ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

EU VAT Module

Excerpt from training manual – Managament and advice

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Management and advice

One of the difficult distinctions in the area of financial exemptions is between ‘transaction’ (carrying out instructions) and ‘advice’ (suggesting what instructions to give). ‘Transaction’ is exempt, but the provision of advice is taxable. If someone goes to an investment professional and buys some investments, it is common for the professional to give some advice first – so is this:

- advice, with incidental transaction (wholly VATable)?
- transaction, with incidental advice (wholly exempt)?
- advice and transaction as two independent supplies (partly exempt and partly taxable)?

The answer should depend on the facts of the case. In many situations, investment professionals take commission on the transaction that is carried out, either from the client (as in a share sale) or from a supplier of financial products (as in some insurance contracts). Where the payment is by commission, it is a common approach to regard the transaction as the principal supply and the advice as incidental. By contrast, where the professional charges a fee which will be payable whether or not a transaction results, that may be regarded as taxable. This is not a perfect distinction, and arguments can arise about the borderline.

Investment management is another example of the difficulty. An investment manager typically carries out transactions throughout the year, and may charge for that. The manager will also charge a fee for ‘looking after the money’. That is generally taxable. Telling the difference between the two, and making sure that one is not artificially raised to subsidise a cut in the other, is not easy.

There is an exemption for one kind of investment management, where the difficulty does not arise.

Article 135(1)(g) the management of special investment funds as defined by Member States;

This exemption is on the borderline between ordinary financial services and ‘exemptions in the public interest’. Special investment funds are usually defined as collective investment schemes such as open ended investment companies (OEICs) and undertakings for collective investment in transferable securities (UCITS) which are typically aimed at smaller investors who need to club together in order to spread risk and achieve economies of scale. So there appears to be a ‘social policy distinction’ between:

- management of the large portfolio of a rich person (taxable); and
- management of the OEIC investments of a large number of less rich people (exempt).

Arguments have arisen about what is meant by ‘management’ and what is meant by ‘special investment fund’.

Abbey National plc and another v C&E Comrs CJEU Case C-169/04 [2006]

A company was the corporate trustee of a collective investment scheme, classified as a special investment fund (SIF) by the UK. What it did for its investors was exempt within

art.135(1)(g). It subcontracted the management of the money to eight fund managers, who made supplies to it. The UK authorities ruled that this was ‘ordinary’ investment management and not exempt – it was no different from what these fund managers did for all their other clients. They were not managing a SIF because they were not dealing with the collective investors

The CJEU ruled that ‘management’ is an independent concept of EU law – it is not possible for a Member State to restrict what it means. Services which are carried out by a subcontractor but which are a distinct whole, and are specific to, and essential for, the management of a SIF, must themselves constitute ‘management of a SIF’ and are therefore exempt.

JP Morgan Fleming Claverhouse Investment Trust plc and another v R&C Comrs CJEU Case C-363/05 [2008]

Following the above case, managers of some closed investment funds (investment trust companies – ITCs) reclaimed VAT, arguing that they ought also to be regarded as exempt because ITCs are so similar to OEICs that they should both be regarded as SIFs. The UK authorities responded that the law says ‘the management of SIFs as defined by Member States’: the Abbey National case showed that Member States could not define ‘management’, so they must be allowed to define ‘SIF’, or the expression would be meaningless.

The CJEU disagreed. It was necessary to apply the definition of SIF with regard to the principles of fiscal neutrality. If ITCs compete directly with OEICs, they have to be treated the same for VAT, or a fiscal distortion will result. It was left to the national court to decide whether the two types of fund were sufficiently similar to compete, but it was clear that they were, and the UK has changed its policy.

Arguments still continue over whether other types of fund (e.g. pension funds) also compete with OEICs and therefore ought to also be within the SIF exemption.

Wheels Common Investment Fund Trustees Ltd and other companies v HMRC CJEU (Case C-424/1): [2013]

In the UK a company which provides fund management services to pension funds argued that the principles of the JP Morgan Fleming Claverhouse decision should apply to exempt its services, because pension funds compete with investment trust companies and open-ended investment companies which are regarded as “special investment funds” for the purposes of the exemption.

HMRC argued that the schemes involved in the appeal, being “defined benefit” schemes (based on final salary rather than the value of a fund), are fundamentally different from investment funds which are regarded as subject to exemption. If they are not directly in competition with other special investment funds such as OEICs and investment trust companies, there is no reason to treat them in the same way for VAT.

Questions were referred to the CJEU. The court agreed with HMRC. Special investment funds were mainly those products covered by the Directive on Undertakings for Collective Investments in Securities (UCITS). The JP Morgan decision showed that where something which was not directly covered by that Directive competed with UCITS, it should be treated in the same way for VAT. However, a pension fund such as that managed by this company

was not in direct competition with UCITS. It was not open to the public, but was an employment benefit made available to the workers of specific companies.

The features which the court identified as differentiating this pension fund from UCITS may be important for considering other Morgan-related arguments:

- the employees do not bear the risk arising from investment performance – their pensions are defined by their salaries and length of service, and it is the employer who will have to make extra contributions if the investments do not perform well;
- the employer is not similar to a private investor in UCITS, because he makes contributions not to maximise investment returns, but to meet a legal obligation to the employees.

The questions referred were very long, but the answer was much shorter. The court ruled that a defined benefit pension scheme is not a SIF, and the principles of fiscal neutrality do not require it to be treated as one.

