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How is the CJEU construing the fund management VAT exemption in light of digitalisation and outsourcing? – Part 1

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In this article, which is divided in two parts, the authors consider two judgments from the Court of Justice of the European Union (CJEU) in respect of the VAT exemption for the management of funds. In particular, the authors examine how these judgments deal with the issue of digitalisation and outsourcing. Part 1 of this article provides an overview of the *Blackrock* case. Part 2 reviews the *DBKAG* case and reflects on the impact that these decisions are likely to have on businesses.

1. Introduction

The European Council Directive 2006/112/EC (VAT Directive) states that "the management of special investment funds as defined by Member States" is exempt from VAT.[1] In order for services to be VAT exempt as the management of special investment funds, two cumulative conditions need to be satisfied:

1. the activities in question must amount to "management"; and
2. the funds being managed must be "special investment funds" (SIFs) within the meaning of the provision.

Given the lack of guidance in the VAT Directive as to what those terms entail, taxpayers and practitioners have been relying on CJEU judgments to understand the scope of the VAT exemption. Over the years, the CJEU has had the opportunity to issue a number of judgments, which have contributed to define and set the scope of the VAT exemption for the management of SIFs. However, given the regulatory and technological developments in the fund management industry, new complex situations continue to arise creating interpretative issues for taxpayers and tax authorities alike. Against this background, we consider below two CJEU judgments relating to the SIF VAT exemption, and in particular, we explore how the CJEU has dealt with the issues arising from technology and outsourcing.

2. Technology and outsourcing: where does the CJEU stand?

It comes as no surprise to the readers that the VAT Directive is not fit for purpose as regards financial services. The text of the VAT Directive is old, and has not been amended for decades. In the meantime, however, technology has developed quickly, and is now ubiquitous across the full spectrum of the financial services industry. This means that more and more sophisticated and complex services are being provided whilst the VAT law remains steadfast. The CJEU is therefore faced with the difficult task of striking a balance between modernity and a relatively archaic piece of legislation. We look at the two most recent judgments of the CJEU on the issue of technology and outsourcing in relation to the VAT exemption for the management of SIFs. First, we consider *Blackrock*,[2] and, second, we analyse the joined judgment in *K and DBKAG*[3] (for the purpose of this note, we only focus on DBKAG).

2.1 Is the supply of fund management through an electronic platform capable of VAT exemption?

The first CJEU decision to deal with the intricacies of technological development and outsourcing in the context of investment management services is Blackrock, following two domestic judgments from the First Tier Tribunal (FTT)[4] and Upper Tribunal (UT)[5].

The facts are as follows. The taxpayer BlackRock UK (Blackrock) purchased services from a US affiliate for the purposes of its activities as a portfolio / investment manager. That US affiliate performed its services, a combination of hardware, software and human input, via a software platform 'Aladdin' whose functionality ranged from portfolio analysis, trade modelling, compliance and risk modelling, corporate actions, trading execution and post-trade portfolio administration. These services provided under the Aladdin license and services agreement enabled Blackrock employed portfolio managers to take decisions about performing financial transactions in respect of managed investment funds. Those investment funds were qualifying SIFs and other funds. Blackrock argued that the services received from the US fell within the VAT exemption provided for the management of SIFs and thus outside the scope of the reverse charge to the extent those services were used for the purpose of managing SIFs.

Both UK tribunals held that the services provided by Blackrock via Aladdin had the required characteristics to qualify as "management" for the purposes of the SIF exemption. The UT noted the clear principles established by the CJEU with respect to the scope of the term management – in particular *Abbey National*[6] and *GfbK*[7] – which require a service to form a *distinct whole* and be *specific and essential* for the management of SIFs.

As we know, these principles are cast amongst an SDC[8]-driven broader jurisprudential doctrine whereby (a) the financial services VAT exemptions are defined according to the nature of the services and not the person supplying those services; and (b) the manner in which the service is performed, whether electronically, automatically or manually, does not affect the application of the exemption *per se*.[9] With respect to (b), any exclusion from a VAT exemption with respect to mere physical or technical supplies should be by reference to the nature of the service and not the way in which the service is performed. That is to say, mere physical and technical supplies lack the necessary requirements of *specificity* and *distinctiveness* to qualify for the VAT exemption.

The UT agreed with the FTT's conclusion that the Aladdin services qualified as "management". The services were found to be sufficiently specific to fund management and sufficiently distinct from the functions of the portfolio managers to so qualify, with an inner coherence relative to fund management. The roles of the portfolio managers and Aladdin were distinct. The provision by way of the Aladdin services of the information and analysis was a function that the portfolio managers did not themselves carry out. In addition, the Aladdin services possessed the necessary specificity: the services were intrinsically connected to the activities characteristic of an investment fund, and specific and essential to the management of a SIF. At domestic level, these decisions upheld the fact that a technology platform could fulfil the VAT exemption requirements. This is of course welcome.

However, Blackrock was using the platform to manage both SIFs and other funds. Having won the argument on the VAT exemption, Blackrock had to argue that a single supply such as the one at hand – i.e. the management of SIFs and other funds – was capable of being apportioned between the exempt component relating to the SIFs and the taxable component relating to the other funds. Given the legal uncertainty on this issue, the UT referred the matter to the CJEU. The issue presented before the CJEU was thus purely related to the issue of apportionment of the single supply, and not about the VAT liability of the Aladdin services. Although the UT decided that the services of Aladdin amounted to *management* in light of previous CJEU judgments, one may wonder if the CJEU would have come to the same conclusion had this issue also been referred to the CJEU.

Unfortunately, the CJEU came to the conclusion that the Aladdin services could not be apportioned on the basis of a single/ multiple supply analysis.[10] In the authors' view, the CJEU could have at least explored the possibility of apportionment through the lenses of Article 135(1)(g) of the VAT Directive by taking into account the commercial reality of the investment management industry, which operates in a digitalised world and whose managers apply investment strategies based on financial and economic criteria rather than taxonomy considerations.[11]

Interestingly, the Advocate General (AG) did point out the following:

> Even though the circumstances of the main proceedings could offer an excellent opportunity to review the criteria that a supply of services must meet in order to fall within the scope of the 'management of [SIFs]' (…) where that service is provided by a third party using an IT platform, I take the view that that debate is not possible in the context of the present case.[12]

The AG further noted:

> Consequently, it is not possible, in the present case, to return to the question of whether, in the modern world, where more and more services are provided digitally, it is necessary to specify the criteria established by the case-law with regard to the supply of management services by third parties, where those services are provided using an *electronic platform*. In that regard, it should be noted that the case in the main proceedings raises a broader question, which is whether the condition of specificity which third-party service providers must satisfy is met in a context in which those services are provided by an IT platform which functions in the same way for all funds.[13]

In the authors' view, the statements made by the AG suggest that there is broad recognition that the current state of CJEU jurisprudence is not good enough to provide clear guidance as to what criteria must be met in a world where investment management services are provided electronically by a third party provider. Putting the apportionment aside, it remains to be seen whether the CJEU would follow the UK tribunals' logic and apply the VAT exemption should a similar case be brought before it.

In conclusion, although the supply of fund management services through an electronic platform is – in theory – capable of being VAT exempt (as set out by the UT in the UK, however to be confirmed at CJEU level), the issue is whether the VAT exemption can be applied in practice in light of the CJEU in *Blackrock* given the diversity of investments and strategies applied by fund and portfolio managers, which are obviously not limited solely to "SIFs". We consider this aspect in Part 2.

References[+]

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