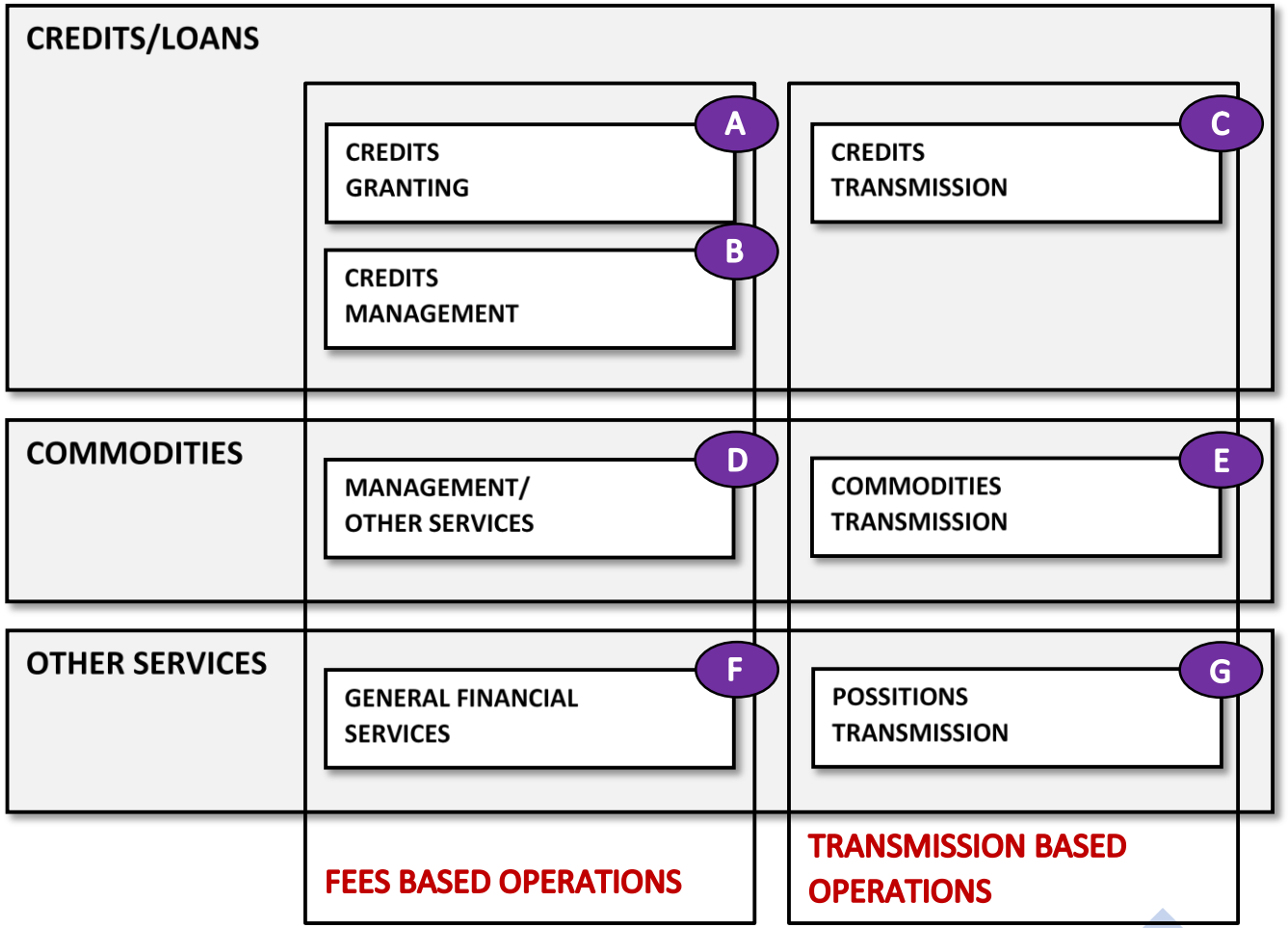
FINANCIAL TRANSACTIONS AND VAT PROPORTIONAL DEDUCTION



Author: Francisco Javier Sánchez Gallardo

BACKGROUND (I)

