

News Analysis: ECJ Decision Clarifies VAT Treatment of Factoring Transactions

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The European Court of Justice's October 27 decision in *Germany v. GFKL Financial Services* (C-93/10) clarifies the VAT treatment of factoring transactions, which has been an area of uncertainty since a previous ECJ decision. (For the decision in *Germany v. GFKL Financial Services* (C-93/10), see *Doc 2011-22610* or *2011 WTD 209-14*.)

The issue with the VAT liability of factoring services is that in most cases, no credit or refund in the form of input VAT is available, making the VAT a cost position. In 2003 the ECJ rendered a decision in the German case *MKG-Kraftfahrzeuge-Factoring GmbH* that significantly affected the VAT treatment of factoring transactions in the EU.¹ Besides creating much uncertainty, the decision made factoring services subject to VAT, although they had previously been considered VAT exempt. It was unclear which factoring transactions would be subject to VAT, and if VAT were due, what the tax basis would be.

Before MKG

Before *MKG*, German and Austrian VAT law distinguished between "true factoring" and "quasi-factoring." True factoring — the purchase of debts with full assumption of the risk of default — was not considered to constitute a business activity for the factoring company because it wasn't treated as a supply for consideration when purchasing or when recovering the debt.² Quasi-factoring occurs when the assignor assigns to the factor (the assignee) debt claims arising from the supply of goods or services but remains fully liable for the debtors' ability to pay the debt claims; economically, the assignor is still the owner of the

claims, but it receives a prepayment from the factor constituting a financing transaction. In addition to providing financing, the factor carries out the following activities for the assignor in a quasi-factoring transaction: assessment of debtor solvency, management of debtor accounts, preparation of analyses and statistical material, and debt collection. While the grant of financing was VAT exempt, the other services provided by the factor were taxable.³

After MKG

The ECJ held in *MKG* that there was no difference in the VAT treatment of true factoring and quasi-factoring transactions and that in both kinds of transactions, the factor (assignee) renders a service to the assignor. The Court stated that in both cases, "the factor makes supplies to the client [the assignee] for consideration and accordingly pursues an economic activity" and that "[any] other interpretation would draw an arbitrary distinction between those two categories of factoring and would make the business concerned bear, in the course of certain of its economic activities, the cost of the VAT without giving it the possibility of deducting that cost in accordance with Article 17 of the Sixth Directive."

Although the ECJ did not recognize different services to be rendered during a factoring transaction, the Austrian and German authorities took the position that the factor's services could be split into a debt collection part and a financing part; however, that separation doesn't apply in Germany if the financing part is ancillary to the debt collection part.⁴ Further, if a factor acquires claims but renders no services to the assignor in the form of financing, managing debtor accounts, or

¹*Finanzamt Gross-Gerau v. MKG-Kraftfahrzeuge-Factoring GmbH* (C-305/01), June 26, 2003, *Doc 2003-16551*, *2003 WTD 135-7*.

²German Federal Finance Court (Bundesfinanzhof, or BFH), Dec. 10, 1981 (V R 75/76; BStBl II 1982, 200).

³Kanduth-Kristen in: Berger et al. (eds.), *UStG-Kommentar2* (2010), section 6 Ann. 165.

⁴German VAT regulations section 29a(2); Austrian VAT Regulations Ann. 757; *Kanduth-Kristen*, *supra* note 3, section 6 Ann. 168.

collecting claims, no VAT is due.⁵ The same should hold true if the factor doesn't provide the service of collecting the claims.⁶

The VAT base for the services rendered in a factoring transaction was the difference between the nominal amount of the debt claims and the purchase price paid by the factor. In factoring nonperforming loans, the nominal amount was replaced by the value of the loan claims. The VAT base was therefore the difference between this value and the purchase price.⁷ In one case in which the assignment of a nonperforming loan was executed similarly to a factoring transaction and treated as such by the Austrian fiscal authorities, the Austrian Administrative Court concluded that no factoring transaction took place because a nonperforming loan was at stake.⁸

The uncertainties caused by the ECJ's decision in *MKG* are obvious: What kinds of transactions are covered by the decision, and, if covered, could the services rendered by the factor be separated in order to be treated differently for VAT purposes?

GFKL

In *GFKL*, a German company purchased mortgages on real estate and debt claims relating to 70 loans from a bank after the loans had been terminated and declared mature; in other words, the purchased debts were defaulted.

Distinguishing *GFKL* from *MKG*, the ECJ emphasized that in *MKG*, the assignee of the debt claims undertook to provide factoring services to the assignor, in return for which it received payment, namely a factoring commission and a fee for taking over the default risk. The Court concluded that because the factor in *GFKL* received no consideration, it did not carry out an economic activity or make any supply of services. The ECJ took a rather formalistic approach when reaching the conclusion that if no factoring commis-

sion and *del credere* fee are charged, no such services are agreed to that are relevant for VAT purposes.

The parties of the assignment transaction executed in *GFKL* described how they arrived at the purchase price of the assigned loan claims, stating that the claims dropped in value and that from that value, a portion must be discounted based on a present-value calculation because of the financing component of the transaction. The ECJ concluded that because the parties determined the purchase price in detail, no factoring commission and *del credere* fee were charged and therefore no services were rendered. The Court held that the discount was not a payment intended to provide direct remuneration for a service supplied by *GFKL*. Although the Court did not go into a substance-over-form discussion, that doesn't mean the substance perspective should be dismissed; it would probably be relevant if the parties had disguised a factoring commission or *del credere* fee as a discount.

After GFKL

One could argue that the *GFKL* decision provides no clarity on typical factoring transactions since the case concerned defaulted debts, not the standard debts commonly involved in a factoring transaction. Although that argument is valid — Austrian and German sources concur that in acquiring nonperforming loans, no typical factoring services are provided⁹ — the ECJ itself referred to *MKG* and elaborated under which circumstances its principles don't apply.

Those circumstances leave no room for doubt: If the parties explicitly set forth how to arrive at a purchase price for debt claims and this calculation does not take into account remuneration for factoring services or for taking over the default risk, no such services that would be subject to VAT were rendered. In effect, the ECJ agrees with the Austrian and German authorities: Only factoring services rendered in the course of assigning debt claims are subject to the tax law consequences of the *MKG* decision; a financing component and other aspects are not subject to VAT. ◆

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⁵Austrian Administrative Court (Verwaltungsgerichtshof, or VwGH), Nov. 11, 2008 (2006/13/0088).

⁶Ruppe, *UStG-Kommentar3* (2005), section 1 Ann. 188/1; German VAT regulations section 18(10).

⁷Ruppe, *supra* note 6, section 4 Ann. 51; German VAT regulations section 18(11).

⁸See *supra* note 5.

⁹Scheiner, Kolacny, and Caganek, *Kommentar zur Mehrwertsteuer*, section 6 Ann. 36; Hahne, *Betriebsberater* 2008, 880; Finanzgericht Düsseldorf on Feb. 15, 2008, 1 K 3682/05 U (in its decision that ultimately led to the *GFKL* case).