisions regarding collective investment undertakings for transferable securities.

invested in real estate could be a SIF, despite not being within the UCITS regime²⁴¹. The UCITS Directive only applies to transferrable securities and other liquid assets – neither of which covers real estate.

I will now consider the appropriateness of each of the principles set out by the Court and analyse to what extent they meet the aims of the VAT exemption.

1. The fund is a collective investment of capital raised from the public

There are two distinct requirements of this criteria:

1. There must be “collective investment” – the fund must consist of investment from more than one investor; and
2. The investment must be raised from the “public”.

The CJEU has been clear, through various AG opinions and judgments, that the intention of the exemption is to facilitate investment by “small” investors and by doing so creating neutrality between direct and collective investment.

A SIF cannot, based on the current definition, be a single investor fund, which appears appropriate given the intent of the law. Single investor funds will typically be setup by sophisticated investors and will not be available for members of the public to invest in. The regulation of single investor funds is also typically less that those which are accessible by a wide range of investors, due to there being no requirement to protect retail investors. This position was explicitly confirmed by the Court in its judgment in C-44/11 (Finanzamt Frankfurt am Main V-Höchst v Deutsche Bank AG), which drew a distinction between collective funds in which investments are pooled, spread over a range of securities and are managed by the fund in its own name whilst each investor owns a share of the fund but not the fund’s investments as such, and investment management provided to single investors where the investor will own the individual securities directly even if this is via a fund wrapper vehicle.

The capital must also be raised from, and by extension the investors will be, the public. The rationale for this appears appropriate and is consistent with the stated policy aim of the EU in respect of the VAT exemption – to facilitate investment by “small” investors.

In *Fiscale Eenheid*, the Court commented *“in so far as investments, whether composed of transferable securities or immovable property...there is direct competition between those forms of investment. In both cases, what matters for the investor is the interest he derives from those investments”*²⁴². It is clear that the Court does not consider the underlying investment assets important in determining whether funds are in competition with each other – what matters is the interest derived by the investor from their investment.

As can be seen from Article 1 of the UCITS Directive, UCITS funds are collective investment vehicles. They are also intended to be marketed to, and invested in by, members of the public. The requirement for a non-UCITS fund to pool investment from members of the public ensures that non-UCITS funds are aligned with the definition of UCITS in this regard. This would appear appropriate given the stated intention of the Court to apply the exemption to funds which are comparable with UCITS.

²⁴¹ 2015. C-595/13 - Staatssecretaris van Financiën v Fiscale Eenheid X NV cs. Court of Justice of the European Union. Paragraph 64.

²⁴² Ibid. Paragraph 63.

2. The fund must operate on the principle of risk-spreading

Article 1 of the UCITS Directive describes UCITS funds as ones which operate on the principle of risk spreading. Introducing this as a requirement for non-UCITS funds to qualify as a SIF ensures a level playing field for the type of investment funds which will be able to avail of VAT exemption.

In case C363/05, JP Morgan Claverhouse Investment Trust plc, The Association of Investment Trust Companies v The Commissioners of HM Revenue and Customs (hereinafter “JP Morgan Claverhouse”), the CJEU considered the principle of risk spreading as part of its detailed consideration as to whether a closed ended investment company, in this case a UK Investment Trust Company (“ITC”), was sufficiently comparable to UCITS to qualify as a SIF. The Court commented at paragraph fifty of its judgment:

“ITCs, like AUTs and OEICs, involve investment in securities through the intermediary of a collective investment undertaking which allows private investors to invest in wide-ranging investment portfolios and thus reduce the stock market risk.”²⁴³

For these reasons, the requirement for risk spreading is considered to be appropriate in determining whether a fund is a SIF or not.

3. The participants bear the investment risk

In order for collective investment to have parity with direct investment, it is entirely logical that the investor must bear the investment risk. Where the investor does not bear the investment risk (e.g., in a defined benefit pension fund, where the sponsoring employer bears this risk in its entirety), it would appear reasonable that such collective investment schemes cannot be considered the same as direct investment.

This point was considered by the Court in C-424/11, Wheels Common Investment Fund Trustees Ltd (and others) v Commissioners for Her Majesty’s Revenue and Customs (hereinafter, “Wheels”)²⁴⁴, which ruled that, for the reasons detailed above, a defined benefit pension fund cannot qualify as a SIF.

4. The fund is subject to state supervision

AG Kokott, in her opinion for case C-595/13, commented that *“the Court of Justice has not yet ruled explicitly that the only assets that should benefit from the exemption are those that are subject to specific State supervision. However, this view is well founded in case-law.”*²⁴⁵

The judgment in case C-595/13, in accepting AG Kokott’s opinion, was the first time the CJEU had explicitly stated the requirement for state supervision to apply for a fund to qualify as a SIF, although as noted by AG Kokott, this was well founded by previous judgments of the Court.

Article 5 of the UCITS Directive requires both the investment fund and the investment manager to be authorised and supervised by their national regulator²⁴⁶. It is noteworthy that a UCITS

²⁴³ 2007. C-363/05 - JP Morgan Claverhouse Investment Trust plc, The Association of Investment Trust Companies v The Commissioners of HM Revenue and Customs. The Court of Justice of the European Union. Paragraph 50.

²⁴⁴ 2013c. C-424/11 - Wheels Common Investment Fund Trustees Ltd (and others) v Commissioners for Her Majesty’s Revenue and Customs. Court of Justice of the European Union.

²⁴⁵ KOKOTT, J. 2015. Opinion of Advocate General Kokott in case C-595/13 Staatssecretaris van Financiën v Fiscale Eenheid X NV cs. Court of Justice of the European Union. Paragraph 22.

²⁴⁶ Article 5 of 2009a. Council Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS). 2009/65/EC. European Union.

investment fund can be established in a Member State different to that of its investment manager and that, once authorised, UCITS investment funds can be marketed and sold in any EU Member State. Whilst there is no EU body with responsibility for direct oversight of national regulators, the European Securities and Markets Authority (“ESMA”) takes an active role in building a common supervisory culture among national regulators, or National Competent Authorities, to promote sound, efficient, and consistent supervision throughout the European Economic Area (“EEA”). This is known as supervisory convergence. Supervisory convergence does not mean a one-size fits all approach but rather ESMA’s role is to promote the consistent and effective implementation and application of the same rules, using sufficiently similar approaches for similar risks. The overall goal is to strive for comparable regulatory and supervisory outcomes across the EEA²⁴⁷.

As discussed earlier in this dissertation, the VAT exemption is, in part, intended to support the EU policy of facilitating investment by so called “small” investors in collective investment funds. Due to their lack of investment and financial market expertise, it is expected that smaller investors will need enhanced levels of protection compared to larger institutional investors. The EU’s implementation of the UCITS Directive and, more recently, Directive 2014/65/EU (markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU – the “MiFID II Directive”) are examples of the EU’s work in this area to give greater protection to investors generally and in particular to those invested in collective investment schemes.

To be in competition with a UCITS fund, therefore, it would appear appropriate to also require non-UCITS funds be subject to state supervision. Not extending exemption beyond investment funds which are subject to state supervision appears sensible, given the stated policy aims of the EU. Investment funds which are not regulated will typically be setup for professional investors and will not be accessible by retail investors. An example would be a hedge fund product which will typically only be suitable for qualified investors with a minimum investment significantly above that of a retail product (often in excess of \$1m)²⁴⁸. Such a product, and investor set, is clearly not one that the EU intends to benefit from VAT exemption.

5. The fund must be subject to the same conditions of competition and appeal to the same circle of investors as UCITS

Ensuring that a non-UCITS fund is subject to the same conditions of competition and appeals to the same circle of investors as a UCITS fund is required to ensure that fiscal neutrality is maintained. As I have already discussed in this dissertation, the principle of fiscal neutrality precludes economic operators carrying out the same transactions from being treated differently in relation to the levying of VAT. Supplies of goods and services which are in competition with each other cannot, as a consequence, be treated differently for VAT purposes.

It would seem clear that the extension of the VAT exemption to non-UCITS funds would only be appropriate where the non-UCITS fund was in competition with UCITS offerings. There are, however, two distinct requirements here: firstly, that the fund is subject to the same conditions of competition; and secondly, that the fund appeals to the same circle of investors. Each of these are considered in turn below.

The fund is subject to the same conditions of competition

In *Fiscale Eenheid*, the Court commented in its judgment that “*only investment funds that are subject to specific State supervision can be subject to the same conditions of competition and appeal*”

²⁴⁷ EUROPEAN SECURITIES AND MARKETS AUTHORITY (“ESMA”). 2020. *Supervisory Convergence* [Online]. Available: <https://www.esma.europa.eu/convergence/supervisory-convergence> [Accessed].

²⁴⁸ AGARWAL, V., BOYSON, N. M. & NAIK, N. Y. 2009. Hedge Funds for Retail Investors? An Examination of Hedged Mutual Funds. *Journal of Financial and Quantitative Analysis*, 44, P.273-305. P.274.

*to the same circle of investors*²⁴⁹. From this comment it is clear that the Court is of the view that for non-UCITS funds to be subject to the same conditions of competition and appeal to the same circle of investors as UCITS, it must be subject to state supervision as detailed at requirement four above.

The fund appeals to the same circle of investors

Given, as I have set out earlier in this dissertation, UCITS funds are intended for the public, it stands that for a non-UCITS fund to be appealing to the same circle of investors it must also be intended for the public. It is important to note that, based on CJEU jurisprudence, it does not seem imperative that a fund must be open to the general public in its entirety for it to be able to qualify as a SIF²⁵⁰. Instead, what is important is that the fund is intended for and directed at retail investors.

In *Wheels*, the CJEU referred to funds which are in competition with each other as being “*regarded as meeting the same needs*”²⁵¹. The Court did not elaborate further on what these needs were, however, it would be reasonable in my view to conclude that this can be conferred from the UCITS Directive – in that respect, when we look at the objective of UCITS as described at Article 1(2)(a) of the UCITS Directive, it would appear that satisfying criteria one to four above would, by extension, satisfy criteria five. Whether a non-UCITS fund is in competition with a UCITS fund will, therefore, be a function of meeting the criteria laid down at points one to four above.

²⁴⁹ 2015. C-595/13 - *Staatssecretaris van Financiën v Fiscale Eenheid X NV cs*. Court of Justice of the European Union. Paragraph 48.

²⁵⁰ EUROPEAN COMMISSION 2017. VAT Committee Working Paper 936 - Scope of the exemption for the management of special investment funds. P.24.

²⁵¹ 2013c. C-424/11 - *Wheels Common Investment Fund Trustees Ltd (and others) v Commissioners for Her Majesty's Revenue and Customs*. Court of Justice of the European Union. Paragraph 26.

CHAPTER 10: THE REMAINING CHALLENGES WITH THE DEFINITION OF A SPECIAL INVESTMENT FUND (“SIF”)

10.1 ALTERNATIVE INVESTMENT FUNDS (“AIFs”)

10.1.1 AN OVERVIEW OF ALTERNATIVE INVESTMENT FUNDS (“AIFs”)

An AIF is, broadly, any investment vehicle which does not fall within the UCITS Directive. As I have discussed earlier in this dissertation, AIFs themselves are generally not subject to state supervision, however, the management company of an AIF is subject to the provisions of AIFMD.

According to the EC²⁵², AIFs can be categorised as follows:

Hedge Funds

Whilst there is no clear definition of a hedge fund, something which is acknowledged by the EC, existing literature defines them as products which *“invest in a wide variety of financial strategies largely outside the control of the regulators, being created either outside the major financial centres or as private investment partnerships. The investors include wealthy individuals as well as institutions, such as pension funds, insurance funds and banks”*²⁵³, and which *“are private investment vehicles not open to the general investment public...this means that hedge funds face less regulation than publicly traded mutual funds, allowing them to hold substantial short positions to preserve capital during market downturns”*²⁵⁴.

Private Equity Funds

As with hedge funds, defining private equity funds is not straightforward. Ferran describes private equity as *“another non-homogenous segment of market activity that cannot be easily defined. In broad terms, private equity funds are funds raised in part from the founders of the fund but mostly from experienced and sophisticated investors, such as funds of funds, pension funds, investment funds, endowments and high net worth individuals...As with hedge funds, investments in these funds are usually structured so as to fall outside the standard collective investment regulatory framework.”*²⁵⁵

According to the Alternative Investment Expert Group of the EC, the typical characteristics of the private equity industry are²⁵⁶:

1. Investment by a dedicated professional team, predominantly in unquoted companies;

²⁵² EUROPEAN COMMISSION 2017. VAT Committee Working Paper 936 - Scope of the exemption for the management of special investment funds.

²⁵³ ARNOLD, G. 2012. *The Financial Times guide to the financial markets*, Pearson. P.43.

²⁵⁴ FUND, W. & HSIEH, D. A. 2013. *Hedge funds – Handbook of the Economics of Finance*. P.1063-1125.

²⁵⁵ FERRAN, E. 2011. After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU. *European Business Law Review*, 12, P.379-414. P.381.

²⁵⁶ EUROPEAN COMMISSION 2017. VAT Committee Working Paper 936 - Scope of the exemption for the management of special investment funds. P.9.

2. Involving active ownership and driving value creation;
3. Drawing capital from a defined pool;
4. Negotiated contractual relationship with qualified/professional investors;
5. Profit-sharing schemes which align interests with investors;
6. Strong self-regulation with defined reporting and valuation requirements;
7. Involving stand-alone management of each individual company;
8. Investing on the basis of a medium to long term strategy and holding period, and with a focus on financial gain through exit by sale or flotation.

The primary difference between hedge funds and private equity funds is that hedge funds are not involved in the management of the companies in which they invest.

European Venture Capital Funds (“EuVECAs”)

EuVECAs are EU regulated²⁵⁷ venture capital funds which invest in order to provide equity start-up capital for a new and uncertain technology or business idea. EU regulation was introduced to allow these funds to be marketed across EU Member States.

EuVECAs are aimed at professional investors, however, other investors are allowed to participate in EuVECAs as long as they invest a minimum of EUR 100,000 in one fund and that they state in writing that they are aware of the risks associated with the investment²⁵⁸.

European Social Entrepreneurship Funds (“EuSEFs”)

EuSEFs are EU regulated²⁵⁹ investment funds whose aim is to fund social enterprises which are set up with the aim to have a positive social impact and address social objectives, rather than with view to solely maximising profit or gains.

EuSEFs are also aimed at professional investors and, as with EuVECAs, other investors are allowed to participate in EuSEFs as long as they invest a minimum of EUR 100,000 in one fund and that they state in writing that they are aware of the risks associated with the investment²⁶⁰.

European Long Term Investment Funds (“ELTIFs”)

ELTIFs are EU regulated²⁶¹ funds which focus on investing in various types of alternative asset classes such as infrastructure, small and medium-sized enterprises and real assets. ELTIFs must be managed by an EU authorised AIF manager²⁶².

