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Review of VAT and Financial Services

I attach a response from the Investment Management Association to the Consultation Paper on modernising VAT obligations for financial services and insurances.

IMA represents the UK-based investment management industry. Our Members include independent fund managers, the investment management arms of retail banks, life insurers and investment banks, and the in-house managers of occupational pension schemes. They are responsible for the management of approximately €3,000 billion of funds (based in the UK, Europe and elsewhere), including authorised investment funds (UCITS and other regulated open-ended funds), institutional funds (e.g. pension, life and charity funds), private client portfolios and a wide range of pooled investment vehicles.

IMA members are therefore interested in many of the issues raised in the Consultation Paper, as well as having a particular interest in the operation of the exemption for management of special investment funds.

In my discussions with you, and in the light of comments made at the recent EC/EBF conference by Commission and national officials, I have understood that a general description of the investment management industry and the current VAT landscape would be useful input. The attached paper seeks to provide that, in addition to commenting on the options raised in the Consultation Paper to address the vexed question of non-deductible input tax. A particular concern of our members is that any changes to legislation or clarification of interpretation, however welcome they may be, will necessarily involve changes to firms' operations, invoicing practices and commercial models. It is therefore paramount that any changes be accompanied by proper transitional periods.

If you have any questions arising from this submission or subsequently as the review progresses, please do not hesitate to contact me.

Julie Patterson
Director, Regulation, Operations & Tax

EC Consultation Paper on modernising VAT obligations
For financial services and insurances

IMA Response, June 2006

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Summary of key recommendations

The following are shown in the order in which they appear in the paper:

- The *status quo* is simply not tenable – there must in short order be amendments to legislation and closer alignment of Member States' implementation and interpretation of the legislation.
- Administrative and legal costs should be small relative to tax take, and should not unfairly fall on any one party.
- Any changes to law or practice arising from this review should be coupled with appropriate transitional periods.
- There needs to be clarity about what is meant by "special investment funds" and what types of vehicle fall within the exemption.
- In particular, the exemption should clearly apply to the functions of management, whoever supplies them, allowing for the exemption of the outsourcing of functions which are specific to and essential for the management of UCITS and other vehicles falling within the exemption.
- There needs to be clarity about whether collective investment schemes are taxable persons.
- The interpretation of Article 13B(d)(5) needs to recognise that distribution of retail products is increasingly intermediated, with more than one level of intermediary involved.
- We do not support the option of uniform limited input credit and do not believe it to be politically achievable at this time.
- Member States should be required to provide for the option to tax B2B business, but it should be a mutual decision of the firm and its customer/supplier, and not one that is imposed by the fiscal authorities.
- We would encourage further discussion of the feasibility at this time of cross border VAT groupings, where such groupings may comprise companies, partnerships, natural persons and other entities.
- We urge that Article 13A(1)(f) be amended so that it can operate properly in the context of eg transfer pricing requirements.

Introduction

Investment managers may be the investment arms of retail or investment banks or insurance groups. They may also be standalone investment management groups or the in-house managers of occupational pension schemes. In particular, they may be UCITS managers. They invest in asset classes and markets around the globe, and their customers are of all types and from many locations. They are small to large-sized national players, pan-European players or global operators, and they may be companies, groups of companies or be established in other ways (such as partnerships). They therefore have an interest in many of the issues raised in the Consultation Paper, including, in particular, the application of the exemption for "special investment funds".

The investment management industry is critical to the functioning of the capital markets and therefore to the ability for businesses to raise capital. For retail savers via pensions or other savings vehicles, it provides professional management and efficient diversification of assets. For holders of life or general insurance policies, it manages the funds that underpin their risk pooling and provide them with protection. In particular, it manages the assets of UCITS, the only EU-regulated product for retail investors.

As at the end of 2005, €6.6 billion were invested in European investment funds, of which €5.2 billion were in UCITS. As regards the investment management sector more widely, in the UK alone as at June 2005 there were about €3 trillion managed out of the UK, 20% of which was for non-UK customers. Moreover, considerably more than €4 trillion was contracted in the UK, but with the investment management of these additional assets being delegated outside the UK (eg to the USA, Switzerland, Japan etc).

Annex 1 provides more information on the forms that investment management can take and the underlying tasks involved.

For the investment management industry, the current VAT landscape is complex, unclear and inconsistent. It and its customers suffer from different VAT treatments, depending on the type of customer (individual, institution, UCITS or other collective investment vehicle), the domicile of that customer, and whether the service is discretionary or advisory investment management. Annexes 2 and 3 provide tabular summaries of that landscape from the perspective of UK-based management companies.

