EUROPEAN COMMISSION
DIRECTORATE-GENERAL
TAXATION AND CUSTOMS UNION
Indirect Taxation and Tax administration
Value added tax

taxud.c.1(2017)6168695 – EN

Brussels, 9 November 2017

VALUE ADDED TAX COMMITTEE
(ARTICLE 398 OF DIRECTIVE 2006/112/EC)
WORKING PAPER NO 936

QUESTION
CONCERNING THE APPLICATION OF EU VAT PROVISIONS

ORIGIN:	**Commission, the Netherlands and Denmark**
REFERENCE:	**Article 135(1)(g)**
SUBJECT:	**Scope of the exemption for the management of special investment funds**

1. INTRODUCTION

The Commission services wish to discuss in the VAT Committee the scope of the exemption for the management of special investment funds provided for in Article 135(1)(g) of the VAT Directive[1]. We have been recently confronted with numerous issues in relation to this exemption, both when it comes to the concepts of "management" and "special investment funds" in that provision. In particular, the questions are: (i) whether certain activities outsourced by fund managers (in particular, advisory services) could be seen as fulfilling the specific and essential functions of the management of special investment funds and thus also be exempt; and (ii) whether certain types of funds could be seen as special investment funds for the purposes of the exemption. If such funds were found to fall within the definition of special investment funds, management services provided in respect of them would be exempt.

In relation to this issue, the Dutch authorities also wish to examine in the VAT Committee a question about the application of this exemption to services consisting in the management of pension funds. The question submitted by the Netherlands is attached in Annex 1. The Danish authorities have also asked that the VAT Committee examines a question about the application of the exemption in relation to the management of specific types of funds (alternative investment funds). The question submitted by Denmark is attached in Annex 2.

Given that these questions are all linked to the scope of the same exemption, they are examined jointly in this Working paper.

2. SUBJECT MATTER

2.1. The scope of this analysis

Under certain conditions, management services provided in respect of investment funds can (and shall) be exempted in accordance with Article 135(1)(g) of the VAT Directive. In particular, the exemption is dependent on two conditions being met: (i) the services must qualify as "management services"; and (ii) such management services must be supplied in respect of funds qualifying as "special investment funds".

This analysis looks at both conditions.

As regards the first condition, it should be examined whether certain supplies of services which can be outsourced by fund management companies, in particular advisory services, could be seen as fulfilling the specific and essential functions of the management activity and thus also be exempt in accordance with Article 135(1)(g) of the VAT Directive.

As regards the second condition, the objective is to shed some light on the type of funds which can be considered to qualify as special investment funds, as this determines whether

[1] Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (OJ L 347, 11.12.2006, p. 1).

the exemption applies. In this respect, three main categories of collective investment funds are examined:

i. Undertakings for Collective Investment in Transferable Securities (UCITS);
ii. Alternative Investment Funds (AIFs), in particular hedge funds, private equity funds, European venture capital funds (EuVECA), European social entrepreneurship funds (EuSEF), and European long-term investment funds (ELTIFs);
iii. Pension funds.

The question raised by the Netherlands relates only to management services provided in respect of pension funds; in particular whether in determining the VAT treatment it is necessary to distinguish between pension funds with Defined Contribution (DC) and pension funds with Defined Benefit (DB). According to the Netherlands, while management services provided in respect of DC pension funds would be exempt from VAT, those provided in respect of DB pension funds should be taxed, based on the case-law[2] of the Court of Justice of the European Union (CJEU).

The question raised by Denmark relates only to management services provided in respect of AIFs. It is asked whether all AIFs must be seen as falling within the definition of special investment funds for the purposes of Article 135(1)(g) of the VAT Directive, in particular in light of the judgment of the CJEU in *Fiscale Eenheid X*[3]. Denmark doubts that all AIFs should automatically be taken to qualify as special investment funds.

Although the VAT Committee has examined the exemption for the management of investment funds in the past[4], it has never dealt with the issues which are the subject of this Working paper.

2.2. What are investment funds?

Prior to examining the scope of the exemption, it is necessary to briefly outline what investment funds are all about. It should be noted that the description below is not comprehensive, but only summarises some of their basic characteristics for the purposes of our analysis.

2.2.1. Purpose and structure of investment funds

An investment fund is basically an investment product created with the purpose of gathering investors' capital, and investing that capital collectively through a portfolio of financial instruments such as stocks, bonds and other securities[5].

There are several parties typically involved in a collective investment fund. Often, the fund in itself has no infrastructure (e.g. employees, offices or equipment)[6] and it is

[2] The Netherlands refer to CJEU, judgment of 7 March 2013, *Wheels Common Investment Fund Trustees and Others* (hereinafter "Wheels"), C-424/11, EU:C:2013:144; and CJEU, judgment of 13 March 2014, *ATP PensionService*, C-464/12, EU:C:2014:139.

[3] CJEU, judgment of 9 December 2015, *Fiscale Eenheid X*, C-595/13, EU:C:2015:801.

[4] See Guidelines resulting from the 17th meeting of 4-5 July 1984 (XV/243/84, p. 34), and Guidelines resulting from the 31st meeting of 27-28 January 1992 (XXI/732/92, p. 59).

[5] For more information, see DG FISMA's website.

therefore managed by a separate company. According to literature, such a specialised management company *"collects money from several investors, pools them in the fund and invests further according to the investment objectives and policies of the investment fund. (…) Most fund management companies administer several investment funds, each with its own distinctive investment objective. The fund management company acts in its own name on behalf of the underlying investors and uses all the rights related to assets entrusted to it. For the protection of underlying investors, management companies are strictly regulated. For its services for the investment fund, the management company charges a fee based on a percentage of the fund's average net assets"*[7].

The management company must, among other responsibilities, choose the portfolio of the fund (i.e. decide in which securities, such as bonds or shares, the capital raised from the investors should be invested). This activity is usually known as "portfolio management" or provision of investment advice. Such an advisory activity may be undertaken by the management company itself, or it may be outsourced to another company.

As described in an OECD report, "*the manager provides services such as portfolio management (advisory) and transfer agency (shareholder recordkeeping). In some cases, the manager may select other firms to sub-advise part, or all, of the portfolio. The manager also may decide to hire unaffiliated parties to perform other services, such as legal and audit services, tax consulting, custodial services and others"*[8]. In particular, the activities of an advisor are described as follows: *"With respect to the portfolio, the adviser decides which securities the CIV* [Collective Investment Vehicle] *will hold, and when they will be bought or sold. The adviser thus will research securities and anticipate market movements. (...) The adviser must also ensure that the CIV's portfolio is consistent with applicable regulations"*[9].

The present document will examine the scenario where a fund is managed by a management company which, in turn, has outsourced the advisory activity to another party (advisory company). Both the management company and the advisory company receive each their corresponding fee in exchange for their services, as can be seen in the diagram below.

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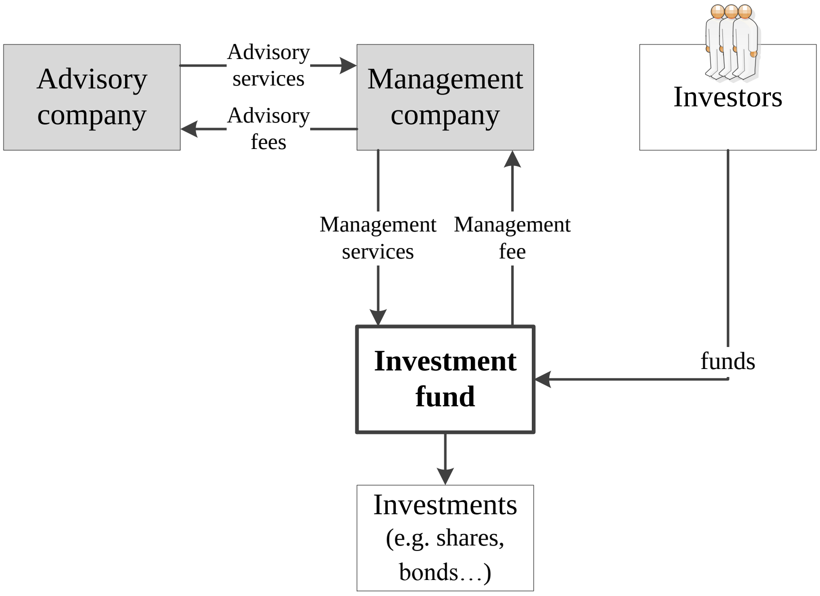
[6] M. St Giles, E. Alexeeva, S. Buxton, *Managing Collective Investment Funds*, John Wiley & Sons, 2005, p. 43.

[7] T. Viitala, *Taxation of Investment Funds in the European Union*, Online Books IBFD (access: 10/10/2017), section 2.1.2.

[8] OECD (Committee on Fiscal Affairs), *The granting of Treaty benefits with respect to the income of Collective Investment Vehicles*, 2010, p. 5. It must be noted that the OECD report explains the concept of advisory services in respect of Collective Investment Vehicles (CIVs), which is close to the concept of UCITS. However, both UCITS and AIF managers can outsource the activity of portfolio management to a third party.

[9] *Ibid*.

Figure 1: Investment fund structure (simplified) object of this analysis



Source: Commission services

2.2.2. EU regulatory framework

Existing EU laws and any initiatives relating to investment funds are taken as a reference in order to explain the main types of funds and their characteristics[10]. A great share of investment funds located within the EU are governed by the EU regulations, in particular the UCITS Directive and the AIFM Directive. There are, however, other funds that are governed by national rules only, often being sub-threshold in terms of assets under management.

There are two main pieces of EU legislation that govern collective investment management in the EU:

- Undertakings for Collective Investment in Transferable Securities Directive (UCITS Directive).
- Alternative Investment Fund Managers Directive (AIFM Directive).

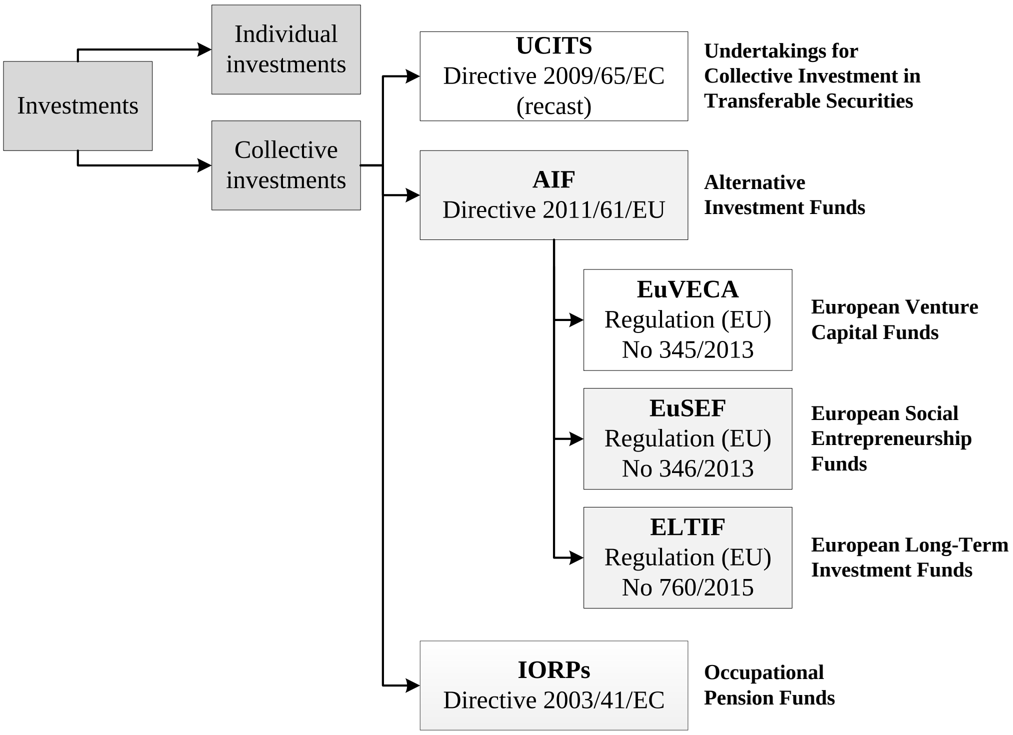
Pension funds are – technically speaking – investment funds too, in the sense that they are based on the pooling of resources among a group of investors. However, from a financial perspective they are often treated as a separate category of collective investments, due to

[10] The implementation of such legislative framework generally falls within the responsibilities of the Directorate-General for Financial Stability, Financial Services and Capital Markets Union (DG FISMA) of the European Commission, and also the European Securities and Markets Authority (ESMA).

reasons linked to investment strategies being different[11]. This is why pension funds are explained and dealt with separately.

