VAT Treatment of Factoring and Invoice Discounting

This document should be read in conjunction with paragraph 6(1)(c) of Schedule 1 to the VAT Consolidation Act 2010 (VATCA 2010)

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Revenue
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Introduction

For the purposes of this guidance:

"Factoring" involves the assignment of a debt to a financier by the originator of the debt (the "client"), the giving of notice of such assignment to the debtor and collection of the debt by the financier. Examples of generic factoring product names used in Ireland include "full service", "main line", "traditional", "maturity".

"Invoice discounting" involves the assignment of a debt to a financier by the client and the collection of the debt by the client as the appointed agent of the financier. Such assignment and the corresponding agency appointment may be disclosed to the debtor or may be kept confidential. Examples of generic invoice discounting product names used in Ireland include "bulk factoring", "agency discounting", "disclosed invoice discounting", "confidential invoice discounting", "confidential factoring", "undisclosed factoring" and "commercial finance". Factoring and invoice discounting are provided as a service, either with or without recourse in the event of default by a debtor in payment.

In this guidance the financier is called a "Factor". This is irrespective of whether the financier provides factoring or invoice discounting services. Unless specific mention is made to the contrary, factoring also includes invoice discounting.

1 Purpose of this Guidance

The purpose of this guidance is to clarify Revenue's position on the VAT treatment of factoring and invoice discounting following the High Court Judgment in the judicial review proceedings in the case of Hagemeyer Ireland plc and the Revenue Commissioners.[1]

Revenue's position originally followed the ruling of the Court of Justice of the European Union (CJEU) in the MKG-Kraftfahrzeuge-Factory GmbH case (case C-305/01) (MKG). However, following the High Court Decision in the Hagemeyer case, Revenue undertook a general review, in consultation with industry groups, of the processes and the legal form of the factoring and invoice discounting arrangements operated in the Irish market.

[1] Unreported High Court Decision of 9 February 2007.

2 MKG case and the Hagemeyer case

Revenue has always accepted that pure debt collection services, and also debt collection or administration provided in accordance with a debt-factoring contract, are taxable activities, with the right to deduction. Conversely, before the CJEU decision in the MKG case, Revenue had regarded true factoring as being, essentially, the granting of credit by the factor and, as such, exempt from VAT without the right to deduction. True factoring in the MKG case was considered to be "the purchase of debts with the full assumption of the risk of default"[2] [by the debtor]. This was compared with "quasi-factoring" which was described in the CJEU Judgment as "where the client assigns to the factor debts owed to him arising from the supply of goods or services but remains fully liable in regard to the debtor's ability to pay."[3]

In Ireland, "true factoring" is usually called "non-recourse factoring" where the Factor collects the debts and assumes the risk of debtor default and is called "non-recourse invoice discounting" where the factor assumes the risk of debtor default and appoints the client to collect the debts as the agent of the Factor.

In Ireland, "quasi-factoring" is usually called "recourse factoring" where the Factor collects the debts but the client remains responsible for debtor default and is called "recourse invoice discounting" where the risk of debtor default remains with the client who collects the debts as the appointed agent of the Factor.

Under both true factoring and quasi-factoring, the Factor is rewarded for his collection and/or administration activities by a "factoring fee", also sometimes referred to by practitioners and the industry as a "service fee", "administration fee", "facility fee" or "ledger management fee".

The facts of the MKG case concerned true factoring which the CJEU held to be a taxable economic activity with the right to deduction. In reaching this decision, the CJEU examined the Sixth VAT Directive where Article 13B(d)(3) (now Article 135(1)(d) of Council Directive 2006/112/EC – the VAT Directive 2006) specifies that "debt collection" cannot be treated as a VAT exempt activity[4]. In arriving at its conclusion, the CJEU commented[5].

"… the term debt collection must be interpreted as encompassing all forms of factoring" and "… factoring must be regarded as constituting merely a variant of the more general concept of debt collection, whatever the manner in which it is carried out".