Not only is the landscape complex, it is uncertain. This uncertainty is a significant concern for businesses, which must bear the considerable legal risks arising. At one level, therefore, Court cases may be welcome, as they can provide clarity of interpretation. However, Governments are increasingly finding reasons to delay implementing the judgements of the ECJ. And even when such changes are made to national laws or practices, they can inflict considerable financial damage on Governments, financial service providers, their suppliers and their customers. It is not just the extent of any retrospective effect that is of concern (which can be significant), but also that businesses have no period in which to adjust their operational structures, invoicing practices and commercial models.

On the question of possible amendments to EU legislation and review of Member States' implementation of it, it is clear, therefore, that ***the status quo is simply***

not tenable. We welcomed the Director General's opening remarks at the recent EC/EBF conference on this and other points. The current situation gives rise to failures to deliver some of the fundamental policy principles and objectives, such as the general principle of fiscal neutrality.

Whatever the nature of exemptions – and the Consultation Paper makes clear that there is no real appetite to revisit the issue of a general introduction of taxation to financial services – they are bound to give rise to some distortions, including non-deductible tax. The Consultation paper provides a good summary analysis of some scenarios giving rise to non-deductible tax and consequent policy issues. ***Such distortions could be considerably reduced for the investment management sector by ensuring that application of the special investment fund exemption is clear and consistent across the EU and takes account of market structures and business operations***.

Legislation should provide certainty of outcome and seek to level the playing field between different types of providers and between different Member States. But it is equally important to be mindful that national industries, and the European industry as a whole, are not disadvantaged vis-à-vis competitors from non-EU jurisdictions.

It is clear from the Consultation Paper and remarks at the conference that fiscal authorities will not entertain a significant fall in the tax take. We understand this position, but would urge the Commission and Member States to recognise the interplay between the VAT take and other tax take, the fact that growth in the industry will permit in the VAT take over time, and that the current legal uncertainty gives rise to significant costs for Governments, which recent ECJ cases have begun to crystallise. Moreover, going forward it is paramount for all parties that ***administrative and legal costs should be small relative to tax take, and should not unfairly fall on any one party***.

We believe that the Commission's three stated objectives for the review:

- reducing the administrative costs for administrations in exercising fiscal supervision and for economic operators in achieving fiscal compliance;
- creating budgetary security for Member States and legal certainty for economic operators; and
- addressing inconsistencies between the 1977 VAT provisions and more recent regulatory and legal provisions

are sensible. But in order for them to be deliverable, national fiscal authorities need:

- to commit to move towards tax certainty;
- to be willing to level the playing field between each other as regards implementation/interpretation;
- to understand both the competitive threat to and the market opportunity for the EU as a whole;
- to accept fully the economic realities of the market place; and
- to recognise the need significantly to reduce the costs of administering the regime relative to the tax take, and to demonstrate a genuine appetite to do so.

A particular concern for our members is that ***any changes to law or practice arising from this review should be coupled with appropriate transitional periods***. By this, we do not mean grandfathering provisions – which serve only to

perpetuate anomalies in Member State practices – but an appropriate period or periods for firms to comply with any new requirements after Member States have transposed them.

The current landscape for investment management

For the investment management industry, the current VAT landscape is complex, unclear and inconsistent. More than any other financial services industry, it and its customers suffer from an array of different VAT treatments, depending on:

- the type of customer (individual, institution, authorised investment fund or other collective investment vehicle);
- the domicile of that customer; and
- whether the service is discretionary or advisory investment management.

Yet in essence the service being provided is the same – investment management. Annexes 2 and 3 provide tabular summaries of that landscape from the perspective of UK based investment management companies.

As well as it being a difficult landscape for firms to navigate, it impacts EU investors. For example, those saving for retirement will suffer different VAT treatments depending on which pension vehicle they chose or are presented with. Moreover, those differences are generally opaque to them, both at the outset and on an ongoing basis.

Where there are exemptions, the boundaries of them are unclear and do not recognise *bona fide* commercial practices, such as outsourcing. For example, in the UK, the market for the distribution of retail investment products is heavily intermediated. "Open architecture", as it is sometimes labelled by the industry and its regulators ("sub-contracting", as defined on page 4 of the Consultation Paper), has to date been less prevalent in a number of Continental markets, but there are clear trends in this direction, such as the development of "platforms", which will be facilitated further by the Markets in Financial Instruments Directive. Similarly, delegation of specific functions to third parties is common as a means of achieving economies of scale and consistency of client servicing standards ("outsourcing", "pooling" or "off-shoring" as defined in the Consultation Paper). In the investment management industry, delegation is also used as a way of tapping specialist investment expertise in particular geographical markets or sectors (eg the Far East, emerging markets, real estate etc). This is of direct benefit to the industry's customers.

