VAT focus

VAT and management of SIFs: a new world post-Brexit?

Speed read

The approach of Advocate General Kokott in the so-called 'Dutch pension fund' cases is to compare the special investment funds in question more closely with the harmonising EU UCITS law than arguably has been the case to date. If the CJEU follows her opinion, this may lead to a stricter interpretation of what is a SIF and one that is different from the UK government's abandoned attempt to codify the VAT exemption into UK law. Despite Brexit, CJEU case law remains relevant when interpreting case law, unless it requires the quashing or disapplication of domestic UK law.

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One might have thought that in our post-Brexit VAT world, as far as UK VAT is concerned, we need not concern ourselves too much with judgments and opinions emanating from the CJEU. However, since the FA 2024 came into force following the receipt of royal assent in February this year, the case law and opinions of the court will be as important as ever as aids to interpreting existing UK VAT legislation.

The recent opinion of Advocate General Kokott is a case in point. In *X, Stichting BPL Pensioen and others* (Joined Cases C-639/22 to C-644/22), she takes yet another look at the scope of the VAT exemption for the management of special investment funds (SIFs), this time in relation to six different, but similar, Dutch occupational pension funds.

The UK VAT liability of the management of SIFs has changed radically over the years in response to case law emanating from the CJEU, which has been asked on several occasions to consider what a special investment fund is and, to a lesser extent, what 'management' means. This evolving case law has created uncertainty for the funds industry. Whether or not the fund investor has to pay 20% VAT on management services will often be an important factor in how a new fund is structured and where it is located.

A new world post-Brexit?

After Brexit, we thought the UK would begin to diverge its VAT code from that of the EU, but for now, at least, this seems to be a damp squib. Following the UK's departure from the EU, the funds industry encouraged HM Treasury to rethink the VAT treatment of financial services. In December 2022, the government embarked upon a consultation on how it intended to achieve the twin aims of (i) improving policy clarity and certainty for all stakeholders on the application of the VAT exemption for fund management services; and (ii) removing reliance on retained EU law.

The government proposed to codify in legislation what was meant by the term 'special investment fund' in respect of the VAT treatment of fund management (based on existing CJEU case law), as well as retaining the existing UK VAT legislation contained in items 9 and 10 (and the relevant notes) of VATA 1994 Sch 9 Group 5. The latter legislation spells out in some detail how the UK has chosen to define a 'special investment fund', even if it offers no help as to what 'management' means.

In response to this consultation, in December 2023, the government essentially decided to do nothing, but indicated it may give some further guidance (see also HMRC's Policy Paper published on 15 April 2024, 'Interpretation of VAT and excise law from 1 January 2024', which makes reference to fund management and updating guidance as necessary). The government's attempt to codify the VAT exemption for the management of special investment funds was abandoned. Perhaps this was a good thing since AG Kokott says in her opinion that the CJEU case law does not give absolute clarity as to the meaning of the VAT exemption for 'the management of special investment funds as defined by Member States', contained in article 135(1)(g) of Council Directive 2006/112/EC (the 'Principal VAT Directive' or 'PVD').

> For the purposes of interpreting UK VAT law, CJEU case law (including opinions of the Advocates General) is still relevant

The impact of FA 2024

Why do we care? The answer is in FA 2024 s 28 on the interpretation of VAT and excise law, which is deemed to have come into force on 1 January 2024. Section 28(4) lays down that although the supremacy of EU law is abolished for VAT and excise law (as it is for other domestic law), this is only so far as it relates to 'the disapplication or quashing of any enactment as a result of EU law (and, accordingly the superseded provisions [by which the supremacy of EU law had effect for interpreting VAT and excise law passed or made before 11pm on 31 December 2020] continue to have effect for the purpose of interpreting VAT and excise law.)'. In other words, EU VAT law can no longer be applied to disapply or quash UK law in favour of the EU law. However, for the purposes of interpreting UK VAT law, CJEU case law (including opinions of the Advocates General) is still relevant, although not binding (see s 28(2) and (5) which preserves retained EU law).