- In 28-11-2007, the European Commission presented its **proposal** for the **modernization** of the VAT Directive regarding the treatment of **financial and insurance** transactions [Document COM(2007) 747 final]. This proposal was finally not adopted and withdrawn.
- In its "Communication from the Commission to the European Parliament and the Council an Action plan for fir and simple taxation supporting the recovery strategy", [document COM(2020) 312 final, dated 15-7-2020], the European Commission, considering the existing EU VAT provisions on **financial services** declared that *"it will present a legislative proposal for amending these outdated provisions. The modernisation will take account of the rise of the digital economy (fintech) and the increase in the outsourcing of input services by financial and insurance operators as well as the way this sector is structured."*
- Most likely, the proposed proposal will address the updating of the current rules on the **exemption** of financial transactions, taking into account the evolution of the financial industry in the last decades.
- The European Commission has opened a process of **public consultation** to obtain opinions on the matter. Link is attached:

https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12671-Review-of-the-VAT-rules-for-financial-and-insurance-services

BACKGROUND (II)

- An issue that probably will not be addressed, but of great relevance in this area, is the **impact on the right to the input VAT deduction** of these operations.
- Not surprisingly, the difficulty of the issue has been pointed out by the ECJ as **justification for the exemption** (judgments of 19-4-2007, Velvet & Steel Immobilien und Handels, C-455/05, 10-3-2011, Skandinaviska Enskilda Banken, C-540/09, and 12-6-2014, Granton Advertising, C-461/12).
- This solution is **misleading**, since, even if they are exempt operations, their effect on the right to deduct must be settled.
- For these purposes, it seems convenient, in my humble opinion to **distinguish** between operations paid for by means of consideration (interests, commissions, fees, etc), which do not involve a transfer of assets, and operations in which there is such a transfer. Also considering the typology of existing transactions, we can differentiate the **categories** represented in the graphic on the first slide.

A. THE GRANTING OF CREDITS

- The granting of credits is an **exempt transaction**. The exemption has been admitted even when operations are carried out by non-financial entities (judgment of 27-10-1993, Muys' en De Winter's Bouw- en Aannemingsbedrijf, C-281/91).
- In this case, the impact on the proportional deduction of VAT is easy to quantify: the **interests** corresponding to the credits granted quantified by reference to the relevant time period.
- **Additional elements**:
  - The **nature of the retribution** obtained (interests, commissions or others) should not be relevant for these purposes.
  - Although the funds used to grant credits have a cost, the amount that should be calculated is the **gross amount** obtained from the credits granted.
  - Even if the client does not pay, the interests on the financing granted should be considered when determining the proportional deduction or pro rata. Only if the taxable base is modified for **non-payments** following the corresponding procedures and requirement should the opposite be admitted.

B. CREDITS MANAGEMENT (AND OTHER RELATED SERVICES)

- If the granting of credits is exempt from VAT, other **operations** related that can be considered as **ancillary** should follow the same treatment (judgments of 25-2-1999, CPP, C-349/96, and 21-6-2007, Ludwig, C-453/05).
- When determining if we are dealing with accessory operations, the **general criteria** of the ECJ should be applied (judgments of 25-2-1999, CPP, C-349/96, or 21-2-2013, Město Žamberk, C-18/12, among others):
  - If the additional management services are provided by the entity granting the credit, they could be easily considerer as ancillary, equally exempted.
  - In case the services are provided by a third party, the exemption could be challenged.
- For any of these operations, its computation in the pro rata should be the amount of **its consideration**, something which, in principle, should not be difficult to be settled.

