

VAT TREATMENT OF SUB-PARTICIPATIONS

In a decision which will be welcomed by loan market participants, the Court of Justice of the European Union (CJEU) has ruled in SKAS (Case C-250/21) that the supply which a sub-participant makes to the grantor under a funded sub-participation agreement falls within the "granting of credit" VAT exemption.

By way of background, the case was a Polish referral to the CJEU and involved a party (the sub-participant) paying an upfront amount to a lender (the grantor) who had granted a loan to a borrower (the debtor). In return for that payment, the grantor agreed to pay the sub-participant the proceeds it received from the debtor. The sub-participant was a Polish securitisation fund, but other than that there did not appear to be anything to distinguish the transaction from a typical sub-participation entered into under standard form LMA documentation. It contained the usual features that the sub-participant provided liquidity to the grantor, the grantor transferred the credit risk to the sub-participant and the sub-participant had no recourse (against the grantor or the debtor) if the debtor defaults.

Earlier this year, the Advocate General (AG) opined in the case that the sub-participant's supply to the grantor did not fall within the VAT exemption for the "granting of credit" (which aligned with the assessment of the Polish tax authorities). This came as a shock to the market and practitioners alike as it is widely accepted that the consideration received by sub-participants (comprising the difference between the proceeds of the loan receivables and the upfront payment) is exempt from VAT. Notwithstanding Brexit, the shockwaves were also felt in the UK as EU case law still has persuasive authority.

The AG's reasoning was that, looking at the economic reality, the sub-participant's service to the grantor comprised two indivisible elements: providing capital to the grantor and assuming the credit risk associated with the loan. The VAT exemption would only apply if the provision of capital was the principal element of the transaction. In an unusual interpretation (which may have resulted from something in the drafting of the Polish law documentation governing the transaction), the AG did not consider that the risk management function could effectively be ignored as being ancillary to the provision of capital.

Although AG opinions are not binding, they are usually followed by the CJEU. In this case, however, the CJEU departed from the AG's opinion and held

Key issues

- A recent Advocate General's opinion in a CJEU case surprised the market by casting doubt on whether sub-participations are exempt from VAT.
- In that opinion, the Advocate General concluded that the assumption of credit risk by a sub-participant is not an ancillary function to the provision of capital to the grantor.
- The CJEU has confirmed the market view that the provision of capital is the essential element of a sub-participation such that the "granting of credit" VAT exemption applies.

(consistent with the prevailing market view) that the supply made by the sub-participant fell within the "granting of credit" exemption. This was on the basis that the key element was found to be the provision of capital for remuneration (which is the essence of the exemption) and those features which distinguished it from a traditional loan (such as the removal of risk from the grantor's balance sheet and there being no recourse against the debtor) were found not to be material for this classification.

The market can breathe a collective sigh of relief as, if the CJEU had adopted the AG's opinion (unless a different VAT exemption could be applied) the granting of sub-participations would have been a VATable supply and the additional VAT costs associated with sub-participations may have been prohibitive (as it is unlikely grantors would be able to recover them). It remains to be seen whether this case could have wider application to transactions involving the transfer of credit risk which were previously not thought to fall within the "granting of credit" exemption. Last but not least, the CJEU decision may serve to open up the Polish market to sub-participations, which has until now, remained undeveloped due to the unfavourable treatment of sub-participations by the Polish tax authorities as a VATable transaction.

If you wish to discuss any of the issues outlined in this briefing, please contact your usual Clifford Chance Finance or Tax contact.

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