²⁵⁷ Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds

²⁵⁸ Article 6 of *ibid.*

²⁵⁹ Regulation (EU) 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds

²⁶⁰ Article 6 of *ibid.*

²⁶¹ Regulation (EU) 2015/760 of the European Parliament and of the Council of 29 April 2015 on European long-term investment funds

²⁶² Recital 8 of *ibid.*

ELTIFs can be sold to both professional and retail investors. Where ELTIFs are distributed to retail investors, some extra requirements are imposed on the manager of the fund.

In general, one of the main differences between UCITS and AIFs is the type of investors for whom they are intended. Recital forty-seven of AIFMD states *“UCITS and AIFs are different both in the investment strategies they follow and in the type of investors for which they are intended”*.

In principle, AIFs can only be sold to professional investors²⁶³, however, marketing AIFs to retail investors is possible at the discretion of each Member State²⁶⁴. As noted above, EuVECA and EuSEFs may be sold to investors other than professional investors, provided that they invest at least EUR 100,000 in one fund and that the investor states in writing that they are aware of the risks associated with the investment. This allows high net worth individuals to invest in these funds, whilst still safeguarding small retail investors from the relative risks of this type of investments. The EC has previously²⁶⁵ considered amending this EUR 100,000 threshold, however, decided not to make any changes to ensure adequate consumer protections. The EC added that *“lowering the investment threshold would inevitably need to be coupled by additional retail investor protection measures which would both introduce costs and detract from the ultimate benefit of more flexible EuVECA and EuSEF fund regimes”*²⁶⁶.

10.1.2 THE VALUE ADDED TAX (“VAT”) TREATMENT OF ALTERNATIVE INVESTMENT FUNDS (“AIFs”) – THE VIEW OF THE EUROPEAN COMMISSION (“EC”) AND THE DIVERGENCE ACROSS MEMBER STATES OF THE EUROPEAN UNION (“EU”)

The view of the EC, in respect of the VAT treatment of AIFs, was put forward through the Value Added Tax Committee in Working Paper No 936²⁶⁷. The EC concluded that it does not seem possible to apply a single VAT treatment to all AIFs and that, instead, a case-by-case analysis should be carried out for each fund considering the tests which have been set out by the CJEU and which are discussed at chapter nine of this dissertation. The EC considered that a single VAT treatment was not possible due the wide range and diversity of AIFs and the fact that AIFs, as an investment vehicle, are not regulated themselves at EU level. In addition, a single VAT exemption for AIFs would also contradict previously settled CJEU jurisprudence in respect of the definition of SIFs (e.g., Wheels).

Any argument that the judgment of the CJEU in C-595/13, which concluded that the specific AIF in question was a SIF, would result in all AIFs automatically qualifying as SIFs was rejected by the EC on the basis that the Fiscale Eenheid case had only considered one particular AIF.

The EC also concluded that, even where a group of AIFs are regulated at EU level (e.g., EuVECA, EuSEFs and ELTIFs), it is not straightforward to conclude that such funds will necessarily always have the characteristics

²⁶³ In accordance with Articles 31(6) and 32(9) of AIFMD

²⁶⁴ In accordance with Article 43 of AIFMD

²⁶⁵ EUROPEAN COMMISSION 2016. Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Regulation (EU) No 345/2013 on European venture capital funds and Regulation (EU) No 346/2013 on European social entrepreneurship funds.

²⁶⁶ Ibid. P.7.

²⁶⁷ EUROPEAN COMMISSION 2017. VAT Committee Working Paper 936 - Scope of the exemption for the management of special investment funds.

of a SIF. As I discussed earlier in this dissertation, the requirement for state supervision is only one of the conditions which needs to be satisfied in order for a fund to be a SIF – the four other conditions must also be met.

Despite the EC's and CJEU's clear preference for a principles based, case-by-case approach to determining a SIF, a number of Member States – Austria, Belgium, Ireland, Luxembourg and the Netherlands – have explicitly included AIFs as being VAT exempt in their domestic VAT law²⁶⁸. Other Member States, such as France, have opted to legislate for a set of criteria to be fulfilled for an AIF to qualify as a SIF, whilst some, including the UK, have not legislated for either.

As a result, there is a clear divergence in the VAT treatment of AIFs across the Member States of EU and the UK.

10.1.3 THE VALUE ADDED TAX (“VAT”) TREATMENT OF ALTERNATIVE INVESTMENT FUNDS (“AIFs”) – THE NEED FOR THE FUND TO BE SUBJECT TO THE SAME CONDITIONS OF COMPETITION AND APPEAL TO THE SAME CIRCLE OF INVESTORS AS UNDERTAKINGS FOR COLLECTIVE IN TRANSFERRABLE SECURITIES (“UCITS”)

The EC's view is that the fifth test set out by the CJEU – that the fund must be subject to the same conditions of competition and appeal to the same circle of investors as UCITS – is unlikely to always be present in an AIF. Indeed, UCITS are intended to be suitable for retail investors but AIFs are, in principle, only available to professional investors. For an AIF to be sufficiently comparable to UCITS for it to be in direct competition, the AIF in question would need to be marketed to retail investors. As is clear from the intent of the legislation, this will not always be the case.

The EC has put forward arguments both for and against AIFs being in competition with UCITS. These are summarised below²⁶⁹.

In favour:

- Firstly, it could be argued that in terms of the characteristics of UCITS and AIFs, and the investors which they target, the dividing lines are less clear than they perhaps have been historically. The ability for AIFs to be marketed to retail investors potentially allows these funds to appeal to the same set of investors as, and thus be in competition with, UCITS.
- Secondly, it could be argued that in its judgment in *Fiscale Eenheid* the CJEU did not actually assess whether that fund appealed to the same circle of investors as a UCITS. The CJEU found that the fund qualified as a SIF on the basis of it being a joint investment, following the principle of risk-spreading and the investors bearing their own risk.

²⁶⁸ PWC 2018. Alternative investment fund management: Is harmonisation needed for the VAT exemption?

²⁶⁹ EUROPEAN COMMISSION 2017. VAT Committee Working Paper 936 - Scope of the exemption for the management of special investment funds. P.29-30.

Against:

- Firstly, whilst it is true that AIFs can be marketed to retail investors, where this is the case, certain conditions have to be met. It could be argued that retail investors in AIFs could be seen as a separate category of investor, distinct from traditional retail investors, given the conditions under which they are allowed to participate in AIFs. Taking EuVECAs and EuSEFs for example, these can only be accessed by retail investors if they invest at least EUR 100,000 and make a statement in writing that they are aware of the risks associated with the investment. The existence of a minimum threshold indicates that AIFs are meant for investors with a specific understanding of financial matters and that many investors would be excluded from them.
- Secondly, despite the CJEU not focussing on the circle of investors being appealed to in its judgment in *Fiscale Eenheid*, that in and of itself cannot be taken to mean that such a condition does not need to be met for a fund to qualify as a SIF. Indeed, the CJEU make reference to this condition in paragraphs forty-seven and forty-eight of its judgment in *Fiscale Eenheid*.
- Thirdly, this interpretation is in line with the well established case law of the CJEU, according to which the exemptions referred to in Article 135 of the VAT Directive are to be interpreted strictly since they constitute exceptions to the general principle that VAT is to be levied on all services supplied for consideration by a taxable person. If AIFs and UCITS are found not to be in competition, treating them differently for the purposes of Article 135(1)(g) of the VAT Directive would not run counter the principle of fiscal neutrality.

It is clearly possible for AIFs to be subject to the same conditions of competition and appeal to the same circle of investors as UCITS, however, this will not be the case for every AIF and, as a result, defining this by reference to the criteria of the CJEU on a case by case basis would appear to be appropriate. Greater consistency across Member States for the adoption and application of these criteria would, however, be beneficial to further harmonise of the VAT exemption for SIFs across the EU.

10.1.4 THE VALUE ADDED TAX (“VAT”) TREATMENT OF ALTERNATIVE INVESTMENT FUNDS (“AIFs”) – THE NEED FOR SPECIFIC STATE SUPERVISION

The fourth test set out by the CJEU to establish whether a non-UCITS fund can be a SIF for the purposes of the VAT exemption is that the non-UCITS fund must be subject to specific state supervision. In the AG opinion in *Fiscale Eenheid*, AG Kokott commented:

“Once specific State supervision of investment funds began to be regulated at EU level with the UCITS Directive, the Court of Justice limited the discretion of Member States to define special investment funds within the meaning of Article 13B(d)(6) of the Sixth Directive: Member States must classify funds that are regulated under the UCITS Directive as ‘special investment funds’. The power of Member States to define was thus overlaid by the harmonisation of supervisory law.

As long as supervisory law is not regulated at EU level, however, Member States continue to have the power to define...in so far as Member States provide for specific State supervision for other types of investment funds also, these too will generally benefit from the tax exemption”²⁷⁰

AG Kokott appears to be suggesting that funds regulated by virtue of an EU Directive, for example the UCITS Directive, are subject to state supervision and therefore have the capability of being a SIF even where the fund is established in another Member State. On the other hand, where the fund is not subject to regulation at EU level then it would require to be regulated by the Member State in order to qualify for VAT exemption in that Member State. AG Kokott’s comments, however, cannot be directly applied to AIFs. Under the UCITS Directive, the investment fund itself is subject to supervision. By contrast, an AIF is not subject to any supervision conferred by an EU Directive but rather, under AIFMD, the investment manager of an AIF is subject to supervision. The Court has never explicitly commented on the need for an investment manager to be subject to state supervision for a fund it manages to be a SIF, although this will have always been the case for UCITS (as the investment manager of a UCITS fund is also subject to state supervision under the UCITS Directive). It is unclear, and untested at the CJEU, whether the supervisory requirement for managers of AIFs is sufficient for the AIF to meet this test. The interpretation of this particular point by Member States has, and continues to, lead to different VAT treatments of AIFs, as described at section 10.1.3.

An AIF may, however, be subject to supervision under domestic law. In this case, the state supervision requirement is clearly met. This adds further weight to the need for a case-by-case analysis to consider whether an AIF can qualify as a SIF.

10.2 OCCUPATIONAL PENSION FUNDS

10.2.1 AN OVERVIEW OF OCCUPATIONAL PENSION FUNDS

Before discussing the VAT position of pension funds, I will first consider the purpose of a pension fund, the types of pension funds typically provided by employers, and the regulatory framework within which pension funds operate.

The purpose of a pension is to ensure that an individual continues to have a source of income after their retirement. Governments will typically provide for a basic pension allowance for all citizens – this is often referred to as a state pension. Additionally, as a benefit of employment, employers will often also provide an occupational pension fund for their employees. Occupational pension funds may be contributed to solely by the employer or to varying degrees by both the employer and the employee. Certain countries also require employers to provide occupational pension funds by law, subject to particular exclusions and minimum thresholds.

In 2003, the EU introduced Directive 2003/41/EC, which covered the activities of institutions for occupational retirement provision (hereinafter “IORP I”). In 2016, the EU recast IORP I with the introduction of Directive 2016/2341 (hereinafter “IORP II”). IORP II created a common standard for occupational pensions which sought to ensure proper protection for pension scheme members and beneficiaries. Both

²⁷⁰ KOKOTT, J. 2015. Opinion of Advocate General Kokott in case C-595/13 *Staatssecretaris van Financiën v Fiscale Eenheid X NV* cs. Court of Justice of the European Union. Paragraph 24.

Directives also enabled an internal market for occupational pension funds and the ability of pension funds to operate across the EU.

However, despite the introduction of both IORP I and IORP II, pension systems are still primarily a national matter, subject to country specific regulations and concepts. In some Member States, occupational pension funds are seen as part of the social security system alongside state pensions and they are regulated as if they were providing insurance to employees against the risk of loss of income following retirement. In other Member States, however, occupational pension schemes are simply seen as a way for employers to pay deferred salary to their former employees²⁷¹. PensionsEurope in their commentary on the introduction of IORP II noted that:

*“the way in which IORPs are organised and regulated varies significantly between Member States – not least because their integration with the first pillar (state) pension provision varies”.*²⁷²

PensionsEurope also added that both the EU and the European Insurance and Occupational Pensions Authority (“EIOPA”) *“should take account of the various traditions of Member States in their activities and should act without prejudice to national social and labour law in determining the organisation of IORPs”.*²⁷³

Occupational pension funds will have a separate and distinct legal personality from that of the sponsoring employer – that is the business which has set up the occupational pension fund for the benefit of its employees. Pension funds are usually set up under the law of trust, with independent trustees appointed to oversee the general management of the scheme.

Historically, there have been two types of occupational pension funds – defined benefit and defined contribution – however, in recent years the pension fund landscape has evolved further with the introduction of hybrid pension schemes. Each of these schemes are explained further below.

Defined benefit pension funds

A defined benefit pension scheme provides an employee with retirement benefits which are calculated based on a percentage of:

- The employee’s salary in the year, or years, prior to retirement; or
- The average salary during all or part of the employee’s employment period.

For example, an employee may build up retirement benefits amounting to, say, 70% of his or her final or average salary. Based on the required employee retirement benefits, the expected mortality rate and the expected return on investment, the pension fund then calculates the necessary premiums.

Irrespective of the calculation basis, under a defined benefit scheme, the employee bears no investment risk – their pensionable earnings are guaranteed.

Defined contribution pension funds

Defined benefit pension schemes are increasingly being closed to new members and being replaced by defined contribution schemes.

Under a defined contribution scheme, the employer and/or employee pay a specific premium to the pension fund in return for retirement benefits. The level of the benefits depends on the pension fund’s investment results, and the employee can usually choose from a number of investment packages with

²⁷¹ ERNST & YOUNG 2012. The EU VAT treatment of pension funds.

²⁷² PENSIONSEUROPE 2016. PensionsEurope welcomes the modernised rules for EU pension funds.

²⁷³ Ibid.

different investment risks and corresponding yields. As a result, under a defined contribution scheme, the employee, or pension scheme member, bears all of the investment risk.

Hybrid pension funds

A hybrid pension fund is often referred to as a Collective Defined Contribution (“CDC”) or defined ambition pension fund.

CDC schemes offer participants a target pensionable income, which is calculated by reference to:

- The employee’s salary; and
- The number of years of service and/or the number of years the person participates in the pension scheme.

In effect, this calculation method is equivalent to a defined benefit scheme. Unlike a defined benefit scheme, however, the contributions made by an employer are typically fixed – if it transpires that the contributions are insufficient, then the pension benefits will be lower than originally envisaged. In this way, the scheme is more akin to a defined contribution scheme.

CDC schemes combine a limited risk for fluctuating pension commitments for the employer with the advantages of a collective pension scheme and a higher, more predictable, pensionable income for the employee.

