



NEWS FLASH

## Update regarding the Luxembourg VAT regime for the investment fund sector.

This update regarding VAT in the investment fund sector reflects a communication prepared by representatives of the VAT working group of the Luxembourg investment fund association (*Association luxembourgeoise des fonds d'investissements* or ALFI) which aims to summarise recent discussions with the Luxembourg VAT authorities (*Administration de l'Enregistrement et des Domaines*) regarding the VAT rules applicable to investment funds and their service providers. This communication was released on 24 January 2011. The contents of this communication are given below, with some comments. We should begin by noting that the EU VAT Directive allows Member States to apply a VAT exemption for management services rendered to special investment funds, and that Member States have the right to define eligible funds. When the services are VAT-exempt, a service provider cannot recover VAT incurred on its costs ("input VAT").

### Input VAT deduction right of Luxembourg suppliers providing management services to foreign investment funds

#### Content of the ALFI communication

*It has been confirmed that the current position of the Luxembourg VAT administration is to refuse the right to deduct input VAT incurred in relation to the management of an investment fund subject to a prudential control by a regulatory authority in one of the EU Member States (e.g. the CSSF in Luxembourg).*

*It is important to note that this question is currently addressed in a case pending in front the Luxembourg Tribunal. This matter may thus evolve.*

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### Loyens & Loeff comments

This is a major change compared with the well-established interpretation and practice in recent years. In view of the wording of the Luxembourg VAT law, it is also surprising. That law clearly lists a number of vehicles which are all supervised by the Luxembourg financial services supervisory commission (*Commission de surveillance du secteur financier* or CSSF) or the Luxembourg insurance commission (*Commissariat aux assurances* or CAA). On this basis, it was generally accepted that services rendered to entities not listed in the law did not fall within the scope of the exemption and therefore opened the right for their service providers to recover input VAT when the fund was eligible to receive exempt services in its own Member State.

Luxembourg investment funds and foreign investment funds distributed in/from Luxembourg are supervised by the CSSF. It is also important to note that the VAT law is modified whenever a new type of investment vehicle is introduced. This was the case when Luxembourg created a legal framework for pension funds, for companies investing in risk capital (*société d'investissements en capital à risque* or SICAR) or securitisation vehicles. Each of these laws only applies to Luxembourg vehicles.

The rationale behind the position of the Luxembourg VAT authorities is apparently to create a level playing field between Luxembourg and foreign funds, on the basis that a service rendered to a foreign fund should not give rise to the right to recover input VAT when the same service rendered to a Luxembourg investment fund would be VAT-exempt. The underlying idea may also be that input VAT should only be recovered if the output transaction is liable to VAT. This approach could be seen as consistent with the VAT principles. However, in its 22 December 2010 judgment in Case C-277/09, RBS Deutschland Holdings GmbH (RBSD) The European Court of Justice (ECJ) clearly ruled that the absence of output tax does not allow Member States in a cross-border situation to refuse the deduction of input VAT when the absence of output tax is due to differing interpretations of the rules by Member States. Of course, it is impossible to predict how the Luxembourg court will rule in the case currently pending. However, we believe that in the light of the clear wording of the law and the RBSD judgment, there are strong arguments against the position of the Luxembourg VAT authorities.

## Input VAT deduction right of Luxembourg investment funds

### Content of the ALFI communication

*The Luxembourg VAT administration has confirmed the position expressed in its circular 723 of 29 December 2006 regarding the input VAT deduction right of Luxembourg investment funds. This means that a Luxembourg investment fund has no right to deduct input VAT. This position is unlikely to change except if new elements arising from a legislative change or court cases.*

## Loyens & Loeff comments

The position of the Luxembourg VAT authorities is based on a strict reading and application of the ECJ's ruling of 21 October 2004 in Case C-80/95, BBL, where, the Court stated that *"the transactions carried out by SICAVs consist in the collective investment in transferable securities of capital raised from the public. With the capital provided by subscribers when they purchase shares, SICAVs assemble and manage, on behalf of the subscribers and for a fee, portfolios consisting of transferable securities."*

Following the ECJ, the Luxembourg VAT authorities thus consider that an investment company with variable capital (*société d'investissement à capital variable* or SICAV) may not recover input VAT because it is remunerated by investors for providing a service, and that this service is VAT-exempt as a management service for a special investment fund. We believe this argument does not reflect the actual facts, as in practice a SICAV, or any other fund, does not receive a fee from the investors, but pays fees to its service providers. This part of the ECJ argumentation is thus not relevant. Moreover, other Member States such as the UK and Ireland recognise a right for their national investment funds to recover input VAT.

Although this might be seen as a drawback for Luxembourg investment funds, there are several reasons for not exaggerating it. The first is the very broad application of the VAT exemption to services rendered to investment funds. The second is the VAT rate in Luxembourg, which is the lowest in the EU, with a standard VAT rate of 15% (12% for the taxable part of depositary bank services), compared with an average of 20% in other EU Member States. These two factors reduce the impact of the non deduction of input VAT. A final reason is that exercising a VAT recovery right implies a much heavier burden of compliance. This explains why in other jurisdictions, some funds, take a cost/benefit approach and prefer to renounce their right, and why the matter has never generated much heat in Luxembourg.

## Exemption for sub-contracted fund administration services

### Content of the ALFI communication

*Based on circular 723bis of 20 April 2010, the VAT exemption for the administrative management of the fund is not applicable to the supply of a "single isolated type of service". In the event of subcontracted fund administration services, these services must "form a distinct whole" and be "specific to and essential for" the management of investment funds (as ruled by the European Court of Justice in its Abbey National Case (C-169/04).*

*In this context, it has also been confirmed that services related to the management of the investments, such as investment advice and assistance in the establishment of the investment policy of a fund supplied by a third party to the management company of a Luxembourg investment fund or pension fund under the regulation of the CSSF or of the CAA continues to benefit from the VAT exemption of article 44.1.d) of the Luxembourg VAT law. In this respect, there is no change compared with the discussions and the documents exchanged between the Luxembourg VAT administration and the ABBL between October 1992 and May 1993.*

## Loyens & Loeff comments

This is the most important element of the communication. Circular 723bis of 20 April 2010 has created some uncertainty regarding the application of the VAT exemption in the case of out-sourced services. We believe this uncertainty has been exaggerated, and that a careful analysis of the VAT and regulatory principles and the operational framework of the Luxembourg investment fund industry would lead to the conclusion that the circular does not really modify the applicable VAT regime, but only clarifies a very specific aspect of it. In this respect, we refer to our article “Does Circular 723bis troubles quiet waters in Luxembourg” which was published in the September-October 2010 issue (Issue 13) of the Luxembourg Fund Review.

The other important element in the communication is the confirmation of the exemption for portfolio advisory services, which is very important in view of the huge amounts of fees paid by Luxembourg investment funds and their management companies to specialised advisers.

Finally, the reference to previous positions confirms the stability of the Luxembourg VAT regime and the broad application of the exemption for management services to investment funds.

We trust this update and comments are useful, and will be pleased to answer any questions you may have.

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