

Assignment of debt and VAT 2/39/21



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Debt assignments are widely used in business. A debt assignment allows the company to turn its trade receivables into working capital. The sale (assignment) of a debt is increasingly taken to mean the transfer of a debt arising from consumer credit to licensed debt recovery service providers in order to recover the debt out of court. In practice, debt assignment has a wide range of uses – it is also used by lenders that take the original creditor's place, including individuals investing in lending platforms.

The VAT treatment of debt assignments is not straightforward and may vary according to the characteristics of each assignment. It is also a misconception that debt assignments do not require an evaluation of their VAT treatment. This article explores how debt assignments are treated for VAT purposes.

The legal framework

Under the **Civil Code** an assigned debt passes from the old creditor (assignor) to the new creditor (assignee). The assignee acquires the creditor's rights from the date of assignment and can deal with the debt on that basis – assign it to another person and enforce it against the debtor. The assignee takes over the debt with all the pertinent rights existing on the date of assignment, including interest. There are different kinds of receivables – some are not due yet and others are overdue. The opportunity to receive interest payments arising from a credit agreement during its operation is one of the reasons why the assignee enters into the transaction.

The price of a debt assignment (the fee for transferring the debt) can be equal to, smaller or greater than the face value of the loan, depending on the goal the parties pursue when entering into the transaction.

The **VAT Act** and the Cabinet of Ministers' regulations are silent on the VAT treatment of debt assignments. The only document issued by the State Revenue Service (SRS) that mentions a debt assignment is the tax leaflet "Questions and Answers about Value Added Tax Treatment." This document explains that amounts received under a debt assignment are not, according to their economic substance, treated as consideration received for a supply of goods or services and are therefore outside the scope of **VAT**.

The tax leaflet fails to explain what is meant by amounts received under a debt assignment. Is it the amount the new creditor has to pay to the former creditor for the transfer of the debt? Or is it the amount the new creditor receives from the debtor? The creditor can also receive interest payments. From the tax leaflet we might conclude that any cash flow arising from a debt assignment is outside the scope of VAT.

However, cases vary. The Court of Justice of the European Union has stated in its case law that in order to find out whether a payment received is taxable or exempt, we should first assess whether the taxpayer's transaction was performed in the course of business and then whether a supply of goods or services for consideration took place.

If we can establish that the transaction was performed in the course of business and the parties agreed on a supply of particular services (goods) and a price, the transaction is within the scope of VAT and the

question is whether it is taxable or exempt.

Since a business involves using tangible or intangible assets to make a profit in the long term, we always need to assess the link between the transaction and the company's core business activity, the purpose of the transaction, and the context in which it is carried out. The treatment of a debt assignment and related payments depends on the original transaction (what agreement forms the basis for the receivable) and on the particular circumstances under which the parties enter into the assignment.

Since the term "taxpayer" is taken to mean all persons that independently carry on a business regardless of its aim and outcome, there may be assignments that fall within the scope of VAT. This article focuses on receivables arising from cash loans.

Exemptions for financial services are prescribed by [section 52\(1\)\(21\) of the VAT Act](#), i.e. transactions specified by article 135(1)(b-f) of the VAT directive. To qualify for an exemption, the transaction must essentially be a financial transaction. Such a transaction may be supplied by a person that is not a bank or financial institution because the service provider's status does not matter. Exempt services are autonomous concepts of EU law that should be interpreted narrowly, and the member state's national laws and interpretations should not be used in interpreting those concepts.

The exemption for financial services prescribed by article 135(1)(d) of the VAT directive has not been directly passed into the [VAT Act](#), i.e. the Latvian statute lacks an exemption for transactions involving debts. However, the exemptions prescribed by article 135(1)(b-d) of the VAT directive are not optional – they exempt those services even if the national law is silent on this. Unfortunately the European case law on the scope of exemption for debt transactions is scarce, and we must remember that an exemption does not extend to debt collection.

Working Paper No. 917 on the sale of non-performing loans (cash debts), which the European Commission's VAT Committee issued on 9 February 2017, states that this transaction should be considered an exempt financial transaction for both the seller and the buyer unless the latter can treat it as a debt collection service (a taxable transaction). The VAT Committee has explained that a transaction has the characteristics of debt collection if a debt is sold below its face value and if that value does not reflect the actual economic value of the debt. The paper states that there have been discussions as to what kind of an exempt financial transaction is carried out in selling non-performing loans. Is it a transaction involving credit, a transaction involving debt, or a transaction involving securities? In this particular case the Commission favoured transactions involving debt.

Certain financial services have special procedures for measuring the value of a reportable transaction for VAT purposes, and exempt services restrict the right to deduct input tax unless they are supplied to third-country persons. As to the value of transactions, normally there are no grounds for reporting the amount paid to buy a receivable. The value of a taxable/exempt supply will depend on the type of transaction. In the case of debt collection services, this value might be the difference between the market value of the debt and its selling price if it is sold below its face value. In transactions involving performing loans, the value of the transaction might be interest payments.

So, when it comes to VAT treatment, each assignment should be assessed on its merits, considering its type and economic substance. It may also be the case that legal title to an asset is acquired as a result of debt assignment.