CLIFFORD CHANCE

VAT EARTHQUAKE STRIKES DUTCH CLOs: IMPLICATIONS FOR THE MARKET

On the afternoon of Friday 21 February 2020, Euronext Dublin's regulatory news service exploded with dozens of notices served by Dutch CLO issuers, informing investors that the CLOs' VAT exemption for collateral management and administration fees had been revoked. Worse still, the revocation had retrospective effect back to 1 April 2019.

This was a development which has been feared since the December 2015 Court of Justice of the European Union (CJEU) judgment in the *Fiscale Eenheid X* case, but which it was hoped would not come to pass. What does that mean for the European CLO industry and what comes next?

Key issues

- Following revocation by Dutch tax authorities of tax rulings previously relied on by Dutch CLO issuers for treatment of collateral management and administration fees, investment management fees are now subject to 21% Dutch VAT
- Most controversial part of the decision is its retrospective application which goes back to 1 April 2019 and is generally expected to be contested in court
- Decision has far-reaching consequences for Dutch CLOs in the immediate term, with investors likely to seek restructuring and migration to other jurisdictions still enjoying VAT protections (such as Ireland)
- In the longer term, however, it cannot be ruled out that the decision's aftershocks may have an impact on the position elsewhere in the EU, and on a broader range of products

WHAT HAPPENED?

Back in the mid-to-late 2000s, the Dutch tax authorities issued numerous Dutch CLO issuers with tax rulings confirming that their collateral management and administration fees benefited from the VAT exemption for the "management of special investment funds as defined by Member States". This was, at the time, not thought to be a controversial position. The basic EU law principle of fiscal neutrality suggests that, if investment management services supplied to UCITS are exempt from VAT, then investment management services supplied to CLOs should be too.

The *Fiscale Eenheid X* case called into question whether unregulated funds could continue to benefit from the exemption, but most tax authorities (and, it seems, the Commission) accepted that the decision was limited to its particular facts. The key element of the CJEU's judgment was a requirement that the funds in question were subject to "specific state supervision", but there was a lack of clarity as to what this meant. This lack of clarity then became a subject of a challenge by the Dutch tax authorities, with the decision of the Dutch Supreme Court on the matter expected later this year.

The market was, therefore, taken by surprise by the Dutch tax authorities' action in February 2020, retrospectively revoking its rulings, and requiring CLO issuers to correct their VAT returns and pay back VAT for the period from 1 April 2019, possibly together with related interest and penalties.

CAN THE REVOCATION BE CHALLENGED IN COURT?

It is certainly possible that CLO issuers or investors will challenge the need to correct VAT returns and the tax authorities' revocation of the rulings in the Dutch courts.

The most promising grounds for challenge would be over the retrospective element of the revocation – there is Dutch case law suggesting that the retroactive revocation of tax rulings is unlawful in at least some cases. However, in the meantime the VAT may still have to be paid up-front, with court processes taking up to ten years.

HOW WILL DUTCH CLOs RESPOND?

It is likely that investors will wish CLOs to consider restructuring to solve the problem. Potential options vary in complexity and associated costs depending on where a CLO is in its cycle (for example within or outside the non-call period). However the obvious step is for a CLO to migrate from The Netherlands to another jurisdiction which continues to permit CLOs to utilise the VAT exemption. As of today, the obvious destination is Ireland.

There are several ways such a restructuring could be accomplished:

- ***Reset*** – for those deals which have come out of the non-call periods, perhaps the simplest solution would be to reset the deal and re-issue the CLO out of an Irish SPV. That way, only the equity approval will be required for changes relating to the migration of the Issuer, whatever form it will eventually take;
- ***Issuer substitution or merger*** – for those deals which are still within the non-call period, alternative solutions may include triggering the Issuer substitution provisions or putting forward a consensual Issuer substitution proposal and effecting the transfer of the Dutch SPV's assets and liabilities to an Irish SPV (through novation or corporate merger). There may be administrative hurdles to overcome before implementing Issuer substitutions, including potential trustee and/or investor consent requirements and the implications of these will need to be examined closely at a deal level;
- ***Migration of seat or place of effective management*** – perhaps the least attractive alternative on the menu of options would be to consider migration of seat or residence/place of effective management of the Dutch SPV. Tax treaty changes make migrating residence more difficult than it was historically. And migrating either seat or residence comes with the risk of potential challenge by the Dutch tax authorities and would need to be carefully considered on a case-by-case basis.