The use of CDC pension schemes is commonplace in the Netherlands and Norway, whilst the UK continues to look at the introduction of CDC schemes²⁷⁴.

10.2.2 THE VAT TREATMENT OF INVESTMENT MANAGEMENT CHARGES TO PENSION FUNDS

Prior to the CJEU’s judgments in *Wheels* and Case C-464/12, *ATP PensionService A/S v Skatteministeriet* (hereinafter “ATP”), the VAT treatment of management fees charged to pension funds varied amongst EU Member States, with management charges being subject to VAT at the standard rate in, for example, Belgium, Ireland, the Netherlands and the United Kingdom, but treated as VAT exempt elsewhere – for example in Germany, Luxembourg and Romania²⁷⁵.

The judgments in *Wheels* and ATP provided some harmonisation on this matter, concluding that charges to a defined benefit pension fund are subject to VAT and those to a defined contribution scheme are, in principle, VAT exempt. Both decisions were reached in considering the criteria set out by the Court, as detailed at chapters two and nine of this dissertation.

The VAT treatment of management fees for hybrid pension funds has not, as yet, been tested by the CJEU. However, a number of Dutch based hybrid pension funds are currently in dispute with the Dutch tax

²⁷⁴ UK PARLIAMENT - WORK AND PENSIONS COMMONS SELECT COMMITTEE. 2018. *CDC pension schemes: the next big thing in UK pensions?* [Online]. Available: <https://www.parliament.uk/business/committees/committees-a-z/commons-select/work-and-pensions-committee/news-parliament-2017/cdc-pension-schemes-17-19/> [Accessed].

²⁷⁵ ERNST & YOUNG 2012. The EU VAT treatment of pension funds.

authority over the VAT treatment of the management services provided to them and so it would appear likely that, at some stage, the Dutch national courts and possibly the CJEU will be asked to opine on this.

The VAT treatment of each type of pension fund is considered in detail, below.

10.2.2.1 DEFINED BENEFIT PENSION SCHEMES – THE COURT OF JUSTICE OF THE EUROPEAN UNION’S (“CJEU”) POSITION ON WHETHER THESE FUNDS ARE SPECIAL INVESTMENT FUNDS (“SIFs”)

The CJEU first addressed the question of whether a defined benefit pension scheme should be considered as a SIF in case C-424/11 (“Wheels”). In *Wheels*, the CJEU ruled that a defined benefit pension scheme cannot be considered a SIF, and therefore avail of VAT exemption on its management fees, as it is not sufficiently comparable with a UCITS fund. Specifically, the Court concluded that the members of a defined benefit pension fund do not bear the investment risk arising from their investment – the benefits received from the fund by the members has no bearing on the performance of the fund and it is, instead, a guaranteed, specific amount based on a separate calculation. The investment risk is, therefore, fully absorbed by the sponsoring employer who has the obligation to ‘top up’ the pension fund to ensure that the members receive the guaranteed amounts. This is in contrast to investors within a UCITS fund, who will bear investment risk.

The Court also concluded that the sponsoring employer of a defined benefit pension scheme is not in a comparable situation to that of an investor in a UCITS fund since, even though they bear the investment risk, the contributions which the employer pays into the retirement pension scheme are a means by which it complies with the legal obligations towards its employees.

The position set out in *Wheels* was also reaffirmed by the Court in C-26/12, *Fiscale eenheid PPG Holdings BV cs te Hoogezand v Inspecteur van de Belastingdienst/Noord/kantoor Groningen* (hereinafter “PPG”)²⁷⁶.

I would also argue that the investor, for the purpose of the VAT exemption, should be considered the person to whom the benefits of the investment are ultimately received. The English dictionary defines an investor as “*a person or organization that puts money into financial schemes, property, etc. with the expectation of achieving a profit*”. In the context of a pension fund, the person seeking to achieve a profit is the employee, or member of the pension scheme, not the sponsoring employer. Even if the sponsoring employer were to be considered the investor, I would argue that they could not be considered a “small” investor – the benefit to whom VAT exemption is intended to be conferred, in line with the stated aims of the EU.

It is notable that in *Wheels* the Court did not comment on any of the other criteria required for VAT exemption and solely focussed on the investment risk test. This highlights the critical issue for pension funds to qualify as a SIF – the question of who bears the investment risk. I will consider this particular point further in sections 10.2.2.4 and 10.2.2.5 for defined contribution pension schemes and hybrid pension schemes respectively.

In my view, for the reasons outline above, treating defined benefit pension funds as non-SIFs is appropriate.

²⁷⁶ 2013a. C-26/12 - *Fiscale eenheid PPG Holdings BV cs te Hoogezand v Inspecteur van de Belastingdienst/Noord/kantoor Groningen*. The Court of Justice of the European Union. Paragraph 31.

10.2.2.2 DEFINED BENEFIT PENSION SCHEMES – SHOULD THE INVESTMENT MANAGEMENT OF A DEFINED BENEFIT SCHEME BE CONSIDERED AN INSURANCE TRANSACTION?

The case for investment management services provided to defined benefit pension funds qualifying as VAT exempt has also seen a different question referred to the CJEU. In case C-235/19, United Biscuits (Pensions Trustees) Limited, United Biscuits Pension Investments Limited v Commissioners for Her Majesty’s Revenue and Customs (hereinafter “United Biscuits”), the CJEU was asked to opine on whether investment management services supplied to a defined benefit pension scheme may be classified as an insurance transaction within the meaning of Article 135(1)(a) of the EU VAT Directive and, on that basis, be exempt from VAT. Article 135(1)(a) states that Member States shall exempt “*insurance and reinsurance transactions, including related services performed by insurance brokers and insurance agents*”.

The position put forward by United Biscuits was that the definition of insurance must be given commonality across all EU legislation and that Article 2(3)(b)(iii) of EU Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (hereinafter “Solvency II Directive”), which establishes common rules relating to insurance across the EU, includes within its scope:

“management of group pension funds, comprising the management of investments, and in particular the assets representing the reserves of bodies that effect payments on death or survival or in the event of discontinuance or curtailment of activity”²⁷⁷

The point at issue is, therefore, whether the provision of investment management services to a pension fund is, in essence, the provision of insurance transactions considering, in particular, the inclusion of the above definition within the Solvency II Directive.

In AG Pikamäe’s opinion²⁷⁸, delivered on 14th May 2020, he concluded that investment management services provided to a pension fund cannot qualify as VAT exempt under Article 135(1)(a) of the EU VAT Directive as the investment management services did not have the material components of an insurance transaction. AG Pikamäe commented that the essentials for an insurance transaction are “*that the insurer undertakes, in return for prior payment of a premium, to provide the insured, in the event of materialisation of the risk covered, with the service agreed when the contract was concluded*”²⁷⁹. It is, therefore, the assumption of risk by the insurer that enables such an activity to be categorised as an insurance transaction. The Court’s judgment, delivered on 8th October 2020, agreed with the conclusions of AG Pikamäe’s – “*investment fund management services supplied for an occupational pension scheme, which do not provide any indemnity from risk, cannot be classified as ‘insurance transactions’*”²⁸⁰.

AG Pikamäe also commented that insurance transactions imply the existence of a contractual relationship between the provider of the insurance service and the person whose risks are covered by the insurance,

²⁷⁷ Article 2(3)(b)(iii) of 2009b. DIRECTIVE 2009/138/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II). 2009/138/EC. European Union.

²⁷⁸ PIKAMÄE, P. 2020. Opinion of Advocate General Pikamäe in Case C-235-19 - United Biscuits (Pensions Trustees) Limited, United Biscuits Pension Investments Limited v Commissioners for Her Majesty’s Revenue and Customs. Court of Justice of the European Union.

²⁷⁹ Ibid. Paragraph 30.

²⁸⁰ 2020a. C-235/19 - United Biscuits (Pension Trustees) Limited, United Biscuits Pension Investments Limited v Commissioners for Her Majesty’s Revenue and Customs. The Court of Justice of the European Union. Paragraph 51.

i.e., the insured. In the case of United Biscuits, as will be the case for other similar defined benefit pension funds, the investment manager does not assume any risk – that remains with the trustee and sponsoring employer – nor does the investment manager contract with the trustees of the pension fund to indemnify them against the materialisation of risk. The investment management services cannot, therefore, qualify as VAT exempt under Article 135(1)(a) of the EU VAT Directive.

In considering the need for alignment between the Solvency II Directive and the categorisation of pension fund management as an insurance transaction for VAT purposes, the AG noted the distinction within the Solvency II Directive between insurance, as set out at Article 2(3)(a) and operations, which includes pension fund management as set out at Article 2(3)(b). In the AG’s view, operations such as pension fund management are not insurance in the strictest sense but rather constitute services which are ancillary to the provision of insurance and is included in the Directive solely to regulate and limit an insurer’s business activities to those of insurance and operations arising directly therefrom.

10.2.2.3 DEFINED BENEFIT PENSION SCHEMES – RECOVERY OF THE VALUE ADDED TAX (“VAT”) CHARGED BY THE SPONSORING EMPLOYER

At the outset, it is noteworthy that UK defined benefit pension schemes pay around £100 million of VAT every year on investment management services²⁸¹ and that the majority of this VAT, as I have set out previously, is in principle not recoverable by these pension funds. This, therefore, clearly accounts for a substantial cost for defined benefit pension funds – and by extension, the sponsoring employers of these funds – as well as representing a significant source of income for the UK government.

Under EU VAT law, a taxpayer will be entitled to recover input VAT they incur where:

1. The input VAT has a direct and immediate link to an output transaction, or transactions, which give rise to the right to deduct the input VAT²⁸²; or
2. Where there is no direct and immediate link between a particular input transaction and one or more output transactions giving rise to the right to deduct, the costs of the services in question are part of a trader’s general costs and are, as such, components of the price of the goods or services which they supply²⁸³.

For a taxpayer to recover VAT, they must be making taxable supplies. Where a taxpayer makes exclusively exempt supplies, they will not be entitled to input tax recovery even where there is a direct and immediate link to those exempt supplies. This is clear from the Court’s judgment in C-98/98 (Commissioners of Customs & Excise and Midland Bank plc, hereinafter “Midland Bank”). It should also be noted that pension funds, as with most other investment funds, will typically have an activity of dealing in securities and other financial instruments and, as discussed at chapter eight, such activities are VAT exempt. It stands, therefore, that pension funds will have either no, or a very low²⁸⁴, ability to recover the input VAT that they incur. This is

²⁸¹ PINSENT MASONS 2013. Defined benefit pension schemes must pay VAT on investment management services says CJEU.

²⁸² 2000a. C-98/98 - Commissioners of Customs & Excise and Midland Bank plc. The Court of Justice of the European Union.

²⁸³ 2013b. C-104/12 - Finanzamt Köln-Nord v Wolfram Becker. The Court of Justice of the European Union.

²⁸⁴ Article 169(c) of the EU VAT Directive permits recovery of input tax where transactions in securities are carried out with customers established outside of the EU. Pension funds, and other investment funds, will therefore be able to recover a proportionate amount of input tax incurred in this respect.

usually in contrast to the sponsoring employer which, depending on its business activities and unless it is also exclusively making exempt supplies, will typically have a greater ability to recover the VAT that it incurs. The question of sponsoring employers recovering VAT on the costs associated with the pension funds they set up is, therefore, clearly important.

The CJEU specifically considered, in case C-26/12 (PPG), whether either of the above tests were met for a sponsoring employer in the situation where it incurred and paid for administration and management services of a pension fund, which had separate legal personality, that it operated for its employees. The Court ruled that the sponsoring employer was, in principle, entitled to recover the VAT incurred as *“the services in question for the purpose of the administration of its employees’ pensions and the management of the assets of the pension fund set up to safeguard those pensions. By setting up the fund, PPG complied with a legal obligation imposed on it as an employer”*²⁸⁵.

In PPG, the sponsoring employer contracted directly with the fund manager to provide the investment management services to the pension fund. Such an arrangement is permissible under Dutch pension law. In the UK, His Majesty’s Revenue and Customs (“HMRC”) has historically allowed sponsoring employers to recover 30% of the VAT incurred on fund management charges, to represent an allocation of the administrative costs incurred in running the pension fund by the asset manager²⁸⁶. This concessionary treatment was irrespective of the fact that the trustees of the pension fund would be the party contracting with, and receiving the services from, the asset manager. Following PPG, HMRC updated their guidance to state:

*“A tripartite contract between a supplier, pension scheme trustee and employer may be used to meet the requirement that an employer contracts for investment services...in order to deduct the VAT incurred on those services”*²⁸⁷

Tripartite contracts have, however, been difficult to implement due to the interaction between these agreements and the law of pension funds as set out in the Pension Act 2004 and, as a result, HMRC has continued to allow the 30% concession. The legal issues surrounding tripartite agreements can be summarised as²⁸⁸:

For asset managers:

- Asset managers have specific duties to the trustees of the pension fund, including a duty to invest in the best interest of the fund members and beneficiaries. Adding the sponsoring employer to the agreement may impact on these duties;
- Asset managers are required to take instruction from the trustees;
- The sponsoring employer would be able to seek redress against the manager for any contractual issues or disputes. This would not be possible under a bi-lateral agreement between the asset manager and the trustees.

²⁸⁵ 2013a. C-26/12 - Fiscale eenheid PPG Holdings BV cs te Hoogezand v Inspecteur van de Belastingdienst/Noord/kantoor Groningen. The Court of Justice of the European Union. Paragraph 25.

²⁸⁶ HER MAJESTY’S REVENUE AND CUSTOMS 2012. VAT Notice 700/17: Funded pension schemes.

²⁸⁷ HER MAJESTY’S REVENUE AND CUSTOMS 2019. VIT45400 - Specific issues: attribution of services received in connection with funded occupational pension schemes following CJEU judgement in PPG - use of tripartite contracts. *In: CUSTOMS, H. M. S. R. A. (ed.)*.

²⁸⁸ CLIFFORD CHANCE US LLP 2015. VAT and Pension Fund Management – the new guidance.

- Given, as per HMRC's requirements to enable VAT deduction, fees would become payable by the sponsoring employer, in the event of non-payment, how long will the asset manager be prepared to wait until they pursue the trustees for payment?

For trustees:

- As with asset managers, trustees have very specific duties conferred on them by pensions law to act in the best interests of the scheme members and beneficiaries, and to act impartially. Including the sponsoring employer in the management agreement adds legal complexity on both matters.

For sponsoring employers:

- Employers paying fees directly to the asset manager may potentially result in no Corporate Tax deduction being available on those costs, which is not the case under the existing arrangements. From a UK perspective, losing a Corporate Tax deduction at 19% removes the economic benefit of such a tripartite arrangement given the additional VAT recovery will only be at a maximum effective rate of 14% (being the additional 70% not recoverable under the current HMRC concession, multiplied by the 20% VAT rate).

