Corporate Tax - Romania

Factoring versus forfaiting: operations subject to value added tax?

Contributed by **Musat & Asociatii**

June 14 2013

Author

Ionut Bohalteanu

Introduction
Factoring
Forfaiting

Introduction

Considering the economic context of the past few years, and increasing number of business agreements have been amended with respect to payment deadlines for invoices. The need to maintain existing clients' loyalty while attracting new clients has led suppliers and providers of goods and services to extend the grace period in which the goods or services are to be paid by clients. This in turn has led supplier companies to identify solutions to improve their cash flow. This update focuses on one such solution: factoring and forfaiting operations.

Although used increasingly often, 'factoring' and 'forfaiting' are defined only in secondary legislation:

- National Bank of Romania (NBR) Order 27/2010 Approving the Accounting Regulations Compliant with the International Financial Reporting Standards Applicable to Credit Institutions;
- NBR Order 27/2011 Approving the Accounting Regulations Compliant with European Directives; and
- Ministry of Public Finance Order 3055/2009 Approving the Accounting Regulations Compliant with European Directives.

'Factoring' is defined as an:

> "*operation whereby the client, referred to as the adherent, transfers the ownership of its commercial receivables (invoices) to the institution, referred to as the factor, the latter having the obligation, in accordance with the agreement concluded, to ensure collection of the adherent's receivables*."

The factor, based on the documents received, pays the face value of receivables, minus the agio, either immediately or on the maturity date thereof, or on the contractual due date as agreed with the adherent.

'Forfaiting' is defined as the:

> "*purchase, without recourse against the previous holder, of receivables with their maturity date not reached, as a result of goods or services supplied, in exchange for a forfeiting tax*."

However, Romanian fiscal legislation (ie, the Fiscal Code,(1) the methodological norms for the application of the Fiscal Code(2) and the Fiscal Procedure Code(3)) does not define factoring or forfaiting activities, which are included in the category of financial banking services as 'payment or assignment of receivable operations'. Factoring and forfaiting activities were previously regulated by Law 469/2002 on Certain Measures for Strengthening Contractual Discipline, which was repealed in 2009.

Thus, 'factoring' was deemed to be an agreement concluded between one party (adherent) – a supplier or provider of goods or services – and a bank or specialised financial institution (factor), whereby the latter provides financing, keeping track of the receivables and safeguarding against credit risks, while the adherent assigns to the factor, by sale, the receivables deriving from the sale of goods or provision of services to third parties.

'Forfaiting' was defined in the same law as an agreement whereby a supplier of goods

or services sells its receivables held over a client to a bank or specialised financial institution in exchange for a forfaiting tax.

In addition, the International Institute for the Unification of Private Law (UNIDROIT) Convention on International Factoring defines 'factoring agreement' as a document whereby one party (the supplier) assigns to another party (the factor) the receivables resulting from the sale of goods or provision of services. For the purposes of the convention, the factor must undertake at least two of the following functions:

- finance the supplier, including granting loans or advance payments;
- maintain accounts (ledgering) relating to the receivables;
- collect receivables; and
- protect against payment default by debtors.

Although Romania is a UNIDROIT member, at present it is not a signatory state to the UNIDROIT Convention on International Factoring. Thus, the convention is not directly applicable to factoring activities performed in Romania; however, its provisions can be considered for informative purposes.

The issue that arises in practice is that EU Directive 2006/112/EC on the common system of value added tax (VAT) does not define factoring or forfaiting activities. This analysis relies on the interpretation of Article 135(1)(d) of the directive, which stipulates as VAT exempt "transactions, including negotiation, concerning deposit and current accounts, payments, transfers, debts, cheques and other negotiable instruments, but excluding debt collection".

Taking the above-mentioned texts in unison, it can be deduced that factoring and forfaiting activities combine the legal features of:

- an assignment of receivables; and
- a financing operation.

Factoring

The European Court of Justice (ECJ) has issued two decisions regarding the VAT treatment of assignment of receivables – *Finanzamt Groß-Gerau v MKG-Kraftfahrzeuge-Factory GmbH* (C-305/2001) and *Finanzamt Essen-NordOst v GFKL Financial Services AG* (C-93/2010).

In *MKG* the issue concerned the existence of two types of factoring – true factoring and quasi-factoring. The key difference between the two is the assumption of the risk of the debtor's default. In the case of true factoring, the transaction risk is taken over by the factor when the receivable is assigned by the supplier, as opposed to quasi-factoring, where the non-collection risk remains with the supplier.

From an economic perspective, in case of quasi-factoring, the supplier is deemed to be the owner of the receivable and the factor may have the right of recourse against the supplier. Taking into account the fact that, in reality, the receivable title is not taken over by the factor, but remains in the supplier's possession, the activity performed by the factor to the benefit of the supplier essentially has the nature of debt collection and, potentially, temporary crediting until the debtor pays the invoices.

