

# Flash News

## Decision on the VAT treatment applicable to transfers of non-performing receivables

28 October 2011

The Court of Justice of the European Union decided on 27 October 2011 that there is no service in the scope of VAT performed upon purchasing a discounted portfolio of non-performing receivables (distressed debt). This decision has a wide impact in the frame of debt restructuring processes, which were and remain an important topic for the financial services industry.

### Background

On 27 October 2011, the Court of Justice of the European Union's ("the Court") delivered the judgment in case C-93/10 GFKL Financial Services AG ("the GFKL case").

The disputed matter was whether a purchase of defaulted debts by GFKL from a bank ("the Bank"), for a price below the debt's face value (discounted price), constitutes a service rendered by the purchaser to the vendor, which is in the scope of VAT. If yes, what should the taxable amount of that service be?

The Decision was preceded by Advocate General Jääskinen's ('AG') Opinion from 14 July 2011.

More details regarding the background of and the AG's Opinion on this case can be found in our Flash News of 15 July 2011.

The reference to the Court was made in order to clarify the scope of the judgment in case C-305/01 MKG-Kraftfahrzeuge-Factoring ('MKG'). In that case, the Court held that an economic activity by which a business purchases debts, assuming the risk of

the debtors' default and, in return, invoices its clients in respect of commission, constitutes a supply of service representing debt collection, which is subject to VAT.

The MKG case generated large debates, most of them surrounding the question whether the verdict of the Court should apply to all debt assignment cases or whether such decision should be regarded as applying only in certain circumstances as it was in the MKG case.

In Germany, for instance, the VAT authorities were of the opinion that the purchase of a portfolio of distressed debt could be seen in certain circumstances as a supply of a service to the vendor, i.e. releasing the vendor from the risk of default and taking care of the debt collection. The deemed remuneration of that service was the difference between the economic value of the debt and the purchase price. That remuneration was subject to VAT.

In Luxembourg, no written public guidance was available.

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## The Decision

The Court followed the AG's preferred reasoning and conclusion on this case, namely that there is no supply of a service in the VAT scope performed by GFKL to the Bank upon purchasing a portfolio of distressed debt.

Firstly, the Court observed that there was no specific agreed commission paid by GFKL to the Bank, unlike as per the facts of the MKG case.

Further on, the Court admitted the existence of a difference between the nominal value and the purchase price of the non-performing receivables. However, the Court took the view that this difference does not represent the consideration for a supply of a service, but a reflection of the actual economic value of the debts at the time of their assignment, which results from the fact that they are doubtful and from the increased risk of default of the debtors.

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## Potential implications

The main consequence of the Decision is that no VAT should apply on the acquisition of portfolio of defaulted debts acquired at a discounted price to the extent that no consideration for a service is paid.

The Decision should reduce the lack of legal certainty arising from the heterogeneous interpretation of the treatment of these transactions amongst the EU triggered mainly by the specific facts and outcome from the MKG case.

It should thus create a clearer legal environment, being for sure welcomed in the current climate at EU level where significant debt restructuring processes still occur.

Nonetheless, in our view, a number of questions remain outstanding with regard to this type of transactions, notably:

- **Are entities having as sole activity the purchase and recovery of debts a taxable person from a VAT viewpoint?**

The answer to this question will be of interest in order to tackle issues like the place of taxation of cross-border services these entities may be receiving, the VAT law applicable to determine whether VAT applies or these services are exempt, the capacity of these entities to recover input VAT, the VAT compliance obligations, etc.

- **What happens if the purchase price of the receivables does not equal their actual economic value (fair market value)?**

The sensitivity of this question may vary depending on the terms and conditions of the transactions and possibly transfer pricing requirements.

- **What is the VAT treatment applicable to the sale of the portfolio from the vendor's perspective?**

This was not a question in this case, however echoes of a VAT exemption can be found in the AG's Opinion. Can this conclusion be reached for other types of financial transactions involving a transfer of the right to cash an amount of money?

- **Is input VAT incurred by the vendor in relation to the transaction recoverable?**

As we can see, this judgement brings clarity on some aspects of distressed debt related transactions, but at the same time triggers the need to consider possible side effects.

In any case, businesses in this sector of activity need as a matter of priority to run a VAT health check of their activities to assess possible opportunities or risks that may be created by this evolution of this jurisprudence of the Court. A fresh look may also be needed for new transactions and the set-up of new acquisition structures.

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