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Memo

To: PwC TLP

From: Simon Cornielje / Jelle Boonstra

Date: 7 May 2024

Reference: SC/JB

Subject: Dutch VAT case law developments in respect of intercompany financing

Dear colleague,

The Dutch VAT implications of intercompany financing are getting increased attention form the Dutch tax authorities. Two recent rulings by the Amsterdam Court of Appeal are expected to amplify this focus even more.

These developments hold significant relevance for the VAT position of holding and financing companies, as well as for businesses/ group companies involved in e.g. treasury or cash pooling operations. Our comprehensive memo below offers detailed insights into these developments and outlines the potential risks to which our clients might become exposed.

Please reach out to us in case we could provide additional clarification and/or support, both internally as towards clients.

Kind regards,

Simon Cornielje / Jelle Boonstra

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Executive summary

Impact

Two recent rulings from the Amsterdam Court of Appeal have highlighted two critical VAT areas for intercompany financing activities that clients need to be aware of:

a) Financing activities can be qualified as non-business activities for VAT purposes:

Financing structures with back-to-back loans, a direct link between incoming/outgoing financing, or atypical financing conditions are particularly vulnerable to re-classification by the Dutch tax authorities. Re-classification of financing arrangements could lead to significant changes in the VAT position of our clients. For instance, the status of a holding / financing company as a VAT taxable person could be (retroactively) annulled. This could (for example) lead to the repayment of initially recovered input VAT and/or invalidate the status of an entity as a VAT group member.

Moreover, we cannot exclude spillover effects to other VAT areas. As an example, structures involving back-to-back management fees could be seen as a non-taxable set up for VAT purposes, which could ultimately nullify (amongst others) a VAT taxable person's right to recover input VAT.

b) Financial activities next to regular business activities could lead to non-recoverable VAT:

VAT taxable persons conducting financing activities in addition to their regular business operations, may become exposed to an (additional) input VAT recovery limitation. This is in particular the case when those financing activities have not been factored into their input VAT recovery right calculations. In particular financing activities such as **treasury** services, **cash pooling**, or the **management of excess liquid assets**, may be scrutinized by the Dutch tax authorities. Upon re-classification as VAT exempt activities by the Dutch tax authorities, VAT taxable persons may no longer be entitled to fully recover input VAT on general costs, or face a decrease in their pro rata input VAT recovery right on general costs.

Recommended next steps

As the abovementioned risks could have substantial adverse financial implications, we advise the following:

- reassess the nature of existing financing activities, such as back-to-back arrangements, deposits and cash pooling, as well as the terms of the loans, including duration, interest rates, and repayment schedules; and
- examine whether clients are engaged in passive financing activities alongside their regular business operations, and if so, to what extent these activities have been factored into their input VAT recovery right calculations.

Based on this assessment, it may be prudent to reevaluate the VAT treatment and prepare for potential discussions with the Dutch tax authorities. Strategies might include requesting pre-consultation or compiling a defense file to substantiate the VAT treatment of choice.

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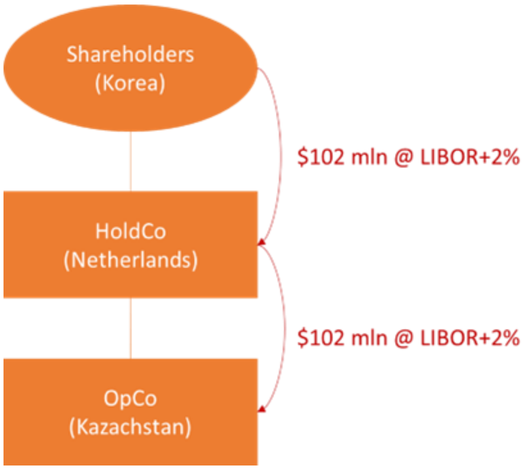
Background: Dutch VAT case law developments in respect of intercompany financing

1. Two cases by the Amsterdam Court of Appeal

1.1. Amsterdam Court of Appeal, January 3, 2024, ECLI:NL:GHAMS:2023:3182 ('HoldCo case')



Until recently, it was widely accepted that the provision of interest bearing loans to non-EU parties constituted an economic activity with input VAT recovery right. However, a recent ruling by the Amsterdam Court of Appeal on January 3, 2024 (hereinafter "HoldCo case") has raised doubts about the sustainability of this position.