Yet the VAT treatment of these services when provided in-house by the investment manager is too often different to that applying when functions are outsourced. This is a flagrant disregard of the fundamental principle of fiscal neutrality. The Consultation Paper recognises this in its commentary on ECJ jurisprudence: *"The nature of the service is important. It does not matter who supplies the service, or how it is supplied."*

VAT is a pre-tax cost of outsourcing and is a limiting factor in the making of a sensible business decision on preferred operating structure. It is a hindrance to open architecture where market participants want to concentrate on their core

competencies, which in turn hinders the industry from achieving economies of cost. In fact, it can drive business outside the EU.

Investment managers provide services to both business and private customers. They are therefore interested in both the B2B and B2C place of supply rules.

The current difference in treatment between B2B financial services business and B2C business causes a number of distortions. The distortions arise due to different VAT rates in Member States, different Member States' interpretations of what is or is not a financial service, and different interpretations of which customers (especially funds) are B and which are C.

There is also an EU competition concern. Private customers receiving investment management services from managers based in the EU will be charged VAT at the rate in force in the manager's domicile. However, should a private individual receive management services from a manager based outside the EU, no VAT may be due. This provides such managers with a tax advantage over EU providers and is a competitive disadvantage for the European wealth management industry.

The current B2B rules depend on the definition of financial services. Most Member States include investment management within that definition (as it should be), but Germany does not.

Also, for collective investment vehicles, it is not uniformly the case that Member States treat them as taxable persons, as evidenced by the *Banque Bruxelles Lambert SA* case (C-8/03). In the *BBL* case the ECJ held, by referring to the UCITS Directive, that the activities of a UCITS were an economic activity, being the assembly and management, on behalf of the investors and for a fee, of portfolios consisting of transferable securities, regardless of their legal form. As a result, UCITS, and other funds with similar characteristics, are taxable persons. But not all Member States' laws or practice conform with this finding and additional ECJ case law may be interpreted to mean that certain funds are, in fact, not taxable persons.

There needs to be clarity about the position of collective investment vehicles and whether they are taxable persons.

UCITS management is exempt from VAT and UCITS managers cannot recover input tax. In contrast, funds based offshore, eg in the Channel Islands and Cayman Islands, are not subject to any local VAT on the management fees paid to the fund manager or operator, but there is some input recovery.

Interpretation of both the exemptions and the place of supply rules are being decided through the Courts. At one level, Court cases may be welcome, as they can provide clarity. However, they can also inflict considerable financial damage on Governments, financial service providers, their suppliers and their customers. It is not just the extent of any retrospective effect that is of concern – although that may be considerable – but also that businesses have no period in which to adjust their operations, invoicing practices or commercial models.

Given the complexity and unevenness of the landscape, businesses understandably construct their operations around that landscape to achieve the most efficient outcomes. Within our industry, the VAT position impacts choice of domicile for the fund and the investment manager, and the way in which functions are or are not

outsourced. It is therefore clear that the current position distorts location choice and investor choice, and gives rise to significant legal and financial risks for the industry and national Governments.

The "Special Investment Fund" Exemption

Article 13B(d)(6) provides for the management of special investment funds as defined by Member States to be exempt. Application of this exemption in different Member States varies considerably, as regards which funds fall within the exemption, what management means and who is a manager.

All Member States include UCITS and strict national equivalents (ie authorised open-ended funds capable of being marketed to the general public) within the exemption. But the spectrum on inclusion ranges from this narrow definition to including all forms of open-ended and close-ended funds, pensions funds (investment management and scheme administration) and unit-linked insurance funds.

Similarly, as regards the definition of management, that is taken by some Member States to be based on Annex II of the UCITS Directive, plus depositary services (ie safeguarding and oversight), plus external legal and auditing fees.

A further difference is the interpretation of certain Member States (including historically the UK) that the exemption applies narrowly to UCITS management provided by the UCITS operator and not to third-party firms that provide those services for or on behalf of the manager. This difference, in particular, goes against the fundamental principle of fiscal neutrality on which EU VAT law is meant to be based.

The UCITS exemption is important because it facilitates savings by retail investors (with relatively modest sums to invest) in the only EU regulated product. Such savers might otherwise be fiscally encouraged to invest direct, exposing them to significant market and credit risks and operational costs. The regulation of the product, as set out in the UCITS Directive and in national regulation, provides a panoply of investor protection safeguards. It provides some levelling of the playing field between UCITS and investment products offered by life insurance companies. Some distortions remain, however. For example, a number of UK investment managers use a life company wrapper to conduct pensions referable business as the management fees charged within the fund are then exempt from VAT.