The EU legal framework for investment funds is summarised in the figure below[12].

Figure 2: Overview of types of investment funds



Source: Commission services

As can be seen from the above figure 2, the EU regulatory framework[13] for investment funds, without taking into account pension funds, is built on two complementary pillars: (i) Directive 2009/65/EC, as amended[14], on Undertakings for Collective Investment in Transferable Securities (UCITS Directive); and (ii) Directive 2011/61/EU[15] on Alternative

[11] For instance, investment funds have a relatively short investment horizon, compared to pension funds. For more information, see J. de Hanan, S. Oosterloo, D. Schoenmaker, *Financial markets and institutions – a European perspective*, Cambridge University Press, 2012, p. 258. However, both investment funds and pension funds are usually described as being two types of a more general category: "institutional investors". Institutional investors are usually considered to be professional investors, as opposed to retail investors (e.g. private individuals). According to the OECD [OECD, *OECD Institutional Investors Statistics 2016*, OECD Publishing, 2017] institutional investors (investment funds, pension funds, and insurance companies) are major collectors of savings and suppliers of funds to financial markets. Institutional investors are also defined as "*specialised financial institutions that manage savings collectively on behalf of small investors…*" [E. Philip Davis, Benn Steil, *Institutional investors*, The MIT Press, 2001, p. xxiii].

[12] For more information, see DG FISMA's website.

[13] For more information, see DG FISMA's website.

[14] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ L 302, 17.11.2009, p. 32). See recast.

[15] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (OJ L 174, 1.7.2011, p. 1).

Investment Fund Managers (AIFM Directive). There are thus two main types of investment funds:

- **UCITS** – On the one hand, the UCITS Directive governs the management of these funds, as well as the funds themselves. UCITS are "traditional" investment funds intended to be marketed to retail investors and marketed across borders, providing a strong consumer protection framework which ensures the funds are suitable for retail investors[16]. Eligible funds are permitted to use the UCITS label and benefit from a cross-border marketing passport, allowing them to market without barriers to all investors throughout the EU.

- **AIFs** – On the other hand, the AIFM Directive does not regulate Alternative Investment Funds (AIFs) themselves, but their managers. AIFs are funds designed for professional investors, which are not regulated at EU level by the UCITS Directive. They include, among others, hedge funds and private equity funds. The AIF portfolio composition is left entirely at the discretion of AIF managers. There is no EU passport to market the AIFs to retail investors, but only to professional investors. Marketing to retail investors can nonetheless be made at Member States' discretion.

2.2.3. Alternative investment funds (AIFs)

AIFs are the category of funds which are not UCITS. Some sub-types of AIFs are governed by specific legislation at EU level, so that they can operate within the Internal Market under the same label: European Venture Capital Funds (EuVECAs), European Social Entrepreneurship Funds (EuSEFs), and European Long-Term Investment Funds (ELTIFs).

Unlike the UCITS Directive, which concerns both UCITS investment funds themselves and their fund managers, it should be noted that the AIFM Directive regulates only fund managers, but not the funds themselves. It follows, as put forward by Denmark, that the AIFM Directive solely concerns the indirect supervision of AIFs as a consequence of the supervision of the managers. Besides, the approval and supervision of AIFs are still a national competence, due to the very different types of AIFs. This is acknowledged in recital 10 of the AIFM Directive: *"It would be disproportionate to regulate the structure or composition of the portfolios of AIFs (...) at Union level and it would be difficult to provide for such extensive harmonisation due to the very diverse types of AIFs…"*.

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[16] See section 3.3 and Annex 6 of the Impact Assessment accompanying the document 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 (Commission Staff Working Document (SWD(2016) 228 final) (hereinafter "EuVECA and EuSEF Impact Assessment").

In contrast, it must be stressed that the specific EU legislation on EuVECAs, EuSEFs and ELTIFs cover the funds' characteristics, that is, they contain provisions on the composition of the portfolio of such funds, their eligible investment targets and the categories of investors that are eligible to invest in them[17].

Managers of AIFs falling within the scope of the AIFM Directive are required to comply with a framework for consumer protection and management of prudential risk suitable for professional investors.

In principle AIFs can be sold to professional investors only, in accordance with Articles 31(6) and 32(9) of the AIFM Directive, professional investors being those qualifying as "professional clients"[18] according to Directive 2004/39/EC[19] (MiFID). Marketing to retail investors can nonetheless be made at Member States' discretion. As acknowledged in the guidance on the implementation of the AIFM Directive issued by the Commission services[20], the marketing of AIFs to retail investors is only allowed under the conditions foreseen in Article 43 of that Directive. While the AIFM Directive does not regulate the establishment of retail funds, which is instead a matter of national law only, Article 43 allows Member States to impose stricter requirements than those applicable to AIFs marketed to professional investors. In any case, it is up to Member States to decide whether marketing to retail investors by AIFs managers should be allowed and under which conditions[21].

An outline of the main characteristics of various types of AIFs can be found below. Some of them (EuVECAs, EuSEFs, and ELTIFs) are governed by specific legislation.

- **Hedge funds** – There is not a clear-cut definition of hedge funds[22], which are not legally defined in the AIFM Directive either. Some common characteristics were pointed out by the Commission services during a public consultation on hedge funds[23], which was part of the work leading to the adoption of the AIFM Directive. Among others, it was said that, traditionally, the hedge fund investor base is confined to institutional or other sophisticated investors.

  Hedge funds could also be described, as found in parts of existing literature, as follows: *"hedge funds (...) 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*

17 Recital 2 of the EuVECA Regulation, recital 3 of the EuSEF Regulation, and recital 7 of the ELTIF Regulation.

18 See section 2.2.4.

19 Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments (OJ L 145, 30.4.2004, p. 1).

20 AIFM Directive Q&As from the European Commission, p. 26.

21 *Op.cit*., p. 14.

22 According to E. Ferran, *After the crisis: the regulation of hedge funds and private equity in the EU*, European Business Organization Law Review, 2011, Vol. 12(3), pp. 379-414, "hedge funds" is a term that is not susceptible to an exhaustive definition because of the range of different investment strategies, markets and asset classes involved.

23 http://ec.europa.eu/internal_market/consultations/docs/hedgefunds/consultation_paper_en.pdf

and bunks…"[24]; and *"...historically, hedge funds 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"*[25].

- **Private equity funds** – Again, defining private equity funds is not a straightforward task, and the AIFM Directive does not provide any guidance. According to some authors, *"Private equity is 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"*[26].

  Private equity consists of investments in companies that are generally not listed on a stock exchange[27] (this is why they are called "private"). Private equity is not only limited to the provision of capital, but also to management expertise to the invested companies in order to create value and subsequently, upon sale of such companies after a medium to long holding period, generate capital gains[28].

  The typical characteristics of the private equity industry were summarised by the Alternative Investment Expert Group of the Commission as follows[29]:

  1) Investment by a dedicated professional team predominantly in unquoted companies;
  2) Involving active ownership 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;
  9) With a focus on financial gain through exit by sale or flotation.

  As regards the characteristic 4) (targeted investors), the expert group stressed in particular that *"all these investors, whether institutional or individual, are regarded as professional. They are all capable of making independent investment decisions and understanding the risks related to those decisions…"*.

[24] G. Arnold, *The Financial Times guide to the financial markets*, Pearson, 2012, p. 43.
[25] W. Fund, D.A. Hsieh, *Hedge funds – Handbook of the Economics of Finance*, Vol. 2, 2013, pp. 1063-1125.
[26] E. Ferran, *op.cit.*
[27] T. Jenkinson, *The development and performance of European private equity* in X. Freixas, P. Hartmann, C. Mayer (editors), *Handbook of European Financial Markets and Institutions*, Oxford University Press, 2008, p. 318.
[28] Alternative Investment Expert Group of the European Commission, *Report on the developing of European Private Equity*, 2006, p. 9.
[29] Alternative Investment Expert Group of the European Commission, *Op.cit.*, p. 10.

The difference between private equity funds and hedge funds would be that hedge funds are not involved in the management of the companies in which they invest: *"private equity funds acquire stakes in companies that are intended to be sold for profit after a number of years. Unlike hedge funds, which are mostly short-term traders, private equity funds take ownership and management control of corporations"*[30].

While the terms "private equity" and "venture capital" are often used interchangeably, private equity is the generic term which encompasses several types of investment. Venture capital is the one made in start-ups and early stage companies, as explained below.

- **European Venture capital funds (EuVECAs)** – Venture capital investments are a sub-set of the private equity sector as set out above, used for start-ups and more risky undertakings. Venture capital funds invest in order to provide equity start-up capital for a new and uncertain technology or business idea. A typical private equity fund, on the other hand, is much more diversified and consists in investments in more established companies. A private equity investment thus entails a lower risk than an investment in venture capital[31].

The label for European venture capital funds, EuVECAs, was introduced by Regulation (EU) No 345/2013[32] (EuVECA Regulation) in order to enable these qualifying funds to be marketed cross-border within the EU[33]. EuVECAs can be managed by an EU authorised AIF manager[34].

EuVECAs are aimed at professional investors. Hence, the scope of this label is defined by reference to the concept of "professional clients"[35] in accordance with MiFID. Other investors not falling within the definition of professional clients for the purposes of MiFID are allowed to participate in EuVECAs, as long as they invest at least EUR 100 000 in one fund and that they state in writing that they are aware of the risks associated with the investment[36].

Recitals of the EuVECA Regulation[37] make it clear that *"in order to ensure that qualifying venture capital funds are only marketed to investors who have the experience, knowledge and expertise to make their own investment decisions and properly assess the risks that those funds carry, (…) certain specific safeguards should be laid down. Therefore, qualifying venture capital funds should only be marketed to investors who are professional clients or who can be treated as professional clients under Directive 2004/39/EC (…) However, in order to have a sufficiently broad investor base for investment into qualifying venture capital funds*

30 J. Robertson, *Private equity funds*, New Political Economy, 1 December 2009, Vol. 14(4), p. 545-555.
31 See Annexes 9 and 10 of the EuVECA and EuSEF Impact Assessment.
32 Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds **(**OJ L 115, 25.4.2013, p. 1).
33 http://europa.eu/rapid/press-release_MEMO-16-2528_en.htm
34 See recital 7 of the EuVECA Regulation.
35 See section 2.2.4.
36 Article 6 of the EuVECA Regulation.
37 Recital 24 of the EuVECA Regulation.

it is also desirable that certain other investors have access to qualifying venture capital funds, including high net worth individuals. For those other investors, however, specific safeguards should be laid down in order to ensure that qualifying venture capital funds are only marketed to investors that have the appropriate profile for making such investments".

- **European Social Entrepreneurship Funds (EuSEFs)** – Investment funds covered by Regulation (EU) No 346/2013[38] (EuSEF Regulation) focus on funding social enterprises which are set up with the explicit aim to have a positive social impact and address social objectives, rather than only maximising profit. While these enterprises often receive public support, private investment via funds still remains vital to their growth. EuSEFs can be managed by an EU authorised AIF manager[39].

  In the same way as EuVECAs, EuSEFs are aimed at professional investors. Hence, their scope is likewise defined by reference to the concept of "professional clients" as defined in MiFID. Other investors not falling within the definition of professional clients for the purposes of MiFID are allowed to participate in EuSEFs, as long as they invest at least EUR 100 000 in one fund and that they state in writing that they are aware of the risks associated with the investment[40].

- **European Long-Term Investment Funds (ELTIFs)** – These funds covered by Regulation (EU) 2015/760[41] (ELTIF Regulation) 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 manager[42].

  ELTIFs can be sold to both professional and retail investors[43]. Where ELTIFs are distributed to retail investors, some extra requirements are imposed on the manager of the fund[44].

2.2.4. Distinguishing between UCITS and AIFs

Generally speaking, one of the main differences between UCITS and AIFs is the type of investors for which they are intended[45]: while UCITS target small or retail investors, AIFs are in principle available for professional investors only. In this respect, AIFs portfolio composition is left to the manager's discretion, and the level of investor protection provided for in the AIFM Directive is lower than that of the UCITS Directive.

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[38] Regulation (EU) No 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds (OJ L 115, 25.4.2013, p. 18).

[39] See recital 7 of the EuSEF regulation.

[40] Article 6 of the EuSEF Regulation.