[2] See paragraph 13 of CJEU Judgment.
[3] See paragraph 13 of CJEU Judgment.
[4] Only the English and Swedish versions of the Sixth Directive specifically stated that "debt collection and factoring" cannot be an exempt activity whereas the German and other language texts only mentioned the equivalent term of "debt collection". The CJEU referred to this in support of its finding in the MKG Judgment – see paragraph 53 of the Judgment.
[5] See paragraph 77 of CJEU Judgment

Having concluded that factoring is a form of debt collecting, the CJEU then dealt with the two principal forms of factoring, namely "true factoring" and "quasi-factoring". The CJEU held that:

"there is no valid justification for treating true factoring and quasi-factoring differently from the point of view of VAT, given that in both cases the factor makes supplies to the client for consideration and accordingly pursues an economic activity."[6]

In implementing the CJEU Judgment in the MKG case, Revenue took the view that since the basis of that decision was that factoring was a form of debt collection, the case would not have any application where debts were purchased but the collection of those debts remained with the originator, that is, the creator and seller of the debts, even if the originator acted as agent for the Factor in the collection of the debts.

However, the High Court has now ruled to the contrary in the Hagemeyer case. The High Court has held that in such circumstances the transaction involved (being the purchase of the debts without recourse) goes beyond the mere provision of an exempt financial service since the purchaser has, in return for consideration in the form of a factoring fee, assumed the risk of debtors' default and relieved the seller (originator) of the debts of the relevant trade credit waiting time before payment. Such a transaction was held to be a taxable economic activity for VAT purposes, the consideration being the relevant factoring fee charged.

The purchase of the debts under a factoring agreement gives the Factor complete discretion as to who, if anyone, to appoint as its agent to collect the debts. This can be the seller or any other undertaking. Such appointment does not change the essence of the transaction from one of factoring. In short, therefore, the High Court has held that "factoring" and "debt collection" are separate, that is, the purchase of the debts, with or without the assumption of the risk of default, constitutes factoring and collection of those debts involves the process of debt collection, and both services are taxable activities.

3 VAT Treatment

Revenue has accepted the High Court decision in the Hagemeyer case and is implementing the Judgment. Through the forum of an Indirect Taxes TALC sub-Group and the assistance of the Asset Based Finance Association, examples of practical scenarios involving debt factoring were submitted to Revenue for its views on the VAT treatment to be applied in the scenarios in question. The Revenue position on those scenarios is now outlined in Appendix 1 to this guidance.

Revenue accept that the taxable consideration for the factoring supply is the relevant fee charged, which is liable to VAT at the time the fee is charged by the Factor. This is usually either upon notification by the seller of the debt to the Factor or a fixed

[6] See paragraph 54 of CJEU Judgment.

periodical amount. Revenue also recognise that it is common practice within the Irish factoring industry to purchase debts at face value with a right to set off relevant fees and charges against the purchase price of debts. The terms of the Factoring Agreement normally provide that the purchase price for a factored debt is only payable well after a debt is assigned to the Factor. Under a recourse Factoring Agreement this currently coincides with the actual collection of the debt from a third-party debtor. Under a non-recourse agreement[7] the purchase price is payable at the expiry of an agreed period from the debt's "due date"[8], if the debtor has not by then discharged the debt. The agreed period is typically (but not essentially) 90 to 180 days after such due date. If the debtor pays earlier, then payment of the purchase price is due / paid at the same time. Once the purchase price has been paid, no further supply takes place for VAT purposes.

It has now been brought to Revenue's attention that many Irish factoring companies, which operate such delayed payment terms under their factoring agreements, also offer and provide advance funding as an additional service. This option permits the clients to request a draw down of advance funding up to an agreed facility limit. This will normally be set as a percentage of the value of uncollected approved factored debts but often subject to an overall maximum financial limit on all such advances.

It is entirely at the discretion of the client whether to utilise this facility for advances. Upon utilisation, the Factor will normally charge an additional advancement fee or charge equivalent to a margin over an agreed base rate for the funds advanced. This is variously called an "advance fee", "discount", "discounting charge" or "discount fee". Revenue accept that this facility for advances, when availed of, constitutes a separate supply for VAT purposes to the main factoring supply and that the nature of the advancement fee is that of a VAT exempt charge for the provision of credit.

Where a taxable person engages in both taxable factoring activities and VAT exempt activities, entitlement to recover VAT incurred on general overhead and dual use inputs will arise on an apportionment basis.