European VAT legislation should be amended to provide clarity on the nature and extent of the exemption and the degree of Member State discretion. In particular, it should allow VAT exemption of the outsourcing of functions which are specific to and essential for the management of those collective investment vehicles falling within the scope of the exemption.

There are practical measures or amendments that would contribute to achieving this result. For example, wherever possible the terms used in VAT legislation should be defined in the legislation itself or by reference to other, related legislation, whose terms will be familiar to those operating in the sector. Principally, these terms can be derived from Community regulatory or accounting legislation. In particular, the UCITS Directive provides definitions of several relevant terms.

Also, discretion should be given to Member States only where it cannot be used to distort intra-EU competition. For example, one Member State may elect to extend the exemption to all collective investment schemes rather than those designed for retail investment. Thus, there exists a tax incentive to base funds in one jurisdiction rather than another.

Non-deductible VAT

- **Zero-rating of B2B supplies**

One of the disadvantages cited by the Consultation Paper for this option is that it would give rise to additional accounting and reporting obligations. As demonstrated by the description of the current VAT landscape for investment managers given above, our sector already operates a complex accounting system, with different VAT treatments for different types of investment management services, for the same service provided for different customers, and for the same service provided for similar customers domiciled in different Member States. There would be transitional costs, but it is not necessarily the case that the industry would find such an option unpalatable.

However, we suspect that the major drawback to this option is that fiscal authorities simply will not accept it and we therefore question whether it is really on the table. That said, it would be one of the simplest options to pursue. Given that the comments of Commission and national officials at the recent conference confirmed our prejudice, we have not sought to garner hard information on the operational costs – transitional and ongoing – versus the perceived benefits of such an option at this stage. However, we recommend that the potential costs/benefits be properly analysed be researched more fully and we should be happy to assist with such an analysis.

- **The Special Investment Fund and Intermediary Services exemptions**

The special investment fund exemption

Given the description of the current landscape set out above, the various ECJ cases that have opined on the extent and meaning of the exemption, and the considerable legal and fiscal uncertainty that now surrounds this exemption, ***we urge that there be clarification*.**

Given that most Member States already allow for supplies to UCITS by third party managers to be exempt, and given that in the light of the *Abbey National* case (C-169/04) the UK fiscal authorities must now amend its interpretation of the exemption, we do not believe that clarification of the definition of management will of itself give rise to material budgetary issues. Rather, it will provide welcome certainty and consistency for all.

We suggest, therefore, that clarification of the special investment fund exemption should be a relatively "easy win", although there does need to be Member State agreement about what is included within certain of the functions of fund administration and in the term "marketing". Regarding the latter, an obvious candidate is the production and maintenance of the "simplified prospectus". This is

one of three legal documents required by the UCITS Directive – the constitutional document (ie instrument of incorporation, trust deed or contract), the prospectus and the simplified prospectus (which, despite its name, is not simply a shortened version of the prospectus).

Separately, though, there is the question of which funds and collective vehicles are meant to be captured by the exemption. Given that the range of funds included by different Member States is considerable, there will necessarily be some winners and losers when judged narrowly on domestic VAT grounds. It is also entirely reasonable for Member States to continue to be tasked with "translating" the legislation to cover their particular types of collective investment vehicle. That said, there are some common descriptors in Community law, whose use would enable the exemption to be more precisely defined. The legislation could usefully, therefore, provide some general descriptions as to the sort of vehicles that Member States should consider for the exemption.

While the description of management of UCITS is pretty clear (with the exception of the term "marketing"), it will be necessary to clarify what is meant by management of the other vehicles eligible for the exemption. An obvious starting point is investment management services (as set out in Annex 1). But there needs to be a debate around whether the functions described in the UCITS Directive as forming "fund administration" are directly applicable to the other vehicles. And in some cases, "marketing" (in the sense of marketing to the general public) is not permissible by national regulation, so might be an empty set.

Taking this approach, and accepting that exemptions necessarily give rise to some distortions that cannot be mitigated by other means, we do not believe that many of the disadvantages cited in the Consultation Paper have weight. Further, we believe that the advantages of this approach could clearly outweigh any residual disadvantages.

<u>The intermediary services exemption</u>

Our industry also has an interest in so-called the intermediary services exemption (Article 13B(d)(5)) and, in particular, the meaning of the phrase *"including negotiation"*. This is of interest, not because it directly impacts fund managers, but because it impacts distributors of investment products, in particular units of investment funds, which are securities in there own right.