[41] Regulation (EU) 2015/760 of the European Parliament and of the Council of 29 April 2015 on European long-term investment funds (OJ L 123, 19.5.2015, p. 98).

[42] See recital 8 of the ELTIF Regulation.

[43] Article 31(1) and (2) of the ELTIF Regulation.

[44] See Articles 26-30 of the ELTIF Regulation, for instance.

[45] See recital 47 of Directive 2011/61/EU.

Retail investors are defined in Article 4(1)(aj) of the AIFM Directive as *"an investor who is not a professional investor"*; and professional investors are defined in point (ag) of the same provision as *"an investor which is considered to be a professional client or may, on request, be treated as a professional client within the meaning of Annex II to Directive 2004/39/EC* [MiFID]*"*.

In turn, professional clients are defined by MiFID as follows:

"Annex II
Professional clients for the purpose of this Directive

Professional client is a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs. In order to be considered a professional client, the client must comply with the following criteria:

I. Categories of client who are considered to be professionals

The following should all be regarded as professionals in all investment services and activities and financial instruments for the purposes of the Directive.

(1) Entities which are required to be authorised or regulated to operate in the financial markets. The list below should be understood as including all authorised entities carrying out the characteristic activities of the entities mentioned: entities authorised by a Member State under a Directive, entities authorised or regulated by a Member State without reference to a Directive, and entities authorised or regulated by a non-Member State:

(a) Credit institutions

(b) Investment firms

(c) Other authorised or regulated financial institutions

(d) Insurance companies

(e) Collective investment schemes and management companies of such schemes

(f) Pension funds and management companies of such funds

(g) Commodity and commodity derivatives dealers

(h) Locals

(i) Other institutional investors

(2) Large undertakings meeting two of the following size requirements on a company basis:

— balance sheet total: EUR 20 000 000,

— *net turnover:* *EUR 40 000 000,*

— *own funds:* *EUR 2 000 000.*

(3) *National and regional governments, public bodies that manage public debt, Central Banks, international and supranational institutions such as the World Bank, the IMF, the ECB, the EIB and other similar international organisations.*

(4) *Other institutional investors whose main activity is to invest in financial instruments, including entities dedicated to the securitisation of assets or other financing transactions".*

Having said that, AIFs that are subject to the AIFM Directive can also be marketed to retail investors at Member States' discretion subject to the conditions laid down in Article 43 of that Directive.

EuVECAs and EuSEFs may for example be sold to non-professional investors, provided they invest at least EUR 100 000 in one fund and that the investors state in writing that they are aware of the risks associated with the investment[46]. This allows high net worth individuals to invest in these funds, while still safeguarding small retail investors from the relative risks of this type of investments.

In the recent proposal[47] amending the EuVECAs and EuSEFs Regulations, adopted by the Commission in July 2016, the threshold of EUR 100 000 for non-professional investors was maintained on the following grounds: *"the minimum investment of EUR 100 000 was introduced to ensure adequate consumer protection. Lowering the investment threshold would inevitably need to be coupled to additional investor protection measures which would only serve to detract from the ultimate benefit of more flexible EuVECA and EuSEF regimes. As the EuVECA and EuSEF are, for the time being, a niche market, it seems more appropriate to let this market develop with a proportionate regime before introducing additional layers of investor protection requirements"*[48].

Besides, ELTIFs can be sold to both professional and retail investors[49]. Where ELTIFs are distributed to retail investors, some extra requirements are imposed on the manager of such funds[50].

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[46] See Article 6 of the EuVECA Regulation and the EuSEF Regulation.

[47] 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 (COM(2016) 461 final). The main objectives of the proposal are (i) extending the range of managers eligible to market and manage EuVECA and EuSEF funds; (ii) increasing the range of companies that can be invested in by EuVECA funds; and (iii) making the registration and cross-border marketing of these funds easier and cheaper.

[48] European Commission, Capital Markets union: new rules to boost funding for venture capital and social enterprises – Q&A, July 2016 (question 8).

[49] Article 31(1) and (2) of the ELTIF Regulation.

[50] See Articles 26-30 of the ELTIF Regulation, for instance.

2.2.5. Pension funds

Pension funds which manage collective investments are usually referred to as occupational pension funds[51] or Institutions for Occupational Retirement Pension (IORPs), as opposed to personal pension funds. They are financial institutions that manage collective retirement schemes for employers, in order to provide benefits to employees (the pension scheme members and beneficiaries), and are regulated at EU level by Directive 2003/41/EC[52] (IORPS Directive).

Occupational pensions, which include an employer contribution, are known as the "second pillar" of pension systems, the "first pillar" being state-based social security pensions, and the "third pillar" being non-compulsory private pension savings by individuals.

There are two main categories of pension funds: defined-contribution pension funds (DC) and defined-benefit pension funds (DB). Broadly speaking, the main difference between DC pension funds on the one hand and DB pension funds on the other[53] is who bears the risk of the investment.

If the fund is a DC pension fund, the level of the contributions made to the fund (from employer and employee) is pre-defined but the retirement benefit to be received by the employee will mainly depend on how well the investment performs (i.e. the pay-out is not guaranteed). In contrast, DB pension funds are those where the retirement benefit, rather than the contribution, is pre-fixed (i.e. the pay-out will remain the same, regardless of how the investment performs). DB pension funds will typically pay out a fixed amount based upon the number of years worked and the level of final salary or the average level of salary[54].

This in turn has an impact on who assumes the risk of the investment: the employees to whom the retirement benefit is going to be paid out (that is the case with DC pension funds), or the employer who is paying for that benefit (in the case of DB pension funds).

It should be stressed that, due to the evolution of pension fund schemes, it is less and less common to find "pure" DB or DC pension funds. Instead, hybrid structures where the elements described above are combined (e.g. DB pension funds, where all or part of the risk is shifted from the employer to another person, such as the fund itself or the employee) are becoming more commonplace.

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51 For more information, see DG FISMA's website.

52 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 (OJ L 235, 23.9.2003, p. 10).

53 Some useful guidance on the definitions of DC and DB pension funds can be found in Annex A (Glossary) of the Impact Assessment accompanying the document Proposal for a Directive of the European Parliament and of the Council on the activities and supervision of institutions for occupational retirement provision (recast) (SWD(2014) 103 final); and in OECD (2005), *Private Pensions: OECD Classification and Glossary*, OECD Publishing, Paris, p. 14.

54 G. Arnold, *,op.cit.*, p. 157.

3. THE COMMISSION SERVICES' OPINION

Article 135(1)(g) of the VAT Directive contains an exemption for *"the management of special investment funds as defined by Member States"*.

At the outset it should be noted that the CJEU has repeatedly stressed that 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[55]. Furthermore, they constitute independent concepts of EU law whose purpose is to avoid divergences in the application of the VAT system as between one Member State and another and which must be placed in the general context of the common system of VAT[56].

Before examining the scope of the exemption, which is the purpose of this document, its purpose is briefly outlined.

3.1. The purpose of the exemption

In determining the scope of a provision of EU law, its wording, context and objectives must be taken into account[57].

The purpose of this exemption was first acknowledged by the CJEU in *Abbey National*, based on observations made by Advocate General Kokott: "*As the Advocate General observed in point 68 of her Opinion, the purpose of the exemption, under Article 13B(d)(6) of the Sixth Directive* [equivalent of Article 135(1)(g) of the VAT Directive]*, of transactions connected with the management of special investment funds is, particularly, to facilitate investment in securities for small investors by means of investment undertakings. Point 6 of that provision is intended to ensure that the common system of VAT is fiscally neutral as regards the choice between direct investment in securities and investment through undertakings for collective investment"*[58].

Advocate General Kokott was even more specific when stating that: *"For that purpose to be achieved* [facilitate investment in common funds for small investors]*, the expenditure on the management of the common fund is to be exempted from tax. If the exemption did not exist, the owners of units in common funds would have a greater tax burden than investors who invest their money directly in shares or other securities and do not have recourse to the services of a fund management"*[59].

It follows that the purpose of the exemption is to avoid distortions of competition between investors participating in funds directly and investors participating in funds by means of an intermediary (i.e. a management company). The need to involve a third-party manager

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55 CJEU, judgment of 19 July 2012, *Deutsche Bank*, C-44/11, EU:C:2012:484, paragraph 42 and the case-law cited.

56 CJEU, judgment of 22 October 2009, *Swiss Re*, C-242/08, EU:C:2009:647, paragraph 33 and the case-law cited.

57 CJEU, judgment of 8 December 2005, *Jyske Finans*, C-280/04, EU:C:2005:753, paragraph 34, and case-law cited.

58 CJEU, judgment of 4 May 2006, *Abbey National*, C-169/04, EU:C:2006:289, paragraph 62.

59 Opinion of Advocate General Kokott of 8 September 2005, *Abbey National*, EU:C:2005:523, points 68-69.

would be mainly driven by the fund having legal personality or not. Funds without legal personality (i.e. contract-based and also referred to as "common funds") could not manage investments themselves and would have to make use of an external company, while funds with legal personality (also referred to as "statutory funds") would be able to manage themselves[60].

It must be noted that the concepts of "common funds" and "special investment funds" seem to have been used as synonyms when referring to funds without legal personality, at least if one follows the reasoning of Advocate General Kokott.

From her statements, it appears that management is a mere cost that funds without legal personality have to assume; and that, without such limitation, small investors would happily buy and sell shares directly (i.e. they would not incur any management cost). However, this could be said to be too simplistic a perspective. In fact, she admits[61] that investing via a fund not only reduces the investment risk, but also entails the choice of investments being made by highly specialised experts (i.e. the management company). Indeed, because of the advantage stemming from such expertise, it is also commonplace for investment funds with legal personality (which should be able to manage their investments themselves according to the findings in *Abbey National*) to outsource management of the fund, due to the complexity of the financial sector and the need for specialised management.

The CJEU ultimately concluded that the exemption should cover not only services provided in respect of common funds (without legal personality), but also in respect of statutory funds (with legal personality)[62].

The findings in *Abbey National* are in line with the opinion of Advocate General Poiares Maduro on one of the questions put in *BBL*[63] (where in the end the CJEU did not have to reply to that question): "*the exclusion of statutory funds which have opted to delegate the management of their assets* [as opposed to the exemption being restricted to contract-based funds] *could affect equality of treatment between the various collective investment*

60 *Abbey National*, point 29: *"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 (...) since the management activity does not involve the provision of services between two independent taxable persons. Without the exemption (...) 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 (...) Article 13B(d)(6) of the Sixth Directive accordingly, as worded, relates only to the management of special investment funds, and does not mention self-managed investment companies".*

61 *Abbey National*, point 27.

62 *Abbey National*, paragraphs 53-56.

63 Opinion of Advocate General Poiares Maduro of 18 May 2004, *BBL*, C-8/03, EU:C:2004:309, points 26-28.

undertakings"; and has since been confirmed by the CJEU in *JP Morgan Fleming Claverhouse*[64].

This is consistent with VAT Committee guidelines previously agreed[65]: "*Most of the delegations took the view that the exemption provided for under Article 13(B)(d)(6) of the Sixth Directive could also be applied to portfolio management services supplied by an outside enterprise to undertakings with a corporate structure or constituted under statute*".

The CJEU recently confirmed this position with its decision in *Fiscale Eenheid X*[66], where it recalled 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.

3.2. Scope of the exemption for the management of special investment funds

As stated above, the exemption provided for in Article 135(1)(g) of the VAT Directive is dependent upon two conditions being met: (i) the services in question must qualify as "management services"; and (ii) such management services must be supplied in respect of funds qualifying as "special investment funds".

As regards the first condition, it should be examined whether certain supplies of services which can be outsourced by fund management companies, such as advisory services, could be seen as fulfilling the specific and essential functions of the management activity and thus be also exempt in accordance with Article 135(1)(g) of the VAT Directive, in light of the case-law of the CJEU (section 3.3).

As regards the second condition, it is only the management of special investment funds that is exempt under Article 135(1)(g) of the VAT Directive. While the concept of "special investment funds" is not defined in the VAT Directive, the CJEU has examined it on numerous occasions. Based on existing case-law, we have analysed various types of funds and the extent to which each of them could be seen as covered by the concept of special investment fund for the purposes of the exemption (section 3.4). In that context, it is also pertinent to briefly address another aspect of this provision, which is the reference to special investment funds being "defined by Member States" (section 3.4.1).