In *MKG* the question was whether, in case of true factoring – when the factor undertakes the risk of the debtor's default without the right of recourse against the assignor – the assignee performed VAT-liable operations or VAT-exempt transactions. The ECJ held that it was not important whether the factor took over the risk of the debtor's default, considering that debt collection is an essential element of factoring and thus factoring services are subject to VAT. Moreover, the court argued that the primary purpose of factoring is to recover and collect debts and, consequently, it should be regarded as part of the concept of 'debt collection'.

The subsequent *GFKL* case was analysed considering the ECJ's decision in *MKG* with respect to the VAT treatment of transactions with receivables. It was deemed that the previous tax treatment took an expansive approach, and that the arguments considered in *MKG* should be reconsidered. Thus, in *GFKL* the court reiterated the arguments and principles invoked in *MKG* – namely, the existence of a connection between the counter-performance undertaken by the assignor and the service supplied by the assignee and, implicitly, whether the value of the services supplied and the counter-performance received are directly linked.

In *MKG* the court concluded that in the case of both true factoring and quasi-factoring, the company purchasing debts and assuming the risk of the debtor's default in exchange for a commission performed an economic activity in relation to which it has the status of a taxable person – a service that did not fall under the VAT exemption rules. Nevertheless, in *GFKL* the court ruled that an operator purchasing, at its own risk, defaulted debts at a price below their face value did not supply services for

consideration and did not carry out an economic activity subject to VAT where the difference between the face value of the debts and their purchase price reflected the actual economic value of the debts at the time of their assignment.

Following the *GFKL* decision, it may be concluded that the manner in which the purchase price of receivables is computed was essential to determining the applicable VAT treatment. Furthermore, unlike the arguments submitted in *MKG*, the assignment of receivables entailing a high risk of the debtor's default will be treated differently from the assignment of other types of receivable.

After the issuance of the *GFKL* decision, the Romanian tax legislation was amended in respect of transactions with receivables, partially regulating the VAT treatment applicable thereto and leaving place for interpretation. Factoring is considered a form of debt collection – an operation not falling under the VAT exemptions provided by Article 141(2)(a)(3) of the Fiscal Code. Pursuant to the methodological norms for the application of the Fiscal Code, the legislation differentiates transactions involving the assignment of receivables according to the following cases:

- The assignee purchases the receivables without the operation having the aim of debt collection, performing an operation outside the scope of VAT; nevertheless, the assignor may perform a VAT-exempt transaction, depending on the sale price of the receivable as compared with its face value.
- The assignee purchases the receivables, regardless of whether the risk of the debtor's default is undertaken, charging the assignor a taxable commission for collecting the debts, and the assignor does not perform a transaction subject to VAT.
- The assignee purchases the receivables, undertaking the risk of the debtor's default, at a price lower than the face value of the receivables, without charging the assignor a fee for collecting the debts and thus not performing an operation subject to VAT; on the other hand, the assignment of receivables by the assignor is deemed to be a VAT-exempt transaction.

In addition, the local legislation also refers to the case where, in accordance with the agreement between the parties, the purpose of the transaction is to grant a loan, rather than to collect a debt, in which case the transaction is deemed to be VAT exempt.

However, the national legislation does not distinguish between the assignment of a receivable with a high risk of the debtor's default and that with a low risk of the debtor's default. In respect of the risk of the debtor's default, several cases may be identified:

- The receivables did not reach maturity; however, they are expected to be collected.
- The receivables reached maturity, but were not collected.
- The receivables did not reach maturity, but cannot be collected because of the debtor's insolvency.

Thus, the amendments made as a result of *GFKL* mainly refer to the manner in which the sale price of the receivable is to be determined with respect to the existence of a debt collection fee.

It may be concluded that factoring involves a taxable service performed by the factor if the factor receives a commission upon taking over the receivable from the adherent. Nevertheless, if the sale price of the receivable is determined based on factors reflecting its economic value at the time of the assignment, without the factor charging any commission, the factor does not perform a transaction subject to VAT.

Forfaiting

As set forth above, forfaiting operations are not regulated by the fiscal legislation *per se*. From the definitions used in the accounting rules, forfaiting implies the sale of commercial receivables before their maturity at a price lower than the receivable face value, the difference representing the forfaiting tax.

In practice, the most common situation is where forfaiting is performed based on bills of exchange or promissory notes. Thus, for payment of invoices received, the client provides the supplier a promissory note or a bill of exchange. Taking into account that the promissory note or bill of exchange cannot be cashed at the time of receipt, but at a later date specified in its content (as a rule, the due date of the invoice), the supplier chooses to conclude a forfaiting agreement with a specialised company (ie, banking or non-banking financial institution) authorised in this respect, in order to cash the value of invoices before their due date in exchange for the assignment of security/payment instruments (eg, bill of exchange, promissory note or cheque). For the benefit granted to the supplier, the institution may charge a fee, assuming the risk of not collecting the face value of the debt from the client (debtor) at the maturity date – unlike factoring, where the non-collection risk may remain with the assignor.

