

COMMENTARY ON THE SDC CASE

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This article concerns the ruling of the ECJ in the SDC case

1. *The relevant facts* of the case can be summarised as follows:

SDC is, in effect, a joint venture of the Danish banks, incorporated (presumably with a co-operative status) under Danish law. It is registered as a VAT tax-payer.

The most significant part of SDC's activities consists in the processing of money transfer instructions given to Danish banks by their respective customers.

According to the judgment, "SDC performed services only at the request of a bank... A customer could give [instructions] to SDC only after having been authorised to do so by a bank... SDC's name was not used vis-à-vis customers and SDC had not undertaken any legal obligation in regard to them. The documentation produced by SDC was sent out in the name of the bank".²

Payment to SDC of the services provided by SDC is billed by SDC to the banks, which are its (only) clients.

Indeed, as noted by the ECJ, the money transfer services provided by SDC "involve no legal relationship between [SDC] and the end recipient, namely the customer of a member bank of SDC; ... *the legal relations which are formed are between the bank and its customer and between the bank and SDC.*"³

It is beyond dispute that money transfer services provided directly by a bank to its clients are exempt from VAT. Query whether services provided by SDC to the banks, as subcontractor for the money transfer services contractually provided by the banks themselves to the clients are also exempt from VAT? In other words,

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² See paragraph 11.

³ See paragraph 46.

should SDC charge VAT to the banks on top of the fees which it charges to the banks in respect of the money transfer services provided to the banks for the benefit of the banks' clients? Unsurprisingly, the Danish VAT authorities took the view that this question should be answered in the affirmative, and SDC disagreed.

Since the answer to the question depends on the proper interpretation of the general principles, and relevant provisions, of the Sixth VAT Directive (the 6th Directive), a request for a preliminary ruling was submitted to the ECJ by the Danish court apprised of the dispute.

It should be noted, at this stage, that the request for a preliminary ruling addressed by the Danish court to the ECJ also encompassed the question whether certain other services, and in particular the buying and selling of securities for the account of the banks' clients, pursuant to "portfolio management" agreements, entered into by the clients with the banks, should benefit from the same VAT exemption (in force at the time) as applied when these other services (the "other services") were provided directly by the banks to their clients.

2. *The first issue* the ECJ had to address was whether the VAT exemption for money transfer services provided by Article 13, B, d, 3 of the 6th Directive is restricted to the provision of such services by credit institutions *only*.

The ECJ, which followed on this question the opinion of its Advocate General, had little difficulty in concluding that the answer to that question should be in the negative: "The transactions exempted... are defined according to *the nature* of the services provided and not according to the person supplying or receiving the services. [The relevant] provisions [of Article 13] make no reference to that person".⁴

The same position was adopted by the Advocate General, and confirmed by the ECJ, in respect of the temporary VAT exemption which was in force, at the time of the relevant facts of the case, for the "other services".

As noted by the Advocate General, however, the "open-ended" character of the VAT exemption of certain financial services, in terms of Article 13 of the 6th Directive, *does not preclude Member States from providing, as a matter of national law, that said services may only be provided by (certain) financial institutions or intermediaries*. "But that is a matter of politico-economic choices made by the Member States in question and not of the application of the Sixth Directive".⁵

⁴ See paragraph 32.

⁵ See paragraph 32 of the Advocate General's Opinion.

3. *The second issue* which the ECJ had to address is whether the exemption from VAT of the money transfer services applies not only between the provider and the beneficiary but also, if the provider subcontracts, between the subcontractor and the provider.

According to the ECJ, which *did not* follow on this point the opinion of its Advocate General, the answer to this second question is also in the affirmative, provided the operations carried out by the subcontractor meet certain conditions.

