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How is the CJEU construing the fund management VAT exemption in light of digitalisation and outsourcing? – Part 2

Bryan Hughes (A&L Goodbody LLP (Dublin)) and Philippe Gamito (Baker McKenzie (London)) · Monday, September 6th, 2021

In the first part of this article, the authors provided an overview of the *Blackrock* case. In the second part of this article, the authors consider the *DBKAG* case and reflect on the impact that these decisions have on businesses in the short and mid-term.

2.2 Is the supply of a specific software capable of VAT exemption?

The facts in *DBKAG* are the following. The license received by the taxpayer in this case was in respect of specialist software that allowed it to carry out calculations for risk management and performance measurement activities. Unlike Aladdin, this software carries out a very specific function and does not have a broad scope.

The supplier customised the software to the taxpayer's particular specifications and parameters, and the operation of the software relied upon its integration within the taxpayer's own systems. This enabled current price and values data to be imported into the software, with the software then performing required risk and key performance calculations without any direct influence from the taxpayer. The output from these calculations was recorded directly into the taxpayer's systems, which the taxpayer then used to submit reports to the fund managers and statutory reports to the regulatory authorities.

The CJEU re-iterated its findings from prior cases in terms of the scope of the VAT exemption. Management services provided by a third-party manager fall, in principle, within the scope of the SIF exemption. However, to be classified as VAT exempt, the services provided by a third party must form a distinct whole, intended to satisfy specific and essential functions of the management of SIFs. In that light, the CJEU found the provision of a software licence should be VAT exempt where used to perform calculations that are essential to the management of risk and determination of yields, as required under local law or regulation in the context of fund management, and that software is used exclusively for the management of SIFs (which, in the case of *Blackrock*, was not the case). The CJEU left it to the referring court to determine whether the software the subject matter of the *DBKAG* case so qualified, although clarified the fact that the software in question could only be used on the technical infrastructure of the management company was not decisive as regards application of the VAT exemption.

The finding that a software license for a one-off license fee may be intrinsically connected to and

thus subject to the VAT exemption for the management of SIFs is of course welcome news, and clearly favourable in light of fiscal neutrality and the advancement of technology in the financial services space. More generally, this substance over form approach is also favourable when one considers VAT exemptions outside fund management, e.g. automated technology delivered trading and trade execution solutions.

3. Where does this leave us?

The CJEU judgments in *Blackrock* as well as *DBKAG* demonstrate the challenge of applying the SIF exemption in the context of digitalised services. This is not going to get better. The supply of fund management services take place more and more electronically, and taxpayers are naturally adapting to such fast moving trends. It brings efficiency, optimisation, rapidity, and volume. On the other hand, the text of the VAT exemption remains static; it has not moved since its inception. What does this mean for businesses?

Under the current state of affairs, EU (and UK) businesses using digital services from third party service providers for the purposes of managing both SIFs and non-SIFs are faced with a likely significant VAT cost resulting from the unsatisfactory conclusion in *Blackrock*. In practice, they will generally have to pay domestic VAT on those services whilst not being able to recover it either in part or in full. This is not good enough for EU (and UK) based businesses who are at a competitive disadvantage compared to US counterparts that have no similar cost. This makes us wonder why there is a VAT exemption for the management of SIFs in the first place if – in practice – such provision is to be blanket denied where a legalistic and technical single supply analysis subsists.

If we consider the VAT exemption and commercials in the round, the position seems wholly inequitable and far too restrictive. This is particularly the case in light of the supposed purpose of the VAT exemption, which purports to promote access of small investors to securities markets. It is said that in the absence of a VAT exemption, unit-holders in collective investment undertakings would be taxed more heavily than large investors who invest their money directly in securities and who do not use fund management services.

Businesses will probably find some comfort in the *DBKAG* judgment although it relates to the provision of a more discrete piece of software rather than a full suite of management services such as the case of Aladdin. That said, it still demonstrates that the electronic nature of the supply is in principle capable of meeting the VAT exemption test in an outsourcing scenario, albeit only when SIFs are concerned. We can only welcome this conclusion which aligns with *SDC* and previous judgments. Nonetheless, it remains to be confirmed – as the AG underscored in *Blackrock* – whether the criteria for VAT exemption can be met in a similar circumstance as the Aladdin platform. In the authors' view, one should be optimistic and hope that the CJEU will uphold the application of the VAT exemption if the services solely relate to the management of SIFs when the distinctiveness and specificity requirements are met.

At this juncture, however, the state of affairs is far from ideal. The potential application of the VAT exemption will come down to individual Member State interpretation and implementation of the principles outlined above, with some Member States being more relaxed than others. A race to the bottom is sub-optimal and calls for change and consistency that allows for maintenance of the purpose of the SIF exemption and in a way that is fair, administratively easy to discharge and provides fiscal certainty within the single market.

It is perhaps timely then that the Commission has decided to kick off a consultation process with stakeholders with the view to reforming the current rules on VAT and financial services more generally.[1] The application of apportionment in relation to the SIF exemption should be one of the matters to be dealt with as part of that process, in the context not only of technology spend but also other services specific to fund management but of dual use vis-à-vis SIFs and other funds. However, if the Commission's last attempt at reform in this area is anything to go by, it will likely be a long time before those rules see the light of day.

From a UK perspective, the UK government recently announced that UK Courts of Appeal and the Supreme Court are permitted to depart from retained EU case law from 1 January 2021.[2] This may result in UK Courts deviating from some restrictive CJEU judgments in favour of more constructive and "industry-friendly" approaches for UK businesses.[3] However, this remains to be seen in the absence of any legislative change of the SIF exemption.[4]

The judgments of the CJEU are of particular relevance to taxpayers and advisors alike in the UK (whether pre or post-Brexit although it has no binding authority post-Brexit) and traditional fund centres such as Ireland, Luxembourg and the Netherlands. Absent reform at an EU level or the UK judiciary potentially moving away from CJEU judgments in the area of financial services – which anyway will take some time – taxpayers should consider the possibility of splitting activities in some way to maintain the VAT exemption. Reliance in this regard would need to be had to a robust framework from the supplier clearly ascribing consideration and underpinned by an appropriate contractual, operational and invoicing structure. The extent to which such fixes would be operationally palatable is debatable and likely to vary on a case-by-case basis.[5]

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References[+]

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