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Advocate General to Supreme Court rejects VAT recovery in accordance with actual use by bank

On December 3, 2021 the Opinion issued by Advocate General ('AG') Ettema (20/01521, ECLI:NL:PHR:2021:1054) about an important case concerning the VAT recovery of a bank was published. The bank in question wanted to determine the VAT recovery right on the basis of a financial analysis of the profit and loss ('P&L') per product. It believed that this VAT recovery method constitutes an 'actual use method', which may be used for determining the VAT recovery right. The AG concluded that it is not possible to apply the actual use method used by the bank.

This case is not only relevant for financial institutions, but also for other taxpayers performing VAT-taxed and VAT-exempt services, such as parties in the public sector, and in education and healthcare.

1. Background and points of law

The taxpayer in this case is a bank that performs both VAT-exempt and VAT-taxed services. All the costs incurred by the bank can be regarded as mixed costs. Most of its turnover consists of VAT-exempt interest income, and commission income of which the majority is subject to VAT. The bank had transferred part of its mortgage receivables to separate securitization companies. The interest the bank received on these receivables was passed on to the aforementioned companies.

The taxpayer prepared a financial analysis of the P&L of each product. To this end, the costs were apportioned to the various product groups by means of three interval-based allocation formulas (based on time registration, actual products purchased and proportional distribution). This resulted in an allocation of the bank's mixed costs to the various product categories.

In its VAT returns, the taxpayer recovered VAT on its mixed costs in accordance with the turnover-pro rata method without taking account of i) the interest expenses paid, ii) the interest received on its notes in the securitization companies and iii) the interest passed on to the securitization companies. In the appeal proceedings, the taxpayer revised the VAT recovery for the year 2014 and the first three quarters of 2015 by calculating the VAT recovery in accordance with actual use.

The point of law addressed by the AG was whether the Court of Appeals Den Bosch ('the Court of Appeals') had set the correct requirements for the actual use method. The Court of Appeals ruled that the VAT recovery calculation on the basis of the P&L per product resulted in a more accurate determination of the VAT recovery than the pro rata on the basis of turnover ('pro rata') and is based on (sufficient) objective and accurately determined data.

The AG also briefly addressed the question whether the paid interest expenses should be deducted from the interest income received when calculating the VAT recovery right and whether the interest that was passed on to the securitization companies must be excluded from the taxpayer's turnover.

2. Opinion issued by AG Ettema

The case pending before the Supreme Court involves fundamental matters of principle, which essentially revolve around the question how strictly the VAT recovery based on actual use should be applied in the Netherlands. The AG believes that the judgment by the Court of Appeals is incorrect and argues that, on the basis of Dutch rules and Dutch Supreme Court case law, the Court of Appeals should have applied a stricter test when assessing the bank's actual use method.

Dutch legislation
The AG begins her Opinion with how the Netherlands has implemented the rules from the EU VAT Directive for the purposes of the VAT recovery on mixed costs. According to EU and Dutch rules, as a starting point the VAT recovery on mixed costs is calculated on the basis of the turnover method. The VAT Directive permits EU Member States to deviate from this and provides for various other VAT recovery methods to be used. According to the Dutch VAT Act 1968 (hereinafter: 'VAT Act'), the VAT recovery must be determined on the basis of actual use if it is plausible that the actual use of the goods and services as a whole does not correspond with the pro rata. The Dutch regulations do not provide for rules on how the VAT recovery on the basis of actual use must be determined.

Discretion EU Member States and Supreme Court interpretation
The AG argues that the VAT Directive allows EU Member States a certain degree of discretion and that it is up to the EU Member States to establish methods and criteria for calculating the VAT recovery. The AG adds that it is customary for the Dutch Supreme Court to formulate legal rules where necessary. In 2006 the Supreme Court ruled that if the actual use can only be determined by approximation, then it is not possible to deviate from the turnover method. The Supreme Court later clarified this by requiring that the actual use method may only be applied if (i) it is convincingly demonstrated that the actual use does not correspond with the recovery right calculated in accordance with the pro rata, and (ii) the actual use can be determined on the basis of objective and accurate data. The AG examined whether the Dutch Supreme Court's assessment framework is stricter than that following from case law of the Court of Justice of the European Union ('CJEU'). We infer from CJEU case law that the most important requirement is that the calculation of the VAT recovery right in accordance with the actual use method is *more accurate* that the determination of the recovery right according to the standard method. In Dutch practice, this is perceived as a less stringent requirement than that advocated by the Dutch Supreme Court to date. The AG concluded that insofar as the test would already be stricter, she believed it was permitted.

