GattiPavesiBianchiLudovici

M. Galimberti

INVESTMENT FUNDS, VENTURE CAPITAL AND PRIVATE EQUITY

Outsourced services rendered to management companies may be VAT exempt

In the last twelve months the Italian Revenue Agency released three letter rulings concerning the scope of the VAT exemption for the management of special investment funds (laid down by Article 135, para. 1, let. g) of the VAT Directive) and its application to outsourced services.
The VAT exemption at stake is dependent upon two conditions: (i) the services in question (which might also be outsourced by the fund manager to third-party service providers) must qualify as "*management*" services; and (ii) such services must be supplied in respect of investment undertakings qualifying as "*special investment funds*".
The three public rulings – two of which issued in response to ruling requests filed by our firm – dealt with both the concepts of "management" and "special investment funds" contained in the VAT exemption provision, and clarified the following.

The activity of "management"

As regards the first condition, the Italian Revenue Agency confirmed that a very wide range of advisory services outsourced by fund managers can in principle be seen as fulfilling the specific and essential functions of the management of special investment funds, thus qualifying as "*management*" services (potentially exempt from VAT).
In particular, the following services - supplied by third party non-regulated service providers to fund manager companies – were deemed sufficiently specific to and essential for the fund management activity to qualify as "management" services themselves:

i. advisory services aimed at generating an appropriate flow of potential investment and divestment transactions in a specific geographical area, supplied to an Italian fund manager company operating in the Private Equity industry by its foreign subsidiary (Letter Ruling no. 628 of 29 December 2020); such a position is of primary importance for Private Equity funds with assets invested in multiple jurisdictions, whose managers might establish "captive" advisory companies locally in order to support the investment activity. Besides reducing the VAT costs for such undertakings, the VAT exemption provides for an equal treatment between branch and subsidiary corporate structures in cross-border scenario (thus reducing the branch bias in the investment fund industry);

ii. advisory services having at their object the analysis of the technological innovation potential of possible target companies, as well as other aspects (such as business ideas, market positioning and related opportunities, financial data...) of the same target companies, rendered by a third party advisor to a manager of Venture Capital funds (Letter Ruling no. 527 of 6 August 2021);

iii. strategic advisory services aimed at supporting the manager with regard to the definition of its strategy, also including the strategy to market the fund shares, rendered by a third party advisor to a fund manager operating in the Private Equity industry (Letter Ruling no. 631 of 29 September 2021).

Qualification of the funds as "special investment funds"

As regards the second condition, the Italian Revenue Agency pointed out that not only UCITS pursuant to Directive 2009/65/EC, but also Alternative Investment Funds (AIFs) under Directive 2011/61/EU - also including, in particular, Private Equity Funds and European Venture Capital funds - can be seen as "*special investment funds*" for the purpose of the VAT exemption.
In line with both the CJEU's case-law and the VAT Committee guidelines, the Italian Revenue Agency confirmed that, in order to be eligible for the VAT exemption, non-UCITS funds (AIFs) shall necessarily be (i) subject to specific state supervision and (ii) financed by at least two participants, who must bear the investment risk.
On the contrary, the circumstance of the fund manager being focused on the management of AIFs reserved to *qualified or professional investors* only was not considered by the Italian Revenue Agency to be an impediment to the qualification of the fund as a "special investment fund" for the purpose of the VAT exemption.

Practical implications of the Italian tax authorities position

With the letter rulings released and published in the last year the Italian Revenue Agency seems to have assumed a relatively wide interpretation of both the concept of "management" and the one of "special investment fund" under Article 135, para. 1, let. g) of the VAT Directive, as implemented in Italy by Article 10, para. 1), no. 1) of the Italian VAT Decree.
This shall be seen as a good news for AIFMs, which normally do not recover or - at best - recover only part of input VAT charged to them, and for whom unrecoverable VAT represents one of the most important cost items. Italian established AIFMs might indeed:

- take advantage of the VAT exemption on a vast range of services outsourced to (or purchased) by both Italian established and non-established advisors; and
- eventually recover input VAT either unduly charged by their suppliers or unnecessarily reverse charged by themselves, on supplies by non-established advisors (limitation period and applicable procedures may vary depending on the specific circumstances of the case).

Advisers and outsourcers supplying the services to fund managers might on the contrary be claimed by the latter for the reimbursement of the VAT unduly charged on said services and paid to the Revenue but not due (the right to claim reimbursement of payments made but not due being subject to a time-limit of 10 years), and would in any case suffer all the negative consequences of the VAT ex-

emption. It should not be forgotten that the VAT exemption implies that the service providers could not recover the input VAT incurred on their own costs, and they will thus – at least try to - pass on to their customers (the fund managers) this unrecoverable VAT, in the form of so-called "hidden VAT". All this being said, it cannot be ignored that the Italian Revenue Agency's recently released letter rulings were very case-specific, so that their immediate applicability to not exactly equivalent cases (in particular with regard to the type and nature of the services supplied by the third-party advisor or service provider) is to be verified on a case-by-case basis. In addition, the scope of the exemption for the management of special investment fund has been and still is one of the hottest VAT topic at the EU level, which keeps causing much controversy, has resulted in many cases brought before the CJEU, and even more matters are likely to be referred in the future.
In case of uncertainties, the best protection available for all parties involved (advisers and fund managers) is therefore to obtain the Italian Revenue Agency's blessing on the VAT regime applicable to the services supplied to the fund manager, through the filing of an advance tax ruling. Such a tax ruling might in principle be relied upon by the parties until revocation (if any), and would in any case prevent the retroactive application of VAT and/or penalties.

Lack of harmonization within the EU: possible double or non taxation in cross-border scenarios

Another point of attention of which fund managers (and their advisors) should become increasingly aware is the lack of harmonization of the VAT exemption at stake at the EU level. Notwithstanding the efforts of both the CJEU and the VAT Committee, the application of the exemption for management services of investment funds is indeed still subject to wide variations between Member States, as they apply very different interpretations in respect of both the concepts of "management" and of "special investment funds". This might easily lead to cases of double or non-taxation:

- advisers established in Member States applying a relatively broad interpretation of the VAT exemption might be denied the right to recover input VAT, irrespective of the VAT regime actually applied in the Member State of establishment of the fund manager (where the advisory services are meant to be made, and where the fund manager might well be required to apply VAT on the outsourced services, through the reverse charge mechanism); this would imply double taxation in the form of output VAT imposed by the Member State of the fund manager and the simultaneous denial of VAT credit or refunds in respect of corresponding inputs by the Member State where the advisor is established; while
- advisers established in Member states applying the exemption more restrictively (because of a narrower interpretation of either the term "management" or "special investment funds" – a notable example being the German Tax Authorities' position) might on the contrary be entitled to a full recovery of their input VAT, regardless of the VAT regime actually applied to their services in the country of establishment of the fund manager (which might indeed apply a broader interpretation of the VAT exemption, thus granting it to the services in question). This would result in double non taxation, in the form of the Member State of the advisor granting the input VAT credits and the Member State of the fund manager not levying output VAT.

These cases of potential double or non-taxation - together with the persistent uncertainties as to the scope of the VAT exemption for the management of investment funds - need to be urgently addressed, in order not to undermine the principle of VAT neutrality. The current Commission's proposal to review the VAT rules for financial services might be the proper occasion to do so.

Gatti Pavesi Bianchi Ludovici
VAT & Indirect taxes
Paolo Ludovici paolo.ludovici@gpblex.it
Pietro Bricchetto pietro.bricchetto@gpblex.it

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