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VAT & SECURITIZATION VEHICLES, WHY PROPER STRUCTURING IS KEY

I. Introduction

Over the years, Luxembourg became a leading center for securitization and structured finance transactions, thanks to a reliable and investor-friendly legal and tax framework.

Indeed, the applicable provisions (Law of 22 March 2004 & EU Regulation 2017/2402) provide for a flexible approach regarding the securitization's definition, the range of assets that can be securitized (movable or immovable, tangible or intangible), the legal form of the vehicle(s) that can be used for structuring the transaction, or the ability to use compartments to segregate the assets and liabilities within the securitization vehicle ("SV").

In particular, the Luxembourg legislation defines securitization as the transaction by which a securitization undertaking: 1) acquires or assumes, directly or indirectly through another undertaking, risks relating to claims, other assets, or obligations assumed by third parties or inherent to all or part of the activities of third parties, and 2) issues financial instruments or contracts, for all or part of it, any type of loan, whose value or yield depends on such risks.

From a VAT standpoint, SVs are commonly considered as VAT taxpayers ("assujetti") per se, usually not entitled to any input VAT recovery. However, any potential VAT leakage is mitigated by the VAT exemption that applies to the management services provided to such SVs, provided they meet the criteria laid down by the European Court of Justice ("ECJ") in terms of "*being specific to and essential for the activity of managing special investment funds*".

As regards the transfer of the risks to the SV, the Luxembourg legislative framework covers different scenarios, with the SV acquiring the legal title to the assets directly ("true sale"), by using credit derivatives ("synthetic securitization") or by committing itself in any other way.

It is in the case of "synthetic securitization" that the EJC recently issued a decision in the case "O. Fundusz" (Case C 250/21, 6 October 2022, Szef Krajowej Administracji Skarbowej v O. Fundusz Inwestycyjny Zamknięty reprezentowany przez O S.A) which is worth taking into consideration when structuring a new securitization transaction.

II. How to qualify the transfer of proceeds of receivables to the SV ?

The dispute with the Polish tax authorities in the above case originates from the request of Fund O., a Polish based securitization fund, for a tax ruling on the VAT treatment of the transfer of all the proceeds from the receivables of the originator (i.e. the banks/investment funds) in exchange for a contractually agreed financial contribution. For the sake of clarity, the debt securities remained in the assets of the originator. The difference between the financial contribution paid by Fund O. to the originator and the amount obtained by Fund O., during the term of the agreement, constitutes the Fund O.'s remuneration.

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The mechanism thus fulfils a dual function, namely, first, that of a credit instrument, the originator receiving liquidity in advance in exchange for the commitment to transfer the proceeds from the receivables concerned to Fund O. and, second, that of risk cover, in so far as that liquidity is released from the credit risk attached to those receivables.

In its decision, the ECJ confirms that in the case at hand, Fund O. provides a service “for consideration” to the originator. It is irrelevant that the remuneration does not take the form of a commission, of an interest or of a specific fee.

Regarding the qualification of that service, from a VAT perspective, the Court did not follow the conclusions of Advocate General Medina and found that the agreement between Fund O. and the originator is made up of a single supply "which consists, essentially, in a payment of capital in return for remuneration". Therefore, for the Court, the features of this transaction are similar to the granting of a credit: Fund O. bears the risk of credit in so far as the debt securities remain in the originator’s assets and it is exposed to the insolvency of the debtors of the receivables, whereas the absence of guarantee (from the originator) is not decisive for the qualification of this supply as a credit transaction. Applying the exemption of article 135(1)(b) of the Directive 2006/112/EC (“VAT Directive") to that transaction is, according to the Court, consistent with the objective of that provision which consists in avoiding an increase in the cost of consumer credit.

III. Transfer of receivables - some points of attention

It is not the first time that the ECJ examines similar securitization transactions, where receivables are transferred in one form or another:

- In case **MKG-Kraftfahrzeuge-Factoring** (Case C-305/01, MKG-Kraftfahrzeuge-Factory GmbH, 26 June 2003), the Court held that a transaction by which a business purchases debts, assuming the risk of the debtors’ default, in return for a remuneration, constitutes debt collection and factoring services, excluded from the VAT exemption for financial services and therefore taxable. In MKG, the Court did not examine whether MKG, when purchasing the debts from MMC-Auto Deutschland GmbH, made available any capital to it for consideration. The main difference probably lies in the fact that in MKG case, the debts were transferred to the factor, together with the risk of the debtors’ default. By contrast, in Fund O. case, even if Fund O. had no recourse against the originator, the debts remained on the originator' balance sheet, only the proceeds of the receivables were transferred to Fund O. Therefore, in case of a “true sale” type of securitization, one should pay specific attention to the risk that the transaction be rather seen as (taxable) debt collection services provided to the originator.

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- In case GFKL Financial Services AG (Case C-93/10, GFKL Financial Services AG, 27 October 2011), the Court examined a purchase of defaulted debts by GFKL from a German bank on a non-recourse basis. It held 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 consideration and does not carry out an economic activity falling within the scope of VAT 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.