In addition, it is confirmed that where an assignment of the debt is made in return for a factoring service, Revenue will disregard the assignment or its reassignment for VAT purposes. All VAT incurred in relation to the putting in place of a factoring agreement and the collection of receivables is understood to directly relate to the taxable factoring activity. VAT incurred directly relating to the VAT exempt advance draw down facility will not qualify for recovery other than as noted at footnote 10 in relation to qualifying activities – see Appendix 1 to this guidance.

However, where a debt is simply assigned for its face value, or other value, to a third party without a factoring or similar arrangement, then such assignment will continue to be regarded as a VAT exempt transfer of, or dealing in, a debt.

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[7] This is the same as "true factoring" referred to in the CJEU Judgment.

[8] The due date for payment as agreed between the client and the debtor, i.e. the expiry of the credit terms.

Finally, while a "factoring fee" (also called a "service fee", "administration fee" or "ledger management fee") which is chargeable to VAT, and an "advance fee" (also called a "discount", "discounting charge" or "discount fee") which is exempt from VAT, are generally common to factoring agreements, factoring agreements may also contain other specific fees and charges for certain services. Appendix 2 to this guidance lists some of these other fees and charges and outlines the VAT treatment of the fees and charges in question.

Appendix 1

VAT treatment of debt factoring – practical scenarios.

- Scenario 1 Non-recourse factoring – i.e. "true factoring"
- Scenario 2 Factoring with recourse, i.e. "quasi-factoring"
- Scenario 3 Invoice Discounting without recourse – i.e. "true-factoring"
- Scenario 4 – Invoice discounting with recourse i.e. "quasi factoring"
- Scenario 5 – Simple Transfer of Debt

Scenario 1 Non-recourse factoring – i.e. "true factoring"

An Irish-established Company A ("Factor") purchases debts from an Irish Company B ("client") for a purchase price of €100,000, being the book value of the debts. Under the factoring agreement the risk of debtor default passes to the Factor, who assumes responsibility for collecting the debts with no recourse to the client.

The Factor will charge a service fee of say 2.5% of the value of the debts. The actual services provided in return for such fee can vary but will usually include some of the following, relief from bad debts, sales ledger administration, provision of credit advice and statistics and a debt collection service from initial contact with debtors through to legal enforcement. The Factoring Agreement provides that:

1. The service fee is payable upon notification of each debt by the client to the Factor.
2. The purchase price of each debt is payable at 90 days past the due date of each debt or its earlier collection.
3. The client can draw down advances from the Factor before such purchase prices are payable.
4. For such advances the client must pay an advancement fee to cover the period from the draw down date until the time of payment of the purchase price specified in point 2 immediately above.

Revenue response:

1. This scenario closely mirrors the facts in the MKG Judgment. The Factor is purchasing debts and assuming the risk of the debtor's default. The factoring consideration is receivable in respect of an economic activity, not falling within the exemption[9], and is therefore taxable with the right of deductibility. The service fee charged by the Factor to its client for providing its factoring services is liable to VAT at the standard rate.

2. The separate advancement fee payable by the client to the Factor will continue to be recognised as an exempt supply for VAT purposes, being paid in return for the provision of funds outside the agreed payment terms of the purchases price under the factoring agreement.

3. If the Factor were not established in Ireland, the VAT treatment for the Irish established client (company B) would be that it has received factoring services or other services that are taxable where received and these are taxable in the hands of such recipient.

4. Should the Factor be Irish-established, and the client not, there would be no VAT liability in Ireland[10].

5. The equitable or legal assignment of title to debts in favour of a Factor pursuant to a Factoring Agreement is disregarded for VAT purposes.

6. The Factor will be entitled to recover all VAT incurred in putting in place the Factoring Agreement and the operation of the agreement, including debt recovery. VAT incurred directly relating to the VAT exempt advance draw down facility will in general not be available for recovery other than as noted at footnote 10 in relation to "qualifying activities".

[9] Under Article 13B(d) of the EU Sixth VAT Directive exempting from VAT the granting, negotiation and management of credit; now article 135 of Council Directive 2006/112/EC.
[10] If the client (Company B) is outside the EU both the factoring supply and the advance draw down supply will be effectively zero rated as a "Qualifying Activity" such that both the factoring fee and the advance draw down fee will permit full VAT recovery.

Scenario 2 Factoring with recourse, i.e. "quasi-factoring"

An Irish-established Company A ("Factor") purchases debts from an Irish established Company B ("client") for a purchase price of €100,000, being the book value of the debts, payable only upon receipt from the debtor. The Factor does not assume the risk of debtor default. If the debtor defaults, then the relevant debts are then reassigned by the Factor back to the client.