Accordingly, the familiar, so-called *Marleasing* principle of consistent interpretation survives for the purposes of interpreting domestic VAT law. This well-known principle provides that domestic law designed to implement EU law must be interpreted, so far as possible, consistently with the wording and purpose of the EU law that the domestic law was designed to implement (see *Marleasing SA v La Comercial Internacional de Alimintacion SA* (Case C-106/89)). Lord Sumption, in his dissenting judgment in *Test Claimants in the FII Group Litigation v HMRC* [2012] STC 1362, held (at [176]) that this EU law principle of interpretation 'any rate as it has been applied in England, is authority for a highly muscular approach to the construction of national legislation so as to bring it into conformity with the directly effective Treaty obligations of the United Kingdom'.

So long as it does not result in the disapplication or quashing of domestic law, one must assume that even CJEU case law that arises after 1 January 2024 will be relevant to the construction of earlier domestic VAT law, even if it requires the courts or tribunals to adopt a 'highly muscular' approach to construe it in conformity with the EU law that the CJEU has interpreted. One can envisage that if the CJEU holds that a particular type of investment fund, which is not currently covered by the UK VAT exemption, an argument for a highly muscular approach may be required to get it within the highly prescriptive terms of the VAT exemption set out in VATA 1994 Sch 9 Group 5 items 9 and 10.

Although new CJEU case law will not be binding, the interpretative provisions of FA 2024 no doubt allowed the UK to abandon its proposed codification of CJEU case law in this area. This has probably turned out to be a good thing, as this case law may yet evolve and mutate as the court considers different fund types and potentially different forms of management. In addition, the provisions of FA 2024 s 28 should mean it is possible for the UK VAT exemption to keep pace with the EU exemption (if the UK courts maintain a highly muscular approach). However, the UK is now, of course, at liberty to modify the law if it chooses to do so and diverge from the EU VAT system.

For this reason, it will be interesting to see what the CJEU makes of AG Kokott's opinion in the Dutch pensions litigation and whether it could change how the UK VAT exemption for the management of special investment funds has been interpreted to date.

Kokott's approach

AG Kokott was first tasked with looking at the scope of this exemption when she gave her opinion in *Abbey National and another v C&E Commrs* (Case C-169/04) in 2005. Although, in this case, the focus was on the meaning of 'management', rather than the SIF itself, both she and the CJEU considered the impact of the EU law on undertakings for collective investments in transferable securities (UCITS) (EC Council Directive 85/611), which came eight years after the VAT exemption (then in article 13B(d)(6) of the Sixth VAT Directive (77/388/EEC)) was introduced. The UCITS legislation has been a constant theme in this line of case law ever since. However, as we shall see below, its importance has grown since *Abbey National* and the later case of *JP Morgan Fleming Claverhouse Investment Trust plc and another v HMRC* (Case C-363/05), where the CJEU followed another opinion of AG Kokott in relation to closed-ended funds, namely investment trust companies (or ITCs) (which themselves were not covered by the harmonising UCITS directive).

So, what exactly is a SIF?

In these latest joined cases, AG Kokott distilled the two questions posed by the Dutch referring court into the following two notions: (i) the nature of a 'special investment fund' in so far as 'it is superposed in EU law'; and (ii) the power conferred on the Member States to define the term 'special investment funds' and the restrictions to which they are subject under EU law.

In relation to the first question, she points out (as she first did in *Abbey National*) that the object of the exemption is to ensure it is no less favourable for private investors to invest in a special investment fund than it is to invest directly in securities, where, in relation to the latter, there is no management service on which VAT is charged that reduces investment returns.