In the HoldCo case, a Dutch intermediate holding company granted an interest bearing loan of over USD 102 million to an affiliated entity. The loan had a deferred interest rate of LIBOR+2%. No specific repayment term was agreed upon and the repayment obligation was subject to the lender's financial performance. Besides providing the interest bearing loan, the intermediate holding company did not engage in any other VAT-relevant activities.

The Dutch tax authorities disputed whether the provision of an interest bearing loan constituted an economic activity and as a consequence, questioned the intermediate holding company's eligibility for recovering input VAT. In first instance, the District Court of North Holland stated that the provision of an interest bearing loan cannot be equated with the investment activities of a typical private investor, as interest bearing loans granted in a business context are generally considered an (extension of an) economic activity. The court's verdict remained unchanged despite the loan being agreed upon under back-to-back conditions and the requirement for the intermediate holding company to on-lend the funds to a predefined affiliated entity.

In the second instance, the Amsterdam Court of Appeal rules differently. The court considers that:

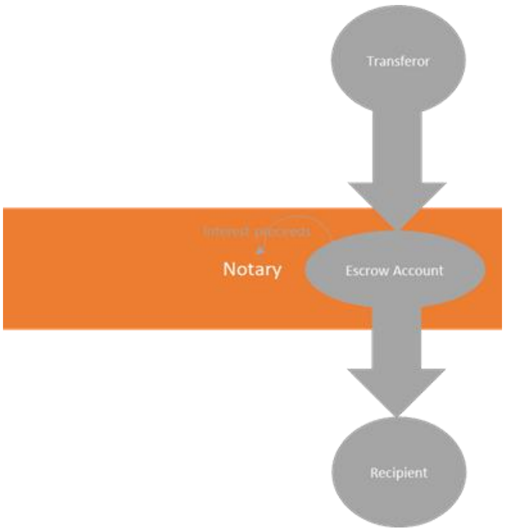
I. the interest-bearing loan is not a standalone economic activity because:
    a. the loan is granted under conditions that are incomparable to those under which a credit institution or bank would do so; and
    b. there is no aim to maximize the return on investment, since the loan has been granted under back-to-back conditions (i.e. without markup); and

II. the loan does not constitute an extension of an economic activity either ("extension concept"), since the intermediate holding company does not engage in any other activities than the provision of the interest bearing loan.

While the abovementioned tiered test is not new, the Amsterdam Court of Appeal applies a stricter interpretation relative to preceding (more nuanced) case law. As the ruling by the Amsterdam Court of Appeal in the HoldCo case has been left unchallenged (and the possibility of doing so has expired), this more nuanced trend may now be (at least partially) a thing of the past.

1.2. Amsterdam Court of Appeal, October 11, 2023, ECLI:NL:GHAMS:2023:2324 ('notary case')

The outcome of the HoldCo case contrasts sharply to a recent ruling by the Amsterdam Court of Appeal in the "notary case." In the notary case, a notary earned interest on temporarily deposited (in-transit) funds from third parties on its escrow account. Despite the seemingly passive nature of this activity compared to the provision of the interest bearing loan in the HoldCo case, the Amsterdam Court of Appeal considered the provision of capital as an extension of the notarial (economic) activities. This ruling has also been left unchallenged and the possibility of doing so has expired.



As a result of this ruling, internal financing activities are more prone to be re-classified as VAT exempt activities more quickly than before. This may lead to a reduction in the right to recover input VAT on general expenses for our clients.

The rulings in the HoldCo and notary cases raise practical questions for clients. Are these rulings by the Amsterdam Court of Appeal indicative of a trend shift? And if so, which companies or sectors are potentially affected by this shift? Furthermore, in which elements of the VAT assessment framework does this trend shift manifest itself?

2. VAT technical analysis

This brings us to the VAT technical aspects of these rulings. As we mentioned before, the tiered test as such is not new. In previous case law it has also been considered whether:

I. the provision of an interest bearing loan constitutes an independent economic activity; and if not, whether

II. the interest-bearing loan constitutes an extension of an economic activity.

We do however have some reservations regarding the redefined interpretation of the tiered test. We will elaborate on this for the remainder of the memo.