C. CREDITS TRANSMISSION

- The assignment of credits is a transaction that has generated **contradictory jurisprudence** in the ECJ:
  - The judgment of 26-6-2003, MKG-Kraftfahrzeuge-Factory, C-305/01, considered that in factoring contracts the entity that provides the service is the one that acquires the credits, assuming the risk of the debtors' default, to manage their **collection**. Such a supply constitutes debt collection **excluded from the exemption**.
  - In the judgment of 27-10-2011, GFKL Financial Services, C-93/10, the ECJ declared that an operator who, at his own risk, purchases **defaulted debts** at a price below their face value does not effect a supply of services for VAT purposes when the difference between the face value of those debts and their purchase price reflects the actual economic value of the debts at the time of their assignment.
- To determine its **impact** on the **proportional deduction**:
  - For the **usual factoring services**, whether they are exempted (pure funding, not expressly faced in the MKG case) or not, their measure should be the corresponding fees or commissions retained by the factor.
  - For **defaulted debts**, it seems convenient to distinguish:
    - Prior to their transmission, the amount to be computed should be the **interest** accrued according to the corresponding contracts, regardless of whether they have been paid by the clients or not.
    - The fact that it is understood that their acquirer does not provide any service when it purchases them for a price that reflects their true economic value does not imply that the sale has no impact on their seller.
    - To measure this impact, it would be necessary to distinguish between its **depreciation** for solvency reasons and the **advance in the collection of interest** that its transmission implies. This second amount should be considered for these purposes.

D. COMMODITIES, MANAGEMENT/OTHER SERVICES

- **Management** services related to securities:
  - They are exempt when they involve a **modification** of the **legal and financial position** of the intervening parties (judgment of 12-13-2001, CSC Financial Services, C-235/00).
  - **Discretionary portfolio management services**, in which the manager decides, according to his own criteria, on the purchase and sale of securities and executes said decisions by buying and selling the securities, are VAT taxed (in these cases, the execution of the purchase and sale orders is ancillary to the management and is also taxed) (judgment of 19-7-2012, Deutsche Bank, C-44/11, relatively contradictory with the previous one).
- These services, which do not imply any transfer of said commodities by their owners, should impact the proportional deduction in the amount of the **consideration received** by them, which does not seem a particularly controversial issue for these purposes.

E. COMMODITIES TRANSMISSION (I)

- The transfer of securities involves carrying out **VAT-exempt transactions**. The foregoing must be understood (judgment of 29-10-2009, SKF, C-08/29):
  - Regardless of the status of the seller,
  - Without prejudice to the fact that the rule of non-subjection for the sale of ongoing businesses that is established in article 19 of the VAT Directive may apply.
- Regarding its **impact on the pro rata**, the following must be taken into account:
  - in the case of **shares in subsidiaries** that have been **managed for several years**:
    - The amount obtained can include the revaluation generated during all those years for, something which can provoke a disproportionate impact.
    - Even if they were **considered as investment goods** according to article 189 of the VAT Directive, their calculation could be understood to be mandatory (judgments of 6-3-2008, Nordania Finans, C-98/07, or 29-10-2009, NCC Construction Danmark, C-174/08), which means that the problem persists.
  - In the case of the sale of **commodities** or fungibles, profitability is obtained by multiple purchase and sale operations with gains and losses. For these operations, OTC or not, taking it as a reference for the simple consideration does not seem appropriate (judgment of 14-7-1998, First National Bank of Chicago, C-172/96).