The Factor will charge a service fee of say 2% of the value of the debts. The actual service provided in return for this fee can vary but will usually include some of the following: sales ledger administration, provision of credit advice, statistics and a debt collection service from initial contact with debtors through to legal enforcement. NB there is no relief from bad debts.

The Factoring Agreement provides that:

1. The service fee is payable upon notification of each debt by the client to the Factor.
2. The purchase price of each debt is payable only if and when the debt is collected.
3. The client can draw down an advance from the Factor before the purchase price is payable in point 2 immediately above.
4. Such advance has to be repaid if the debt is uncollected.
5. For each advance the client must pay an advancement fee to cover the period from the draw down date until either payment of the purchase price in accordance with point 2 immediately above, or the advance is repaid.

Revenue response:

1. Even though the Factor does not accept the risk of debtor default, the VAT treatment is the same as in Scenario 1.
2. Points 2 to 7 inclusive of the response to Scenario 1 also apply.

Scenario 3 Invoice Discounting without recourse – i.e. "true-factoring"

An Irish-established Company A ("Factor") purchases debts from an Irish Company B ("client") for a purchase price of €100,000, being the book value of the debts. Under the factoring agreement the risk of debtor default passes to the Factor. The client is appointed as the agent of the Factor to collect the debts. The Factor has no recourse to the client for debtors' default.

The Factor will charge a service fee of say 1.5% of the value of the debts. The actual services provided in return for such fee can vary but will usually include some of the following: the relief from bad debts, provision of credit advice, review and advise on ledgers and systems and statistics. The Factoring Agreement provides that:

1. The service fee is payable upon notification of each debt to the Factor.
2. The purchase price of each debt is payable at 90 days past the due date of the debt or its earlier collection.
3. The client can draw down advances from the Factor before such purchase prices are payable.
4. For such advances the client must pay an advancement fee to cover the period from the draw down date until payment of the purchase price specified in point 2 immediately above.

Revenue response:

1. Apart from the fact that the originator, as the appointed agent of the Factor, continues to collect the debt, this scenario mirrors that of Scenario 1 above. In keeping with the Hagemeyer decision, Revenue accepts that the Factor, by relieving the vendor of the risk of default, is carrying on a taxable economic activity.
2. Points 2 to 7 of the response to Scenario 1 also apply.

Scenario 4 – Invoice discounting with recourse i.e. "quasi factoring"

An Irish-established Company A ("Factor") purchases debts from an Irish established Company B ("client") for a purchase price of €100,000, being the book value of the debts, payable only upon receipt from the debtor. The client is appointed the agent of the Factor to collect the debts. The Factor does not assume the risk of debtor default. If the debtor defaults, then the relevant debts are reassigned by the Factor back to the client.

The Factor will charge a service fee of say 1% of the value of the debts. The actual services provided can vary but will usually include some of the following: provision of credit advice, review and advice on ledgers and systems and statistics. NB there is no relief from bad debts. The Factoring Agreement provides that:

1. The service fee is payable upon notification of each debt by the client to the Factor.
2. The purchase price of each debt is payable only if and when the debt is collected.
3. The client can draw down an advance from the Factor before such purchase price is payable in accordance with point 2 immediately above.
4. Such advance has to be repaid if the debt is uncollected.

5. For each advance the client must pay an advancement fee to cover the period from the draw down date until payment of the purchase price in accordance with point 2 immediately above, or the advance is repaid.

Revenue response:

1. Apart from the fact that the originator, as the appointed agent of the Factor collects the debt, this scenario mirrors that of Scenario 2 above.

2. Points 2 to 7 inclusive of the response to Scenario 1 also apply.

Scenario 5 – Simple Transfer of Debt

An Irish-established Company A (the purchaser) purchases debts with a book value of €100,000 from an Irish-established Company B (the vendor). At this time, the market value of the debts is agreed to be €97,000 and the debts are purchased for such market value. Neither party raises an invoice for commission or other services.

Revenue response:

1. The sale of the debts by Company B is VAT exempt.

2. In keeping with the decision in the Hagemeyer and MKG cases, the activities of Company A do not fall to be regarded as taxable factoring services for VAT purposes as the arrangement is not governed by a factoring agreement and there is no consideration or fee received or payable to Company A. Accordingly, this will be regarded for VAT purposes as a simple debts transfer agreement.