The distribution of units of investment funds (and, in particular, UCITS) is increasingly intermediated. A smaller and smaller proportion of retail investors purchase units of funds direct. A significant proportion uses the services of their bank, insurance company, stock broker or financial adviser, but these in turn are increasing using B2B fund "supermarkets" or platforms. So, the end investor is likely to be two or more levels removed from the fund manager. In some cases the different intermediaries will pass the name of the end investor along the chain to the manager, but in most cases the intermediaries will pass block trades to the manager for a nominee account in the intermediary's name. The manager will not have any direct relationship with the end investor and may often not know who they are or have any easy way of finding out.

The application of VAT, and in particular whether certain services/suppliers are within the scope of the Article 13B(d)(5) exemption, gives rise to anomalies and

inconsistency of treatment of European investors. For example, investors will be impacted differently if they are charged on the basis of commissions or fees for financial advice, and depending what channel they use to effect their investment.

The interpretation of Article 13B(d)(5) needs to recognise that distribution of retail products is increasingly intermediated, with more than one level of intermediary involved.

- **Uniform limited input credit option**

We believe that the disadvantages of such an option are considerably weightier than the text in the Consultation Paper would imply. In particular, we find it difficult to imagine a process by which Member States would agree on a common rate or rates which would be acceptable to the various and diverse industry sectors. The Paper says that this option has worked in practice and cites Australia as an example. But there is in practice a sharp contrast between one sovereign Government's decision-making process and the EU legislative negotiating process.

That said, we believe there would be mileage in seeking to secure a better agreement on how Member States should approach their partial exemption methodology. There, therefore, needs to be an informed debate about the interpretation and application of Article 17(5), and consideration of the right of taxpayers to adopt alternative methods of calculating deductible VAT.

We suggest that there are three broad principles that should govern the treatment of residual input tax:

- The VAT recovered should represent the use to which that VAT was put, ie the recovery of VAT must be fair and reasonable.

- The methodology should give rise to minimal administrative costs.

- The methodology should be capable of being adapted to reflect changing market conditions.

- **Option to tax**

An option to tax could, indeed, remove the issue of tax sticking in the system and we do not in principle have an objection to its being available. However, it would be of considerable concern if established and confirmed public policy dictated that certain financial services should be exempt, only to find ourselves in the position of individual Member States requiring the option to tax to be used (ie compulsion).

We therefore support the proposal that Member States be required to provide for the option to tax B2B business, but for it to be a decision of the firm, having obtained the prior and express consent of its customer.

We would note, however, that it is not clear that the option to tax could be easily decided on for UCITS or other retail investment funds. For these vehicles, the depositary is there to act in the interests of all shareholders. It is therefore not immediately obvious that the UCITS or its depositary could agree to an invoice being paid from fund assets that included VAT when there is a specific exemption. They would have to be convinced, both initially and on an ongoing basis, that the impact

was at worst financially neutral for the fund (ie that the inclusion of VAT was more than offset by a reduction in the supplier's fee). Such a judgement would be difficult and would depend on other factors, such as whether the fund itself was registered for VAT and had some input recovery. Certainly, it cannot be in left to the supplier alone to make such a decision.

- **Creation of cross-border VAT bodies**

As the Consultation Paper notes, one way to avoid some of the problems raised by "hidden" VAT is to allow for VAT groups or groupings. Under such a provision, if all eligibility criteria were met, there would be no taxable transactions between group members, which might be companies, natural persons or any other forms of entities (including partnerships, for example).

There is the germ of such a provision in Article 4(4), but it cannot work on a cross border basis because its transposition is not compulsory for Member States, and the criteria for eligibility differ widely between those few Member States that have transposed it. We appreciate that the implications of *Societas Europea* are only now being fully recognised, but we would urge the Commission and national authorities to give this option due weight. It must in the long term be the way forward.

The treatment of cost sharing arrangements is also an important issue and seems to us eminently fixable. The problem is well known. Article 13A(1)(f) is mandatory for Member States, yet some have not transposed it. This is unacceptable. Others take a literal or very restrictive interpretation of the phrase "*exact reimbursement of their share of the joint expenses*", which, when coupled with transfer pricing requirements, renders it impossible to meet. ***The wording of the provision needs to be revisited***.

Annex 1

A Description of Investment and Fund Management

Investment management concerns the activity of managing a pool of assets ("a portfolio") consisting of equities, bonds, money market instruments, cash, derivatives, property, commodities or other assets. The portfolio can be the reserves or surplus funds of a business, charity or government body, the assets of an individual or family, a pool/fund designed for a specific purpose and for specific beneficiaries/policy holders (e.g. a pension fund, life fund or family trust), or a widely held collective investment vehicle (such as UCITS).

Investment management can be conducted on a discretionary or non-discretionary (advisory) basis. ***Discretionary investment management*** is the term used to describe the position where the manager (the service provider) is allocated a portfolio to invest according to a given investment objective and within set parameters, and where the manager has complete discretion within that objective/those parameters as regards asset selection, asset sales/purchases and the selection of appropriate dealing venues.

