ECJ: Acquisition of non-performing loans not subject to VAT “when” …

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Decision by the European Court of Justice (EJC) dated 27 October 2011 in Case C-93/10

One of the main controversial points in the context of transactions involving defaulted debts (= non-performing loans) has been decided upon:

In his decision dated 27 October 2011 regarding case C-93/10, Finanzamt Essen-Nordost v. GFKL Financial Services AG, the European Court of Justice held that in the case at hand the transfer of defaulted bank debts to a buyer, as well as the acquisition of the credit risk and debt collection by the buyer, is not subject to VAT (Value Added Tax).

The ECJ follows the opinion stated by the Advocate General of the ECJ, Niilo Jääskinen, on 14 July 2011 who held that the discount from the face value reflects the current market value of the debts and not a remuneration rewarded by the bank that is directly linked to any service of the buyer (cp. our Legal Insight on the Advocate General’s opinion and the history of this legal controversy).

Consequently, the court held that – unlike in cases of factoring such as in Case C 305/01 MKG-Fahrzeuge-Factoring – the acquisition of defaulted bank debt at one’s own risk at a price below face value does not effect a supply of services for consideration and that thus, the buyer does not carry out an economic activity within the former Sixth Directive (today cp. Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax).

However, the ECJ decision is explicitly subject to the condition (“when”) that 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. In other words, the seller must not grant any remuneration to the buyer for the collection of the debts or the assumption of the credit risk.

It remains to be seen whether the (German) tax authorities will, in practice, be tempted to use this condition to challenge agreements between the parties in respect of the purchase price of non-performing loans as (typically) reflecting or not the actual economic value. And if so, what level of documentation in the purchase agreements would be required by the parties to “prove” the economic value of the non-performing loans at the point of their assignment.

Despite this uncertainty, the decision is a very positive one. The uncertainty should hopefully be overcome by properly documenting the considerations of the parties in respect of the determination of the actual economic value of the debts in a manner comparable to the stipulations in the documentation as described by the ECJ in the case at hand.

The decision does not contain any explicit statements regarding non-defaulted debts. The treatment of VAT until now with regard to “true” and quasi-factoring, i.e. where the seller remains fully liable with regard to the debtor’s ability to pay, is not called into question.