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LEASE FUNDING AND VAT - THE DUTCH APPROACH

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In a standard operating lease, part of the lease instalments relates to the financing costs incurred by the lessor. As the lease instalments in their entirety are subject to VAT, tax is due from the lessee on this financing component of the lease rental. Lessees without a right to deduct VAT in full have sought ways to avoid paying VAT on the financing component. A feasible structure appeared to be a lease/financing scheme in which the lessee issues an interest-free loan to the lessor. As the lessor has the use of this interest-free loan, the lessor no longer incurs financing costs. Without any financing costs, the lease instalments can be lower. Lower instalments naturally lead to less VAT being due. VAT savings thus appeared to be within reach.

In the Netherlands, the use of lease/financing schemes led to trench warfare between VAT experts. One side was convinced that the provision of an interest-free loan actually constituted a payment in kind for the lease, and VAT was thus due on the value of the loan. Understandably, the Dutch VAT authorities adhered to this view. The other camp saw no payment in kind - VAT was due only on the lease instalments. Recently, the Dutch Supreme Court ended the dispute by issuing a clear decision[2] on the question whether or not VAT was due. After analysing the facts, the Court clearly sanctioned the use of lease/financing schemes to save VAT. According to the Court, the provision of an interest-free loan was not a payment in kind for the lease. As a result, the loan was not subject to VAT. Is the Dutch approach an example for others?

The Lease Structure

The case presented to the Dutch Supreme Court was relatively simple. A leasing

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2 Decision of 28th March 2001, no. 35.311.

company leased cars to various lessees. During these (operating) leases, the lessor remained the full owner at all times; the lessee could not acquire the car. For the purposes of Dutch VAT, each lease was considered a supply of a service. Cars were not only leased to lessees who could deduct VAT, but also to lessees who could not recover the VAT on the lease instalments.

In the instant case, cars were leased to an entrepreneur performing VAT-exempt activities. For this group of lessees, a special scheme was introduced. Under that scheme, the lessee and the lessor concluded not only an operating lease agreement, but also a separate loan agreement. The amount lent by the lessee equalled the purchase price of the subject matter of the lease. The loan had another special feature: it was interest free. Furthermore, the loan tracked the book value of the leased car. A diminishing value corresponded to a lower loan amount. The special scheme thus resulted in the lessee more or less taking over the financing of the car. The lessor could avail itself of 'free' money for investment and did not incur any financing cost. Without financing costs, the lease instalments were lower.

The Dutch VAT inspector categorised the interest-free loan as a payment in kind for the lease of the car. In his view, the lessor received payment partially in cash (the lease instalments) and partially in kind (the interest-free loan). As with all payments in kind, VAT should have been paid on the value of the payment in kind. For the lessor, that value equalled the amount of interest charged on a comparable interest-bearing loan. Accordingly, the inspector levied an additional VAT assessment for that amount.

The lessor successfully challenged the VAT assessment before the Amsterdam Tax Court, which annulled the assessment, referring to a previous decision of the Dutch Supreme Court with respect to a comparable lease/financing scheme.[3] Not pleased with the decision of the Amsterdam Tax Court, the VAT inspector appealed the case to the Dutch Supreme Court, which upheld the decision of the Amsterdam Tax Court, thereby sanctioning the use of VAT-saving lease/financing schemes.

In its judgment, the Dutch Supreme Court introduced a new VAT doctrine: the 'means' doctrine, which addresses the situation in which a customer provides its supplier with certain 'means', which the supplier can use only for its services towards that customer. 'Means' thus supplied do not constitute a payment for the services. Such 'means' cannot be considered a payment in kind. The provision of the 'means' takes place outside the scope of VAT.

3 Dutch Supreme Court, judgment of 2 October 1996, no. 31443.

The 'Means' Doctrine in Practice

The 'means' doctrine can be elucidated as follows. Imagine a cab driver with engine trouble. If our driver wants his car to be repaired, he must take it to a service station. He must actually 'hand over' the car to a car repairman. No one in his right mind would consider that temporary provision of the car as a payment in kind for the repair work to be carried out, since the garage receives the car for a certain period of time, but the garage cannot freely make use of the car. The car can be 'used' only in order to carry out the repair services. The car is thus a 'means' for the requested services. The provision of the car takes place outside the scope of VAT.

Another example would be the situation in which someone provides a tailor with a piece of cloth in order to make a new suit. Handing over the fabric does not constitute a payment for the tailoring services to be performed. The tailor does not derive any profit from the piece of fabric, since it will be processed into the ordered clothing in its entirety. The raw material provided by the customer, the piece of cloth, is thus a 'means' that remains outside the scope of VAT.

Money as 'Means'

In its judgment, the Dutch Supreme Court acknowledged that an amount of money could also be used as 'means'. In certain situations, providing an amount of money could be compared with providing the car or the piece of fabric in the examples above. In that case, handing over money does not constitute a payment! We live in a strange world.

According to the Supreme Court, the lessor used the interest-free loan to finance the lease subject matter. The loan was used solely to perform services for the lessee, i.e. the lease of a car. Under these circumstances, the loan did not constitute a payment for the lease. Instead, providing the loan could be compared with providing the automobile or the piece of fabric in the above examples – 'means' outside the scope of VAT. Following this reason, the Court concluded that the interest-free loan was not a payment for the lease. The decision of the Amsterdam Tax Court was therefore upheld: the lease/financing structure was not subject to additional VAT.