3.3. Condition 1: the activity of management

The scenario at hand involves the provision of a service consisting in the management of a fund by an independent management company, which is a service for which the company receives a fee (management fee). In order to help it determine the portfolio of the fund,

[64] CJEU, judgment of 28 June 2007, *JP Morgan Fleming Claverhouse Investment Trust and The Association of Investment Trust Companies* (hereinafter "JP Morgan Fleming Claverhouse"), C-363/05, EU:C:2007:391, paragraphs 35-36.

[65] Guidelines resulting from the 31st meeting of 27-28 January 1992 XXI/732/92, p. 59.

[66] *Fiscale Eenheid X*, paragraph 34. See also *JP Morgan Fleming Claverhouse*, paragraph 45; *Wheels*, paragraph 19; and *ATP PensionService*, paragraph 43.

such a management company receives advisory services from another company (advisory company), also in exchange for a fee (advisory fee).

In such circumstances, the question is whether the advisory services (provided by the advisory company to the management company) should be treated as independent from the management services (provided by the management company to the fund) and thus be taxed according to normal rules; or whether such advisory services could be considered fulfilling the specific and essential functions of the management activity and therefore also be exempt in accordance with Article 135(1)(g) of the VAT Directive.

We assume that both services have been provided in respect of a fund qualifying as a special investment fund, which is the second condition for the exemption being applicable.

First of all, according to case-law of the CJEU[67] in respect of other provisions to be found in Article 135, it is possible to break down an exempt supply of services into separate services (also referred to as constituent elements of the exempt service), each of which could still be exempt depending however on their characteristics. In particular, for such constituent elements to be exempt, they must form a distinct whole, fulfilling in effect the specific, essential functions of the exempt service. In other words, those operations must be distinct in character and be specific to, and essential for, the exempt transactions[68].

More recently, the CJEU has examined similar questions for the purposes of Article 135(1)(g) of the VAT Directive.

In *Abbey National*, the CJEU examined whether management activities provided by a third-party management company could be exempt. In this respect, the CJEU acknowledged that the wording of Article 135(1)(g) of the VAT Directive does not in principle preclude the management of special investment funds from being broken down into a number of separate services which may come within the meaning of "management of special investment funds", and thus benefit from exemption under that provision[69]. In order to be regarded as exempt, such services must concern specific essential elements of the management of special investment funds, and mere material or technical supplies (e.g. making available of a system of information technology) would not be covered[70]. Moreover, it also stressed that the exemption is defined according to the nature of the services, and not according to the person supplying or receiving the services[71], thus covering third-party suppliers.

In *GfBk*[72], the CJEU dealt with another case which also resembles the question that we are examining. GfBk was an undertaking whose activity was the provision of advice relating to investment in financial instruments and the marketing of financial investments. Having concluded a contract with an Investment Management Company (IMC) which managed a collective investment fund, GfBk undertook to *"advise the IMC in the management of the*

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67 CJEU, judgment of 5 June 1997, *SDC*, C-2/95, EU:C:1997:278, paragraphs 64-66; and CJEU, judgment of 13 December 2001, *CSC Financial services*, C-235/00, EU:C:2001:696, paragraph 23.
68 *SDC*, paragraph 68.
69 *Abbey National*, paragraph 67.
70 *Abbey National*, paragraph 71.
71 *Abbey National*, paragraph 66.
72 CJEU, judgment of 7 March 2013, *GfBk*, C-275/11, EU:C:2013:141.

fund" and *"constantly to monitor the fund and to make recommendations for the purchase or sale of assets"*. GfBk also undertook to *"pay heed to the principle of risk diversification, to statutory investment restrictions…and to investment conditions…"*. For its advice GfBk was paid a percentage of the value of the investment fund. Although the portfolio selection was made by GfBk, the final decision and responsibility continued to lie within IMC[73].

The CJEU applied the test referred to above, and found that in order to determine whether advisory services concerning investment in transferable securities provided by a third party to a management company fall within the concept of "management of special investment funds" for the purposes of Article 135(1)(g) of the VAT Directive, it is necessary to examine whether such advisory services have the effect of performing the specific and essential functions of management of a special investment fund[74].

It was concluded that *"services consisting in giving recommendations to an IMC* [Investment Management Company] *to purchase and sell assets is intrinsically connected to the activity characteristic of the MIC, which (...) consists in the collective investment in transferable securities of capital raised from the public"*[75]. In other words, one of the essential elements of the activity of managing funds involves determining the assets in which the capital will be invested. Where such an activity is not performed in-house by a management company but outsourced to an advisory company, the activity could still be exempt in the circumstances set out above.

So, based on the above case-law of the CJEU, it seems that the VAT exemption for the management of special investment funds could apply to services outsourced by a management company of a special investment fund to a third party, provided that the services supplied by the third party form a distinct whole and are specific to, and essential for, the management itself. Accordingly, the CJEU has accepted that advisory services provided by an advisory company to the management company of a special investment fund, which consist in giving recommendations to purchase and sell assets, could be exempt in accordance with Article 135(1)(g) of the VAT Directive.

However, a couple of remarks must be made in respect of the findings of the CJEU.

Firstly, in order to determine whether a given advisory service could be exempt on the above grounds, a case-by-case analysis must be carried out, taking into account the specific nature of the activities involved without regard to whether the services are labeled as "management" or as "advisory".

And secondly, from a more general perspective and in line with a narrow interpretation of the exemption, it cannot be concluded that just any service provided in connection to the management of special investment funds is to be exempt. In this respect, the CJEU has held, for instance, that the functions of depositary of undertakings for collective investment and mere material or technical supplies, such as the making available of a system of information technology, are not specific to, and essential for, the activity of

[73] *GfBk*, paragraph 16.
[74] *GfBk*, paragraph 23.
[75] *GfB*k, paragraph 24.

management of special investment funds[76]. Another example where the CJEU found the exemption not to be applicable is the activity of management of immovable property intended to preserve the assets invested by a fund, as it was not seen as being specific to, and essential for, the activity of management of special investment funds but rather inherent to any type of investment[77].

3.4. Condition 2: possible qualification as special investment funds

Based on case-law of the CJEU, it shall be examined for various types of funds whether they could be seen as special investment funds for the purposes of the exemption. Prior to that, it is nonetheless pertinent to briefly address another aspect of this provision, which is the reference to special investment funds being "defined by Member States"

3.4.1. Special investment funds "as defined by Member States"

The question is whether the reference to special investment funds being "defined by Member States" means that each Member States can modify the scope of the exemption by means of defining at national level what special investment funds are.

This question was answered by the CJEU in *JP Morgan Fleming Claverhouse.* As a preliminary remark, the CJEU stressed[78] that while the exemptions provided in Article 135 of the VAT Directive have their own independent meaning in EU law which must be given a common definition whose purpose is to avoid divergences in the application of the VAT system from one Member State to another, the legislation may confer the task of defining certain terms of an exemption on the Member States. In such cases it is for each Member State to define the concepts in question in their own domestic law, subject to the terms of the exemption laid down by the EU legislature. An important caveat was however made, namely that: "*…it is clear from the case-law of the Court concerning VAT that, when the Member States come to define certain terms of an exemption, they may not prejudice the objectives pursued by the Sixth Directive* [equivalent of the VAT Directive] *or the general principles underlying it, in particular the principle of fiscal neutrality*".

The CJEU further expanded on its explanation[79] by making clear that: "*the task of defining the meaning of the words 'special investment funds' does not in any way permit the Member States to select certain funds located on their territory and grant them exemption and exclude other funds from that exemption. (...) The interpretation according to which it is for the Member States to select the investment funds which are eligible for the exemption and exclude others would negate the significance of the terms 'special investment funds' in Article 13B(d)(6)* [equivalent of Article 135(1)(g) of the VAT Directive] *whose objective is to prevent discrepancies in the application of VAT to such funds. Article 13B(d)(6) of the Sixth Directive thus only grants the Member States the power to define, in their domestic law, the funds which meet the definition of 'special investment funds'. That power should (…) be exercised subject to the objective pursued by the Sixth Directive and the principle of fiscal neutrality of the common system of VAT*".

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76 *Fiscale Eenheid X,* paragraph 74.
77 *Fiscale Eenheid X,* paragraph 78.
78 *JP Morgan Fleming Claverhouse*, paragraphs 19-22.
79 *JP Morgan Fleming Claverhouse*, paragraphs 39-43. See also *Fiscale Eenheid X*, paragraphs 32-33.

It may seem difficult to reconcile the two principles set out by the CJEU, that is, the elements of the exemption having their own independent meaning at EU level, and Member States having some leeway in defining at national level which funds qualify as special investment funds.

An explanation for that seeming contradiction was given by Advocate General Kokott in her Opinion in *Fiscale Eenheid X*: "*there are in fact two different regulatory areas: on the one hand, VAT law and, on the other, State supervision of investment funds (...). VAT law was harmonised prior to supervisory law. Therefore, EU VAT law had to refer to national law if it sought to exempt from VAT the management of investment funds that are subject to specific State supervision. Originally, only the Member States determined which investment funds were to be regulated by the State…*"[80]. This would explain why reference was made to "as defined by Member States" when the equivalent of Article 135(1)(g) of the VAT Directive was first introduced in the VAT legislation[81]. The CJEU confirmed this explanation with its judgment in that same case[82].

Taking this into account, steps since taken towards harmonisation through the adoption of EU financial legislation on investment funds (i.e. by means of the UCITS Directive) have inevitably had an impact on the discretion of Member States to define at national level which funds could qualify as special investment funds, as also acknowledged by the CJEU: "*The introduction at EU level* [of the UCITS Directive] *(...) limited the discretion of Member States to define special investment funds (...) The Member States' power to define was (...) overlaid by the coordination, at EU level, of laws relating to the supervision of investments. The concept of special investment funds within the meaning of Article 13B(d)(6) of the Sixth Directive is therefore determined both by EU law and by national law*"[83].

In any case, the reference to "as defined by Member States" should not be taken to mean that Member States can modify the scope of an exemption set out at EU level by means of their national legislation. In contrast, that reference must be interpreted as granting *"only the power to define, in its domestic law, the funds which meet the definition of special investment funds"*[84].

3.4.2. UCITS

The existing case-law of the CJEU on this issue is straightforward in determining that funds which constitute UCITS within the meaning of the UCITS Directive automatically qualify as special investment funds for the purposes of Article 135(1)(g) of the VAT Directive. In consequence, management services provided in respect of UCITS, which are special investment funds, must be exempt in accordance with that provision.

80 Opinion of Advocate General Kokott of 20 May 2015, *Fiscale Eenheid X*, EU:C:2015:327, points 20-22.
81 Article 13B(d)(6) of the Sixth VAT Directive.
82 *Fiscale Eenheid X*, paragraph 42.
83 *Fiscale Eenheid X*, paragraphs 44-46.
84 *Fiscale Eenheid X*, paragraph 32.

According to the CJEU, "*funds which constitute UCITS within the meaning of Directive 85/611* [equivalent of the UCITS Directive] *also constitute special investment funds*"[85].

Not only has the CJEU made clear that UCITS qualify as special investment funds, but it also acknowledges that funds not formally qualifying as UCITS but with similar characteristics must be regarded as special investment funds: "*Funds which – without being UCITS within the meaning of Directive 85/611 – display characteristics identical to those of UCITS 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 must also be regarded as special investment funds*"[86].

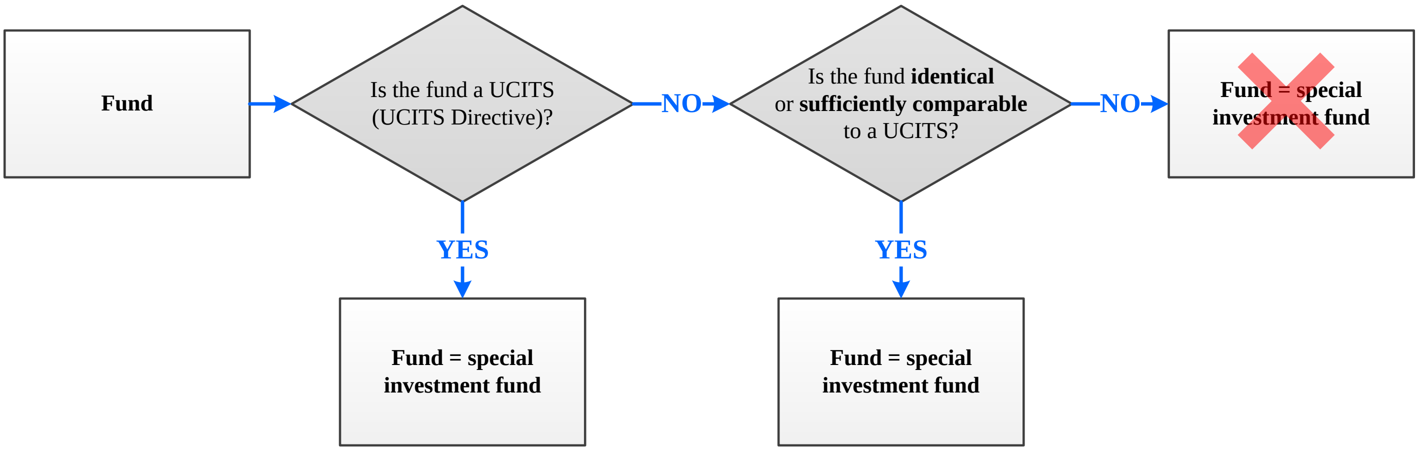
In fact, whenever the CJEU has been confronted with the question of whether a given fund could be seen as a special investment fund, it has assessed to which extent such given fund could be seen as a UCITS, or could be compared to UCITS.