Unfortunately, this objective of the exemption, expressed in this way, does not help one define what a special investment is. However, if one looks back to what she said in her earlier opinion in *Abbey National,* one can see the relevance of this objective to the overall interpretation of the exemption at issue. In the latter case, she said (at [27]) that 'in a common fund, the money of a large number of investors is collected and invested in securities of all sorts, and also in other items such as real property or goods. For investors, this has the advantage over direct acquisition of securities that the risk is spread more widely, and the choice of investments is made by highly specialised experts.' However, this comes at a cost. She concluded that the VAT exemption is intended to facilitate access by small investors to this type of fund managed by experts.

On this basis, her opinion helps one understand the type of fund the exemption is targeting, being relatively small private investors who can benefit from collective investment. However, in this latest case, she says (at [23] and based on the CJEU in *Fiscale Eenheid X* (Case C-595) at [32] in which she also gave the opinion) the aim of the VAT exemption is to ensure VAT neutrality for different forms of investment, i.e. between direct investment and collective investment.

Having considered the purpose of the exemption, AG Kokott then points out (at [24]) that after the EU began to harmonise the supervision of investment funds with the recast UCITS Directive (2009/65/EC), the CJEU restricted the Member states' power to define a special investment fund. As she puts it, 'VAT law was ... superposed to some extent by the harmonisation of supervisory laws'. This, she says, means the funds in question would have to be regarded as special investment funds as a matter of EU VAT law if they constituted UCITS covered by that harmonising EU law.

It appears that the AG's starting point in these latest Dutch pensions cases is whether, if the fund is not a UCITS, the fund has characteristics sufficiently comparable for it to be in competition with a UCITS

However, all the parties to this litigation agreed that the pension funds at issue were not UCITS. She then opined that funds that display features sufficiently comparable for them to compete with UCITS must also be regarded as special investment funds. Readers will recall that the CJEU adopted her opinion in the earlier litigation involving ITCs (being closed-ended funds). The court held that despite being expressly excluded by the earlier harmonising law on UCITS (Directive 85/611), such funds were, nevertheless, special investment funds for VAT purposes (see *JP Morgan Fleming Claverhouse* at [26]–[37] of the CJEU's judgment). At this stage in the development of the case law, it was not necessary for the fund to have the specific features set out in the then harmonising UCITS law. Indeed, closed-ended funds were excluded. Nevertheless, the CJEU found that there would be a breach of fiscal neutrality if the management of open-ended funds were exempt, but (as was the case in the UK at the time) the management of closed-ended funds were taxable.

Despite this earlier judgment, where the court was willing to depart from the constraints of the earlier UCITS Directive, it appears that the AG's starting point in these latest Dutch pensions cases is whether, if the fund is not a UCITS, the fund has characteristics sufficiently comparable for it to be in competition with a UCITS.

Are occupational pension funds SIFs?

One might have thought the question of whether or not a defined benefit pension scheme (which is what the Dutch cases essentially concern) constituted a 'special investment fund' had been clearly determined by the litigation brought by Ford Motor Company in the *Wheels* litigation. In that case, the CJEU held that the management of a pool of occupational pension funds designed to provide pensions based on the final salary and length of service of various categories of employees was not within the SIF VAT exemption (see *Wheels Common Investment Fund Trustees Ltd and others* v *HMRC* (Case C-424/11)). By contrast, the CJEU held in *ATP Pension Service A/S* (Case C-464/12) that the management of defined contribution pension funds, if the funds met certain conditions, did qualify for the SIF VAT exemption.

However, AG Kokott noted that these two cases were decided on their own specific features. She said it is still not clear from previous case law what the specific characteristics of a SIF are. This time, her starting point is to compare the funds with a UCITS fund because the CJEU held in *Wheels* and *ATP* that a fund covered by the UCITS Directive *is* a special investment fund for VAT purposes (see the judgments of the CJEU in *Wheels* at [23] and *ATP* at [47]). On this basis, she says one must consider the criteria in article 1(2) of the UCITS Directive and then consider whether the fund in question is comparable. The criteria laid down in the directive are funds:

> '(a) 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; and
>
> '(b) with units which are, at the request of holders, repurchased or redeemed, directly or indirectly, out of those undertakings' assets. Action taken by a UCITS to ensure that the stock exchange value of its units does not significantly vary from their net asset value shall be regarded as equivalent to such repurchase or redemption.'