In her opinion, AG Medina points out a number of differences between the factual circumstances of GFKL and those of Fund O.:

- In Fund O., the situation is not related to the acquisition of a debt, let alone a defaulted debt, by the investment fund, but rather a transfer of the proceeds related to the receivables. Fund O. does not acquire defaulted debts at a price below their face value. Moreover, there is no change in the claim itself, meaning that, under the agreement, the originator remains a creditor of the principal debtor, while Fund O. acquires from the originator solely a claim for the payment of the amounts transferred to the originator by the principal debtor under the original loan relationship;
- Not only does Fund O. purchase the products (the proceeds of the receivables) of a portfolio of loans, but it also undertakes to bear the risk of the principal debtor's failing to pay, at the same time having no right to claim against the originator for that failure. Consequently, it appears that the originator obtains an advantage which goes beyond the mere receipt of the nominal value of the receivables of a portfolio of loans;
- The claims at issue in GFKL constituted defaulted debts, while the object of the agreement in Fund O. are loans that are not yet due and thus whose recovery cannot be determined at the time of the execution of the upfront payment by Fund O.

For the above reasons, AG Medina was of the opinion that in Fund O., as opposed to GFKL, there is a supply of a service towards the originator, which enters the scope of the VAT. Nevertheless, for the sake of completeness, it should be noted that AG Medina considered that this supply shall not benefit from the VAT exemption applicable to the granting of credit pursuant to article 135(1)(b) of the VAT Directive.

As one might see from this high-level comparison of those three cases, some slight differences in the factual circumstances and the way a securitization transaction is structured might lead to totally different results in terms of VAT impact.

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IV. Qualification of the services as granting of credit & input VAT deduction right issues

The qualification of services supplied by SVs to originators as a granting of credit that benefits from the VAT exemption of article 135(1)(b) of the VAT Directive could have a significant impact on the input VAT deduction right of the SVs depending on the place of establishment of the originators (banks/investment funds).

Article 169 (c) of the VAT Directive theoretically entitles a VAT taxpayer for an input VAT recovery when it provides VAT exempt financial services to counterparts established outside the European Union. Therefore, in case the originator is located outside the EU, it could in theory be argued that the SV performs a VAT exempt activity consisting in the granting of credit and it may be entitled to deduct the input VAT incurred on costs that are directly linked to this activity.

Nevertheless, it should pointed out that in practice the Luxembourg VAT authorities tend to deny the recovery of the input VAT to any of the investment vehicles cited under article 44§1 (d) LVL, including securitization vehicles.

Given that the qualification of the services supplied by SVs are completely fact sensitive, a VAT assessment on a case-by-case basis is absolutely needed. Depending on whether a SV could in practice have an input VAT deduction right or not, different VAT compliance obligations would also be triggered.

V. And what about the VAT treatment of the servicing fees?

This particular issue was not examined by the Court in the case Fund O., but is frequently raised in practice when structuring a securitization transaction. In particular, when the SV assumes the risk of non-payment, it will seek to get those receivables paid by the third parties debtors. It will thus appoint a service provider (which might be the originator or a specialized third party) to “service” the debt. Therefore, a key component of the service provided to the SV consists in debt recovery services, which are, as a principle, subject to VAT. Indeed, article 135(1)(d) of the VAT Directive exempts from VAT “transactions, including negotiation, concerning (…) debts (…), but excluding debt collection”.

In the context of a SV, which, in Luxembourg, is considered as an investment fund in the meaning of article 135(1)(g) of the VAT Directive, one might question whether the debt recovery services provided to the SV shall be nevertheless VAT exempt for the reason that they are “specific to and essential for the activity of managing special investment funds”. Two different provisions of the VAT directive, under the same heading of the VAT exemptions, seem to contradict each other in this specific context of a securitization transaction.

In the authors' opinion, in the context of a SV, it makes very little doubt that the debt recovery services are essential for the management of the portfolio of the vehicle and thus meet this condition.

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As regards the second condition, the Court held in DBKAG (C-58/20, judgment of the Court of 17 June 2021 K and DBKAG v Finanzamt Österreich) that "by contrast, services which are not specific to the activity of a special investment fund but inherent in any type of investment do not fall within the scope of that concept of 'management' of a special investment fund". Therefore, unless specific circumstances, debt recovery services provided to a SV, considered in isolation, should not differ too much from debt recovery services provided to other types of customers, and in that respect, do not seem to fulfill prima facie this character of being "specific" to the management of an investment fund.

VI. Conclusion

Securitization transactions remain quite complex operations, which require an in-depth analysis from a regulatory, legal and tax perspective. On the VAT side, this new ECJ case outlines the importance of a proper analysis of the project, to anticipate any possible VAT leakage that might arise when setting up the structure or during its lifetime.

VII. How could BDO help you ?

Should you have any questions on the above, or need assistance with the VAT qualification of your securitization transactions and the identification of the potential VAT implications, please feel free to contact our VAT experts.

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