Given that UCITS are the reference against which the CJEU examines this question, it seems that the analysis for determining whether any fund constitutes a special investment fund can be boiled down to the questions set out below. If one of them is answered in the affirmative, the fund would qualify as a special investment fund.

1) Does the fund constitute a UCITS within the meaning of the UCITS Directive?
2) If not, does the fund display characteristics <u>identical</u> to those of UCITS, or <u>sufficiently comparable for them to be in competition</u> with UCITS?

The reasoning to follow is reflected in the diagram below.

Figure 3: Reasoning of the CJEU for identifying "special investment funds"



Source: Commission services

[85] *ATP PensionService*, paragraph 46. This statement is also based on other case-law, in particular *Abbey National*, paragraph 63; *Deutsche Bank*, paragraphs 31-32; and *Wheels*, paragraph 23.

[86] *ATP PensionService*, paragraph 47. This statement is also based on other case-law, in particular *Abbey National*, paragraphs 53-56; *JP Morgan Fleming Claverhouse*, paragraphs 48-51; and *Wheels*, paragraph 24.

Where a fund does not qualify as a UCITS within the meaning of the UCITS Directive, it is thus necessary to determine whether the fund is identical or sufficiently comparable to a UCITS. Hence, a comparability analysis must be carried out.

To that extent, it is important to determine which the characteristics of UCITS are and, in particular, on which grounds the CJEU in the first place considered UCITS to be special investment funds.

When describing the main characteristics of UCITS, the CJEU has basically reproduced Article 1(2)(a) and (b) of the UCITS Directive, which determines that UCITS: *"are undertakings the sole object of which is the collective investment in transferable securities and/or in other liquid financial assets of capital raised from the public, which operate on the principle of risk-spreading and the units of which are, at the request of holders, re-purchased or redeemed, directly or indirectly, out of those undertakings' assets"*[87]. The CJEU has also remarked that *"what are involved* [in UCITS] *are 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"*[88].

Some of the main characteristics of UCITS, which the CJEU has found relevant in order for them to qualify as special investment funds, drawn from the case-law above, can therefore be listed as follows.

The "comparability test"

i. *The fund is a* ***collective investment*** *in transferable securities and/or in other liquid financial assets of capital raised from the public*[89].

It seems that one of the most important characteristic of UCITS that the CJEU has taken into account in order to shape the meaning of special investment funds is that the fund constitutes a "collective investment" or joint funds, that is, a pooling of several investors, where the investor owns a share of the fund but not the fund's investment as such[90].

In this respect, the CJEU has stated that a fund made up of assets of a single person, as opposed to one being a collective investment tool, does not qualify as a special investment fund. For instance, in *Deutsche Bank*, it found that: *"In specific terms, what are involved* [in UCITS] *are joining funds, in which many investments are pooled. (…) By contrast, services such as those performed by Deutsche Bank in the main proceedings concern generally the assets of a single person, which must be of relatively high overall value in order to be dealt with profitably in such a way. (…) Consequently, the portfolio management carried out by Deutsche Bank (…) does not correspond to the concept of management of special investment funds"*[91].

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87 *Deutsche Bank*, paragraph 32. See also *Wheels*, paragraph 23; *ATP PensionService*, paragraphs 49-50; and *Fiscale Eenheid X*, paragraph 36.

88 *Deutsche Bank*, paragraph 33.

89 *Deutsche Bank*, paragraph 32; *Wheels*, paragraph 23; *ATP PensionService*, paragraph 49; and *Fiscale Eenheid X*, paragraph 36.

90 *Deutsche Bank*, paragraph 33; *ATP PensionService*, paragraph 50.

91 *Deutsche Bank*, paragraphs 34-35.

The CJEU has also highlighted that UCITS manage their investments in their own name and on their own behalf, while each investor owns a share of the fund but not the fund's investment as such. This scenario is opposite to that where the portfolio manager buys and sells investments in the name and on behalf of a client investor, who retains ownership of the individual securities[92].

The aspect "raised from the public" should be nuanced. Based on the CJEU's findings in *Wheels*, it does not seem imperative that a fund must be open to the general public for it to be able to qualify as a special investment fund. In this respect, in *Wheels* it was acknowledged that a pension fund, while not identical to a UCITS, could still qualify as a special investment fund if sufficiently comparable to UCITS[93].

Another remark should be made concerning the reference to "transferable securities" or "other liquid financial assets". Although investment should, in principle, be in securities or financial assets, the CJEU in *Fiscale Eenheid X* admitted that a fund with investments in immovable property, thus not a security or a financial asset, could qualify as a special investment fund. That was however only so under certain conditions and as such, one would need to be careful to extrapolate from this.

ii. *The fund must operate on the principle of **risk-spreading***[94].

Based on the existing case-law, this condition has been given a great deal of weight by the CJEU when it comes to assessing whether a fund could constitute a special investment fund. In *JP Morgan Fleming Claverhouse*, for instance, it was found that certain types of funds were comparable to UCITS in particular because of the risk-spreading principle[95].

iii. *The return on the investment depends on the performance of the investments, and the **holders bear the risk** connected with the management of the fund*[96].

It seems necessary not only that the fund operates on the principle of risk-spreading, but also that such risk is borne by the investors in the fund. For instance, in *Wheels* it was concluded that a pension fund was not comparable to a UCITS because the members of the retirement pension scheme in question did not bear the risk arising from the management of the investment fund in which the scheme's assets were pooled, unlike private investors with assets in a collective investment undertaking[97]. In fact, it was the employer and not the members of the pension scheme (that is the employees, who were also the beneficiaries of the fund), bearing the risk. This aspect will be further examined in section 3.4.4, in respect of pension funds.

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[92] *Deutsche Bank*, paragraphs 33-34.

[93] In *Wheels*, the CJEU concluded that a number of characteristics differentiate the pension fund object of that analysis and UCITS, so that they could not be regarded as meeting the same needs and being comparable. In particular, such difference related to the principle of risk-spreading.

[94] *Deutsche Bank,* paragraph 32; *ATP PensionService*, paragraphs 49 and 51; and *Fiscale Eenheid X*, paragraph 36.

[95] *JP Morgan Fleming Claverhouse*, paragraphs 50-51.

[96] *Wheels*, paragraph 27; *Fiscale Eenheid*, paragraph 52; and *ATP PensionService*, paragraph 53.

[97] *Wheels*, paragraph 27.

iv. *The fund must be subject to **State supervision***[98].

This condition was referred to by the CJEU in *Fiscale Eenheid X*, which examined whether certain funds set up for the purposes of investing in immovable property could be regarded as special investment funds.

While using the concept of UCITS as a benchmark, the CJEU also made reference to State supervision: *"In order to be capable of being regarded as exempt special investment funds within the meaning of Article 13B(d)(6) of the Sixth Directive, companies such as those at issue in the main proceedings must therefore display characteristics identical to undertakings for collective investment as defined by the UCITS Directive and carry out the same transactions or, at least, display features that are sufficiently comparable for them to be in competition with such undertakings. It must be noted as a preliminary point that, as the Advocate General indicated in points 22 to 29 of her Opinion, the exemption referred to in Article 13B(d)(6) of the Sixth Directive applies to investment undertakings that are subject to specific supervision at national level"*[99].

The CJEU in this followed the opinion of Advocate General Kokott, according to which "*the only assets that should benefit from the exemption are those that are subject to specific State supervision*"[100].

The matter of State supervision seems to have been relevant in that case because it concerned a fund consisting of immovable property, which is not covered by the UCITS Directive (applicable only to investment funds consisting of transferable securities). What was pointed out is that it is not important that the fund falls within the scope of the UCITS Directive, but that apart from other characteristics displayed the fund was subject to State supervision. By default, all UCITS will be subject to State supervision, but that should not preclude other funds not qualifying as UCITS from being regarded as special investment funds, provided that they are also subject to State supervision according to their national law.

The findings of the CJEU in the case were as follows: *"Investment companies such as the companies at issue in the main proceedings, in which capital is pooled by several investors who bear the risk connected with the management of the assets assembled in those companies with a view to purchasing, owning, managing and selling immovable property (...) may be regarded as 'special investment funds' (...), provided that the Member State concerned has made those companies subject to specific State supervision"*.

This conclusion seems to have created some controversy. Some interpret the outcome of this case as meaning that any fund could qualify as a special investment fund provided that it is subject to State supervision and regardless of any other criteria being met. According to this view, the condition of State supervision would be the one and only condition to be met.

The Commission services do not share this interpretation, for two main reasons.

98 *Fiscale Eenheid X*, paragraphs 39-40.
99 *Fiscale Eenheid X*, paragraphs 39-40.
100 *Fiscale Eenheid X*, point 22.

Firstly, it seems clear that being subject to State supervision is just one of the conditions which must be met for a fund to be sufficiently comparable to UCITS; but not the only one. In other words, State supervision is a condition necessary but it is not sufficient for a fund to compare to UCITS. This is evident, in particular, from paragraph 48 of *Fiscale Eenheid X* where it is said that: *"As the Advocate General stated in point 27 of her Opinion, only investment funds that are subject to specific State supervision can be subject to the same conditions of competition and appeal to the same circle of investors"*.

Therefore, what really matters is that funds are sufficiently comparable to UCITS. If a fund is not even subject to State supervision, the possibility of it qualifying as a special investment fund would have to be discarded immediately.

This can be clearly drawn from the findings of the CJEU[101], which refer to the opinion of the Advocate General in which it is concluded that: *"... Member States are to regard as special investment funds those funds which, without being collective investment undertakings within the meaning of the UCITS Directive, at least display features that are sufficiently comparable for them to be in competition with such undertakings. Such competition can essentially exist only between investment funds that are subject to State supervision. Only those kinds of investment funds can be subject to the same conditions of competition and appeal to the same circle of investors"*[102].

And secondly[103], if being subject to State supervision was the only relevant condition to be looked at, funds which are made up by an individual portfolio – as opposed to funds which are collective investment undertakings – and which are subject to State supervision[104] could end up being seen as special investment funds. Exempting management services provided in respect of such individual investments would run counter to the *ratio legis* of Article 135(1)(g) of the VAT Directive.

v. *The fund must be subject to the same **conditions of competition**[105] **and appeal to the same circle of investors**[106] as UCITS.*

This statement of the CJEU is very much linked to the principle of fiscal neutrality, which precludes economic operators carrying out the same transactions from being treated differently in relation to the levying of VAT. So, supplies of goods and services which are in competition with each other cannot be treated differently for VAT purposes (in other words, a different VAT treatment can be applied to what is a different situation). Given the settled case-law of the CJEU as regards the exemption for management services provided in respect of UCITS, it seems that one of the relevant questions to be asked when assessing the scope of Article 135(1)(g) of the VAT Directive is whether a given fund can

[101] *Fiscale Eenheid X*, paragraph 51.
[102] *Fiscale Eenheid X*, point 27.
[103] In the same line, see E. van Kasteren, *The VAT Exemption for the management of special investment funds: a never ending journey?*, 18 Derivatives & Financial Instruments, No. 2, 2016, Journals IBFD.
[104] E.g. on the basis of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments (OJ L 145, 30.4.2004, p. 1), usually referred to as "MiFID I". Collective investments are explicitly excluded from the scope of this Directive, in accordance with its Article 2(1)(h).
[105] See, among others, *Fiscale Eenheid X*, paragraph 47; *Wheels*, paragraphs 23-24; and *ATP PensionService*, paragraphs 46-47.
[106] *Fiscale Eenheid X*, paragraph 48.

be seen as being in competition with UCITS. For two funds to be in competition, they would have to target the same circle of investors, as said by the CJEU in *Fiscale Eenheid X*.