We disagree with these assessments by the AG and agree with the taxpayer that the CJEU advocates a broader interpretation of the actual use rules than the Dutch Supreme Court. The CJEU has ruled several times that an actual use method may be applied if this results in a more accurate VAT recovery calculation. Therefore, we

believe that the Dutch Supreme Court can no longer maintain the approach it has taken since 2006, in which strict requirements are imposed on the objectivity and accuracy of the actual use method. As the CJEU is a higher court of law, the later rulings by the CJEU should prevail.

We consider it an infringement of the principle of legality if the Dutch Supreme Court imposes a requirement to the detriment of the taxpayer that is stricter, than that provided for in the VAT Directive and according to the interpretation given to it by the CJEU. We do not see any stricter requirement in the Dutch VAT Act than in the laws of some of the other EU Member States on which the CJEU has ruled. Insofar as it is possible to stipulate a stricter requirement, the Dutch legislator should clearly lay this down in rules. However, we believe that the Dutch legislator cannot do this either and that the actual use method – despite the fact that this facility is based on an 'optional provision'– must be interpreted in accordance with EU law.

In recent case law, the Dutch Supreme Court chose to stick with the requirement that actual use must be determined objectively and accurately, without considering the CJEU's requirement of a 'more accurate' method. In doing so, the Dutch Supreme Court did not or failed to sufficiently consider the CJEU judgments. There may not have been any reason to do so in these recent cases, because the primary disputed issues were often different. We believe that in the present case there are reasons to do so. Insofar as the Dutch Supreme Court believes that its original approach from 2006 is the correct one, it would be a welcome development for Dutch practice if the Dutch Supreme Court at the very least lets the CJEU assess this by asking for a preliminary ruling.

The taxpayer's recovery method
According to the AG, the Court of Appeals has wrongly tempered the rules of law for actual use. The AG concludes from this that it is not possible for the taxpayer to recover VAT on the basis of actual use, because the requirements stipulated by the Dutch Supreme Court are not met.

We infer from the AG's Opinion that assumptions and presumptions cannot be relied on, and it seems that this is the reason for not further evaluating the bank's VAT recovery method. However, what is missing from this analysis is that these assumptions and presumptions were used by a 'registered controller' (a certified financial controller in the Netherlands) to, for financial reasons, arrive at a P&L per product. As far as we are concerned, the latter is an objective and accurately prepared calculation, or at least justifies asking the Court of Appeals who bears responsibility for assessing the factual situation to assess whether this is the case. The AG has ignored this in her Opinion. We believe that the task of a registered controller can be compared in that sense to the task of a court, whereby a court may have to deal with various presumptions and assumptions and must establish what the facts are in law. The latter then comes with an objective conclusion, despite the fact that various elements were included in the assessment process.

What also stands out is that the AG has rejected the taxpayer's VAT recovery method without proposing to refer the case back to another Court of Appeals (which is standard Dutch procedure) for a further assessment. If the Supreme Court were to follow the AG in her argument that the Court of Appeals did not apply the rules of law correctly, then as far as we are concerned the case should be referred back to a Court of Appeals to assess the case based on the rules of law that according to the Dutch Supreme Court do apply.

Dutch Bank Decree
The AG also claims that the application of the Bank Decree (Decree by the Deputy Minister of Finance dated November 9, 1982, no. 282/15703) means that a VAT recovery on the basis of actual use is not possible. The Bank Decree, which is intended for banks, contains several general provisions and approvals for determining the VAT recovery right, including an approval that the revision of the VAT recovery for the preceding year may take place no later than in the VAT return for the ninth month of the current financial year (instead of the last period of the previous financial year). In addition to this, the Bank Decree contains an approval for calculating the VAT recovery right, with this being conditional on the recovery calculation being made on the basis of turnover. The AG argues that the Bank Decree cannot be applied selectively. As the taxpayer has opted to definitively calculate the VAT recovery right on the foregoing in the ninth month of the current year and to report this in the VAT return for the third quarter of the current year, it is therefore no longer possible to opt for the actual use method.

We wonder whether the approvals in the Bank Decree can only be applied completely and in full. In the case of other tax policy decrees, we also see that taxpayers apply certain approvals and not others, albeit that this concerns a more coherent decree on the VAT recovery of banks. In practice, it is customary to report adjustments by banks in the VAT return for the third quarter/September.