In PPG, at paragraphs twenty-seven and twenty-eight, the Court commented:

"If there were no right to deduct the input tax paid, not only would the taxable person be deprived, by reason of the legislative choice to protect pensions by a legal separation of the employer from the pension fund, of the tax advantage resulting from the application of the deduction system, but the neutrality of VAT would also no longer be guaranteed.

That consideration is not called into question by the possibility, raised at the hearing, of complying with the legal obligation of providing a pension scheme for the taxable person's employees by other means than setting up a fund in the form of a legally and fiscally separate entity. The contrary view would amount to restricting the freedom of taxable persons to choose the organisational structures and the form of transactions which they consider to be most appropriate for their economic activities and for the purposes of limiting their tax burdens"²⁸⁹

From these comments, the intention of the Court would appear to be, in principle, to allow sponsoring employers to recover the VAT on costs associated with operating a pension fund for their employees, even where the pension fund is a separate legal person and the services are contracted for and provided to the pension fund as a separate legal person. It remains to be seen whether further defined benefit pension funds will take action on this matter, however, from a UK perspective a departure from the current policy would appear unlikely in the short term due to the difficulties discussed earlier in this section.

10.2.2.4 DEFINED CONTRIBUTION PENSION SCHEMES

Case C-464/12 (ATP) ruled that defined contribution pension funds could qualify as a SIF and enjoy VAT exemption on their management fees. At paragraph fifty-nine of its judgment, the Court commented:

²⁸⁹ 2013a. C-26/12 - Fiscale eenheid PPG Holdings BV cs te Hoogezand v Inspecteur van de Belastingdienst/Noord/kantoor Groningen. The Court of Justice of the European Union. Paragraphs 27-28.

*“pension funds such as those at issue in the main proceedings may fall within the scope of that provision if they are funded by the persons to whom the retirement benefit is to be paid, if the savings are invested using a risk-spreading principle, and if the pension customers bear the investment risk”.*²⁹⁰

We can see that the Court has laid down the same conditions as in C-595/13 (Fiscale Eenheid) – namely the requirement for the participant to bear the investment risk and for the pooling of investments for the purpose of risk spreading. In C-464/12 (ATP), the Court did not comment on the state supervision requirement, however, EU domiciled pension funds, such as the one in this case, are subject to the provisions of IORP I and IORP II, which requires supervision and regulatory oversight of occupational pension funds operating in the EU by the competent authority of the Member State in which the pension scheme is located.

Until 1st April 2020, defined contribution pension funds were not specifically mentioned within Schedule 9 (“Exemptions”) of the UK’s Value Added Tax Act 1994 (“VATA 1994”)²⁹¹. UK investment managers had, instead, been able to rely on EU jurisprudence to avail of VAT exemption for UK schemes which met the relevant conditions. From 1st April 2020, Statutory Instrument (“SI”) 2020/209²⁹² inserted item (k), “a qualifying pension fund”, to Schedule 9 Group 5 Item 9 of VATA 1994, bringing UK law formally into line with the EU position. SI 2020/209 also added the following conditions for a pension fund to be “qualifying”:

- “qualifying pension fund” means a pension fund in relation to which all of the following conditions are satisfied—
 - (a) it is solely funded, whether directly or indirectly, by pension members;
 - (b) the pension members bear the investment risk;
 - (c) the fund contains the pooled contributions of more than one pension member;
 - (d) the risk borne by the pension members is spread over a range of investments; and
 - (e) the fund is established in the United Kingdom or in a member State;
- “pension member” means, in relation to a qualifying pension fund, a person to or in respect of whom retirement benefits are to be paid from the fund;

There is a clear application and consistency of the criteria required for pension funds to qualify as a SIF under UK VAT law and those set out by the CJEU.

10.2.2.5 HYBRID PENSION SCHEMES

As can be seen from the CJEU’s conclusions and analysis of the VAT treatment of defined benefit and defined contribution pension funds, the critical test for pension funds is who bears the investment risk – the sponsoring employer or the participants. I will now consider this particular point for hybrid pension schemes, however, before doing so will briefly consider the other conditions required for pensions funds to avail of VAT exemption to evidence the importance of the investment risk test.

²⁹⁰ 2014. C-464/12 - ATP PensionService A/S v Skatteministeriet. The Court of Justice of the European Union. Paragraph 59.

²⁹¹ 1994. Value Added Tax Act 1994. United Kingdom.

²⁹² 2020b. The Value Added Tax (Finance) Order 2020. 2020/209. United Kingdom.

The conditions for a pension fund meeting the SIF tests can be summarised as follows:

Condition	Is the condition met?	Comment
The fund is a collective investment of capital raised from the public; and	Yes.	<p>In the AG opinion in ATP, AG Cruz Villalón commented at paragraph sixty-two²⁹³:</p> <p><i>“The fund can only be considered a pooling of the beneficiaries’ funds if the beneficiaries enjoy an unconditional legal right with respect to their investment. They may not be able to realise the right at will (i.e. sell their entitlement) and they may receive the benefit of their investment only upon retirement”.</i></p> <p>The CJEU confirmed this view in its judgment in ATP, and also added that neither the source of the contributions to the pension fund nor the contribution method was relevant, commenting at paragraphs fifty-three and fifty-four:</p> <p><i>“53. For the purposes of determining whether an undertaking constitutes a special investment fund, the fact that the contributions are paid by the employer is irrelevant: the employer may be under an obligation to transfer to the pension fund sums corresponding to employees’ contributions....</i></p> <p><i>54. The fact that the amount paid into the pension fund is based on collective agreements between labour-market organisations is also irrelevant: it does not alter the fact that the contribution is paid by the worker (or at least in his name and on his behalf), that he will benefit from the proceeds of his investments and that he also bears any risks in that connection. By the same token, it is of little consequence that workers have the option of making additional contributions or that other persons may contribute to the pension fund through personal retirement savings plans.”²⁹⁴</i></p>

²⁹³ CRUZ VILLALÓN, P. 2013. Opinion of Advocate General Cruz Villalón in case C-464/12 - ATP PensionService A/S v Skatteministeriet. Court of Justice of the European Union. Paragraph 62.

²⁹⁴ 2014. C-464/12 - ATP PensionService A/S v Skatteministeriet. The Court of Justice of the European Union. Paragraph 53-54.

The fund must operate on the principle of risk-spreading; and	Yes.	As is an accepted matter for the CJEU, pension funds will operate on the principle of spreading risk ²⁹⁵ . In both the preamble to and at Article 7 of IORP II, the EC comment that occupational pension funds should “ <i>have an equitable spread of risks and benefits between generations in occupational retirement provision</i> ”. ²⁹⁶
The return on the investment made by each participant is dependent on the performance of the investments over the period in which they are held. In this respect, the participants are entitled to the profits and bear the risk connected with the management of the fund; and	Dependent on pension fund type	In his opinion on ATP, AG Cruz Villalón commented at paragraph sixty-three: <i>“the beneficiaries have to bear both the cost of the fund and the risks of the investment, even though the contributions can be paid by their employer as part of their payment package. This will generally be the case with respect to defined-contribution, but not with respect to defined-benefit schemes”</i> . ²⁹⁷ As noted above, this is the critical condition for pension funds to qualify as a SIF. For a full analysis of the application of this test to specific types of pension funds see: <ul style="list-style-type: none"> • Defined benefit – section 10.2.2.1 • Defined contribution – section 10.2.2.4 • Hybrid schemes – section 10.2.2.5/below
The fund is subject to specific state supervision; and	Yes.	Occupational pension funds are subject to supervision of the competent authority in their home Member State. This is conferred by Article 9 of IORP II.

The question for hybrid pension funds is, therefore, who bears the investment risk. There would appear to be three possible outcomes here:

1. The risk is entirely borne by the employee

This would apply where the pensionable amount is not guaranteed and is entirely dependent on the fund’s investment performance. In such an instance, the fact pattern would appear to be

²⁹⁵ See for example, *ibid*.

²⁹⁶ Article 7 of 2016. DIRECTIVE (EU) 2016/2341 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs). 2016/2341. European Union.

²⁹⁷ CRUZ VILLALÓN, P. 2013. Opinion of Advocate General Cruz Villalón in case C-464/12 - ATP PensionService A/S v Skatteministeriet. Court of Justice of the European Union. Paragraph 63.

identical to that of a defined contribution pension fund and, in line with CJEU's findings in ATP, the investment management fees should be VAT exempt.

2. The risk is entirely borne by the employer

Where the pensionable amount is fully guaranteed by the employer and, by extension, the pension scheme members bear no investment risk, the fact pattern would appear to be identical to that of a defined benefit pension fund and, in line with CJEU's findings in Wheels and PPG, the investment management fees should be subject to VAT.

3. The risk is shared, or borne in part, by both the employee and employer

In order to consider the position where there is a partial guarantee of pensionable benefits and the employer and employee share investment risk, we must revisit AG Cruz Villalón's opinion in ATP. At paragraph sixty-four, the AG comments:

*“special investment funds as defined by Member States’ has to include occupational pension funds where such funds pool the assets of several beneficiaries, and allow the spreading of the risk over a range of securities. **This is only the case where the beneficiaries bear the risk of the investment**” [emphasis added].*

There are two possible interpretations of this statement:

1. Exemption is available where the beneficiaries bear any element of the investment risk; or
2. Exemption is available only where the beneficiaries must bear all of the investment risk.

The Court has not yet been asked to opine on the VAT treatment of a hybrid pension scheme and, until then, domestic tax authorities where hybrid pension schemes are commonplace will be required to consider this issue under their domestic VAT law. In the Netherlands, for example, a number of CDC pension schemes are currently challenging the Dutch tax authority's assertion that their investment management charges are subject to VAT.

Bennet and van Meertem concluded that a Dutch CDC pension scheme should be considered as a SIF for the purposes of the VAT exemption. They also argued that, on the introduction of CDC schemes in the UK, the VAT exemption should be extended to these pension funds as well²⁹⁸. It is noteworthy that this conclusion was based on the positions where *“there would be no legal requirement to pay any deficit make up contributions”*. This conclusion appears consistent with those set out above.

10.3 TERRITORIALITY OF THE VALUE ADDED TAX (“VAT”) EXEMPTION FOR SPECIAL INVESTMENT FUNDS (“SIFS”)

There is a divergence amongst Member States when it comes to the application of VAT exemption for non-domestic, or offshore, funds. These approaches can be categorised into three distinct groups:

²⁹⁸ BENNETT, P. & VAN MEERTEN, H. 2019. How Do CDC Schemes Qualify under the IORP II Directive?

1. Member states who take the position that the exemption can only apply to their domestic funds;
2. Member states who, in addition to allowing exemption for domestic funds, also extend this to overseas funds marketed to retail investors in their territory;
3. Member states who allow exemption for all comparable funds in other EU Member States, or even those located outside the EU.

These differing approaches lead to differing VAT recovery profiles for asset managers, depending on where they and their investment funds are established²⁹⁹. It worth noting that the territoriality of the VAT exemption for the management of a SIF has not been specifically tested by the CJEU. I will examine each of the above approaches in turn but, before doing so, will consider the impact of countries identifying, or not as the case may be, offshore funds as SIFs.

10.3.1 THE IMPACT OF INCLUDING OFFSHORE FUNDS AS SPECIAL INVESTMENT FUNDS (“SIFs”)

Generally, charges by an EU based investment manager to a foreign investment fund will not be subject to domestic VAT due to the EU place of supply rules which, for B2B, require VAT to be applied in the location of the recipient of the services (i.e., the location of fund).

From the fund’s perspective, a local VAT obligation in their own Member State will only occur to the extent that the fund is not considered a SIF under domestic VAT law in the fund’s Member State. In this respect, the VAT due on the management fees charged to a fund will be identical irrespective of whether they engage a domestic or foreign asset manager. This ensures that fiscal neutrality is achieved between comparable domestic funds without regard to the location of the fund’s investment manager.

For the investment manager, their supply will be outside the scope of VAT – no domestic VAT will be due on the management fee, due to the place of supply being in a different country to that of the manager. However, the inclusion of an offshore fund as a SIF in the domestic VAT law of the country of the investment manager will restrict the manager’s ability to recover the input VAT it incurs in making its supply. This is contrasted with the position where the fund is not categorised in domestic VAT law as a SIF, in which case full input VAT recovery will be available on the costs associated with the investment management supply. The potential impact is shown in the table below.

	SIF in Manager’s Location	Not a SIF in Manager’s Location
Management fee revenue – outside the scope of VAT	100	100
Outsourced costs associated with supply – net of VAT	(50)	(50)
Irrecoverable VAT – assumed VAT rate of 20%	(10)	-
Profit	40	50

²⁹⁹ PWC 2018. Alternative investment fund management: Is harmonisation needed for the VAT exemption?

We can see, therefore, that the determination of an offshore fund as a SIF in the territory of the manager has a direct impact on the profit a manager will achieve from its activity, as well as the amount of VAT the tax authority will collect.

10.3.2 RESTRICTING EXEMPTION TO DOMESTIC FUNDS ONLY – INTERPRETING THE JUDGMENTS AND ADVOCATE GENERAL (“AG”) OPINIONS OF THE COURT OF JUSTICE OF THE EUROPEAN UNION (“CJEU”)

In JP Morgan Claverhouse, the CJEU commented at paragraph thirty-nine that:

*“the Commission consider that the Member States alone are empowered to identify, amongst the funds on their territory, those which meet the definition of ‘special investment funds’”.*³⁰⁰

The use of the phrase *“amongst the funds on their territory”* suggests that the Court does not intend for Member States to be able to extend the definition of a SIF beyond those established in their own country. Furthermore, in *Fiscale Eenheid*, the Court, at paragraph forty-nine, stated that a fund *“cannot constitute a special investment fund within the meaning of Article 13B(d)(6) of the Sixth Directive unless national law provides for specific State supervision in respect of such a fund”*³⁰¹. Taken literally, this would suggest that unless a fund is subject to the supervisory laws of a specific Member State, it cannot be a SIF in that Member State. Whilst this specific point has not been tested at the CJEU, the literal interpretation of the Court’s judgments in both JP Morgan Claverhouse and *Fiscale Eenheid* would suggest that restricting the VAT exemption to domestic funds established in, or supervised by, a specific Member State is the intention of the Court.

In the AG opinion in *Fiscale Eenheid*, AG Kokott offered some further clarity on this:

“Once specific State supervision of investment funds began to be regulated at EU level with the UCITS Directive, the Court of Justice limited the discretion of Member States to define special investment funds within the meaning of Article 13B(d)(6) of the Sixth Directive: Member States must classify funds that are regulated under the UCITS Directive as ‘special investment funds’. The power of Member States to define was thus overlaid by the harmonisation of supervisory law.