Based on the above, it is not enough for qualifying as a special investment fund that a fund is "comparable to a UCIT", but it also has to be *"sufficiently comparable for them to be in competition with such undertakings* [UCITS]"[107], which is a modulation of the comparability test.

This aspect will be further discussed in section 3.4.3 below, in respect of AIFs.

3.4.3. AIFs (hedge funds, private equity funds, EuVECA, EuSEF, and ELTIF)

Where confronted with the question of determining whether a given fund could be regarded as a special investment fund for the purposes of Article 135(1)(g) of the VAT Directive, the CJEU, as explained above, systematically examines whether such fund (i) constitutes a UCITS within the meaning of the UCITS Directive; or, alternatively, (ii) whether the fund displays characteristics identical to those of UCITS, or sufficiently comparable for it to be in competition with UCITS.

By definition AIFs do not qualify as UCITS within the meaning of the UCITS Directive but they could still be seen as special investment funds if identical or sufficiently comparable for them to be in competition with UCITS.

Based on the characteristics outlined in sections 2.2.2 and 2.2.3, it is evident that AIFs and UCITSs are not identical. However, what remains to be examined is whether they are sufficiently comparable. As regards the comparability analysis, the characteristics of UCITS, which the CJEU has found relevant in order for them to qualify as special investment funds, have been listed under section 3.4.2 above.

In particular, those conditions are: (i) being collective investments in financial assets of capital raised from the public; (ii) operate on the principle of risk-spreading; (iii) investors bearing the risk of the fund; (iv) being subject to State supervision; and (v) being subject to the same conditions of competition and appealing to the same circle of investors as UCITS.

The question is whether the provisions contained in the AIFM Directive ensure a sufficient degree of detail and harmonisations of AIFs' characteristics as to allow carrying out the above assessment (applying the comparability test) for AIFs "as a whole". In other words, the question to reply to is whether for the whole category of AIFs it is possible to determine that all of them qualify as special investment funds, in the same way as the CJEU has determined that UCITS qualify as special investment funds.

According to the Commission services, it does not seem possible to conclude in a general way for AIFs "as a whole" that this would be so. It is rather that a case-by-case analysis should be carried out for each fund. This is mainly due to the wide range of portfolios and types of existing AIFs which are not governed at EU level, as also acknowledged in recital 10 of the AIFM Directive (*"It would be disproportionate to regulate the structure*

[107] *Wheels*, paragraphs 24 and 26.

or composition of the portfolios of AIFs (...) at Union level and it would be difficult to provide for such extensive harmonisation due to the very diverse types of AIFs…"). Moreover, the judgment of the CJEU in *Fiscale Eenheid X* cannot be taken to validate such a position (that all AIFs would automatically qualify as special investment funds), given that the conclusions were based on the specific characteristics outlined in section 3.4.2 above having been met in the case at hand.

Even where the characteristics of a sub-type of AIFs are set out at EU level (as a result of the EuVECA Regulation, the EuSEF Regulation, and the ELTIF Regulation respectively), it is not straightforward to conclude that such funds will necessarily always have the characteristics outlined in section 3.4.2. Hence, even here a case-by-case analysis should be carried out.

As regards the comparability test, it seems in particular to be doubtful that characteristic (*v*) – the fund being subject to the same conditions of competition and appealing to the same circle of investors as UCITS – would always be present. This particular aspect is analysed separately below.

If AIFs as a whole were deemed to qualify as special investment funds for the purposes of Article 135(1)(g) of the VAT Directive, any fund would qualify as a special investment fund[108] and, therefore, management services provided in respect of any investment fund would *de facto* be eligible for exemption. This could be said to run counter to the findings of the CJEU, for instance, in *Wheels* (the pension fund was not found to qualify as a special investment fund). And in such circumstances, the restriction introduced by the EU legislator whereby only management services provided in respect of "special" investment funds are exempted would become meaningless.

A remark concerning the terminology of Article 135(1)(g) of the VAT Directive must nonetheless be made. While some linguistic versions of the VAT Directive use the term "special investment funds", as in English – e.g. "*Sondervermögen*" (German version), or "*särskilda investeringsfonder*" (Swedish version); other linguistic versions refer to "common funds" – e.g. "*fonds communs de placement*" (French version); "*fondos comunes de inversión*" (Spanish version); "*fondi comuni d'investimento*" (Italian version); or "*fundos comuns de investimento*" (Portuguese version). Some other versions simply refer to investment funds – e.g. "*investeringsforeninger*" (Danish version).

The term "common funds" seems to denote the legal form of the fund, based on the findings of the CJEU in *Abbey National.* In this respect, common funds are funds based on a contractual agreement among the investors, as opposed to funds with legal personality (statutory funds): *"The undertakings (...) may be constituted in accordance with contract law (as <u>common funds</u> managed by management companies), trust law (as unit trusts), or <u>statute</u> (as investment companies)"*, according to Article 1(3) of the UCITS Directive.

According to the CJEU[109], such disparity in the use of words (and in particular the use of "special investment funds") probably stems from the fact that when the exemption was

[108] There are two main categories of investment funds (UCITS and AIFs), and the CJEU has admitted that UCITS qualify as special investment funds.
[109] *Abbey National*, paragraph 55.

first included in the Sixth VAT Directive[110], the terminology at EU level in this field had not yet been harmonised[111]. In any event, as outlined above in section 3.1, the CJEU has found that both contract-based funds and funds with legal personality could be eligible for the exemption. As a consequence, the extent to which the word "special" in the wording of Article 135(1)(g) of the VAT Directive can be said to limit the exemption is unclear.

Being subject to the same conditions of competition

It is not clear whether an AIF can be considered to be *"subject to the same conditions of competition and appeal to the same circle of investors"* as UCITS, as required by the CJEU in *Fiscale Eenheid X*[112]. In fact, UCITS target retail investors but AIFs are in principle available to professional investors only. If an AIF is found not to be sufficiently comparable to UCITS for it to be in direct competition, the AIF in question would not qualify as a special investment fund and management services provided in respect of that AIF could not be exempt.

Given that there is not a straightforward answer, we shall put forward arguments in favour and against considering AIFs to be subject to the same conditions of competition and appealing to the same circle of investors as UCITS.

<u>In favour</u> of considering AIFs passing the test, two arguments could be made.

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 more blurry now than they perhaps were in the past. In fact, AIFs and several of the associated sub-categories (EuVECAs, EuSEFs, and ELTIFs) originally designed for professional investors can also be made available to retail investors. This could lead one to think that, in fact, "appealing to the same circle of investors [as UCITS]" would become less relevant as a condition to be examined under the comparability test.

And secondly, one could say that in *Fiscale Eenheid X*, which concerned an AIF[113], the CJEU did not actually assess whether that fund actually appealed to the same circle of investors as a UCITS. The CJEU found that such a fund qualified as a special investment fund on the basis of it being a joint investment, following the principle of risk-spreading, and the investors bearing their own risk[114].

<u>Against</u> considering AIFs passing the test, there could be three main arguments made.

Firstly, it is true that AIFs can be marketed to retail investors too, as explained in sections 2.2.3 and 2.2.4, but to do so certain conditions have to be met. While the retail

110 Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment (OJ L 145, 13.6.1977, p. 1).

111 Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ L 375, 31.12.1985, p. 3).

112 *Fiscale Eenheid X*, paragraph 48.

113 That case concerned funds exclusively investing in immovable property, which is outside of the scope of the UCITS Directive, and which therefore qualified as AIFs.

114 *Fiscale Eenheid X*, paragraphs 52-54.

investors targeted would not qualify as professional investors in the sense of Annex II of the MiFID Directive, they could still be seen as a limited category of retail investors given the conditions under which they are allowed to participate in AIFs.

In terms of retail investors, these can certainly not be seen as average investors. For instance, EuVECAs and EuSEFs can only be marketed to retail investors insofar as they are willing to invest at least EUR 100 000 and make a statement in writing that they are aware of the risks associated with the investment. The mere 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 (that is, retail investors whose available capital to invest is lower than the minimum threshold). And while ELTIFs are available to professional and retail investors, extra requirements are imposed in the latter scenario[115].

Secondly, even if in *Fiscale Eenheid X* the CJEU did not seem to focus on the investors targeted, that in itself cannot be taken to mean that such a condition must be deemed irrelevant, even less so given the explicit reference to this particular condition made in paragraphs 47 and 48 of that judgment.

And 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, or any sub-type of 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.

3.4.4. Pension funds

A further question to be examined is whether pension funds could qualify as special investment funds for the purposes of Article 135(1)(g) of the VAT Directive.

The CJEU has already dealt with this question in several cases, in particular *Wheels* and *ATP PensionService*. The analysis, again, takes UCITS as reference in order to find out whether a given pension fund (i) constitutes a UCITS within the meaning of the UCITS Directive; or, alternatively, (ii) whether the fund displays characteristics identical to those of UCITS, or sufficiently comparable for them to be in competition with UCITS.

As regards the first question, the CJEU has found that pension funds cannot qualify as UCITS within the meaning of the UCITS Directive because they do not raise capital from the public, but are an employment-related benefit which employers grant only to their employees[116]. Pension funds could however still qualify as special investment funds if identical or sufficiently comparable for them to be in competition with UCITS.

Concerning the second question, while not being identical, it needs to be assessed whether pension funds are comparable to UCITS. As regards the comparability analysis, the

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[115] See Articles 26-30 of the ELTIF Regulation, for instance.
[116] *Wheels*, paragraph 25. See also *ATP PensionService*, paragraph 48.

relevant characteristics of UCITS, which the CJEU has found relevant in order for them to qualify as special investment funds, have been listed under section 3.4.2 above: (i) being collective investments in financial assets of capital raised from the public; (ii) operate on the principle of risk-spreading; (iii) investors bearing the risk of the fund; (iv) being subject to State supervision; and (v) being subject to the same conditions of competition and appealing to the same circle of investors as UCITS.

The Commission services nonetheless believe that such test should be adapted for the purposes of its application to pension funds. In this respect, for instance, as regards characteristic (i), the CJEU has already found that pension funds not raising capital "from the public" does not preclude them from being comparable to UCITS[117]. Linked to that, and because access to pension funds is often restricted to a certain group of investors (e.g. employees), it seems difficult to require that pension funds appeal to the same circle of investors as UCITS, for them to qualify as special investment funds.

This analysis should be carried out on a case-by-case basis, but some general reflections are outlined below.

Based on the existing case-law, it seems clear that a distinction between DC and DB pension funds needs to be made. According to the CJEU, this distinction is mainly based on a different assessment of characteristic (iii), namely that the investor must bear the risk of the investment.

The CJEU has concluded in *ATP PensionService* that DC pension funds are sufficiently comparable to UCITS and, therefore, management services provided in respect of those pension funds can be exempted in accordance with Article 135(1)(g) of the VAT Directive. In contrast, the CJEU found in *Wheels* that DB pension funds are not sufficiently comparable to UCITS and, therefore, management services provided in respect of such pension funds cannot benefit from the exemption.

The CJEU justified the difference in outcome mainly on the grounds that the investment risk was borne by different persons: *"In Wheels* [DB pension funds], *the members of the scheme did not bear the risk arising from the management of the investment fund in which the scheme's assets were pooled, because the pension was defined in advance on the basis of length of service with the employer and the amount of the salary (...). By contrast, the schemes at issue* [DC pension funds] *(...) are funded by the persons to whom the retirement benefit is to be paid and those persons bear the investment risk"*[118].

As a result of this, only DC pension funds can be seen as comparable to UCITS, given that the investors bear the risks of the fund[119]. This is a characteristic not shared by DB pension funds. It follows that only management of DC pension funds is eligible for the exemption under Article 135(1)(g) of the VAT Directive, and not that of DB pension funds.

Scenarios may however arise, where the classification of a pension fund as DB or DC is less clear-cut. In this respect, a couple of points should be made.

[117] *Wheels*, paragraph 25. See also *ATP PensionService*, paragraph 48.
[118] *ATP PensionService*, paragraph 52.
[119] For more information, see section 2.2.5.

Firstly, the Netherlands stress the fact that "pure" DB schemes, such as that analysed in *Wheels* where the employer was the only one bearing the risk, are becoming rare; and that there could be a development towards schemes where the financial risk for employers is more limited, and rather assumed by the pension fund itself.