'Bills of exchange' and 'promissory notes' are defined as negotiable credit securities and payment/security instruments that evidence the debtor's obligation to pay on

handling or at a determined due date a certain amount of money to the beneficiary or on its order.

Unlike factoring – where the factor has no certainty regarding the collection of the receivable from the debtor – in the case of forfaiting, this risk is mitigated due to the payment instrument (bill of exchange or promissory note) received from the debtor. This does not remove the possibility that the face value of the bill of exchange or promissory note (when cashed in on its due date) will not be received by the holder because of the debtor's lack of available funds. Nevertheless, the transfer by the debtor of a bill of exchange or promissory note in order to pay invoices may be deemed a form of securing the payment; consequently, the party purchasing the bill of exchange or promissory note enjoys higher certainty when taking over the risk of the debtor's default, without the right of recourse against the supplier.

In accordance with the forfaiting agreement, the bills of exchange or promissory notes are transmitted through endorsement to the entity taking over the commercial receivable from the supplier.

Similarly to factoring, forfaiting implies the assignment of a receivable; the difference between the two is that in factoring, it is assigned the right to collect from the client the invoices issued by the adherent, unlike forfaiting, in which payment instruments (bills of exchange or promissory notes) are assigned.

'Endorsement' is defined as the action whereby the holder of the security (the endorser) transfers to another entity (the endorsee) – by means of a written statement, underwritten on the security instrument upon its delivery – all the rights deriving from the security thus prepared and filled in. Similar to the endorsement, the assignment of receivables is a specific means of transferring obligations entailing the (contractual) consent of will whereby the creditor (the assignor) voluntarily transfers its receivable right to another entity (the assignee) in exchange for a consideration or free of charge, with the assignee thus becoming creditor in its stead and able to collect the assigned receivable from the debtor.

Unlike factoring, where the debtor (the client) must be notified in relation to the new entity to which payment must be made (the factor), in the case of forfaiting, the receivable may be assigned without notification to the debtor and is valid subject to a mere specification in its content regarding the transfer of the security.

The above complies with the common law in respect of assignment of receivables – specifically, Article 1573 of the Civil Code, which provides that the "receivable shall be assigned by the mere convention between the assignor and the assignee, without notification to the debtor".

In respect of forfaiting, Article 141(2)(a)(3) of the Fiscal Code lists the following VAT-exempt transactions without deduction rights: "transactions, including negotiations, concerning deposit or current accounts, payments, transfers, debts, cheques and other negotiable instruments, except for debt collection". By analysing the law, it can be seen that the legislation differentiates between transactions with receivables and those with negotiable instruments.

As set forth above, bills of exchange and promissory notes sold in accordance with the forfaiting agreement are negotiable credit securities and payment instruments evidencing the debtor's obligation to pay. Thus, forfaiting implies the sale of a negotiable instrument. Therefore, the mere sale of the bill of exchange or promissory note before the maturity date is a VAT-exempt operation without deduction rights.

However, the value collected by the supplier in consideration of the bill of exchange or promissory note endorsed to the new holder is lower than its face value, because the latter charges a fee in exchange for paying the receivable before its due date. Thus, it should be examined whether the difference between the face value of the bill of exchange or promissory note and the amount collected by the supplier before the maturity date of the security – namely, the forfaiting tax – is subject to VAT.

The essential purpose of forfaiting is to ensure that funds are available before the maturity date of the security. Thus, the purpose of the endorsement is not to collect the debt from the debtor. Consequently, from a VAT standpoint, the new holder of the promissory note or bill of exchange will not be deeded to have performed an operation subject to VAT.

Despite the above, and considering that the fiscal law leaves room for interpretation in respect of the VAT treatment applicable to agreements involving the assignment of receivables – and even more so in relation to forfaiting, which, unlike factoring, is not expressly stipulated in the Fiscal Code – VAT treatment will be determined on a case-by-case basis, depending on the contractual provisions applicable to each situation.

For further information on this topic please contact Ionut Bohalteanu at Musat & Asociatii by telephone (+40 21 202 5900), fax (+40 21 223 3957) or email (ionut.bohalteanu@musat.ro). The Musat & Asociatii website can be accessed at

www.musat.ro.

Endnotes

(1) Law 571/2003 on the Fiscal Code, as subsequently amended and supplemented.

(2) Government Decision 44/2004 Approving the Guidelines for the Enforcement of Law 571/2003 on the Fiscal Code, as subsequently amended and supplemented.

(3) Government Ordinance 92/2003 of the Fiscal Procedure Code, as subsequently amended and supplemented.

The materials contained on this website are for general information purposes only and are subject to the disclaimer.

ILO is a premium online legal update service for major companies and law firms worldwide. In-house corporate counsel and other users of legal services, as well as law firm partners, qualify for a free subscription. Register at www.iloinfo.com.

Online Media Partners

© Copyright 1997-2013 Globe Business Publishing Ltd