

## **JP Morgan Fleming Claverhouse Investment Trust plc v Commissioners of HM Revenue and Customs**

### **~ Opening the Floodgates?**

**By Philip Woolfe**  
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*JP Morgan Fleming Claverhouse Investment Trust plc v Commissioners of HM Revenue and Customs<sup>1</sup> ("JP Morgan") concerns the issue whether fund management services supplied to an investment trust company ("ITC") are exempt from VAT. However, the ECJ's approach to the issue of fiscal neutrality potentially has much wider implications.*

The appellants in the main proceedings were JP Morgan Fleming Claverhouse Investment Trust plc, an ITC managed externally by JP Morgan Fleming Asset Management (UK) Limited ("the Managers"), and the Association of Investment Companies, acting on behalf of its members. In proceedings in the VAT Tribunal, they contended that the supplies received by ITCs from their Managers should be exempt from VAT, in line with management services supplied to other kinds of investment funds.

#### **Types of investment fund**

In understanding the case, it is important to bear in mind in particular two distinctions which HMRC sought to draw between different types of investment funds.

The first distinction is that between open-ended and closed-ended investment funds. Open-ended funds are characterised by the fact that the fund is obliged to buy back its units or shares from any of its investors who wish to sell. As such, the capital of the fund varies whenever an investor buys or sells units or shares and the value of a unit or share is fixed by reference to the value of the assets of the fund. On the other hand, in closed-ended funds the fund is not required to buy back units or shares in that manner,

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<sup>1</sup> Case C-363/05, as yet unreported.

and the investors realise their investment by selling those units or shares on a secondary market at the prevailing market price.

The second distinction is that between investment funds which must by law be managed by external fund managers and those which may be managed internally. The significance of this distinction is that external management services are subject to VAT unless exempted, but internal management is not subject to VAT at all.

### **The VAT treatment of investment funds in the UK**

In the United Kingdom, open-ended funds include Authorised Unit Trust Schemes ("AUTs") and Open-ended Investment Companies ("OEICs"). AUTs and OEICs must be managed by external managers. However, the management of those funds by external managers is exempt from VAT under Items 9 and 10 of Group 5 of Schedule 9 to the VAT Act 1994 and was acknowledged to be so by HMRC.

By contrast, an ITC is a type of closed-ended fund. Further, although ITCs are not required by law to be managed externally, 90% of ITCs do in fact entrust the management of investments to external fund managers. Prior to *JP Morgan*, HMRC did not consider the management of an ITC to be VAT exempt.

### **The issues and the order for reference**

In the proceedings before the VAT Tribunal, the Appellants relied upon Article 13B(d)(6) of the Sixth Directive (now Article 135(1)(g) of the Principal VAT Directive) which requires Member States to exempt the "*management of special investment funds as defined by Member States*".

The issue of what constituted management services was previously addressed by the ECJ in Case C-169/04 *Abbey National*.<sup>2</sup>

In the present proceedings, four questions were referred by the VAT Tribunal for decision by the ECJ:

1. Are the words "special investment funds" in Article 13B(d)(6) of the Sixth Directive capable of including closed-ended investment funds, such as ITCs?
2. If the answer to the first question is in the affirmative, does the phrase "as defined by Member States" in Article 13B(d)(6):
  - (a) allow Member States to select certain of the "special investment funds" within their jurisdiction to benefit from the exemption of the supply of management services and exclude others from the exemption, or
  - (b) does it mean that the Member States are to identify those funds within their jurisdiction which fall within the definition of "special investment funds" and that the benefit of exemption should extend to all such funds?
3. If the answer to the second question is that Member States can select which "special investment funds" benefit from the exemption, how do the principles of fiscal neutrality, equal treatment and the prevention of distortion of competition affect the exercise of that discretion?
4. Does Article 13B(d)(6) have direct effect?

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<sup>2</sup> [2006] ECR I-4027

## The arguments of the parties

As to the first issue, the Appellants argued before the ECJ that closed-ended investment funds, such as ITCs, could in principle fall within the meaning of "special investment funds". HMRC argued the contrary and relied upon the fact that closed-ended investment funds are excluded from the scope of the harmonising measures in the UCITS Directive.<sup>3</sup>

As to the second and third issues, HMRC argued that the term "as defined by the Member State" in Article 13B(d)(6) gave Member States a wide discretion to select the funds eligible for exemption. The Appellants argued that the Member States are only empowered to identify which funds fall within the meaning of "special investment funds" as defined in accordance with, in particular, the principles of fiscal neutrality and the objectives pursued by the provision.