According to the ECJ, "... transactions concerning transfers and payments [and the other services] include operations carried out by a data-handling centre [namely SDC] *if those operations are distinct in character and are specific to, and essential for, the exempt transactions...*; [in other words] the mere fact that [these] operations...are carried out by a data-handling centre [namely SDC] does not prevent them from constituting services [exempted from VAT pursuant to Article 13 of the 6th Directive, provided the national Danish Court apprised of the case comes to the conclusion that] those operations were separate in character and specific to, and essential for, those services".⁶

4. *The meaning of the criteria which must be met by the operations carried out by the subcontractor in order to benefit from the VAT exemption which applies in the relationship between the head-contractor and the latter's clients.*

4.1 On the face of it, the meaning of the criteria laid down by the ECJ is far from evident. When are the operations carried out by a subcontractor such as SDC "distinct in character [and] specific to, and essential for [these] transactions"?

In order to understand the ECJ's reasoning, regard must be had to the arguments put forward by the Danish tax authorities and the European Commission to rebut SDC's position.

As noted by the Advocate General, "the Danish Government rightly emphasises that if [SDC's] line of argument were to be followed, any independent undertaking contracting with a banking institution to provide it with a service more or less linked to typical banking "transactions" which the Sixth Directive regards as exempt would also be able to claim exemption, such as the telephone undertaking which is instrumental in transmitting the orders for transfer, or the transport and security company which physically transports the funds from one branch to another and so on".⁷

⁶ See paragraph 82, point 2 and point 3.

⁷ See paragraph 62.

Pursuant to this line of reasoning, the Advocate General took the view that:

"the "transaction" [exempted from VAT by the Sixth Directive] is [exclusively] the legal operation effected between the customer and the banking institution. When there is, for example, an order for payment, or a transfer, the parties to the legal relationship are the customer who gives the order and [the bank] which accepts the order and performs a service for the customer consisting in the transfer of the funds to a third person; ... in other words, the "transaction", that is, *the legal operation* between the bank ... and its customer, is one thing and the way in which [the bank] materially complies with its obligation to perform the service agreed is quite another. The only allusion to that legal operation [between the bank and its customer] in the Sixth Directive is the reference in Article 13B to "exempt...transactions"; ... [the Danish Court apprised of the case] itself recognises that there is no legal link of any kind between [SDC] and the customers of the [banks]. SDC therefore supplies its services to [the banks] alone and is under an obligation only to them, whilst the customers are not even aware of its name. There are therefore no "transactions" of any kind between [SDC] and the customers of the [banks]; ... The part played by [SDC] is reduced to providing [the banks] with a given electronic service ... basically consisting in the handling and electronic transmission of data; ... That "service" is merely one of the instruments available to the banks ... for carrying out the obligations agreed with the customer. But [these services] ... must not be confused with those I have just referred to ... ; ... The banks ... have two choices for effecting ... transactions of transfer ...: either they use their own staff and equipment, as is done for other bank transactions, or they make a contract with a third party for the actual performance of some of those tasks; ... In the second case, with which these proceedings are concerned, the legal relationship between the customer and the ... bank continues unaltered, just as if the bank had actually performed those tasks with its own resources. All that changes is the internal method of working of the [bank] itself, but that has no significance for the customer whose contract is exclusively with the bank ... *which is solely liable to him* ... Choosing one option or the other is the business policy decision [of the bank] ... If [the bank] engages the services of another undertaking [namely, SDC] to perform certain tasks instead of performing them itself with its own staff and equipment, *it will have to pay the VAT relating to the performance of those services [provided by SDC]*".⁸

The Advocate General then went on specifically to advise the ECJ to hold that SDC could not benefit from the VAT exemption available to the banks for which it was acting as subcontractor because "... the creditors and debtors in the credit

⁸ See paragraphs 45-54.

transfers ... are the customers (individuals and companies in their capacity of those giving orders or beneficiaries) and institutions effecting the payments, *accepting the risks and obligations appropriate to this type of contract* "...;... In particular, the description of the credit transfers [by the Danish Court in the prejudicial question addressed to the ECJ]... makes it clear that SDC's ... function is data handling on behalf of the financial institutions, *but that it does not itself, legally speaking, effect the credit transfer*. It is therefore inappropriate to apply the exemption under discussion to these instrumental functions..."⁹

In other words, in the Advocate General's opinion, exemption of the "operation" only applies to the "legal operation" because it is only the bank which is contractually responsible vis-à-vis its client for carrying out the money transfer instructions, and not SDC. Indeed, SDC is only a subcontractor, without any contractual responsibility vis-à-vis the bank's clients.