As long as supervisory law is not regulated at EU level, however, Member States continue to have the power to define....

*in so far as Member States provide for specific State supervision for other types of investment funds also, these too will generally benefit from the tax exemption”*³⁰²

AG Kokott appears to be suggesting that funds regulated by virtue of an EU Directive, for example the UCITS Directive, are subject to state supervision and therefore have the capability of being a SIF even where the

³⁰⁰ 2007. C-363/05 - JP Morgan Claverhouse Investment Trust plc, The Association of Investment Trust Companies v The Commissioners of HM Revenue and Customs. The Court of Justice of the European Union. Paragraph 39.

³⁰¹ 2015. C-595/13 - Staatssecretaris van Financiën v Fiscale Eenheid X NV cs. Court of Justice of the European Union. Paragraph 49.

³⁰² KOKOTT, J. 2015. Opinion of Advocate General Kokott in case C-595/13 Staatssecretaris van Financiën v Fiscale Eenheid X NV cs. Court of Justice of the European Union. Paragraphs 23-26.

fund is established in another Member State. On the other hand, where the fund is not subject to regulation at EU level then it would require to be regulated by the Member State in order to qualify for VAT exemption in that Member State.

10.3.3 EXTENDING EXEMPTION TO OVERSEAS FUNDS WHICH ARE MARKETED TO RETAIL INVESTORS IN THE TERRITORY OF A MEMBER STATE OF THE EUROPEAN UNION (“EU”)

The UK, in addition to conferring exemption to domestically established funds, also allows VAT exemption to overseas funds which meet certain conditions. VATA 1994 provides for overseas collective investment schemes which are registered with the Financial Conduct Authority (“FCA”) under the relevant provision of the Financial Services and Markets Act 2000 (“FSMA 2000”) to qualify as a SIF, unless:

- The collective investment scheme is not currently being marketed in the UK; and
- It has never been marketed in the UK; or
- less than 5% of its shares or units are held by, or on behalf of, investors who are in the UK.

Where the above conditions are met, the investment scheme is not treated as being a SIF for UK VAT purposes³⁰³. This is often referred to as the ‘active marketing’ requirement.

This provision has the effect of removing the VAT exemption for overseas funds which are not, in effect, marketed to, or targeted at, retail investors in the UK. In principle this appears to be consistent with the EU policy to only allow exemption for “smaller”, or retail, investors.

This provision does, however, introduce significant complexity to UK VAT law. In HMRC’s own internal manuals they *“recognise that the question of whether or not a fund/sub-fund is actively marketed to UK retail investors is potentially complex”*³⁰⁴.

Switzerland also allows foreign investment funds to qualify for VAT exemption, but applies a simpler approach to determining this than the UK. Swiss VAT law³⁰⁵ provides, at Article 21 paragraph 19(f), for a VAT exemption for the management of collective investment schemes in accordance with the Collective Investment Schemes Act of 23rd June 2006³⁰⁶ (“CIS Act”). The CIS Act covers both domestic and foreign collective investment schemes which are registered with the Swiss Financial Market Supervisory Authority (“FINMA”) for distribution in Switzerland. For this purpose, the VAT exemption does not draw a distinction between retail and institutional investors – if the fund is registered with FINMA, VAT exemption will apply.

Despite the additional complexity of the UK’s system, the carve out in UK law for overseas funds which are not marketed to retail investors in the UK ensures that a UK asset manager’s VAT recovery profile is

³⁰³ 1994. Value Added Tax Act 1994. United Kingdom. See Schedule 9, Part II, Group 5, Note 6A.

³⁰⁴ HER MAJESTY’S REVENUE AND CUSTOMS 2020. VATFIN5260 - Management of investments, portfolios, funds, ‘wrapper’ products and related services: VAT exemption for the management of open-ended collective investment schemes: ‘actively marketed’.

³⁰⁵ 2009c. Federal Act on Value Added Tax of 12th June 2009. Switzerland.

³⁰⁶ 2006c. Collective Investment Schemes Act of 23rd June 2006. Switzerland.

consistent with that for non-retail domestic funds – i.e., in both circumstances VAT recovery will be allowed. In my view, the UK’s approach achieves the stated policy aims of the EU and the UK.

10.3.4 EXTENDING EXEMPTION TO ALL COMPARABLE FUNDS IN OTHER MEMBER STATES OF THE EUROPEAN UNION (“EU”)

From 2013, Luxembourg’s VAT law was updated to include investment funds from other EU Member States which are similar to those domestic funds to which VAT exemption is conferred and which are monitored by a supervisory body in a different Member State of the EU³⁰⁷. Prior to this update, Luxembourg VAT law restricted the definition of a SIF to funds established in Luxembourg which were subject to the supervision of the Commission De Surveillance Du Secteur Financier (“CSSF”), the Luxembourg financial markets regulator. The decision of the Luxembourg tax authority to extend the scope of the VAT exemption was taken in response to ongoing VAT litigation between the tax authority and a Luxembourg based investment manager in respect of whether an Irish domiciled fund could qualify for VAT exemption under Article 44(1)(d) of Luxembourg VAT law at that time. The litigation was finally concluded in 2016 in favour of the taxpayer – who had argued an overseas fund could not fall within the exemption – through a judgment of the Luxembourg Cour d’Appel (its appellate court)³⁰⁸.

Article 5 of The UCITS Directive states that:

“1. No UCITS shall pursue activities as such unless it has been authorised in accordance with this Directive.

Such authorisation shall be valid for all Member States.”³⁰⁹

Whilst there is a notification procedure for a UCITS fund to be marketed in a Member State other than the Member State in which it is established and supervised, as defined in Chapter XI of the UCITS Directive, the competent authority of the Member State in which the UCITS is being marketed has no supervisory oversight for the UCITS fund. The UCITS fund is, therefore, only supervised by its home regulator.

For the purpose of the VAT exemption, the question is whether the UCITS Directive confers wider supranational supervision of funds, which would mean that a UCITS qualifies as a SIF in all Member States irrespective of its country of establishment.

The fundamental freedoms of the EU preclude Member States from treating cross border situations less favourably than domestic situations, where both the offshore and domestic situations are “objectively comparable”³¹⁰. The question here is whether an offshore fund, which meets all of the conditions set out by the CJEU, is sufficiently comparable to a domestic fund which also meets each of the conditions. This

³⁰⁷ See Article 44(1)(d) of 1979. Loi du 12 février 1979 concernant la taxe sur la valeur ajoutée. A-No.11. Luxembourg.

³⁰⁸ HERBAIN, C. A. & RICHARDIN, M.-I. Investment Fund Taxation - VAT and Investment Funds. *EUCOTAX Series on European Taxation*, 59, P.63-82.

³⁰⁹ Article 5 of 2009a. Council Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS). *2009/65/EC*. European Union.

³¹⁰ 2006b. C-446/04 - Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue. The Court of Justice of the European Union. Paragraph 46.

question must be considered in the context of the stated policy aim of the EU for the SIF VAT exemption – namely to encourage investment in collective funds by retail, or “small”, investors.

It could be argued that the management of a UCITS fund should not have differing VAT treatments in different Member States, given the harmonisation of the regulation and operating framework for UCITS funds across the EU – i.e., they are, *prima facie*, “objectively comparable”. To do so would sit contrary to the principle of fiscal neutrality and potentially encourage asset managers and funds to organise themselves in a particular way to take advantage of the differing VAT rules across Member States for, effectively, the same product sets. However, this approach would only work where a UCITS fund is available for investment by retail investors across all EU Member States – we must remember that not all UCITS funds will be available in every Member State, specifically where the fund has not made the necessary notifications to the domestic supervisory authority in a particular country. Where the fund is not available for investment by retail investors, and in considering EU policy, there is no rationale to treat the fund as SIF.

The “objective comparability” of non-UCITS EU funds is less clear and would require a case-by-case analysis. However, as a general observation, I would advocate for a similar consideration of the comparability test. One could argue that any fund within the EU which meets the tests set out by EU should be, by default, a SIF in all Member States. However, in my view, this would be far too blunt an approach. Where a non-UCITS fund is not available or marketed for investment to retail investors, or indeed at all, in a specific Member State, there is, as with UCITS funds, no logic in my view to qualifying that fund as a SIF in the Member State of the manager by default. A blanket approach to categorising SIFs, in the way adopted by Luxembourg, is therefore not one I would advocate for.

10.3.5 EXTENDING EXEMPTION TO FUNDS LOCATED OUTSIDE OF THE EUROPEAN UNION (“EU”)

As a starting point, it is without doubt that extending the definition of a SIF to cover all non-EU domiciled funds is not appropriate. Doing so would result in investment funds which clearly are not intended for retail investors, and which are not in competition with UCITS, being included within the exemption.

Non-EU funds can currently be distributed to EU investors – indeed AIFMD recognises the concept of a non-EU AIF. For a non-EU AIF to be marketed to EU investors, however, the fund must receive approval from both ESMA and the EC. Approval will only be given where ESMA is satisfied that there are no significant obstacles regarding investor protection, market disruption, competition and the monitoring of systemic risk. This opens the very real possibility that where a non-EU funds is approved as an AIF, it will bear a number of the hallmarks and, importantly, investor protections of EU based funds.

The merits of an AIF being considered a SIF is discussed at section 10.1 of this dissertation – in my view there will be AIFs, including those domiciled outside of the EU, that will be comparable to and in competition with UCITS, however, this can only be determined on a case-by-case basis. Taking, for example, a US mutual fund which is intended for retail investors, offers similar protections to those investors as a UCITS fund and is regulated by the US Securities and Exchange Commission (“SEC”) – where such a product is approved by ESMA and the EC for marketing to EU retail investors, it does not seem unreasonable to conclude that this is likely to be in competition with UCITS.

Article 169(c) of the VAT Directive states that *“the taxable person shall be entitled to deduct the VAT...used for...transactions which are exempt pursuant to points (a) to (f) of Article 135(1), where the customer is established outside the Community or where those transactions relate directly to goods to be exported out of the Community”*. This provision has the effect of allowing a taxpayer to recover input VAT on transactions

in securities where the customer is based outside of the EU. The VAT exemption for the management of a SIF provided for in Article 135(1)(g) is not, however, included within Article 169. As I have discussed earlier in this dissertation, the VAT exemption for SIFs has, at least in part, its origins in the exemption conferred by Article 135(1)(f) and, in general, not extending Article 169 to cover asset management of non-EU funds puts EU investment managers at a disadvantage to those based outside of the EU in locations with more favourable, or potentially no, consumption tax system such as the USA. However, from an investor perspective, including investment management services within Article 169 would disadvantage EU funds compared to those based outside of the Community – this would be particularly true where non-EU funds which are approved by ESMA and the EC for marketing in the EU and are, thus, in competition with UCITS. For this reason, the case for extending Article 169 to include investment management services is not, in my view, strong.

10.4 VALUE ADDED TAX (“VAT”) RECOVERY FOR SPECIAL INVESTMENT FUNDS (“SIFs”)

Article 168 of the EU VAT Directive allows a taxable person to deduct the VAT they incur in so far as the goods and services on which this VAT is incurred is used for taxable transactions. Businesses which make exempt supplies will not, in principle, be able to recover any VAT incurred – this applies to managers of SIFs and, typically, the SIFs themselves in the majority of cases. Where the SIF is engaged in security or share dealing activities, as will be the case for UCITS funds, the SIFs revenues will be VAT exempt (see section 8.1 for a detailed commentary on the VAT treatment of security dealing activities). There will be instances where a SIF has a business activity other than share dealing – for example, real estate funds whose VAT recovery profile will be dependent on the nature of the rental or property disposal income they receive. In a number of instances this will be taxable and entitle the fund to VAT recovery.

There are differing approaches to the VAT recovery for SIFs across the EU. PwC, in its study on the economic effects of the VAT exemption for financial services in 2006, concluded that differences between Member States in terms of approaches to VAT recovery calculations for businesses with partial recovery entitlements, was one of the features of the EU VAT system which led to distortion³¹¹.

A number of Member States, including the UK and Ireland, allow a SIF which is transacting in securities to recover input VAT on its security transactions which are based outside of the EU. This is allowed under Article 169(c) of the EU VAT Directive, which states:

“In addition to the deduction referred to in Article 168, the taxable person shall be entitled to deduct the VAT referred to therein in so far as the goods and services are used for the purposes of the following:

(c) transactions which are exempt pursuant to points (a) to (f) of Article 135(1), where the customer is established outside the Community”.

As a reminder, Article 135(1)(f) exempts *“transactions, including negotiation but not management or safekeeping, in shares, interests in companies or associations, debentures and other securities”.*

The Irish tax authority also allows, by concession, asset managers to look-through to the VAT recovery rate of the funds being managed to determine the amounts of input VAT which can be recovered by the

³¹¹ PWC 2006. Study to Increase the Understanding of the Economic Effects of the VAT Exemption for Financial and Insurance Services. P.41-43.

manager. This would appear to be contrary to EU VAT law as Article 169(c) does not include the management of SIFs, which is covered by Article 135(1)(g), within its scope.

In Luxembourg, the tax authority's position³¹² is that all Luxembourg domiciled SIFs whose management is VAT exempt carry out an economic activity and are taxable persons by default. However, with limited exceptions for certain AIFs³¹³, the Luxembourg tax authority does not generally permit any VAT recovery for these SIFs³¹⁴. Where a Luxembourg SIF has investments in non-EU securities, not allowing a proportionate input VAT recovery appears contrary to Article 169(c) of the EU VAT Directive and impedes fiscal neutrality. According to Herbain and Richardin³¹⁵, despite this official situation, the Luxembourg tax authority has a "certain tolerance" on a "case-by-case" basis which can result, "on occasion" to input VAT recovery. This occasional departure from the official position, in my view, only serves to create further complexity and further undermines the principles of fairness and fiscal neutrality.

10.5 THE APPLICATION OF VALUE ADDED TAX ("VAT") LAW TO INDUSTRY AND TECHNOLOGICAL DEVELOPMENTS

The investment management industry is continually developing with investment managers responding to market conditions, technological enhancements and investors needs to develop new and innovative investment products, strategies and service delivery models. Historically, VAT law has struggled to keep pace with the industry – as highlighted earlier in this dissertation, in 2020, two of the twenty-three cases referred to the CJEU were in respect of the VAT treatment of investment management which evidences the continuing challenges for the industry.

In particular, the wider application of technology across the industry has given rise to interpretive challenges with added complexities in identifying what service is being provided – is it an investment management service or a technology service – and how existing VAT law applies to these. Newly designed investment products – for example, cryptocurrencies and non-fungible tokens ("NFTs") – and service delivery models – for example, robo-advice and model portfolio services – are the latest developments to pose interpretive challenges to the industry and tax administrations.