In ***non-discretionary or advisory investment management*** mandates, the manager cannot undertake an asset sale or purchase without the prior and explicit agreement of the client (i.e. it advises the client to undertake a particular transaction and the client can accept or reject that advice; should the client accept the advice, the manager will then execute the trade).

Generally, the assets held in the portfolio are not on the books of the manager itself but are held elsewhere (by, or registered in the name of, a custodian or the client itself). So, when an investment manager undertakes a transaction, it does so on behalf of the fund/client (i.e. it operates in the market on an agency, not a principal, basis). On occasion, an investment management mandate may include the provision of custody services or other functions. This is most often seen in the wealth management sector.

Portfolios may be constituted in the form of companies, by contract, as trusts or as partnerships. They may be domiciled in a Member State or elsewhere, may or may not be authorised for sale/promotion to the general public, and may or may not be subject to other forms of regulation (such as insurance regulation, pension regulation, listing rules or national income and corporation tax regime requirements).

The portfolios may be directly invested, especially if the portfolio is large. But it is increasingly not economically viable for smaller portfolios to be directly invested, because of high overhead costs, so they tend to be invested via collective investment vehicles. Even for large portfolios, if some exposure is required to a particular sector or asset class (e.g. emerging markets or property), it is often achieved via investment in collective investment vehicles.

The activity of investment management includes a number of functions:

- Portfolio asset allocation
- Identification of investment benchmarks and criteria
- Investment research
- Individual asset selection
- Passing purchase or sell orders to the market for execution

- Liaising with the client's custodian on trade confirmations and reconciliations, commissions payable, trade settlement issues, currency charges, stock lending activity etc
- Portfolio valuations, performance monitoring and reporting
- Provision of information needed to meet regulatory obligations
- Depending on the wishes of the client, dealing with shareholder engagement issues ("corporate governance")

Discretionary investment managers may outsource many of these functions, but will still have their own infrastructure or central support functions such as compliance, risk management, legal, finance and accounting, tax, internal audit, HR, company secretariat and office facilities management.

The investment manager may operate in only one Member State or provide investment management services on a global basis in Europe (EC/EEA), Asia Pacific including Japan, and the Americas.

Fund management is a term applied to the management of collective investment vehicles where the manager undertakes investment activities concerning the assets of the fund on behalf of all its participants (or unit/shareholders) and also a number of administrative duties. That is, the provider is not just managing the investments of the fund but is also operating the vehicle. UCITS management is a specific example of such activity.

Collective investment vehicles have varying characteristics, in particular they may:
- Reduce specific risk by diversification
- Reduce cost through economies of scale
- Offer professional management of assets
- Offer access to specialised markets, sectors or instruments
- Involve degrees of investor protection
- Offer flexibility and liquidity

UCITS provide all these and, in particular, a high level of investor protection safeguards.

From the investor's/beneficiary's point of view, a fund may be "wrapped" in another fund or product (e.g. a unit-linked insurance policy, or a bank or insurance bond). In which case, the protections afforded the investor are largely determined by the particular features of the wrapper.

Collective investment vehicles may be open-ended or close-ended. ***Open-ended funds*** involve an investor owning a *pro rata* share of the portfolio of assets. The net asset value ("NAV") of the fund is simply the market value of the portfolio. The number of shares can vary, increasing if the investments exceed the withdrawals during any day, and *vice versa*. The price of a share will vary according to the number and value of assets in the portfolio and not because of supply and demand for the share itself. Open-ended funds are open for dealing (i.e. their shares/units may be sold or bought) on any dealing day, which may be every market/bank open day (i.e. daily, in practice), or less frequent (sometimes known as "limited redemption"). UCITS must be open for dealing at least once a fortnight.

Close-ended funds are like a company with a fixed amount of capital, whose share value is dependent on supply and demand factors in the market in which the shares

are traded (which may be only partly related to the NAV of the fund's underlying portfolio of assets). They can operate in corporate, contractual or trust form, although the corporate form is most common. These vehicles have an initial offer period to raise capital, at the end of which they close to further subscription, unless existing holders agree to an increase in capital. Investors must otherwise buy or sell shares via the secondary market.

The 1985 ***UCITS Directive***, as amended, harmonises many aspects of product regulation across the EU for open-ended funds marketed to the general public. It also provides for both a product passport and a management company passport (although the latter is widely regarded as inoperable and is the subject of review by the EU Commission).

UCITS stands for "Undertakings in Collective Investment in Transferable Securities", and these schemes could originally be invested only in equities and bonds, with cash held solely for liquidity purposes. However, UCITS may now also invest in cash, money market instruments, derivatives and other UCITS.

