



Comparability of AIF and UCITS: a recurring question in relation to sec. 4 no. 8 lit. h of the German VAT Act

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1 Background

The exemption in accordance with Art. 135 para. 1 lit. g of the EU VAT Directive is subject to two requirements: firstly, the taxable person must provide a “management service” within the meaning of the regulation. Secondly, the service must involve the management of “special investment funds”, as defined by the Member State. Both requirements can be found in sec. 4 no. 8 lit. h of the German VAT Act, which implements the VAT exemption into national law.

In its recent judgment, the ECJ dealt with the concept of special investment funds. There is no dispute that an undertaking for collective investment in transferable securities (UCITS) falls within the concept of a special investment fund. In simple terms, this is a securities fund. However, according to the current national legislation, the management of all other investment funds, within the meaning of the German Investment Code (*KAGB*), is also VAT exempt. Such alternative investment funds (AIF) can be any type of entity in which the money of several investors is pooled for investment according to a defined investment strategy, for example, real estate funds, ship funds, venture capital funds, crypto funds and private equity funds. Up until 31 December 2023, a further legal requirement was that such an AIF must be comparable to a UCITS (see KMLZ VAT Newsletter 46 | 2023). The ECJ also requires such comparability with regard to Art. 135 para. 1 lit. g of the EU VAT Directive.

2 Facts (ECJ judgment of 5 September 2024 – cases C-639/22 to C-644/22)

The VAT exemption of management services, provided to Dutch pension funds in the sector of company pension schemes, was disputed before the ECJ. Employees pay a portion of their salary into these pension funds. The amount of the



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contributions is based on the extent to which existing pension obligations are covered by the fund's assets (the so-called "policy coverage ratio"). When calculating the contributions, the expected investment return is also taken into account. The calculation of the pension benefits themselves is based on the salary and the employee's number of years of service or the number of quarterly contributions. Depending on the fund's policy coverage ratio, there may then be reductions or supplements made to the pension benefits. In one of the funds, the supplement is fully financed by the investment return.

3 ECJ decision

In various earlier decisions, the ECJ had already stated that a special investment fund, that is not a UCITS, must be comparable to a UCITS in order for its management to be VAT exempt. Comparability requires, inter alia, that investors be entitled to profits from the special investment fund and that they bear the investment risk. This is not the case if the pension, from the pension fund, is determined solely on the basis of criteria such as the amount of contributions or number of years of service, regardless of the fund's investment performance.

Due to the fact, that, in the case at hand, the policy coverage ratio and the associated calculation of supplements and reductions in pension payments are at least partly dependent on the investment performance, the investors have to bear a certain investment risk. However, the ECJ has now ruled that not every modest investment risk is sufficient. Rather, it must be comparable to that of an investor in a UCITS. The amount of the pension payments must therefore depend, "significantly" or "primarily", on the performance of the investments made by the fund (positively or negatively). In the proceedings at hand, the ECJ indicates that employees do not bear such a risk but leaves it to the national court to make a final decision.

The ECJ also addresses a second interesting aspect. In the context of tax neutrality, the ECJ judgment also states that management services provided to funds are VAT exempt if a Member State treats the management of comparable funds as being VAT exempt. A fund can therefore be compared not only with UCITS, but also with other funds treated by the Member States as VAT exempt.

4 Consequences for the practice

The ECJ clarifies a further detail with regard to the requirement of bearing risk, which has already been addressed in previous decisions. For comparability with UCITS, it is not sufficient to bear a minimal risk from the investment. In Germany, according to the wording of the current legal situation, this could be particularly relevant for "old cases" (2023 and earlier). It is questionable as to whether and to what extent such an investment risk is still required in order for the corresponding fund to be managed exempt from VAT. The requirement of comparability between UCITS and AIF was removed from the law by the legislator as of 1 January 2024.

This raises, in particular, the question of whether the German VAT exemption provision is in conformity with Union law. The ECJ has, once again, clearly referred to the requirement of comparability with UCITS. For AIF managers (and also pension funds, within the meaning of the German Insurance Supervision Act), an assertion of any failure to comply with Union law could be interesting in cases where, due to the aimed input VAT deduction, output transactions not subject to the VAT exemption are better for them. However, due to the reference to the possibility of a comparison with other funds, that the Member State considers to be VAT exempt, the Member State appears to be being given a certain degree of discretion. This could, in turn, suggest that the current regulation is, in fact, in line with Union law. It was precisely in order to put an end to the disadvantage faced by funds established in Germany that the legislator removed the criterion of comparability.