Cryptocurrencies and NFTs, as investable assets, clearly have the potential to be included in investment funds and an investment fund which includes either or both assets is likely to be an AIF³¹⁶. The comments on the VAT treatment of AIFs set out earlier in this chapter are therefore equally relevant to funds which invest in cryptocurrencies and NFTs. The VAT treatment of transacting in cryptocurrencies and NFTs is not considered in this dissertation.

The principles based approach applied by the EU to defining a SIF inherently gives rise to interpretive challenges. However, it does ensure that it is possible for new products to qualify for exemption from inception and thus, in my view and on balance, is better than prescribing particular funds as SIFs. Supplementing a principles based approach with clear and timely guidance by domestic and, where

³¹² 2013d. Circulaire No 723ter du 7 novembre 2013. 723. Luxembourg.

³¹³ AIFs invested in real estate, works of art, or other tangible goods may be entitled to recover VAT. See: BAILLY, J. & LAMBION, M. VAT and AIFs: how AIF structures can safely navigate VAT rules.

³¹⁴ Ibid.

³¹⁵ HERBAIN, C. A. & RICHARDIN, M.-I. Investment Fund Taxation - VAT and Investment Funds. *EUCOTAX Series on European Taxation*, 59, P.63-82.

³¹⁶ As a result of the conditions for a fund to be a UCITS – specifically the liquidity requirements set out in Article 1 of the UCITS Directive.

relevant, supranational legislators on the application of these principles to new products would help mitigate the interpretive challenges.

CHAPTER 11: ALTERNATIVES TO THE VALUE ADDED TAX (“VAT”) EXEMPTION FOR SPECIAL INVESTMENT FUNDS (“SIFs”)

11.1 ZERO RATING

11.1.1 THE DIFFERENCE BETWEEN ZERO RATING AND EXEMPTION

Before discussing the appropriateness of zero rating compared to exemption, we must consider the differences between both VAT treatments.

Whilst both zero rated and exempt supplies are not subject to VAT, the distinction between each is important for VAT purposes. Supplies which are VAT exempt will not entitle the supplier to deduct any input tax incurred in making those supplies. This input tax, therefore, becomes a cost component of the supplier’s business. That contrasts with supplies which are zero rated which will entitle the supplier to deduct any input tax incurred in making those supplies. The impact of this can be shown in the following, simple, example:

	Exempt trader	Zero-rated trader
Sales	100	100
Purchases – exclusive of VAT	(50)	(50)
Irrecoverable VAT [<i>assuming a 20% VAT rate</i>]	(10)	-
Net profit	<u>40</u>	<u>50</u>

11.1.2 THE EUROPEAN UNION’S (“EU’S”) VIEW ON ZERO RATING

The EU prohibits Member States from having a reduced rate of VAT of less than 5%³¹⁷ and, as a result, Member States cannot therefore introduce a zero rate of VAT on any goods or services.

The EU has, however, allowed Member States to retain zero rating for goods and services which were being treated as such by a Member State prior to 1st January 1991. This was originally intended to be a transitional measure only and phased out when the Single Market came into force on 1st January 1993, however, a zero rate of VAT remains in place in a number of Member States today, including in Belgium, Denmark, Ireland, Malta, Finland and Sweden³¹⁸. The UK also applies a zero rate of VAT to certain goods and services and did so whilst it was a Member State of the EU.

³¹⁷ Article 99 of 2006d. Council Directive 2006/112/EC - The Common System of Value Added Tax. 2006/112/EC. European Union.

³¹⁸ EUROPEAN COMMISSION 2021. VAT rates applied in the Member States of the European Union - Situation at 1st January 2021.

Where the EC consider that a Member State has introduced a rate of VAT of less than 5%, they can commence infraction proceedings to rectify this. The UK was most recently infringed by the EC for allowing a zero rate of VAT to be applied to commodity trading under the Value Added Tax (Terminal markets) order 1973, as amended by the Value Added Tax (Terminal Markets) (Amendment) Order 1975.

The EC cites five arguments against allowing a zero rate of VAT³¹⁹:

1. The zero rates are justified exclusively under Article 28(2) of the Sixth Directive. The crucial point here is that the zero rates should be used for the benefit of the final consumer, and the interpretation the Commission puts upon this is that zero rates cannot be used for intermediate goods. This means, for instance, that the Irish and Portuguese use of the zero rate to relieve fertilizers, animal feedstuffs and seeds from VAT, and the zero rating by the UK of construction, newspaper advertising, fuel and power, water, sewerage, animal feedstuffs and safety wear are questioned by the EC. Similarly, the common exemption or zero rating of such goods by Latin American governments would be questioned under the rules of the EC. The argument is that the link between the preferential tax treatment of the good and the advantage to the final consumer is insufficiently direct.
2. Even where the zero rate can be seen to benefit the final consumer directly, the Commission argues that the zero rates in one Member State will cause consumers in other Member States to claim the same benefit, and this will disrupt the Community-wide tax base.
3. To the extent that the use of zero rated goods and services expands, it erodes the tax base, creating distortions and requiring a higher VAT rate to be used on the taxed sectors to raise the same revenues.
4. The system of refunds that have to be made to taxable persons through the zero rating system entail high administrative costs, only to compensate traders and not to raise any revenue. In the EC's view this is administratively wasteful and undesirable.
5. It is argued that even the social justification of zero rating might be better achieved by more appropriately targeted direct transfers than through the tax system.

11.1.3 DOES ZERO RATING BETTER SERVE THE POLICY AIMS OF THE EUROPEAN UNION ("EU")?

In considering whether zero rating is more appropriate than exemption for the management of a SIF, we must return to the policy aim of the VAT exemption, which is:

1. To ensure neutrality between direct and collective investment: facilitating investment in collective investment funds by "small" investors; and
2. To adhere to the principle of fiscal neutrality: ensuring VAT equivalence irrespective of the legal form of investment vehicles.

³¹⁹ TAIT, A. A. & INTERNATIONAL MONETARY FUND 1988. Value Added Tax - International Practice and Problems. P.54.

Despite the EU's disfavour for a zero rate of VAT, in my view, applying VAT at a zero rate to the management of SIFs would better and more wholly achieve the EU policy aim of facilitating investment in collective investment funds by "small" investors, through the removal of the VAT cost from the supply chain.

As I have already discussed at chapter seven, and in the view of the EC, the IFS and a number of industry and academic contributors, irrecoverable VAT costs incurred by the providers of exempt supplies will be passed onto the end consumer, potentially in full but at least in a significant part. Tait commented "*if that trader sells to the public, he must pass on the tax on inputs to the public in his price or cut payments to his factors of production (capital and labor). This suggests that countries that genuinely wish to pass on to the consumer the benefits of VAT-free goods and services should be allowed to use the zero rate*"³²⁰.

The VAT exemption for SIFs does not entirely result in a level playing field between direct and collective investment, with additional VAT costs being incurred for those collectively investing rather than via their own account. This could be solved for by the introduction of a zero rate of VAT which would remove the cost of VAT, in full, from collective investment.

11.1.4 THE ARGUMENT FOR APPLYING A BUSINESS TO BUSINESS ("B2B") ZERO RATING TREATMENT TO THE MANAGEMENT OF SPECIAL INVESTMENT FUNDS ("SIFs")

Having concluded that, from a policy perspective, zero rating better serves the overall policy aims of the EU and the UK, I will now consider whether zero rating could be applied to management charges to SIFs under a New Zealand style B2B system. My analysis of New Zealand's zero rating VAT treatment for B2B financial services is detailed at 6.3.

11.1.4.1 IS AN INVESTMENT FUND A BUSINESS FOR THE PURPOSES OF VALUE ADDED TAX ("VAT")?

Before considering whether zero rating the management of a SIF could be applied in a similar way to the New Zealand GST system, we must first consider whether an investment fund can be considered a "business" for VAT purposes.

The EU VAT Directive defines, at Article 9, a taxable person as "*any person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity*". Article 9 provides further clarity on the definition of an economic activity, noting that:

*"The exploitation of tangible or intangible property for the purposes of obtaining income therefrom on a continuing basis shall in particular be regarded as an economic activity".*³²¹

³²⁰ Ibid. P.51.

³²¹ Article 9 of 2006d. Council Directive 2006/112/EC - The Common System of Value Added Tax. 2006/112/EC. European Union.

The Oxford English Dictionary definition of “investment” is “the action or process of investing money for profit”³²². The definition of an investment fund is “investment products created with the sole purpose of gathering investors’ capital, and investing that capital collectively through a portfolio of financial instruments such as stocks, bonds and other securities”³²³. Taken literally, it is difficult to argue that the EU’s definition of an economic activity would not cover the activities of an investment fund.

This is also supported by the legal definitions given to investment funds. In the UK, s.235 of FSMA 2000 defines a collective investment scheme as:

*“any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income”.*³²⁴

The CJEU has also considered the extent to which an investment fund should be considered as a taxable person. In case C-8/03 (“BBL”), the CJEU ruled that the activities of an investment fund, in this specific case a Luxembourg established SICAV, were such that the fund should be considered a taxable person for VAT purposes. In particular, the Court commented at paragraphs forty-one to forty-four:

“...The Court has already held that the transactions covered by that provision are those which consist in drawing revenue on a continuing basis from activities which go beyond the compass of the simple acquisition and sale of securities, such as transactions carried out in the course of a business trading in securities (see EDM, paragraph 59).

It follows from Article 1(2) of Directive 85/611 that the transactions carried out by SICAVs consist in the collective investment in transferable securities of capital raised from the public. With the capital provided by subscribers when they purchase shares, SICAVs assemble and manage, on behalf of the subscribers and for a fee, portfolios consisting of transferable securities.

Such an activity, which goes beyond the compass of the simple acquisition and the mere sale of securities and which aims to produce income on a continuing basis, constitutes an economic activity within the meaning of Article 4(2) of the Sixth Directive.

*It follows that SICAVs are taxable persons within the meaning of Article 4 of the Sixth Directive.”*³²⁵

The CJEU judgments in C-155/94 (“Wellcome Trust”) and C-77/01 (“EDM”), which are covered at section 8.1 of this dissertation, add further support for investment funds being taxable persons for VAT purposes. Additionally, in Luxembourg, all investment funds whose management is VAT exempt are taxable persons – circular 723³²⁶ issued by the Luxembourg tax authority in 2013 recognised collective investment funds with legal personality as such. Investment managers are deemed to be the taxable person on behalf of any funds without legal personality³²⁷.

³²² OXFORD UNIVERSITY PRESS 2022. *Oxford English Dictionary*.

³²³ EUROPEAN COMMISSION. 2018b. *Investment Funds* [Online]. Available: https://ec.europa.eu/info/business-economy-euro/growth-and-investment/investment-funds_en [Accessed].

³²⁴ S.235 of 2000b. Financial Services and Markets Act 2000. United Kingdom.

³²⁵ 2004a. C-8/03 - Banque Bruxelles Lambert SA (BBL) v Belgian State. The Court of Justice of the European Union. Paragraphs 41-44.

³²⁶ 2013d. Circulaire No 723ter du 7 novembre 2013. 723. Luxembourg.

³²⁷ HERBAIN, C. A. & RICHARDIN, M.-I. Investment Fund Taxation - VAT and Investment Funds. *EUCOTAX Series on European Taxation*, 59, P.63-82.

11.1.4.2 THE MERITS OF ZERO RATING MANAGEMENT FEE CHARGES TO SPECIAL INVESTMENT FUNDS (“SIFs”)

Having concluded at 11.1.4.1 that an investment fund is a “business” for VAT purposes, I will now consider the merits of zero rating management fees to SIFs.

It is widely accepted that zero rating B2B supplies resolves the issue of cascading VAT charges throughout the supply chain and, as I have discussed earlier in this dissertation, this particular issue under the current exemption framework frustrates EU policy. In my view, this is the key argument for zero rating.

Even with a zero rate, however, challenges remain.

Firstly, under a general financial services B2B zero rating system, it is accepted that there are potential issues with the calculation of recoverable input tax and the apportionment of input tax on mixed supplies³²⁸. This, however, only applies where a financial services business is providing services to businesses and end-consumers, which shouldn’t be the case for asset managers given our conclusions at 11.1.4.1 – i.e., investment funds are businesses for VAT purposes. The benefit of a B2B zero rating is that asset managers revenues would become either zero rated (for SIFs) or subject to domestic VAT at the standard rate (for non-SIFs) – in both scenarios, full input deduction would be available to them, and no apportionment calculation would be required. It is acknowledged that the issue of apportionment would remain for the investment funds themselves, in the same way as it does today.

Another disadvantage³²⁹ highlighted with B2B zero rating is the administrative burden put on financial organisations to distinguish between businesses and end-consumers. This perceived disadvantage is, however, mitigated to a large, possibly full, extent in the context of investment funds, for the following reasons:

1. Firstly, as discussed at section 11.1.4.1, an investment fund should be considered as being in “business” – there should be no need, therefore, for an asset manager to determine this for the funds it is managing;
2. Secondly, asset managers currently need to identify their clients as SIFs or non-SIFs for the purposes of applying the exemption – this would continue under a system of zero rating;
3. Thirdly, as highlighted at chapter six, financial institutions already have to comply with substantial requirements to verify a client's status. It is arguable whether there is any meaningful additional information gathering requirements imposed by zero rating.

EY’s comment, in a report prepared for the European Banking Federation, that *“the approach that appears to have been most satisfactory and given rise to the least amount of concerns is one under which the exemption is limited to margin services, and B2B financial services are zero-rated”*³³⁰, adds further weight to benefit of introducing such a system.

Finally, there is an argument that a move from exemption to zero rating would result in a reduction in tax collection by governments. This would be caused by the removal of any irrecoverable VAT borne by asset managers, and other providers of services to asset managers and investment funds, from the supply chain under zero rating. It is reasonable to expect that this proposition would, therefore, be unattractive to

³²⁸ MERRILL, P. R. 2011. VAT Treatment of the Financial Sector. *Tax Analysts*, P.163-185.

³²⁹ HUIZINGA, H. 2002. A European VAT on financial services? *Economic Policy*, 17, P.497-534.

³³⁰ ERNST & YOUNG 2009. Design and Impact of the 'Option to Tax' System for Application of VAT to Financial Services (report prepared for the European Banking Authority). P.30.

governments, particularly now given the current economic climate and the need to fund the Covid-19 pandemic.

The only question here is which is the greater priority for governments: enabling the policy aim of encouraging “small” investors to access collective investment schemes and ensuring that this is put on parity with direct investment; or protecting the current levels of tax collection and avoiding any possible political fallout that would inevitably come from such a change.