E. COMMODITIES TRANSMISSION (II)

- **Alternative approaches**, which are better adapted to a philosophy of proportional attribution of the goods and services acquired for use in operations that generate the right to deduction and others that do not:
  - Are **acceptable** (judgment of 7-10-2014, Banco Mais, C-183/13)
  - Provided that they are **more accurate** than the strict application of a proportional distribution based on the turnover figures (judgments of 18-10-2018, Volkswagen Financial Services (UK), C-153/17, or 30-4-2020, CTT-Correios de Portugal, C-661/18).
- In this situation, there are several **options**:
  - One possibility would be the reference of the amount to be computed to the **margin obtained in a certain time period**. This option raises some additional questions, such as the following:
    - The adequacy of the acceptance of negative margins in some transactions and, if so, the scope of the compensation, that is, the determination of the transactions whose positive and negative margins could be offset to determine the final amount to be considered.
    - Its possible **limitation** to operations with **fungibles**, that is, commodities different than shares in subsidiaries to which services have been provided and, consequently, it can be considered that had a special relationship with their holding company.
  - For the latter, and assuming that the multi-year impact is properly justified, a certain **periodification** should be acceptable.
  - Other methods of valuation of the transaction, by means of which the **consumption of inputs** for its realization was evaluated (for example, a third- and independent-party management fees), could also be analyzed.

F. GENERAL FINANCIAL SERVICES

- In the case of operations in which there is a **consideration as such**, it does not seem controversial that its amount is the magnitude that should be computed for these purposes.
- The foregoing must be understood without prejudice to:
  - Difficulties in the delimitation of **some exemption cases** (judgments of 28-6-2007, JP Morgan, C-363/05, or 7-3-2013, Wheels, C-424/11).
  - The need to compute the amounts that taxpayers make their own, although engage third providers for some functions **outsourcing** (judgments of 5-6-1997, SDC, C-2/95, or 3-10-2019, Cardpoint, C-42/18).

G. POSSITIONS TRANSMISSION

- Once again, we are faced with the **provision of services** for VAT purposes.
- Unless there is a specific case of exemption applicable, these transactions will **not** be **VAT exempted** (judgment of 22-10-2009, Swis Re Germany Holding, C-242/08, related to an insurance contracts portfolio transmission, but perfectly applicable).
- In certain assumptions, **dysfunctions** similar to those indicated in the comments to situation E may occur, when accumulating in a single transaction that impacts the pro rata of one year, income that, in other circumstances, could be received periodically.
- As in case E, in this situation, there are several **options**:
  - With the same precautions that we have indicated in the comment to situation E, and assuming that the multi-year impact is justified, the same **periodification** that was proposed in that case could be maintained in this one.
  - Other methods of valuation of the transaction could also be used, by means of which the **consumption of inputs** was evaluated for its realization.

SOME OTHER QUESTIONS

- **Other relevant issues** for these purposes are the following:
  - The **obligation to computer financial operations** for the calculation of the proportional deduction when such operations are carried out by non-financial entities, which article 174.2 of the VAT Directive subordinates to the fact that they are non-accessory, with varied jurisprudence for these purposes (judgments of 29-4-2004, EDM, C-77/01, 11-7-1996, Régie dauphinoise, C-306/94, or 29-10-2009, SKF, C-08/29).
  - The impact of the existence of **fixed establishments**, once again with contradictory statements regarding the impact of operations on the proportional deduction (judgments of 12-9-2013, Le Crédit Lyonnais, C - 388/11, and 24-1-2019, Morgan Stanley, C-165/17).
  - The treatment of **financial leasing operations**, both in terms of their qualification as deliveries of goods (judgment of 4-10-2017, Mercedes-Benz Financial Services UK, C-164/16, among others) and regarding their impact on the deduction pro rata (judgment of 7-10-2014, Banco Mais, C-183/13).

FINAL COMMENTS

- At the end of the day, **what is intended** with the pro rata **is to calculate a proportion**:
  - The application of this principle to operations carried out with financial assets is difficult, hence the exemption.
  - The foregoing, however, should not lead to dysfunctions such as those existing nowadays.
  - The differences between the EU States in the right to deduction (despite VAT being a harmonized tax), additionally hinder any type of progress in this area, which does not prevent individual initiatives on their part.
- Additional information about some of those topics can be found in the book **"ECJ case-law on VAT"**, also **available electronically** and whose link is attached:

https://www.efl.es/catalogo/manuales-juridicos/ecj-case-law-on-vat