From this provision in the harmonising law on UCITS, she distilled five relevant characteristics, being:

1. capital must be raised from the public (which was not the case with the funds at issue as there were a limited number of investors);
2. the fund must operate on the principle of risk-spreading (this criterion was satisfied);
3. there must be a repurchase or redemption obligation out of the fund's assets at the request of the unit holder (this criterion was not satisfied);
4. there must be state supervision (the parties agreed this criterion was satisfied); and
5. unit holders must bear the investment risk.

In relation to the final criterion of investment risk, she opined that the referring court should determine whether the relationship between guaranteed and variable pension rights met this criterion in circumstances where the pension was fundamentally determined by the length of service and level of employment income. The pension fund's financial position was not a relevant factor in this case, as one of the parties had asserted.

Based on her assessment (although ultimately a matter for the referring court), she did not think the pensions at issue were sufficiently comparable to a UCITS. However, it is curious that in her opinion (at [50]), she said: 'Member States may also extend the tax exemption to a pension fund like that at issue in the main proceedings. There is, however, no obligation to do so under EU law.' This approach appears to give the Member States greater latitude to diverge from one another as to the meaning of SIFs. Although, this is the case in practice, as the definition does vary throughout the EU, the AG's approach seems to go against the harmonising principles of the PVD and the EU single market.

It would seem somewhat odd if the court follows her opinion on this point since it has previously held that the scope of the exemption, although to be defined by the member states, is limited such that a 'member state cannot in particular, without negating the very terms "special investment funds", select from among special investment funds those which are eligible for the exemption and those which are not. That provision thus grants it only the power to define, in its domestic law, the funds which meet the definition of "special investment funds"'. (See *Fiscale Eenheid X NV cs* [2016] STC 2230 at [32], where, in addition, the court held that a fund consisting of investment in real property rather than securities was capable of being a SIF if it was subject to state supervision.)

Finally, the advocate general revisited the direct effect of article 135(1)(g), which the CJEU has already held was directly effective in *JP Morgan Claverhouse* at [59] (albeit then as article 13B(d)(6) of the Sixth Directive). This time, she opined that the applicants could rely on direct effect 'only in so far as the pension funds at issue in the main proceedings are comparable to a UCITS' (and if it is not possible to interpret national law in conformity with EU law).

The AG's approach is to compare the funds in question more closely with the harmonising EU UCITS law than arguably has been the case to date

As we have seen from FA 2024 s 28, this latter EU right is no longer available to UK taxpayers. If a court or tribunal were to find it impossible using a 'muscular approach' to interpret UK law in conformity with an interpretation of EU law, where a fund is comparable to a UCITS, then the taxpayer could no longer rely on the direct effect of EU law since it would require the disapplication of UK law requiring a supply to be taxable in circumstances where it was not possible to interpret UK law consistently with the UK VAT exemptions. As we know from VATA 1994 s 4(2), 'a taxable supply is a supply of goods or services made in the United Kingdom other than an exempt supply'. Therefore, if, on a muscular interpretation, it is not possible to get the management of a fund within either item 9 or 10 of Sch 9 Group 5, one can no longer disapply s 4(2) to give the EU provision direct effect.

Where does this leave us?

It will be interesting to see if the CJEU makes any subtle changes to the scope of the VAT exemption and whether this could be relevant to the interpretation of the UK VAT exemption. Certainly, the AG's approach is to compare the funds in question more closely with the harmonising EU UCITS law than arguably has been the case to date. If the CJEU follows her opinion, this may lead to a stricter interpretation of what is a SIF and one that is different from the UK government's abandoned attempt to codify the VAT exemption into UK law. ■