Sacrifices Made by the Lessee

During the proceedings before the Supreme Court, the Dutch State Secretary of Finance emphasised the expenses incurred by the lessee. According to the State

Secretary, the lessee could not dispose of a certain amount of money for a certain period of time as he had placed that money in the lessor's hands. As a result, the lessee possibly lost interest income. The 'sacrifice' thus made constituted a payment for the lease and should have been subject to VAT. Many Dutch VAT experts sympathised with this point of view. The Supreme Court did not, however. In the Court's view, the lost interest income constituted costs directly incurred by the lessee. The Court saw no direct link between those costs and the provision of a car under the lease. The sacrifice thus made by the lessee was therefore not remuneration for the lease.

Perhaps this discussion would be clearer if we were to look again at our cab driver and his broken-down car. The cab driver cannot generate income as long as his vehicle is in the garage for repairs. The income thus sacrificed does not constitute a remuneration for the repair work, however. The garage does not profit in any way from the income lost by the driver. The lost income is an (extra) expense incurred by the driver, which has no direct link with the repairs performed. Of course, no VAT is due on this sacrificed income. The same reasoning can be used with respect to the sacrificed interest under a lease/financing scheme.

Timing of the Transactions

In the lease/financing structure reviewed by the Dutch Supreme Court, the timing of transactions was noteworthy. The lessor had acquired the cars before obtaining the interest-free loan from the lessee. Strictly speaking, the loan therefore could not be used to finance the cars. The cars were already financed. The lessor could use the money for other purposes. The loan was nonetheless a payment in kind.

In his opinion for the Dutch Supreme Court, the Solicitor General supported an economic approach. In his opinion, a historical connection between the loan and the investment made by the lessor was not required. A linking of the loan to the book value and life span of the car sufficed. A loan granted after the lessor purchased the car altered the way in which the car was financed. Such a loan did not differ significantly from a loan granted before the purchase of the cars. The Supreme Court apparently agreed with the view of the Solicitor General. As a result, it seems that a VAT-saving lease/financing structure can be implemented at any given moment, as long as the loan is linked to book value and economic life span of the subject matter of the lease.

Sixth Directive and the European Court

The question arises whether the 'means' doctrine of the Dutch Supreme Court is in accordance with the provisions of the Sixth Directive.[4] Unfortunately, the Sixth Directive does not seem to give clear guidance on the position of such means provided by a customer. Case law of the European Court, however, seems to favour the Dutch approach.

Relevant here is the decision of the European Court in the *First National* case.[5] In that case, the First National Bank of Chicago carried on a wide variety of banking activities, including foreign exchange dealings. In this respect, the bank purchased and sold currencies. The spread between the purchase price and the sale price of the currencies constituted profit for the bank. During proceedings before the UK High Court, the following questions were referred to the European Court:

1. Do such foreign exchange transactions constitute the supply of goods or services for consideration?

2. If there has been a supply of goods or services for consideration, what is the nature of the consideration in relation to such transactions?

The EC Court's answer to the first question was affirmative; the exchange transactions constituted a supply of services that was subject to VAT. Looking for the taxable amount, the Court considered the following:

While they are subject to a supply, currencies transferred to a trader by his counter party in the course of a foreign exchange transaction cannot be regarded as constituting remuneration for the service of exchanging currencies for other currencies or consequently as constituting consideration for that service.

According to the Court, determining the consideration for these services came down to determining what the bank received on foreign exchange transactions, i.e. the remuneration on foreign exchange transactions that the bank could actually *take for itself*. Apparently, all other amounts that the bank received were considered 'means' and thus outside the scope of VAT. The only relevant amount was the amount that

4 Sixth Council Directive (77/388/EEC) of 17th May 1977 with respect to the harmonization of the laws of the Member States relating to turnover taxes – common system of value-added tax: uniform basis of assessment.

5 *The Commissioners of Customs and Excise v First National Bank of Chicago* (Case C-172/96).

the bank 'kept in its pocket at the end of the day', i.e. the net result of its transactions over a given period of time.

The European Court also considered its previous decision in the *Glawe* case,[6] which revolved around the VAT position of slot machines. Should VAT be calculated on all money inserted or on the net result of the machine after deduction of prizes paid out? The Court held that tax was due only on the net result. The only relevant amount was the amount of money present in the slot machine 'at the end of the day'. Apparently, the rest of the money inserted was considered 'means', without VAT implications. This money was used to provide a service to the customer: paying out prizes.

The above case law appears to supports the 'means' doctrine employed by the Dutch Supreme Court. What is relevant is what a taxpayer can keep for himself, not what he receives from his customer.

Conclusions

Under an operating lease, VAT savings can be achieved by adding to the lease an interest-free loan from the lessee. Financing the subject matter of the lease with such a loan, the lessor can calculate lower lease instalments. The lessee thus avoids paying VAT on any financing component. Such lease/financing structures have clearly been sanctioned by the Dutch Supreme Court. The European Court appears to have followed the same reasoning. Perhaps such structures are 'ready for use' throughout the EU.

6 *Glawe v Finanzamt Hamburg-Brambeck-Uhlenhorst* (Case C-38/93).