UCITS may be established as investment companies, eg SICAVs (Société Investissement à Capital Variable) or OEICs (Open-ended Investment Companies), as contractual funds (commonly known as "FCPs" – Fonds Communs de Placement – or Sondervermögen), or as unit trusts (in the UK and Ireland). Contractual funds and unit trusts (referred to as "common funds") are not persons in law, but take their identity (and, therefore, nationality) from the management company. SICAVs have a structure close to that of a company proper. They have a board of directors, which may itself manage the scheme (known as "self-managed"), appoint third parties to undertake certain activities, or which may appoint an overall scheme manager (which may, in turn, delegate activities). UK OEICs, on the other hand, do not have boards, but have one Authorised Corporate Director, which is the management company.

Annex II to the UCITS Directive states that the functions included in the activity of UCITS management are:

- Investment management
- Administration
  - *a) legal and fund management accounting services*
  - *b) customer enquiries*
  - *c) valuation and pricing (including tax returns)*
  - *d) regulatory compliance monitoring*
  - *e) maintenance of unit-holder register*
  - *f) distribution of income*
  - *g) unit issues and redemptions*
  - *h) contract settlements (including certificate dispatch)*
  - *i) record keeping*
- Marketing

Marketing is not defined in the UCITS Directive, but the Directive does distinguish between marketing and advertising.

It is common for UCITS managers to outsource fund administration and accounting, including valuation and pricing. Many managers also outsource investment management (in whole or in part) to an affiliate company or a third party, and some

outsource marketing and distribution (eg to their owner bank or insurance company, or to independent distributors such as fund supermarkets and financial advisers). The costs of such outsourcing currently may be subject to VAT. In practice, much negotiating time is spent between the relevant parties looking at ways to minimise the impact of the additional VAT cost.

A key piece of the governance structure of UCITS is the role of the depositary, which combines oversight of the operation of the scheme and safeguarding of the scheme's assets, and is required by the UCITS Directive. Moreover, in the UK, the depositary must be completely independent of the AIF manager (ie it cannot be in the same group).

In practice, the precise functions performed, outsourced or overseen by the depositary varies from Member State to Member State. Indeed, the practical characteristics of "oversight" also vary. The depositary may engage a global custodian (commonly, an affiliate company) to safeguard the assets of the UCITS, but not its oversight responsibilities.

Custody involves:

- Safe keeping of assets (physical or electronic)
- Trade settlement of purchases and sales of assets that have been initiated by the AIF manager (or its delegated investment manager) acting as agent for the fund
- Dealing with tax registration requirements of particular markets e.g. relief at source from withholding tax or capital gains tax exemption
- Cash and foreign exchange management
- Collection of income and tax reclamation

Annex 2

Current VAT treatment for a typical discretionary investment manager or advisory investment manager

The investment manager acts as an agent for its clients on buy/sell trades of equities, fixed income securities etc., where it will interface with various counterparties including brokers and global custodians. Brokerage and intermediary services are normally exempt from VAT at the client level and should not directly affect the VAT position of the investment manager.

The global custodian usually holds legal title to the clients' assets and is responsible for safe keeping of assets, deposits of surplus cash, income collection, foreign exchange (fx) and trade settlement. If this is provided as a bundled service it is exempt to EU customers and zero-rated to all other customers. If the service is unbundled or a client selects only certain functions, then the VAT position may be different since some services are treated as standard rated.

The following provides a tabular summary of the VAT treatment of the services of a UK-based investment manager. <u>It comes with the health warning that such a summary can at best give a general overview or insight into the complexity of the landscape, so cannot be used as a definitive guide.</u>

<u>Key:</u>

E Exempt outputs – management fees of UCITS or transaction commission
PE Partial exemption method
PWM Private, wealth management client
RC Reverse Charge
SR Standard rate of 17.5% on outputs
ZR Zero-rate or outside the scope within the EU on outputs, but with input recovery

References to institutional clients include approved Investment Trust Companies (close-ended, listed vehicles that are compliant with certain investment and governance criteria) and unregulated pooled investment vehicles (open or close-ended, domiciled onshore or offshore)