Multiple allocation formulas
A question that still remains unanswered is the extent to which a method based on actual use can be refined and whether multiple allocation formulas can be applied. According to the AG, it is not possible to apply multiple allocation formulas, because this method would resemble the recovery calculation according to the sector method, which the Dutch legislator did not implement in Dutch VAT law. Moreover, according to the AG, it follows from Dutch Supreme Court case law that a dual calculation method is not possible. We believe that this deserves some nuance. It follows from Dutch Supreme Court case law that the recovery right for mixed costs 'as a whole' must be calculated on the basis of turnover on the on hand or actual use on the other. This therefore only requires that one method (turnover or actual use) is used and, in our view, this does not preclude the use of various allocation formulas within the actual use method. After all, a prohibition on the latter would be diametrically opposed to the requirement that the actual use must be determined objectively and accurately.

That the AG did not further address this is a missed opportunity, because current case law is not clear about this. Moreover, the AG did not further elaborate on the conclusion of the Court of Appeals that the taxpayer's method fits within the doctrine that follows from the CJEU judgment in the Morgan Stanley case (January 24, 2018, C-165/17). This judgment suggests that application of multiple allocation formulas can even be an obligation.

Other disputed issues
It is disappointing that the AG proposes, on the basis of a very brief analysis, that the question whether the paid interest expenses should be deducted from the received interest income when calculating the recovery right and whether the interest that is passed on to the securitization companies must be excluded from the taxpayer's turnover, be settled by invoking Section 81(1) Judiciary (Organization) Act (*Wet op de rechterlijke organisatie*), in which case the Dutch Supreme Court would settle the case without any substantive assessment. We would have liked the AG to have substantiated her views in more detail.

3. Practical consequences

The AG's Opinion is probably disappointing for various market parties. EU case law has long offered more scope than Dutch case law for applying a recovery method based on actual use instead of the standard turnover pro rata method. It, of course, remains to be seen whether the Dutch Supreme Court will follow the AG's Opinion.

If the Dutch Supreme Court follows the approach advocated by the AG, the bar for taxpayers to apply a VAT recovery calculation on the basis of actual use will be set very high. In practice, this will usually mean that market parties will automatically revert to a rigid and rough VAT recovery calculation based on turnover ratios. We consider this undesirable, particularly in cases where it is evident that the actual use of the mixed costs does not correspond to the turnover ratios. Moreover, this creates an imbalanced situation in which – in the Dutch domestic situation – parties are dependent on a VAT recovery method based on turnover, while – in the international context – taxpayers can arrive at a more balanced and reasonable VAT recovery on the basis of principles following, for example, from the CJEU judgment in the Morgen Stanley case (January 24, 2019, C-165/17).

The views on the Dutch Bank Decree are also relevant for various market parties. If the Dutch Supreme Court were to follow the AG, the Bank Decree can only be applied completely and in full. In that case, market parties will have to reconsider whether they should apply the Bank Decree.

With regard to the other disputed issues, we would not like to derive a general effect from the AG's proposal to settle this by invoking Section 81(1) Judiciary (Organization) Act.

4. What can you do now?

It is clear from this case that a lot can be at stake financially, particularly for enterprises in the financial sector. If the Dutch Supreme Court does not follow the AG and reaches another conclusion, we suspect that the Dutch tax authorities will regard that as a change in case law. That would be advantageous for the Dutch practice.

For the past that means that taxpayers can only invoke this with retroactive effect if they have preserved their rights. We therefore recommend that you take action to preserve your rights. For taxpayers that, on the basis of the Bank Decree, have included the definitive pro rata calculation for 2020 in the VAT return for the third quarter/September 2021, the formal notice of objection deadline will probably expire in the first half of December (this is normally six weeks from the payment of VAT in the VAT return for the third quarter/September). Although the AG concluded that it is not possible to apply an actual use method if a taxpayer opts to make the pro rata adjustment in the VAT return for the third quarter/September of the following year in accordance with the Bank Decree, we consider it advisable to submit a notice of objection anyway in anticipation of the Supreme Court judgment. This is, in principle, the only way to possibly retain a formal opening for the year 2020.

If it is advantageous to apply an actual use method for 2021, we recommend that you either include the VAT recovery adjustment for this in the last VAT return for the year or promptly submit a notice of objection against this VAT return. In addition to a taxpayer's personal preferences and the relationship with the Dutch tax authorities, it is important for procedural law purposes whether the VAT return results in VAT being payable or in a VAT refund. We recommend that, in any case for the VAT recovery position in 2021, you do not wait until the VAT return for the third quarter/September 2022, but submit a notice of objection against the (payment of VAT in the) VAT return for the fourth quarter/December 2021.

If you would like to discuss this judgment, feel free to contact the advisors of KPMG Meijburg & Co's Indirect Tax Financial Services Group or your usual advisor.

KPMG Meijburg & Co
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