From a UK perspective and with the country no longer being a member of the EU and subject to its laws and the jurisdiction of the CJEU, there is a clear opportunity to zero rate investment management services to SIFs to secure the UK’s existing and significant financial services sector, as well as ensure the UK is an attractive location for investment funds in the future. It is acknowledged that tax is only one, albeit a very important, aspect of a business’ or fund’s decision to setup and launch in a particular jurisdiction – market access, access to talent, and regulatory considerations, amongst others, will also play a role.

11.2 REDUCED RATING

If the EU would not be prepared to introduce a zero rate of VAT for the supply of investment management services to SIFs, consideration could be given the implementation of a reduced rate.

Whilst a shift in the VAT treatment from exempt to taxable would enable asset managers to recover the VAT incurred in providing their service, this benefit would be offset by the VAT levied on their management fees. As discussed at chapter seven, the introduction of VAT to these services would increase the cost of collective investment for investors and the imposition of VAT on collective investment in any form frustrates the EU policy of ensuring that there is parity between direct and collective investment – the former would be VAT free, the latter subject to VAT. It would also, again as explained earlier in this dissertation, jeopardise the principle of fiscal neutrality – funds without legal personality would be treated differently to those with legal personality.

Even if, under the current exemption model, the manager’s irrecoverable VAT costs are indirectly passed onto the fund through increased management fee charges, reduced rating would only serve to change the way in which this cost is incurred by the fund. A reduced rate, compared to exemption, does however have the benefit of transparency around the VAT cost of investment management. This, in my view, is not a strong enough reason for a reduced rate, given the wider impact on EU policy and its fundamental principles as set out above.

11.3 TAXING INVESTMENT MANAGEMENT, BUT ENABLING SPECIAL INVESTMENT FUNDS (“SIFs”) TO RECOVER THE VALUE ADDED TAX (“VAT”) CHARGED

An alternate approach to achieve the EU’s policy could be to have investment managers charge VAT on their management fees, at either the full or a reduced rate, but allow SIFs to recover the VAT charged. This would achieve the same outcome as zero rating by removing the cost of VAT in its entirety from the supply

chain. It would also ensure the decision to outsource elements of the investment management process would not be impacted or impeded by increased VAT costs.

However, this approach is not without a number of policy and administrative challenges.

Firstly, allowing investment funds to recover VAT in every instance would run contrary to the EU VAT Directive. Under current VAT law, funds which solely invest in securities will only be able to recover VAT based on their proportion of non-EU investments (as allowed by Article 169 of the VAT Directive). A change of this magnitude to the EU VAT rules would almost inevitably have a number of unintended consequences.

Secondly, this approach would shift the burden of VAT onto Member States in which funds are established and would, by extension, have a disproportionate impact on traditional investment fund locations such as Luxembourg and Ireland. Given that any change to EU law requires unanimous agreement by all Member States, it is difficult to see such an obstacle being overcome.

Thirdly, this would result in a significant number of investment funds, which are not registered for VAT today, having to become registered and tax administrations having to process a substantial number of VAT refunds for these funds. There would also be an ongoing operational cost to the funds to deal with the required VAT compliance, as a result of becoming VAT registered.

Finally, there is a timing and cash flow benefit to the investment funds of zero rating compared to this approach.

11.4 OPTING TO TAX INVESTMENT MANAGEMENT SERVICES

As discussed at section 6.8, opting to tax supplies of financial services which would otherwise be exempt of VAT has been available since the inception of the EU VAT system³³¹. Article 137(1)(a) of the EU VAT Directive states *“Member States may allow taxable persons a right of option for taxation in respect of...the financial transactions referred to in points (b) to (g) of Article 135(1)”*.

Electing for an option to tax has the effect of:

- Requiring investment management charges to domestic SIFs to be subject to domestic VAT at the standard rate. Absent of the option, these supplies would have been VAT exempt; and/or
- Changing the VAT status of intra-EU supplies of investment management services to SIFs from outside the scope of VAT without right to input tax recovery to outside the scope of VAT with right to input tax recovery.

The only Member States which allow for an option to tax on investment management services provided to a SIF are Estonia, France, Lithuania and Germany. In Lithuania and Germany, the option can only be made in respect of B2B transactions³³².

³³¹ See Article 13(C)(b) of 1977. Council Directive 77/388/EEC - SIXTH COUNCIL DIRECTIVE of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes — Common system of value added tax: uniform basis of assessment. 77/388/EEC. European Union.

³³² DE LA FERIA, R. & LOCKWOOD, B. 2009. Opting for Opting In? An Evaluation of the Commission’s Proposals for Reforming VAT for Financial Services. P.13.

The advantages and disadvantages of opting to tax financial services, generally, are set out section 6.8. What follows is an analysis of the impact of the option to tax regime on the management of SIFs.

As a general observation, allowing an option to tax for the investment management of SIFs has the effect of frustrating the stated policy aim of the EU. As discussed at chapter seven of this dissertation, the imposition of VAT on any service, including collective investment management, will increase the overall cost for the consumer – in this case the end-investor – and this is contrary to the policy aims of the EU. In this respect, the option to tax provision could be viewed as a mechanism which only enables this frustration.

There are, however, two scenarios where, in theory, the option to tax helps to facilitate the EU's policy of removing the VAT cost from collective investment.

1. Investment funds which have right to full VAT recovery

Investment funds which can recover all, or the vast majority of, the VAT they incur on their costs will not be adversely impacted by the imposition of VAT to their investment management fees. Whilst this is unlikely to include UCITS funds, due to the requirements of the UCITS Directive, it is possible for AIFs to carry on activities which allow them to register for, and recover, VAT. Examples include funds invested in real estate and other infrastructure assets.

For funds with this VAT profile, the option to tax will allow for VAT costs to be fully removed from the supply chain by:

- VAT being charged on the management fees by the asset manager, which will be recoverable by the fund; and
- The asset manager, by virtue of it making taxable supplies, being able to recover all of the VAT it incurs in delivering its service. This will remove any cascading or indirect VAT charges from the supply.

2. Asset managers managing offshore SIFs

Asset managers who are exclusively managing offshore SIFs will also be able to apply the option to tax to remove the VAT cost from the supply chain. This is achieved by:

- No VAT being charged on the management fees to the fund, by virtue of the place of supply being the country of the offshore fund; and
- No reverse charge VAT obligation for the SIF in its home country, by virtue of it being a SIF (and, therefore, its management fees being VAT exempt locally); and
- The revenue for the asset manager being taxable (i.e., outside the scope of VAT with right to recovery), and thus enabling full recovery of the VAT incurred by the manager in delivering its service. This will remove any cascading or indirect VAT charges from the supply.

In order for an option to tax to achieve the policy aims of the EU, it requires the ability for it to be applied on a selective, case-by-case basis. It also requires a wider application across more Member States – perhaps a mandatory availability for taxpayers across the EU, rather than it being optional for individual Member States. In its current form, the limited and varied availability and application of the option to tax only creates a disparity amongst Member States which adversely impacts on intra-EU competition and further frustrates harmonisation across the EU.

Whilst the option to tax has the potential to deliver on the policy aims of the EU in certain circumstances, it cannot do so across all SIFs on its own and, as a result, zero rating should be considered a better and more complete mechanism to achieve these policy aims.

CHAPTER 12: CONCLUSIONS

Throughout this dissertation I have considered the current definition of a SIF, the policy behind this definition and its appropriateness, as well as a number of challenges which exist with this definition and a range of possible alternatives to the current position.

Before setting out my conclusions, as a general comment, it is acknowledged that the interaction of tax policy, economics and the political environment is complex. Tax policy which plays negatively from a political perspective, even where the policy is well intended and will achieve its aim, inevitably becomes a difficult proposition. This is often due to the public perception of a particular measure which, due to the complexities of the tax policy and tax legislation, and its application to complex commercial scenarios, is in many cases not fully understood. Changes to tax policy, as a result, not only require political will, but invariably also involves a trade-off between a variety of competing factors.

12.1 THE MOST APPROPRIATE APPROACH TO APPLYING VALUE ADDED TAX (“VAT”) TO THE MANAGEMENT OF SPECIAL INVESTMENT FUNDS (“SIFs”)

In my view, the best way to fully and properly achieve the UK and EU’s policy aim – that is to remove the VAT cost of collective investment by retail, or household, investors – is to have investment management fees zero rated.

Zero rating ensures that there is no VAT cost embedded within the supply chain of investment management services which, as I have shown in this dissertation, is not the case for exemption or full taxation. Clearly the introduction of a zero rate of VAT will reduce the overall tax collection by governments, through the removal of irrecoverable VAT costs on these services by investment managers. However, as discussed at chapter seven of this study, it is probable that some, if not all, of this irrecoverable VAT cost is embedded into the investment management fees charged by managers and ultimately borne by the investor under the current framework. VAT exemptions have a distortive effect on market pricing, with suppliers of exempt services incurring additional VAT costs themselves which, in theory, will impact on the pricing of their services. The extent to which this VAT cost is passed on indirectly to the end consumer will be dependent on a range of market and economic factors. The only way to truly remove this cost and achieve the stated policy aim is, therefore, zero rating. It is acknowledged that the matter of reduced tax collection cannot, however, be completely ignored particularly given the current economic environment, the Covid-19 pandemic and the need for governments to fund the economic cost of this and public welfare expenditure.

Following Brexit, with the UK no longer being subject to EU law which expressly prohibits a rate of VAT below 5%, zero rating is now a possibility for the UK and one which, in the context of the management of SIFs, I would advocate for. In his Mansion House speech on 1st July 2021, the UK Chancellor of the Exchequer at the time and now Prime Minister, Rishi Sunak, expressed the importance of the financial services sector to the UK economy and the UK government’s commitment to leveraging the UK’s new legal freedoms to strengthen this, commenting:

“The UK will use our new freedoms to follow a distinctive approach founded on UK law, protected by independent UK regulators, designed to strengthen UK markets.”³³³

Zero rating would make the UK an attractive location for investment funds and investment managers post-Brexit and will help to secure the UK’s existing and significant financial services sector, as well as ensure the UK is an attractive location for investment funds in the future. It is acknowledged that tax is only one, albeit a very important, aspect of a business’ or fund’s decision to setup and launch in a particular jurisdiction – market access, access to talent, and regulatory considerations, amongst others, will also play a role. Brexit, however, provides the UK government with an opportunity to change the VAT treatment of SIFs for the benefit of investors, and particularly retail investors, as well as for the wider economy.

Despite the EU’s disfavour for a zero rate of VAT, it is clear from a policy perspective that this treatment would better and more wholly achieve the EU aim of facilitating investment in collective investment funds by “small” investors by fully removing the cost of VAT from the supply chain. The question is which is the greater priority for the EU and its Member States: enabling the policy aim of encouraging “small” investors to access collective investment schemes and ensuring that this is put on parity with direct investment; or protecting the current levels of tax collection and avoiding any political fallout that would almost inevitably come from such a change.

In concluding that an investment fund is a “business” with an economic activity for VAT purposes, consideration could be given at an EU level to a B2B zero rating for the management of SIFs. This would follow the approach currently legislated for in New Zealand, without the requirement to evidence that the fund is VAT registered. Zero rating B2B services which would otherwise be VAT exempt is something which seems to have garnered favour amongst academics and legislators alike, due to it solving a number of the inherent problems with VAT exemptions.

It is clear that zero rating is the best way to achieve the EU’s policy aim, however, given that EU law does not allow for a zero rate of VAT and that any change to this would require consensus across all Member States, such an approach seems unlikely. Should zero rating not be viable, then VAT exemption remains strongly preferable to full, or even reduced, taxation. As I have explained in this dissertation, exemption better serves the EU policy aims compared to full or reduced taxation – introducing VAT to management costs for SIFs would, as discussed at chapter seven, increase the overall cost to investors. When we consider that 30%³³⁴ of the value of invested assets in the EU comes from retail, or household, investors and a further 53%³³⁵ from pension schemes and insurance companies, who ultimately act on behalf of millions of households, the significant impact that this social VAT exemption has on the financial wellbeing of the public at large is clear to see. At a time when the effects of the global financial crash of 2008 are still being felt by households across the globe and with policymakers increasingly focussed on ensuring that individuals save sufficiently for their retirement, the removal of the VAT exemption on investment management services would be both socially damaging and politically challenging. This issue is only further exacerbated by the current economic downturn and high inflationary environment caused, at least in part, by the Covid-19 pandemic with increased numbers of households reliant on savings to be able to continue to make ends meet.

Aside from fulfilling EU policy and the economic benefit to investors, removing the VAT exemption would also imply that investors would also lose some, or all, of the following benefits:

- Access to professional investment managers, ensuring the better management of assets;

³³³ SUNAK, R. 2021. The Chancellor’s 2021 Mansion House speech, delivered on 1 July 2021.

³³⁴ EUROPEAN FUND AND ASSET MANAGEMENT ASSOCIATION 2019. Asset Management in Europe: An overview of the asset management industry. P.5.

³³⁵ Ibid.

- Ease of access to investments which would not be available for retail investors investing on their own account, e.g., commercial real estate;
- Diversification of investment risk, or at least better access to diversified investment strategies;
- Investment protection;
- Access to appropriate long-term investment vehicles necessary to meet the aging population and cost of retirement;
- Reduced transaction costs;

Providing access to these benefits is critical to encouraging and facilitating long-term investment and savings. With an estimated pensions saving gap – that is how much more individuals need to save in order to achieve an adequate standard of living in retirement – of EUR 2 trillion per year³³⁶ across Europe, the importance of this is clear.

It is acknowledged that VAT exemption is not always favourable to a positive VAT rate, with possible adverse impacts on both B2B supplies as well as those to final consumers. It is also acknowledged that the general principle that VAT exemptions are distortive to the proper functioning of a consumption tax system is one that, theoretically, I agree with. However, the long standing nature of a number of exemptions in European VAT systems, particularly those which concern individuals savings and investment, and the significant adverse impact that applying VAT to these services would have to the financial wellbeing of these individuals makes any wholesale changes economically and politically difficult. Investment management services provided to SIFs certainly falls within this category.

The same economic outcome as zero rating could be achieved by taxing investment management, at either the full or a reduced rate, and allowing SIFs to recover the VAT charged. In my view, however, this approach is hugely problematic, both legally and administratively. It would also shift the burden of VAT onto Member States in which funds are established and would, by extension, have a disproportionate impact on traditional investment fund locations.

The option to tax for investment management of SIFs only serves to achieve the EU policy aims in limited circumstances – specifically, where a fund has full right to VAT recovery or where a manager exclusively manages offshore SIFs. For all other funds, the option to tax has the effect of frustrating the stated policy of the EU by increasing the overall cost for the consumer. In order for an option to tax to achieve the policy aims of the EU, it requires the ability for it to be applied on a selective, case-by-case basis. It also requires a wider application across more Member States – perhaps a mandatory availability for taxpayers across the EU, rather than it being optional for individual Member States. In its current form, the limited and varied availability and application of the option to tax only creates a disparity amongst Member States which adversely impacts on intra-EU competition and further frustrates the attempts at harmonisation across the EU. In my view, whilst the option to tax has the potential to deliver on the policy aims of the EU in certain circumstances, it cannot do so across all SIFs on its own and, as a result, zero rating should be considered as a better and more complete mechanism to achieve these policy aims.