Whatever the chosen migration path, it is clear that time of the restructuring will be of essence as most deals would include provisions effectively deducting 21% in VAT on the respective fees from the available funds payable to investors going forward.

However such a move is not without risk: whilst there is currently no indication that the Irish tax authorities will follow the Dutch tax authorities and narrow the scope of their exemption, it is possible that subsequent events will force them

to do so, for example another CJEU decision (perhaps an appeal of the current Dutch action), or even action by the Commission.

Position on payment (and funding) the "back VAT" amount will also require careful consideration.

WHAT ARE THE WIDER IMPLICATIONS?

As well as CLOs, there are other special purpose vehicles in The Netherlands which currently rely upon the "special investment fund" exemption. Their VAT position must now be in doubt.

And, as noted above, there is a risk that other tax authorities eventually follow the Dutch tax authorities. That would impact CLOs and a variety of other funds and capital markets SPVs across the EU.

It must therefore be good practice for those structuring new CLOs and capital markets SPVs carefully to consider how the entity would be impacted by future changes in the VAT treatment of the services it receives. Are the economic consequences clear in the note documentation? How would unexpected VAT be funded? Are there substitution provisions which assist trustees to respond quickly to potential restructurings? These issues will undoubtedly remain in sharp focus from now on.

Please reach out to your usual Clifford Chance contact if you would like to discuss any of the above.

CONTACTS

Michiel Sunderman
Partner, Tax

T +31 20 711 9658
E michiel.sunderman@cliffordchance.com

Willem Specken
Senior Counsel, Tax

T +31 20 711 9102
E willem.specken@cliffordchance.com

Nolan Groenland
Senior Associate, Tax

T +31 20 711 9159
E nolan.groenland@cliffordchance.com

Dan Neidle
Partner, Tax

T +44 207006 8811
E dan.neidle@cliffordchance.com

Jessica Littlewood
Partner, CLO

T +44 207006 2692
E jessica.littlewood@cliffordchance.com

Bruce Kahl
Partner, Trusts

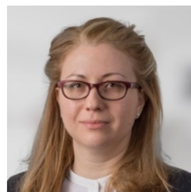
T +44 207006 2419
E bruce.kahl@cliffordchance.com

Robert Villani
Partner, CLO

T +1 212 878 8214
E robert.villani@cliffordchance.com

Frank Graaf
Of Counsel, CLO

T +31 20 711 9150
E frank.graaf@cliffordchance.com



Julia Tsybina
Counsel, CLO

T +44 207006 4368
E julia.tsybina@cliffordchance.com

Samantha Loh
Senior Associate, CLO

T +44 207006 4506
E samantha.loh@cliffordchance.com

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

© Clifford Chance 2020

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571

Registered office: 10 Upper Bank Street, London, E14 5JJ

We use the word 'partner' to refer to a member of Clifford Chance LLP, or an employee or consultant with equivalent standing and qualifications

If you do not wish to receive further information from Clifford Chance about events or legal developments which we believe may be of interest to you, please either send an email to nomorecontact@cliffordchance.com or by post at Clifford Chance LLP, 10 Upper Bank Street, Canary Wharf, London E14 5JJ

Abu Dhabi • Amsterdam • Barcelona • Beijing • Brussels • Bucharest • Casablanca • Dubai • Düsseldorf • Frankfurt • Hong Kong • Istanbul • London • Luxembourg • Madrid • Milan • Moscow • Munich • Newcastle • New York • Paris • Perth • Prague • Rome • São Paulo • Seoul • Shanghai • Singapore • Sydney • Tokyo • Warsaw • Washington, D.C.

Clifford Chance has a co-operation agreement with Abuhimed Alsheikh Alhagbani Law Firm in Riyadh.

Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.