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Tax services

VAT treatment of loan sub-participations

CJEU holds that agreements are VAT exempt credit transactions

Executive summary

On 6 October 2022, the Court of Justice of the European Union (CJEU) released its judgment in the *O. Fundusz Inwestycyjny Zamknięty reprezentowany przez case (C-250/21)*. The case focused on the VAT treatment of sub-participation agreements, which allow a bank or lender to transfer its risk on an underlying loan to a third party.

The CJEU rejected the approach set out in the Advocate General's (AG) Opinion and has held that these agreements constitute VAT exempt credit transactions. In her earlier Opinion, the AG had argued that the sub-participations constitute a risk management service which should be subject to VAT.

This judgment will be welcomed by banks and lenders which would have faced additional VAT costs had the Court followed the AG's Opinion.

Background

A sub-participation agreement allows a lender to transfer all or part of the risk and reward of a loan it has issued to another party, the sub-participant. Depending on whether the sub-participation is funded or unfunded, the sub-participant may need to make an upfront payment to the lender. Thereafter, as amounts are received from the borrower, the lender will pass them back to the sub-participants. Although risk and reward of loans effectively pass, whether in whole or part, to each sub-participant, the underlying loan remains in place. There is no loan novation and no syndicated loan under which lenders each take a tranche of a larger loan.

In this referral, the CJEU was asked to consider whether sub-participation agreements fell to be VAT exempt "transactions concerning the granting and the negotiation of credit and the management of credit" or not. The question put before the CJEU was narrow and it was not specifically asked to consider what alternative exemptions or treatments could apply.

In practice, sub-participations may be used for a variety of reasons. Whilst their use does de-risk the lender, they are also used to give investors access to lending opportunities. This dual purpose was recognised in the judgment and, indeed, in this case the sub-participant was an investment fund.

Judgment

The judgment began by considering whether a supply for VAT purposes existed and, if so, which party was the supplier, and which was the customer. In the CJEU's view, the sub-participant provided a service to the lender when it made a 'financial contribution available' to the lender in return for the lender agreeing to transfer loan receivables to the sub-participant. This conclusion echoed the AG's Opinion but, in considering the purpose and nature of that service, the CJEU deviated from the logic put forward by the AG.

As a recap, the AG's Opinion argued that a sub-participant was providing a risk management service which lacked the formal characteristics of a loan. Because of this, the AG considered that the service should be subject to VAT. The Court's full judgment appears to have rejected this approach preferring a 'substance over form' analysis. In its view, whilst exemptions should be interpreted narrowly, this needs to be done consistently and in a way which ensures fiscal neutrality.

The CJEU has concluded that sub-participations do replicate the terms of a typical loan. The sub-participant makes a 'payment of capital in return for remuneration' (para 36), thereby replicating the key characteristics of a traditional loan. The sub-participant assumes risk on the amount it has forwarded, a hallmark of any grant of credit.

Unlike the AG's Opinion, the judgment does not go into detail on the purpose and benefits of sub-participations. It does recognise that these agreements have a dual function – the provision of credit and of risk cover – but does not take this analysis any further, instead focusing on the fact that sub-participations share the characteristics of a standard loan.

Implications

This judgment provides a welcome clarification for banks and lenders. Had the Court followed the AG's Opinion, VAT may have been due on the full value of every sub-participant's 'fee' (i.e., amounts paid away by the lender). The addition of VAT to sub-participations would have materially impacted their attractiveness given VAT charged to the lenders would likely have been irrecoverable, either in whole or part.

The wider applicability of the judgment is interesting. The CJEU's logic is clear that a service which exposes a third party to potential losses in return for a payment ought to attract the same treatment as a standard loan arrangement. Whether this is true in practice and in all cases is, however, not clear and Tax Authorities have often struggled to assign a VAT treatment to complex financing arrangements which replicate a loan's characteristics, including securitisations.

The CJEU's conclusion also appears to be anchored to the facts of the case in which a capital amount was paid to the lender in return for the payment of proceeds from loan receivables. If this upfront payment is not present, it is not wholly clear whether the CJEU's conclusions automatically apply to other products which result in the transfer of a risk or reward to a third party. Of course, even if 'capital' payments are not present, the product may fall under a different exemption heading, but this would need to be considered on a case-by-case basis.

How we can help

Although this judgment is unlikely to generate additional costs, it does highlight the uneasy interaction of VAT rules and investment banking products. Many of these have a split function – part risk management, part investment – and there is a need to monitor both their purpose and their form.

We can assist businesses to understand and manage issues and complexities as they arise across Europe's financial markets.

Further information

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