ATP PensionService A/S v Skatteministeriet CJEU (C-464/12): [2013]

Following the failure of Wheels Common Investment Fund to obtain exemption for services relating to a defined benefit pension scheme, questions were referred to the CJEU concerning the application of the same rules to a defined contribution scheme.

The CJEU ruled that the term 'special investment funds as defined by member states' may cover pension funds such as those at issue in this case if they were funded by the persons to whom the retirement benefit was to be paid, if the funds were invested using a risk-spreading principle, and if the pension customers bore the investment risk. The court also ruled that the term 'management of special investment funds' covered services by means of which an undertaking established the rights of pension customers vis-a-vis pension funds, through the opening of accounts in the pension scheme system and the crediting to such accounts of the contributions paid. That term also covered certain accounting services and account information services, such as those listed in Annex II to EC Directive 85/611/EEC. The VAT exemption laid down for transactions concerning payments and transfers covered services by means of which an undertaking established the rights of pension customers through the creation of accounts within the pension scheme system and the crediting to those accounts of the contributions paid, and any transactions which were ancillary to those services or which combined with those services to form a single economic supply.

GfBk Gesellschaft fur Borsenkommunikation mbH v Finanzamt Bayreuth CJEU (Case C-275/11) [2013]

Another case on the extent of the exemption for ‘management of special investment funds’ was referred from Germany to the CJEU. In this case, the services were indisputably supplied to special investment funds; the issue was whether they qualified as ‘management’ of those funds, as in the Abbey National case (Case C-169/04).

The appellant provided what appear to be advisory rather than management services. It contracted with an investment fund ‘to advise in the management of the fund’ and ‘constantly to monitor the fund and to make recommendations for the purchase or sale of fund assets’. It was also required ‘to pay heed to the principle of risk diversification, to statutory investment restrictions ... and to investment conditions.’ Its remuneration was calculated as a percentage of the value of the fund. The fund managers took the final decisions on whether

or not to follow the recommendations, after checking whether they would contravene any regulatory investment limits.

The court went against the views of several governments and the Commission. It ruled that advisory services concerning investment in transferable securities, provided by a third party to an investment management company which is the manager of a special investment fund, fall within the concept of “management of special investment funds” for the purposes of the exemption, even if the supplier does not fall within the provisions of the UCITS Directive (which governs the operation of special investment funds).

The court considered that the relevant question was whether the service provided by the appellant was “intrinsically connected to the activity characteristic of an investment management company”. Although the UCITS Directive did not explicitly describe this activity in its list of management activities, that list was not intended to be exhaustive but rather illustrative. The breadth of service included within “management” by the Abbey National decision suggested that these services should also fall within the exemption.

The German government raised the issue of fiscal neutrality – that allowing this service to be exempt, while other similar services provided to individuals were taxable, would create a distortion. The court applied the Deutsche Bank decision (see below): fiscal neutrality is a principle of interpretation of the law where there is doubt about what the Directive means, but cannot override the Directive when the meaning is clear. The court observed that the same services would be taxable if provided to anyone who was not a SIF manager. There was therefore no possibility of fiscal distortion other than that specifically provided for by the VAT Directive. It also noted that taxing these services would create a fiscal advantage in favour of SIFs using their own in-house investment advisers (although the VAT consequences of outsourcing are a common feature of the system and are hardly an overpowering reason to allow an appeal).

Lastly, a question was raised about the possible illegality of the service. The client SIF did not have regulatory authority to delegate management to the appellant. The full court confirmed that there cannot be a VAT distinction based on the lawfulness or otherwise of transactions. Whether or not there had actually been a breach of the SIF rules in Germany, the service provided was still exempt.

Limitations to fiscal neutrality

Finanzamt Frankfurt am Main V-Höchst v Deutsche Bank AG CJEU Case C-44/11 [2012]

A portfolio investment manager provides a range of services:

(a) deciding, on the basis of expert knowledge and observation of the markets, what securities should be bought or sold, and when;

(b) implementing those decisions by actually buying and selling the securities; and

(c) a series of more administrative services connected with holding the securities.

If these are provided in the context of a special investment fund as defined by the member state, they are exempt. Otherwise, they are taxable. A German bank sought to claim

exemption for portfolio management services, supplied to wealthy clients, on the basis of the principle of fiscal neutrality: the service was essentially the same as that supplied to special investment funds, and there was a risk of distortion of competition – a wealthy individual might invest in a SIF rather than in a portfolio because of the difference in the VAT charge.

The court ruled that the principle of fiscal neutrality can be used to interpret the law when there is some doubt, but it cannot override the clear wording of the Directive. The law provides that management of SIFs is exempt and other investment management is not. Exemptions must be narrowly construed, and it was clear that the circumstances of an individual wealthy investor were not directly comparable to those of the normal investors in SIFs, which are normally 'joint funds, in which many investments are pooled and spread over a range of securities which can be managed effectively in order to optimise results, and in which individual investments may be relatively modest; such funds manage their investments in their own name and on their own behalf, while each investor owns a share (one or more units) of the fund but not the fund's investments as such.'

The court also ruled that the services of a portfolio manager are likely to be so closely linked that they form a single economic supply that can only have one liability (i.e. taxable). Some portfolio managers levy separate charges for taking decisions (taxable management) and arranging transactions on the basis of those decisions (exempt intermediary services). This decision suggests that this is not correct.