General Note

While Revenue has attempted to respond to the scenarios posed, it should be borne in mind that these are general in nature and that each case has to be decided by reference to its own particular facts and circumstances.

Appendix 2

- Take-on Fee (of a fixed amount)
- Arrangement Fee
- Computerised Services
- Collect-out Fee
- General Indemnities
- Facility Fee (payable on each anniversary)
- Arrangement fee (for variations to the agreement or services outside its scope)
- Costs of outside visits
- Legal fees incurred
- Debt enforcement costs
- Credit status reports

VAT treatment of debt factoring – treatment of certain fees and charges

Generally, factoring companies have a standard agreement that they use with their clients. Generally, also, the only variations to such agreements that are permitted relate to the financial terms negotiated with each client, such as, the level of charges and any pre-conditions to funding. These do not affect the framework of the agreements, including the services and funding, or the consequent VAT treatment.

All factoring facilities operate on the basis that the purchase of debts involves an assignment by the client of the purchased debts.

As already explained in this guidance, what is common to factoring agreements is generally a "factoring fee" (also called a "service fee", "administration fee" or "ledger management fee") which is chargeable to VAT, and an "advance fee" (also called a "discount", "discounting charge" or "discount fee") which is exempt from VAT. Factoring agreements, however, may also contain other specific fees and charges for certain services. Below is a description of some of the more common of these other fees and charges. Where possible an outline of the VAT treatment to be applied to these fees and charges is also set out. It should be borne in mind that this outline of the VAT treatment is general in nature. Each case has to be decided by reference to its own particular facts and circumstances.

Take-on Fee (of a fixed amount)

Factoring agreements often do not specify what this covers but, in general, it is intended to cover the work load involved by the Factor in testing and verifying the client's sales ledger and other records before, the commencement of the relationship, obtaining the sales ledger and setting up the control account and all necessary reconciliation. If this is the case, then the take-on fee relates to debt collection and ledger management. Accordingly, the fee is chargeable to VAT.

Arrangement Fee

Again, there may be no definition or explanation of this fee in a factoring agreement. In general, this fee is agreed before negotiations for the facility start and is payable upon commencement of the facility. The VAT liability very much depends on the activity and the specific circumstances, e.g. if the arrangement only relates to the negotiation of the terms for the advancement of credit then this would be an exempt supply for the negotiation of credit.

Computerised Services

Factors often agree to provide licensed software and a user manual to enable the client to send EDI messages, download details of debts, request payments and view accounts. VAT is chargeable on any fee for this service. Such service is often provided free of charge, in which case the agreed services covered by the normal taxable service charge will also include the computerised services.

Collect-out Fee

If the client's parallel agency to collect is cancelled by the Factor, this fee becomes payable. This usually happens upon breach of the agreement by the client or its insolvency. This fee is often described as being for "additional work in collecting or procuring the collection of debts" as a result of such breach or insolvency. This fee is chargeable to VAT.

General Indemnities

There are often indemnities in favour of the Factor for various out of pocket expenses incurred before and during the relationship. As the indemnities are in very general terms, and often akin to claims for damages, it is beyond the scope of this guidance to express a view on their VAT treatment.

Facility Fee (payable on each anniversary)

Among factoring companies, a facility fee is normally charged in relation to the provision of financial facilities and if this is the case then it would be exempt from VAT. If it is not for a financial facility, then it is liable to VAT.

Arrangement fee (for variations to the agreement or services outside of its scope)

The arrangement fee should be liable to VAT if the variations or services relate to taxable supplies. If the fee relates to exempt supplies such as the negotiation of credit, it is exempt from VAT.

Costs of outside visits

Costs of outside visits are an ancillary charge to the factor's debt collection and factoring services and, as such, are liable to VAT.

Legal fees incurred

Legal fees would relate to perfection of security, debt collections or enforcement of rights, and would be ancillary to the factor's debt collection and factoring services and, as such, liable to VAT.

Debt enforcement costs

Debt enforcement costs are ancillary to factoring services and are liable to VAT.

Credit Status Reports

Factors often agree to provide credit status reports on any of the client's customers or proposed customers. This is ancillary to the factoring service and is liable to VAT.