In the opinion of the Commission services, the shift of the financial risk from the employer to the fund should not change the fact that the beneficiaries of the investment (e.g. the employees) do not bear the risk arising from the management of the investment fund in which the scheme's assets are pooled. Given that investors bearing the risk of their investments constitute one of the characteristics of UCITS, as indicated in section 3.4.2, funds where the risk is borne by anyone other than the investor cannot be said to be comparable to UCITS. As a result, such funds would not qualify as special investment funds, and management services provided in respect of them could not profit from the exemption in Article 135(1)(g) of the VAT Directive. That would be so, regardless of whether the risk is borne by the employer, by the fund itself, or by a combination of the two.

And secondly, where the financial risk of an investment is shared between the investors and some other party (e.g. the employer, or the fund itself) – that is, where the line between DB and DC schemes is less clear – the extent to which the investors can be said to bear the risk should be assessed on a case-by-case basis. A fund could only be qualified as a special investment fund for the purposes of Article 135(1)(g) of the VAT Directive if the risk is substantially borne by investors.

In any case, the Commission services wish to stress the need to apply the comparability test only according to the criteria defined by the CJEU, and regardless of how funds are classified for regulatory purposes (e.g. DB, DC or hybrids).

3.5. Conclusions

Under certain conditions, management services provided in respect of investment funds can be exempt in accordance with Article 135(1)(g) of the VAT Directive. In particular, the exemption is dependent on two conditions being met: (i) the services must qualify as "management services"; and (ii) such management services must be supplied in respect of funds qualifying as "special investment funds".

Condition 1: the activity of management

- Based on the case-law of the CJEU, it seems that the VAT exemption for the management of special investment funds could apply to services outsourced by a management company of a special investment fund to a third party, provided that the services supplied by the third party form a distinct whole and are specific to, and essential for, the management of special investment funds. In particular, the CJEU has accepted that advisory services provided by an advisory company to the management company of a special investment fund, which consist in giving recommendations to purchase and sell assets, could be exempt in accordance with Article 135(1)(g) of the VAT Directive.

Condition 2: possible qualification as special investment funds

UCITS

- The existing case-law of the CJEU on this issue is straightforward in determining that funds which constitute UCITS within the meaning of the UCITS Directive automatically qualify as special investment funds for the purposes of Article 135(1)(g) of the VAT Directive. In consequence, management services provided in respect of UCITS, which are special investment funds, shall be exempt in accordance with that provision.
- In order to determine whether any fund qualifies as a special investment fund for the purposes of Article 135(1)(g) of the VAT Directive, the CJEU systematically takes UCITS as a reference. It follows from the case-law that, if either of the following questions is answered in the affirmative, a fund would qualify as a special investment fund.

  1) Does the fund constitute a UCITS within the meaning of the UCITS Directive?
  2) If not, does the fund display characteristics <u>identical</u> to those of UCITS, or <u>sufficiently comparable for them to be in competition</u> with UCITS?

- Based on the response given to the questions above, even if a fund does not qualify as a UCITS within the meaning of the UCITS Directive, or even if a fund is not identical to a UCITS, such fund could still qualify as a special investment fund if sufficiently comparable with a UCITS. As regards such <u>comparability analysis</u>, it seems that the main characteristics of UCITS which the CJEU has found relevant for them to qualify as special investment funds are the following:

  i. The fund is a **collective investment** in transferable securities and/or in other liquid financial assets of capital raised from the public;
  ii. The fund must operate on the principle of **risk-spreading;**
  iii. The return on the investment depends on the performance of the investments, and the **holders bear the risk** connected with the management of the fund;
  iv. The fund must be subject to **State supervision**; and
  v. The fund must be subject to the same **conditions of competition and appeal to the same circle of investors** as UCITS.

AIFs (hedge funds, private equity funds, EuVECA, EuSEF, and ELTIF)

- By definition AIFs do not qualify as UCITS within the meaning of the UCITS Directive but they could still qualify as special investment funds if identical or sufficiently comparable for them to be in competition with UCITS. Based on their characteristics AIFs and UCITSs are not identical, but what remains to be examined is whether they are sufficiently comparable according to the UCITS characteristics as outlined above (and in section 3.4.2).

- According to the Commission services, it does not seem possible to conclude in a general way for AIFs "as a whole" that AIFs and UCITS are comparable. It is rather so that a case-by-case analysis should be carried out for each fund, due to the wide range of portfolios and types of existing AIFs which are not governed at EU level, as acknowledged in recital 10 of the AIFM Directive.

- Even where the characteristics of a sub-type of AIFs are set at EU level (as a result of the EuVECA Regulation, the EuSEF Regulation and the ELTIF Regulation respectively), it is not possible to conclude that such funds will necessarily always have the UCITS characteristics. Hence, a case-by-case analysis should also be carried out.

- As regards the comparability test, it seems in particular doubtful that characteristic (*v*) – the fund being subject to the same conditions of competition and appealing to the same circle of investors as UCITS – would always be present. On the one hand, it is true that AIFs are sometimes available to retail investors (which could lead one to thinking that they are targeting the same market) and the CJEU has never explored in depth this (in particular, in *Fiscale Eenheid X*), which, according to some, could be seen as undermining the need to fulfil that characteristic. On the other hand, the conditions under which AIFs can be marketed to retail investors remain quite strict (and this *de facto* constitutes a very limited category of retail investors), and the reference made to characteristic (*v*) – that is, applying to the same conditions of competition and appeal to the same circle of investors – is constant in the existing case-law and cannot be ignored. The latter more narrow interpretation would be 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.

- If AIFs, or any sub-type of 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 to the principle of fiscal neutrality.

Pension funds

- The CJEU has already examined whether pension funds could qualify as special investment funds for the purposes of Article 135(1)(g) of the VAT Directive. While pension funds cannot qualify as UCITS within the meaning of the UCITS Directive (because they do not raise capital from the public, but are an employment-related benefit which employers grant only to their employees), they could still qualify as special investment funds if identical or sufficiently comparable to UCITS.

- The comparability test outlined in section 3.4.2 should be carried out on a case-by-case basis, and would also need to be adapted for the purposes of its application to pension funds. In particular, it seems difficult to require that pension funds appeal to the same circle of investors as UCITS for them to qualify as special investment funds, given that access to pension funds is often restricted (e.g. to employees).

- It seems clear that a distinction between DC and DB pension funds needs to be made from the perspective of their VAT treatment. According to the CJEU, only DC pension funds can be seen as comparable to UCITS, given that the investors bear the risks of the fund themselves. This is a characteristic not shared by DB pension funds, where the risk is borne by the employer and not the investors (that is, the employees). It follows that only management of DC pension funds is eligible for the exemption under Article 135(1)(g) of the VAT Directive, and not that of DB pension funds.

- In other scenarios, where the classification of a pension fund as DB or DC is less clear-cut, there will be a need to apply the comparability test according to the criteria defined by the CJEU, and regardless of how funds are classified for regulatory purposes (e.g. DB, DC or hybrids).

- In particular, in a pension fund where there is a shift of the financial risk from the employer to the fund in itself, and where the beneficiaries of the investment (e.g. the employees) do not bear the risk, the fund could not be said to be comparable to UCITS, based on the existing case-law. In cases where the financial risk of an investment is shared between the investors and some other party (e.g. the employer, or the fund itself), the extent to which the investors can be said to substantially bear the risk (and thus be comparable to UCITS) should be assessed on a case-by-case basis.

4. DELEGATIONS' OPINION

The delegations are requested to give their opinion on the issues raised.

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ANNEX 1

Question from the Netherlands

As you are aware, the VAT treatment of management services performed for pension funds is currently discussed and examined in the Netherlands at the request of the Dutch Parliament. In your letter to Mr. Harry Roodbeen of the Dutch Ministry of Finance of 12 June 2017 you confirmed that this issue will be included in the agenda for the upcoming VAT Committee meeting in December 2017. Further to this letter we herewith send you our questions and preliminary analysis on the matter.

1. Questions and backgrounds

The Netherlands wishes to discuss with the VAT Committee the application of the exemption of article 135(1)(g) of the VAT Directive to the management of pension funds.

Background is the Dutch practice of collective retirement schemes, put in place by employers in order to provide retirement benefits to their employees and executed by pension funds. For determining the VAT treatment of management services in respect of these retirement schemes, the Dutch tax authorities distinguish between pension funds with Defined Contribution ('DC') and pension funds with Defined Benefit ('DB'). Management services provided in respect of DC pension funds are exempt from VAT. Those services provided to DB pension funds are taxed as they are not seen as covered by the VAT exemption.

Broadly speaking, one of the main differences between DC and DB pension funds is the rights granted to the employee. In DC pension schemes, the level of the contributions made to the fund is pre-defined, but the retirement benefit to be received by the employee is not guaranteed and will depend on the results of the collective investment of the contributions. In DB pension schemes, the retirement benefit for the employee is guaranteed and determined in advance without reference to the value of the scheme assets. The retirement benefit paid out by the pension fund differs per employee, depending on how long the employee lives after retirement. There is no (direct) link with the actual investment return on the contributions paid for the employee.

This distinction in the rights granted to the employee has an impact on who bears the risk of the investment: the employees to whom the investment benefit will be paid (DC pension fund), or the pension fund/employer who has guaranteed a pre-fixed retirement benefit to the employee (DB pension fund).

In the first situation the DC pension fund is a special investment fund as meant in the VAT exemption of article 135(1)(g) of the VAT Directive. The second situation of a DB pension fund does not qualify as such, because the investment risk is borne by another person than the beneficiaries. Management of such DB funds is therefore not exempt under article 135(1)(g) of the VAT Directive, but taxed with VAT.

Our questions for discussion with the VAT Committee are:

- Do other EU Member States tax management services provided to DB pension funds as described in the foregoing with VAT?

- If not, on what grounds would the management services be exempt from VAT?

- Where do Member States set the dividing line between a DC pension fund that qualifies for exempt management services and a DB pension fund that does not?

- More specifically, do Member States consider a pension scheme with guaranteed retirement benefits for the employees as a DB scheme, even when the risks are (mainly) for the account of the pension fund instead of the employer?

2. Preliminary analysis

2.1 Article 135(1)(g) of the VAT Directive

The management of special investment funds as defined by Member States is exempt from VAT. The CJEU had already in JP Morgan Fleming[1] pointed to investment risk being one of the factors to be taken into account when assessing whether a fund has the characteristics of being a special investment fund.

From the CJEU case law follows that European regulated Undertakings for Collective Investment in Transferrable Securities ('UCITS')[2] qualify as special investment funds. By means of this proxy, the CJEU has assessed whether pension funds executing a DB and DC scheme are 'identical' or 'sufficiently comparable' to UCITS and, therefore, whether they can be treated as special investment funds. The CJEU concludes that pension funds can be treated as special investment funds, if they are funded by the persons to whom the retirement benefit is to be paid (i.e. the pension customers), the funds are invested using a risk-spreading principle and the pension customers bear the investment risk.

In this regard, the CJEU ruled in the Wheels Common case[3] that DB pension funds are not sufficiently comparable to UCITS and thus do not qualify as a special investment fund. Therefore, management services provided in respect of such DB pension funds cannot benefit from the VAT exemption.

In contrast, the CJEU found in the ATP case[4] that DC pension funds are sufficiently comparable to UCITS and thus qualify as a special investment fund.

As a consequence, management services provided in respect of those DC pension funds should be exempt from VAT pursuant to article 135(1)(g) of the VAT Directive.

The CJEU justified the difference in outcome mainly on the grounds that, depending on the rights granted to the employees, the investment risk is borne by different persons. The essential characteristic of a special investment fund is the pooling of assets of several beneficiaries, enabling the risk borne by those beneficiaries to be spread over a range of securities. In the Wheels Common case (DB pension schemes) the fund is not open to the public, but constitutes an employment-related benefit which employers grant only to their employees.

[1] CJEU 28 June 2007, C-363/05 (JP Morgan Fleming).
[2] As meant in Directive 85/611.
[3] CJEU 7 March 2013, C-424/11 (Wheels Common).
[4] CJEU 13 March 2014, C-464/12 (ATP).

Such an investment is not identical or sufficiently comparable to UCITS to be in competition with them. The collective members of the scheme did not bear the risk arising from the management of the investment fund in which the scheme's assets were pooled, because the retirement benefits were defined in advance on the basis of length of employment with the employer and the amount of the salary. By contrast, the schemes at issue in the ATP case (DC pension scheme) are funded by the persons to whom the retirement benefit is to be paid and those persons bear the investment risk. Distinguishing between DC and DB pension funds for the purposes of applying the exemption laid down in article 135(1)(g) of the VAT Directive therefore seems to stem directly from the case law of the CJEU on this issue.

