

# News Flash

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**The ECJ judgement regarding the application of VAT exemption for financial services based on the sub-participation agreement**

## The ECJ judgement regarding the application of VAT exemption for financial services based on the sub-participation agreement

In this edition of our News Flash, we present you a case concerning with the application of VAT exemption for financial services, as ruled by the European Court of Justice (ECJ) in a recent period.

In the judgment C-250/21 dated October 6, 2022, the ECJ dealt with the question of, **whether the services provided by Fund O based on a sub-participation agreement with a bank or another investment fund can be considered as activities related to granting loans, which are exempt from VAT** in accordance with Article 135 of the EU VAT Directive (§ 38 of the VAT Act).

### Case background

This judgment concerns Fund O (sub-participant), which planned to conclude agreements with banks or other investment funds (originator). Within this arrangement, the originator pledged to transfer all revenue from receivables to the sub-participant, up to the contractually stipulated financial sum (greater than the actual value of the receivables).

The revenues from receivables were included in the originator's assets. The difference between the financial amount paid to the originator and the amount received by the sub-participant during the agreement represented the sub-participant's reward. **The mechanism of sub-participation serves a dual function: acting as a credit instrument and covering risks.**

Fund O requested a binding tax opinion from the Polish Minister of Finance to confirm the VAT exemption for the provided services, either as loan provision or financial guarantees. The Ministry of Finance rejected the exemption, arguing that **the agreement cannot be considered as a loan agreement due to specific aspects such as:**

- the **inclusion of the receivables within the originator's assets,**
- clear **specification of the source of financial funds** for the sub-participant,
- and the fact that **in case of the debtor's liquidation, the sub-participant has no right to claim the remaining outstanding amount** from the originator.

Additionally, as no security is provided in favour of the originator, this service cannot be considered as providing financial guarantees.

The case eventually reached the court, which considered that while this agreement indeed represents a financial service aimed at acquiring financial resources, it has specific characteristics distinguishing it from a loan agreement. Whether these features hinder the qualification of agreements as loan agreements for VAT purposes was the subject of a preliminary question posed by the national court to the ECJ.

### Credit provision and the right to deduct VAT

The ECJ has previously emphasized in its jurisdiction that VAT exemptions are exceptions to the general principle that VAT shall apply on each service provided by a taxable person for consideration. Specifically, regarding Article 135(1)(b) of the VAT Directive, which concerns the provision of credit, it should be noted that **the essence of providing loans primarily lies in providing capital for remuneration.** Although this

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remuneration is secured through interest payments, other forms of consideration cannot prevent a certain activity from being considered "provision of credit."

In the case of services provided based on the sub-participation agreement, capital is provided to the originator by the sub-participant as remuneration, representing the difference between the expected value of receivable returns and the amount of financial payment made to the sub-participant.

Since the receivables do not transfer to the sub-participant but remain included in the originator's assets, the sub-participant cannot file a claim against the originator if the debtor fails to fulfil obligations related to the receivables. **This circumstance, where the sub-participant is exposed to potential losses and assumes credit risk, characterizes every transaction involving the provision of credit.**

The fact that there are no guarantees provided in favour of the sub-participant is not decisive for the qualification of the respective agreement as a transaction involving the provision of credit according to the ECJ. Measures taken to mitigate credit risk, usually involving the provision of guarantees or other forms of security, may differ depending on the type of financing.

These measures do not have a substantial character for the purpose of such qualification, as this qualification depends only on the combination of two elements: providing capital and paying a reward.

### **The ECJ decision regarding the services provided by the sub-participant**

In this specific case, the ECJ decided that **services provided by the sub-participant based on the sub-participation agreement, consisting of providing a financial amount to the originator in exchange for the transfer of receivable proceeds specified in this agreement, which remain included in the originator's assets, fall under the concept of credit provision exempt from VAT.**

You can read more about [the right to deduct VAT](#) and tax audit process in our previous news.

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