Type of UK manager	**Description of services provided by/to UK manager**	**Domicile of clients**	**Treatment of VAT on outputs and inputs**
Discretionary investment manager	Investment management	UK institutional and UK PWM	SR with full right of recovery of inputs
Global discretionary investment manager	Investment management	Global institutional, PWM, overseas affiliates and offshore funds e.g. Luxembourg Dublin UCITS or EU non-UCITS	SR as above for UK and EU PWM. ZR EU & elsewhere, with full right of recovery of inputs
Global manager outsourcing discretionary	Delegated or distributed investment management to overseas affiliate or	Global institutional and PWM	SR on RC with full right of recovery of inputs, or E if there is a valid

investment management	third party investment advisor (e.g. US or Japanese equity mandates)		argument under recent case law
Investment manager based in Channels Islands (CI)	Delegated or distributed investment management to UK affiliate	UK institutional PWM and offshore Captives	No CI VAT and ZR with full right of recovery of inputs
Global discretionary investment manager and affiliate operator of offshore funds	Investment management	Eg Cayman Island hedge fund or Channel Islands fixed income fund	ZR with full right of recovery of inputs
PWM-only discretionary investment manager	Investment management	Global PWM including offshore family trusts	SR for UK/EU and ZR elsewhere with full recovery of inputs
Global advisory investment manager	Advice only on stocks selection or investment in UCITS and offshore funds	Global PWM	E on transaction commission charged for execution services subject to PE on inputs. SR on management fees to UK/EU and ZR elsewhere
Operator of "Common Investment Fund" (= fund with charitable status)	Investment management, sales and marketing of units in CIF and fund administration	Registered charities in England & Wales	SR with low effective recovery of inputs
Global discretionary investment manager of a UK unauthorised unit trust (UUT) or Exempt Property Unit Trust (EPUT)	Investment management, administration, sales and marketing of units. Used for UK property fund and feeder for offshore UUT	Fund for exempt UK investors per Section 100 CGTA 1992.	SR with full right of recovery of inputs
Manager of non UCITS offshore fund outside EU	Operator type services	Channel Islands or Cayman Islands	No local VAT or RC UK VAT

Annex 3

Management of UCITS

The following provides a tabular summary of the VAT treatment of the different aspects of UCITS management, depending who provides those services. It is based on the current position in the UK and indicates what the position post the *Abbey* case is expected to be (although at the time of writing we await the decision of the HM Revenue & Customs on this). As for Annex 2, it comes with the health warning that such a summary can at best give a general overview or insight into the complexity of the landscape, so cannot be used as a definitive guide.

Key:
E Exempt output
PE Partial exemption method
RC Reverse Charge
SR Standard rate of 17.5% on outputs
ZR Zero-rate or outside the scope within the EU on outputs, but with input recovery

Description of service provided and by whom	UK treatment of VAT on outputs and inputs as at May 2006	Possible UK treatment of VAT on outputs and inputs from June 2006
UK UCITS manager conducting all activities in house	E	E
UK UCITS manager outsourcing investment management to UK third party	E	E
UK UCITS manager outsourcing investment management to EC third party	ZR from supplier; no RC by UCITS or UCITS manager	ZR from supplier; no RC by UCITS or UCITS manager
Brokerage services on transactions in underlying assets of the UCITS	E	E
Fund administration outsourced to UK third party	SR with input recovery for supplier, but not recoverable by the manager or the UCITS (unless registered for VAT for other purposes)	E
Individual aspects of fund administration (eg register, pricing and valuation, customer queries) outsourced to different UK suppliers	SR, with input recovery for the suppliers, but not for the manager or the UCITS	E if the service provided is deemed to be specific to and essential for management of the UCITS; otherwise, SR with no or only partial recovery for the manager of UCITS
Fund administration outsourced to EC third party	ZR from supplier; possible RC for UCITS/UCITS manager with no or partial	ZR from supplier; no RC for UCITS/UCITS manager if service deemed to be

	recovery	specific to and essential for management
Individual aspects of fund administration (eg register, pricing and valuation, customer queries) outsourced to different UK suppliers	Possibly ZR from supplier; SR on RC of UCITS/UCITS manager with recovery	ZR from supplier, with or without recovery; no RC on UCITS/UCITS manager if service specific to and essential for management, else RC with partial or no recovery
Customer call centre outsourced to a third country	ZR from supplier with recovery by the supplier; possibly no RC of UCITS/UCITS manager with recovery	No RC on UCITS/UCITS manager if specific to and essential for management, else RC with partial or no recovery
Depository services (oversight and safe-keeping of assets)	SR	SR
Depositary outsourcing safe-keeping to a global custodian	E	E
External audit of UCITS	SR	SR

This summary can only begin to indicate the complexity of the current situation (pre and post the most recent *Abbey* case). The position at a European level is more complex and distorted. For example, in many (possibly most) Member States, depositary fees for oversight and safe-keeping of the assets are exempt, despite the judgment in the *Abbey* case. A number also exempt auditors' fees and certain legal fees. On the other hand, a number of Member States have hitherto not permitted the administration of the fund (and in some cases even the investment management of the fund) to be delegated outside the fund's domicile to another Member State.