2.1. Amsterdam Court of Appeal 3 January 2024, ECLI:NL:GHAMS:2023:3182 (HoldCo case)

<u>*Step I: Interest-bearing loan = economic activity?*</u>

The Amsterdam Court of Appeal has ruled that an interest-bearing loan does not qualify as a standalone economic activity because it is lacking sufficient ‘commercial or business character’. The court bases this conclusion on the manner and conditions under which the loan was granted, which it deems incomparable to those of a typical "bank or credit institution". We believe this interpretation is however too narrow, as it does not align with the test prescribed by the Court of Justice of the European Union (“CJEU”). The CJEU states that the comparison should be made with a "private investor"; not a bank or credit institution. Only in case of insufficient comparability to a private investor (i.e., an individual with a savings account) an investment could potentially constitute an economic activity. Considering the risky nature of the interest bearing loan in question, we do not consider the grantor to be sufficiently comparable to a typical private investor. The fact that the holding company is not comparable to a bank or credit institution either (as determined by the Amsterdam Court of Appeal), should not be decisive in our view.

Secondly, the Amsterdam Court of Appeal argues that the holding company does not aim to maximize its return on investment. This argument is also derived from the CJEU case law. The emphasis on maximizing the return on investment may seem counterintuitive at first, as VAT is not levied based on profit and pricing is normally left to the discretion of the VAT taxable person. In our opinion, the CJEU's "return on investment criterion" should therefore not be interpreted too strictly. A strict interpretation would contradict the legal nature of VAT, unduly restrict the autonomy of the VAT taxable person, and even go beyond the "at arm's length principle" applied in corporate tax law (as this criterion should also be tested between unaffiliated parties). We believe instead that the CJEU introduced this criterion to emphasize the objective nature of recognizing an economic activity. If a business does not have sustainable/healthy turnover projections (n.b. not profit), the intended activity does not constitute an economic activity, since the ‘return on investment’ is objectively insufficient.

In the case at hand, the Amsterdam Court of Appeal concludes that there is insufficient comparability to a typical loan granted in a business context, since the loan is granted under back-to-back conditions without a markup and therefore the return on investment is nil. This view deviates from the judgment of the District Court of North Holland, which stated that the interest income should be taken into consideration as such and not on balance with interest costs, to determine whether the provision of capital constitutes an economic activity. From a VAT perspective, the approach taken by the District Court of North Holland seems more conceptually accurate to us, since testing for profit is irrelevant for VAT purposes. Nevertheless, the reason why the Amsterdam Court of Appeal chooses a different approach, remains unaddressed.

Step II: Interest-bearing loan = extension of an economic activity?
Since there is no standalone economic activity (according to the Amsterdam Court of Appeal), the next question is whether the provision of the interest bearing loan constitutes an extension of an economic activity. Given that the holding company does not engage in any other activities besides holding shares and providing the interest bearing loan, it is understandable that such an extension does not exist in this case.

2.2. Amsterdam Court of Appeal 11 October 2023, ECLI:NL:GHAMS:2023:2324 (notary case)

Step I: Interest-bearing loan = economic activity?
Relative to the HoldCo case, the line of reasoning in the notary case is somewhat reversed. According to the notary, the short-term provision of client capital out of an escrow account is considered too

passive in nature to constitute an economic activity. The notary argues that the interest income should not be factored in its input VAT recovery calculation for general costs.

This reasoning seems reasonable to us, as the interest income is generated without significant effort and/or risks, similar to that a private investor. However, the lower court (first instance) found this argument insufficiently substantiated. Additionally, as the activity constitutes an extension of an economic activity (notarial activities), the interest revenue cannot be ignored for the purpose of calculating the pro rata allocation key.

Step II: Interest-bearing loan = extension of an economic activity?
The Amsterdam Court of Appeal has upheld the ruling of the lower court. From the reasoning provided by the court, it can be inferred that the threshold for recognizing an economic activity is considerably lower when there is a "direct, sustainable, and necessary" extension of an economic activity. This makes sense given the tiered nature of the test, as disregarding the second step would render it otherwise meaningless.

This implies that both 'sub-tests' of comparability with a private investor and the pursuit of maximum return on investment play a limited (if at all) role for testing whether financing activities constitute an extension of an economic activity. Therefore, even seemingly passive activities can be considered as an extension of an economic activity and result in an input VAT recovery limitation.

It is important to note that in each specific case, it must be determined whether the financing activity does indeed constitute an extension of an economic activity, as this not necessarily always the case. As a main rule however, financing activities that originate from a particular economic activity, are generally considered an extension of that economic activity.

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