Modern consumption tax systems will typically have a wider tax base than traditional systems, such as those in the UK and the EU and, as part of my research, I have considered the extent to which there are lessons which can be drawn from the approach of modern VAT systems to dealing with the VAT treatment of investment funds. It is clear, however, that setting VAT policy for investment funds is a global challenge, irrespective of the maturity of a tax regime, and the challenges for both modern and traditional systems are similar. In 2020, New Zealand's tax administration issued a policy paper³³⁷ which outlined a series of

³³⁶ AVIVA 2016. Mind The Gap - Quantifying the pension savings gap in Europe. P.3.

³³⁷ POLICY AND STRATEGY, I. R. 2020. GST policy issues – an officials' issues paper.

technical tax policy issues and potential policy options, and this included a specific section on fund management. The policy document described the current GST treatment of investment management services as “*complex and inconsistent*”³³⁸ and considered a range of possible options, each of which have been considered in detail in this dissertation – full taxation, exemption, zero-rating and RITC.

A RITCs system, which is applied in Australia, is in my view not preferable for two reasons. Firstly, the complex and differing nature of investment managers’ product offerings would make designing a set input VAT recovery percentage very challenging and almost certainly lead to distortive financial impacts across the industry. It would also create further complexity, particularly for managers who provide other non-investment management related services, and almost certainly give rise to characterisation issues.

It is clear from the research that FTT is not intended to be a tax on consumption and should not therefore be considered as an alternative to a VAT. Even if FTT were to be considered as an alternative, it is also clear from the research that FTT is less preferable to VAT. There may, however, be a case for FTT in addition to a VAT, which would be based on, amongst other considerations:

1. National governments views on the need for the financial sector to pay for the costs of the previous financial crises and/or global development;
2. The effect of FTT in reducing financial market risk and helping to prevent asset price bubbles, although the empirical evidence would suggest that FTT, in this respect, is counterproductive;
3. National governments views on required market liquidity and the need to safeguard markets and investors against speculative trading, and the impact of a FTT on this.

12.2 THE MOST APPROPRIATE APPROACH TO DEFINING A SPECIAL INVESTMENT FUND (“SIF”)

The definition of a SIF on a principles basis with specific reference to the regulation which governs products which are intended for retail investors, as currently defined by the CJEU, is in my view entirely appropriate and one which I would continue to advocate for.

Whilst a principles based approach inherently gives rise to interpretive challenges, it ensures that the definition of a SIF can remain appropriate for newly designed or developed products and markets, and importantly, ensures that it is possible for new and innovative products to qualify for VAT exemption from inception, which may not be the case with a prescriptive approach. A principles based approach also allows the legal definition to be able to respond quickly to market and regulatory changes which will help VAT law keep pace with the investment management industry, something which has challenged it historically. Tax administrations and policy makers should ensure that appropriate guidance is provided to enable taxpayers to determine when a fund meets the SIF conditions and focus on doing so in a more timely and proactive manner. With the principles based approach, ensuring that funds which are in competition with UCITS funds are clearly identified is critical to ensure that exemption, or zero-rating, is delivered to comparable products.

³³⁸ Ibid. P.49.

I would also encourage greater alignment across the EU on the domestic definition of SIFs by Member States. Today, there are clear divergences with the application of the SIF VAT exemption across Member States – in particular in terms of how AIFs and offshore funds are treated.

I agree with the EC's conclusions that it does not seem possible to apply a single VAT treatment to all AIFs and that, instead, a case-by-case analysis should be carried out for each fund considering the tests which have been set out by the CJEU. A single VAT exemption for AIFs would clearly contradict previously settled CJEU jurisprudence in respect of the definition of SIFs. This adds further weight to the argument for a principles based approach.

I would, however, advocate for a wider application by other countries of the UK's 'active marketing' approach to offshore funds, including non-domestic UCITS. Despite the additional complexity of the UK's system, the carve out in UK law for overseas funds which are not marketed to retail investors in the UK ensures that the VAT profile of UK asset managers is consistent across onshore and offshore non-retail funds – in both circumstances VAT recovery will be allowed. It also ensures parity between domestic and offshore funds which are intended for domestic retail investors. As a result, in my view, the UK's approach best seeks to achieve the stated policy aims of both the EU and the UK. If a less complex approach to the treatment of offshore funds would be preferred, then a Swiss-style system, where foreign funds which are registered with the national regulator for distribution locally are treated as SIFs in that country, could be given consideration at an EU level. Although an administratively simpler method, the Swiss approach does not draw a distinction between retail and institutional investors – if the fund is registered, VAT exemption will apply – and in this sense it does not fully achieve the policy aims of the EU, particularly when compared to the UK's 'active marketing' approach. Either way, harmonisation of the approach to the treatment of offshore funds across the EU would be beneficial.

Pension funds is another area where challenges remain, particularly in the context of hybrid pension schemes. The key questions for pension funds are in respect of investment risk – who bears this, to what extent, how does this translate into the SIF criteria set out by the CJEU, and is exemption available where the beneficiaries bear any element of the investment risk or only where the beneficiaries bear this in full? Whilst the CJEU has not yet been asked to opine on the VAT treatment of a hybrid pension scheme, given the scale of litigation on this matter in the Netherlands currently, it is expected that this will be addressed by the Court at some stage in the future. Until then, however, domestic tax authorities in countries where hybrid pension schemes are commonplace will be required to consider this issue under their domestic VAT law.

12.3 AVENUES FOR FURTHER RESEARCH

This research establishes a series of suggested policy positions for the VAT treatment of investment management services which could be applied internationally to achieve the wider policy aim of encouraging investment by retail investors into collective investment funds.

The issue of VAT and investment funds is complex, however, and there are a range of areas which either have not been covered by this research or could be expanded upon.

Firstly, there continues to be challenge and litigation³³⁹ around what services should constitute "management" for the purpose of the VAT exemption conferred by Article 135(1)(g) of the EU VAT Directive.

³³⁹ See, for example: C-231/09 Blackrock Investment Management (UK) Limited v Commissioners for Her Majesty's Revenue and Customs, and C-58/20 K and DBKAG v Finanzamt Österreich, anciennement Finanzamt Linz

Further research in this area would be particularly useful given the ongoing interpretive challenges, developing service delivery models and wider application of technology by investment managers to deliver their management services.

Secondly, VAT grouping and its interaction with investment managers and the investment funds that they manage is an area which could be reviewed to consider, amongst others: the differing approaches to VAT grouping across the EU; the concept of investment funds being able to VAT group with their manager, as is the case in Ireland; and the advantages and disadvantages of cross-border VAT grouping.

Thirdly, the VAT treatment of investment management services provided to hybrid pension schemes is an area which, as I highlight in this dissertation, is expected to be litigated at the CJEU in the future. A detailed review of hybrid pension schemes across the EU and the application of the CJEU's SIF tests to these would, as a result, be an interesting and topical research area.

Finally, with the UK no longer being part of the EU and the scale of the UK's financial services sector, the territoriality concept for SIFs in the EU, which is discussed at chapter ten of this dissertation, will only become more pertinent. Further research, potentially encapsulating a country-by-country analysis, would be beneficial as policy is shaped in this area going forward.

APPENDIX: APPLICATION OF OTHER INDIRECT TAXES TO TRANSACTIONS IN SECURITIES – FINANCIAL TRANSACTION TAXES (“FTTs”)

Whilst, for the reasons outlined at section 8.1 of this dissertation, it is not considered appropriate to levy VAT on transactions in securities, there may be merit to applying other indirect taxes to such transactions – specifically Financial Transaction Tax (“FTT”).

FTTs are not new to the economic debate with Keynes first advocating for a “*Government transfer tax*” in 1936³⁴⁰. However, since the economic crisis of 2008, FTT has received a significant amount of attention³⁴¹, with its introduction in the EU having been proposed, and rejected, by the European Council. Following this rejection, a group of Member States in favour of this tax introduced a subsequent proposal for enhanced cooperation in the area of FTT³⁴². This enhanced cooperation proposal, which would cover eleven of the twenty-seven EU Member States, is currently under consideration.

According to the original EU proposal, the main objectives of FTT are³⁴³:

- The harmonisation of legislation concerning indirect taxation on financial transactions, which is needed to ensure the proper functioning of the internal market for transactions in financial instruments and to avoid distortion of competition between financial instruments, actors and marketplaces across the EU;
- Ensuring that financial institutions make a fair and substantial contribution to covering the costs of the financial markets crisis and creating a level playing field with other sectors from a taxation point of view;
- Creating appropriate disincentives for transactions that do not enhance the efficiency of financial markets thereby complementing regulatory measures to avoid future crises.

Schulmeister summarised the advantages and disadvantages of a FTT, as put forward by various academics (in particular: Keynes, 1936; Tobin, 1978; Stiglitz, 1989; Summers – Summers, 1989; Eichengreen – Tobin – Wyplosz, 1995; Arestis – Sawyer, 1998; Spahn, 2002; Pollin – Baker – Schaberg, 2003; Jetin – Denys, 2005), as³⁴⁴:

Advantages:

- There is excessive trading activity in modern asset markets due to the predominance of short-term speculation, which results in volatility of asset prices in both the short and, more importantly, long term.
- Current markets favour a culture of speculation, rather than enterprise, which decreases economic growth and employment. A FTT could be used to redress this – an analysis of the French FTT,

³⁴⁰ INTERNATIONAL MONETARY FUND & MATHESON, T. 2011. Taxing Financial Transactions: Issues and Evidence. P.12.

³⁴¹ SCHULMEISTER, S. 2009. A General Financial Transaction Tax: A Short Cut of the Pros, the Cons and a Proposal, INTERNATIONAL MONETARY FUND & MATHESON, T. 2011. Taxing Financial Transactions: Issues and Evidence.

³⁴² EUROPEAN COMMISSION 2013. Proposal for a COUNCIL DIRECTIVE - implementing enhanced cooperation in the area of financial transaction tax.

³⁴³ Ibid.

³⁴⁴ SCHULMEISTER, S. 2009. A General Financial Transaction Tax: A Short Cut of the Pros, the Cons and a Proposal. P.3-5.

implemented in August 2012, concluded that the tax had a significant impact on investor behaviour³⁴⁵.

- A transaction tax would have a stabilising effect on asset prices and would, as a result, improve overall macroeconomic performance.
- A FTT would compensate the distortion effect caused by the financial services VAT exemptions.
- A transaction tax would provide governments with considerable revenues. According to the IMF, in the UK, Stamp Duty on share transactions, which is a form of FTT, raises a significant amount of revenue for the government at a low administrative cost³⁴⁶. However, empirical analysis suggests that FTTs in other countries have been less effective in raising revenue³⁴⁷. The tax benefits of transaction taxes to governments are, therefore, varied.

Disadvantages:

- The high transaction volumes in modern financial markets reflect the liquidity necessary for the price discovery process. This liquidity ensures that asset prices will reflect their fundamental equilibria.
- A significant number of short-term transactions are related to hedging, utilised for the purpose of reducing overall risk. Hedging, used in this way, is stabilising for the market.
- FTT would increase transaction costs, resulting in reduced liquidity and an increase in the volatility of asset prices. This was the conclusion of two separate empirical studies on the effects of FTT in the USA and Italy³⁴⁸. In such an outcome, the FTT achieves the opposite effect than intended.
- Transaction taxes are hard to implement, particularly those in respect of international transactions. In addition, it can be expected that taxpayers will find ways to circumvent the tax.

It has also been argued that a FTT reduces the efficiency of a stock market by increasing the value, and potentially stopping the occurrence, of trades which would benefit both parties. This in turn has a detrimental effect on the liquidity of capital markets and results in a decrease in the efficiency of the economy by a slower reallocation of resources to where they are most productive³⁴⁹. For these reasons, the London Stock Exchange has long been a proponent for the abolishment stamp duty³⁵⁰.

In considering the above, Schulmeister did conclude that FTT should be applied to specific transactions, however, not all contributors agree with this view. The IMF's 2010 report to the G20 on Financial Sector Taxation noted its preference for a FAT over a FTT and, as highlighted earlier in this dissertation, also noted its view that it was better to fix the current VAT system rather than introduce a new tax on the financial

³⁴⁵ MEYER, S. & WAGENER, M. 2013. Politically Motivated Taxes in Financial Markets: The Case of the French Financial Transaction Tax. P.17.

³⁴⁶ INSTITUTE OF FISCAL STUDIES, HAWKINS, M. & MCCRAE, J. 2002. Stamp duty on share transactions: is there a case for change? P.5-6.

³⁴⁷ INTERNATIONAL MONETARY FUND & MATHESON, T. 2011. Taxing Financial Transactions: Issues and Evidence. P10-11.

³⁴⁸ WANG, H. K. & YAU, J. 2012. Would a Financial Transaction Tax Affect Financial Market Activity? *Policy Analysis*, RUHL, T. R. & STEIN, M. 2014. The impact of financial transaction taxes: Evidence from Italy. *Economics Bulletin*, 34, P.25-33.

³⁴⁹ INSTITUTE OF FISCAL STUDIES, HAWKINS, M. & MCCRAE, J. 2002. Stamp duty on share transactions: is there a case for change? P.7.

³⁵⁰ Ibid. P.1.

sector³⁵¹. The IMF's view is shared by Shaviro, who concluded that *"the case for enacting an FAT is considerably stronger than that for an FTT"*³⁵². An analysis of FAT is presented above at section 6.5.

FTT is not intended to be a tax on consumption and should not, in my view, be considered as an alternative to a VAT. Even if it were to be considered as an alternative, it is clear from the above that FTT is less preferable to both a FAT and a VAT. There may, however, be a case for FTT in addition to a VAT, which would be based on:

1. National governments views on the need for the financial sector to pay for the costs of the previous financial crises and/or global development;
2. The effect of FTT in reducing financial market risk and helping to prevent asset price bubbles. The empirical evidence highlighted above would, however, suggest that FTT, in this respect, is counterproductive;
3. National governments views on required market liquidity and the impact of a FTT on this.

³⁵¹ INTERNATIONAL MONETARY FUND, CLAESSENS, S., KEEN, M. & PAZARBASIOGLU, C. 2010. Financial Sector Taxation: The IMF's Report to the G-20 and Background Material.

³⁵² SHAVIRO, D. 2012. The Financial Transactions Tax versus (?) the Financial Activities Tax. P.30.

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