2.2 Dutch case law and discussions

Based on the CJEU case law as described in the previous paragraph, the Dutch tax authorities apply the exemption for special investment funds only to pension funds with a DC scheme like the one in the ATP case. They consider the management services for pension funds with a DB scheme taxable.

This distinction was challenged before the Dutch courts for a pension fund with DB characteristics, that grants a retirement benefit based on the length of employment with the employer and the salary of the employee. The employer's liability to fund a deficit of the pension fund was limited. In case of a deficit that could not be resolved otherwise, the pension fund could as ultimum remedium decrease the pension benefits granted to the employees. In case of a surplus of the scheme's assets in comparison to the scheme's future obligations, the pension fund could decide to lower the contributions, which were partially paid by employers and partially by employees.

In the case at hand it was argued that under these circumstances the pension scheme economically is for the account of the employees, who run the investment risks. The argument against this conclusion is that a deficit between the scheme's assets and the scheme's future obligations is the result of much more circumstances, such as the current low interest (which leads to a high valuation of the future pension obligations) and demographic developments (people live longer, relative obsolete population). In fact a deficit points to a guaranteed retirement benefit for the employees granted by the employers to their employees. All risks, including future obligations, interest, demographic developments and investments, are for the account and risk of the pension fund that executes the retirement scheme.

Under reference to the aforementioned CJEU case law, the Dutch Supreme Court ruled that, in case of the described pension fund, the investment risks are for the account of the pension fund and not for the employees. The risk of a possible decrease in pension benefits in case of a deficit is too indirect to conclude that the pension fund is comparable to UCITS. Following this court case, the Dutch Parliament requested the Dutch Ministry of Finance to investigate whether this outcome is in line with EU case law and practice in other EU Member States.

The dividing line between a qualifying pension fund and a non-qualifying pension fund for application of the VAT exemption is especially of interest to the Netherlands, as 'pure' DB-pension schemes are becoming rare (at the current low interest they cannot be financed anymore). There is a development towards schemes where the financial risks for employers are limited. If these risks are then for the account of the pension fund, which legally/contractually bears the risks because it executes a pension scheme where retirement benefits are guaranteed to the employees as long as they live, the Netherlands consider the scheme not comparable to UCITS. The investment risks, as well as all other pension scheme's risks, are for the account of another person than the beneficiaries. That makes the situation more comparable to insurance products for the account and risk of an insurer (for instance life annuity). If it regards a pension scheme where the ultimate benefit and the investments risks are for the direct account of the employees, the pension fund is considered to be comparable to UCITS and open for application of the VAT exemption for the management of special investment funds.

I trust to have informed you sufficiently on the questions and our preliminary analysis for the upcoming VAT Committee meeting of next December. If you require further information or clarification, please do not hesitate to contact me.

ANNEX 2

Question from Denmark

The AIFM Directive (Directive 2011/61/EU) has introduced common EU regulations concerning supervision etc. concerning managers of alternative investment funds (AIF managers).

In dialogue with the business community, business representatives have stated that it is their view that, in line with the practice of the European Court of Justice, all AIFs must be considered to be special investment funds in VAT terms. The business community has also stated that the tax authorities in a number of member states share their view, and administer accordingly.

The Danish tax administration is not in immediate agreement with the legal position stated. It is also our impression that in this respect there is a non-uniform administrative practice in the member states. To ensure the correct functioning of the internal market, equal terms of competition and the wish for uniform practice in the member states, we therefore request that this subject be discussed by the VAT Committee at the earliest possible opportunity.

Background

The background to the disagreement is as follows:

Article 135(1)(g) of the VAT Directive states that the management of special investment funds, as defined by the member states, is exempt from VAT.

According to the European Court of Justice's practice, this definition competence does not, however, entitle the member states to determine that some investment funds must be able to receive management services that are exempt from VAT, and that other investment funds may not. The definition concept solely gives the member states access to define which funds are covered by the concept of special investment fund under national law[1].

The member states achieved definition competence in conjunction with the exemption for management of investment funds because the VAT exemption was introduced prior to the EU's harmonisation of civil law pertaining to the rules for approval and supervision of UCITS investment funds[2].

This harmonisation of civil law has subsequently taken place in two stages.

First with the UCITS Directive (Directive 2009/65/EC).

Then with the AIFM Directive (Directive 2011/61/EU).

It should be noted that the UCITS Directive concerns both UCITS investment funds and managers of UCITS investment funds, while the AIFM Directive solely concerns the

[1] See eg paragraph 32 of the judgment in case C-595/13, Fiscale Eenheid X.
[2] See eg paragraphs 42-43 of the judgment in case C-595/13, Fiscale Eenheid X.

approval and supervision of managers of alternative investment funds. The AIFM Directive therefore solely concerns the indirect supervision of AIFs as a consequence of the supervision of the managers. The rules for the approval and supervision of AIFs are still a national competence. This is because there are very different types of AIFs. It will therefore be a disproportionately large task to determine common rules at EU level for the structure and composition of AIF portfolios[3].

The judgment in case C-595/13, Fiscale Eenheid X

The judgment in case C-595/13, Fiscale Eenheid X, concerns a period in which the UCITS Directive had been introduced, but the AIFM Directive had not yet been introduced. The judgment therefore does not consider the AIFM Directive's significance to VAT exemption in the VAT System Directive[4]. As yet there are no judgments from the European Court of Justice which consider the significance of the AIFM Directive for VAT exemption.

On the other hand, the judgment in case C-595/13, Fiscale Eenheid X and previous judgments, shows that the introduction of the UCITS Directive has curtailed the member states' margin of discretion with respect to the definition of investment funds in connection with the VAT exemption[5]. The member states must thus with regard to VAT recognise all UCITS investment funds subject to the UCITS Directive as investment funds. The member states must with regard to VAT also recognise investment funds that are not collective-investment undertakings covered by the UCITS Directive, but which have similar characteristics to UCITS investment funds and thereby undertake the same transactions. Likewise the member states with regard to VAT must recognise investment funds that are not collective-investment undertakings covered by the UCITS Directive, but which have similar characteristics to such an extent that they compete with them[6].

In the judgment in case C-595/13, Fiscale Eenheid X, the European Court of Justice states that investment funds that are not collective-investment undertakings covered by the UCITS Directive are only considered to have similar characteristics to UCITS investment funds, or to have similar characteristics to such an extent that they compete with UCITS investment funds, if the investment funds are subject to specific State supervision[7]. Investment funds that are not subject to specific State supervision therefore cannot be recognised as investment funds for VAT purposes.

Yet even if investment funds that are not UCITS investment funds are subject to specific State supervision, according to the judgment in case C-595/13, Fiscale Eenheid X, they must display the other characteristics required to be an investment fund within the

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3 See recital 10 in the preamble to the AIFM Directive.

4 It must be noted, however, that the fact that the AIFM Directive applies to managers of real estate funds is named by the court in paragraph 61 in case C-595/13, Fiscale Eenheid x, as a further argument for real estate funds to be subject to the concept of investment funds in the VAT System Directive, if the conditions are otherwise fulfilled.

5 See eg paragraphs 45 and 46 of the judgment in case C-595/13, Fiscale Eenheid X.

6 See eg paragraph 47 of the judgment in case C-595/13, Fiscale Eenheid X.

7 See paragraph 48 of the judgment in case C-595/13, Fiscale Eenheid X.

meaning of the exemption, if they are to be able to receive management services which are exempt from VAT[8].

The practice of the Court shows that the necessary other characteristics comprise the following:

- The objective of the investment fund is to make collective investments[9].
- Investments are made in accordance with the principle of risk diversification[10].
- The investment risk is borne by the investors[11].

The significance of the AIFM Directive for the interpretation of the VAT Directive

As the Danish tax authorities understand the viewpoints of the business community, these must either believe that after the introduction of the AIFM Directive the AIFs are exempt from being subject to a concrete assessment of whether they pass the Court's test of collective investment, risk diversification and the requirement that the investment risk be borne by the investors, or that the EU legislator and/or the Court should have assessed that all AIFs will always fulfil all three requirements in the test.

In other words, the viewpoint is that just as the introduction of the UCITS Directive has curtailed the member states' margin of discretion with respect to the definition of special investment funds in connection with VAT exemption, the AIFM Directive has also curtailed the member states' margin of discretion.

In this regard, the Danish tax administration agrees that the AIFM Directive, like the UCITS Directive, curtails the member states' margin of discretion with regard to determining which investment funds are subject to specific State supervision. All AIFs must be considered to be subject to specific State supervision, as the indirect supervision of AIFS as a consequence of the financial authorities' supervision of managers means that the AIFs must be considered to be subject to specific State supervision[12]. As a general rule, all AIFs therefore fulfil this requirement for VAT exemption[13].

On the other hand, we do not find that on the adoption of the AIFM Directive the EU legislator should have decided to exempt the AIFs from in principle being subject to a requirement of a concrete assessment of whether the individual AIF shows the other necessary characteristics that an investment fund must have in order to constitute an investment fund in VAT terms. Nor do we find that on the adoption of the AIFM Directive the EU legislator can be considered to have assessed that all AIFs will always fulfil all three requirements in the test.

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8 See paragraph 51 in the judgment in case C-595/13, Fiscale Eenheid X.

9 See eg paragraph 51 in the judgment in case C-464/12, ATP PensionService A/S.

10 See eg paragraph 51 in the judgment in case C-464/12, ATP PensionService A/S. On the other hand, it is not a requirement that investment is solely in securities and/or liquid assets. See paragraphs 52-64 of the judgment in case C-595/13, Fiscale Eenheid X.

11 See eg paragraph 51 in the judgment in case C-464/12, ATP PensionService A/S.

12 AIFs managed by managers that, according to the Directive, are exempt from supervision, are therefore not subject to specific State supervision

13 Unless they are managed by a manager that is exempt from supervision.

In this connection we refer to the fact that the AIFM Directive solely regulates managers of alternative investment funds, and not the funds themselves, precisely because there are many different types of AIF.

The question that remains is whether in its judgment in case C-595/13, Fiscale Eenheid X, the European Court of Justice has considered whether all AIFs can always be deemed to fulfil all of the three aforementioned requirements, just as all UCITS investment funds can always be considered to fulfil all three requirements.

Of particular interest in this respect is paragraph 61 of the judgment in case C-595/13, Fiscale Eenheid X. Both the Danish tax administration and the business community's representatives assume that their own viewpoint is supported by this paragraph. The paragraph is thus considered to confirm opposing viewpoints. The paragraph has the following wording:

"*The fact that Directive 2011/61, which represents at EU level a further step in the harmonisation of specific State supervision of investments, also applies to real estate funds, as indicated inter alia by recital 34 in the preamble thereto, supports that interpretation.*"

The Central Tax Administration finds no support in paragraph 61 or in the judgment overall for a viewpoint that all AIFs can always be considered to fulfil all three requirements and therefore, like the UCITS investment funds, are exempt from the requirement of a concrete assessment of their fulfilment of the three requirements in the test.

AIF definition

In the same way, both the tax authorities and the business community will probably each use the definition of an AIF in Article 4(1)(a) of the AIFM Directive to support their opposing viewpoints. The provision has the following wording:

"*1. For the purposes of this Directive:*

a) "AIFS" means collective investment undertakings, including investment compartments thereof, which:

(i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and

(ii) do not require authorisation pursuant to Article 5 of Directive 2009/65/EC".

For an understanding of the provision, the Danish tax administration refers to the ESMA Guidelines for key AIFM terms. It should be noted in particular that, according to the guidelines, the term "capital raising" may comprise the receipt of capital from very few investors. There is thus no requirement that the general public or a certain wider group must have access to invest in the fund. Even the fact that close family members are the only potential investors in an investment fund is only something that, in our reading of the guidelines, would *probably* exclude the fund from constituting an AIF.

With regard to the test's risk diversification requirement, the ESMS guidelines can, admittedly, be understood to mean that the AIF's defined investment policy must entail risk diversification, but this is not seen to be an explicit requirement in the actual AIFM Directive.

Discussion by the VAT Committee

As stated above, in order to ensure the correct functioning of the internal market, equal terms of competition and in view of the wish for uniform practice in the member states, we would like the issue to be considered by the VAT Committee at the earliest possible opportunity.