4.2 This approach was, however, specifically rejected by the ECJ.

According to the ECJ, *"the exemption... is not subject to the condition that the service be provided by an institution which has a legal relationship with the end customer. The fact that [an exempted] transaction... is effected by a third party but appears to the end customer to be a service provided by the bank does not preclude exemption for the transaction... [if]... [those] operations carried out by a data handling centre are distinct in character and are specific to, and essential for, the exempt transactions"*.¹⁰

In other words, what is exempted, is the "transaction" as such, and not (exclusively) the "legal transaction" between the bank and the client.

Yet, in order for the "transaction" thus carried out by the subcontractor to benefit from the exemption available to the head-contractor in his relationship with his client, the "transaction" must "be distinct in character and specific to and essential" for the services provided by the head-contractor to the client.

What is meant by these words?

4.3 The answer is given by the ECJ as follows:

"In order to be characterised as exempt transactions... the services provided by a data-handling centre must, viewed broadly, form a distinct whole, fulfilling in effect the specific, essential functions of [the] service described [by Article 13 of the 6th Directive]. For "a transaction concerning

⁹ See paragraphs 71 to 73.

¹⁰ See paragraphs 82, point 2 and point 3.

transfers", the services provided must therefore *have the effect of transferring funds and entail changes in the legal and financial situation*. A service exempt under the 6th Directive must [effectively] be distinguished from a mere physical or technical supply, such as making a data-handling system available to a bank. In this regard, the national court must examine in particular *the extent of the data handling centre's responsibility vis-à-vis the banks, in particular the question whether its responsibility is restricted to technical aspects or whether it extends to the specific, essential aspects of the transactions*.¹¹

- 4.4 The same position was taken by the ECJ regarding the availability of the exemption for the "other services" provided by SDC to the banks, in particular in the field of portfolio management: "SDC's operations entitled "Advice on, and trade in, securities" cover two types of different services. The first type consists of separate information services characterised by the supply of financial information to the banks, whilst the second type *form an integral part of the system of the market in marketable securities; ...none of the [exempted] transactions [described by Article 13 of the 6th Directive] concerns operations involving the supply of financial information. Such operations cannot therefore be covered by the exemption...; on the other hand it is not excluded that some operations belonging to the second group are to be considered as transactions in "shares..., debentures and other securities" within the meaning of...the 6th Directive. [The Danish court apprised of the case] points out here that SDC carries out stock exchange transactions for [the banks'] customers by purchasing or selling securities held in customers' portfolios [by these banks]; it is undisputed that the transactions in shares and other securities [referred to in the 6th Directive]... include transactions on the market in marketable securities; furthermore, trade in securities involves acts which alter the legal and financial situation as between the parties and are comparable to those involved in the case of a transfer or a payment;...the answer to be given [to the Danish court apprised of the case] ...must therefore be that ... the [exempted] transactions in shares, ... debentures and other securities include operations carried out by a data-handling centre [such as SDC, acting as subcontractor for the banks] if they are separate in character and are specific to, and essential for, the exempt transactions"¹² provided, in legal terms, by the banks themselves to their customers.*

¹¹ See paragraph 66.

¹² See paragraphs 69 to 73.

Here, too, it is, according to the ECJ, for the Danish court apprised of the case to check whether the services thus provided by SDC meet the conditions laid down by the ECJ.

In my view, these conditions - must be interpreted to mean that the "subcontracting service" provided by SDC to the banks will benefit from the exemption available to the banks in their relations with their clients if - but only if - the banks are bound, in terms of their responsibility vis-à-vis the clients, by the acts performed by SDC as subcontractor in the same way as they would be if they had - materially - carried out these operations "in-house", with their own personnel and computers.