Finally, HMRC argued that Article 13B(d)(6) required further implementation by Member States and therefore did not have direct effect. The Appellants argued that the apparent discretion of Member States under that provision could not preclude taxpayers from relying upon it where the national implementing measures exceed the limits of that discretion in that they are contrary to the principle of fiscal neutrality or to the objective pursued by the provision.

## The judgment of the ECJ

The ECJ held that the words "special investment fund" in Article 13B(d)(6) of the Sixth Directive are in principle capable of including closed-ended investment funds. It agreed with Advocate-General Kokott that there was no relevant difference between open-ended and closed-ended investment schemes such that the latter could not fall within the term "special investment schemes". Accordingly, the ECJ rejected HMRC's contention that there was a relevant distinction between those types of investment funds, based on the UCITS Directive.<sup>4</sup>

As to the second and third issues, the ECJ rejected HMRC's argument that the term "as defined by the Member State" in Article 13B(d)(6) gave Member States a wide discretion to select the funds eligible for exemption. The Court held that Member States' discretion to define the funds which are covered by the notion of "special investment funds" was limited. The ECJ's analysis focused on the principle of fiscal neutrality, holding that it would be contrary to that principle to exclude closed-ended funds from the scope of the exemption where those funds are collective investment undertakings which allow investors to invest in securities and where those funds are in competition with funds exempt from VAT.<sup>5</sup> On the facts of the present case, the Court commented that "the management of ITCs falls within the objective of the Sixth Directive and ITCs constitute investment funds comparable to AUTs and OEICs which fall within the definition of 'special investment funds' and therefore held that "the exclusion of ITCs from the exemption provided for by Article 13B(d)(6) does not appear justified in the light of the objective of that provision and the principle of fiscal neutrality".<sup>6</sup>

As to the fourth issue, the ECJ held that Article 13B(d)(6) of the Sixth Directive had direct effect and could therefore be relied upon by a taxable person in a national court.<sup>7</sup>

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<sup>3</sup> 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 1985 L 375, p 3 as amended.

<sup>4</sup> Judgment of the Court, paragraphs 31-35

<sup>5</sup> Judgment of the Court, paragraph 48

<sup>6</sup> Judgment of the Court, paragraph 51

<sup>7</sup> Judgment of the Court, paragraph 62

## Conclusions and implications

The most striking point arising from *JP Morgan* is the prominent role given by the ECJ to the principles of fiscal neutrality and non-distortion of competition, which raises as many questions as it answers.

In the judgment, the view seems to have been taken that, at least for VAT purposes, the principle of fiscal neutrality (which was said to encompass the elimination of distortions of competition) applies where similar (but not necessarily identical) supplies are treated differently for tax purposes. The ECJ agreed with Advocate-General Kokott that whether or not management services supplied to a particular investment vehicle are exempt will depend largely on whether it is or is not in competition with another fund which does gain the benefit of VAT exemption.<sup>8</sup>

Competition between similar supplies is inferred from the fact of their similarity; and a distortion of competition between them is inferred from that and from the disparity of fiscal treatment between them. The distortion need not be significant.<sup>9</sup> The experience of competition law suggests that it is by no means straightforward to determine when two goods or services are in competition with one another. In the context of financial markets, many forms of investment are to some extent substitutable, depending on circumstances. However, it is far from clear from the judgment that competition law analysis is to be used in the VAT context.

Following *JP Morgan*, it is therefore possible that other forms of investment funds will be able to benefit from VAT exemption for management services. During the proceedings before the ECJ, HMRC specifically raised the fear that, if the line was not drawn against ITCs, it might be necessary to exempt other forms of pooled investments, such as pension funds, unit linked life assurance policies, investment clubs and venture capital trusts.<sup>10</sup> In light of the ECJ's view that the principle of non-distortion of competition may be engaged even where the distortion is not substantial, HMRC may indeed struggle to contain the scope of the exemption. The ECJ did not decide that wider issue.<sup>11</sup> Further litigation is therefore likely specifically on the scope of the exemption in Article 13B(d)(6), in which both national courts and the ECJ may be required to focus more closely on technical issues of determining when two goods or services are in competition with one another.

*Paul Lasok QC and Mario Angiolini represented JP Morgan Fleming Claverhouse Investment Trust plc and Raymond Hill represented the United Kingdom Government.*

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<sup>8</sup> See Judgment of the Court, paragraph 48

<sup>9</sup> Judgment of the Court, paragraphs 46-47.

<sup>10</sup> See Opinion of Advocate-General Kokott, paragraph 41.

<sup>11</sup> See Judgment of the Court, paragraph 52.