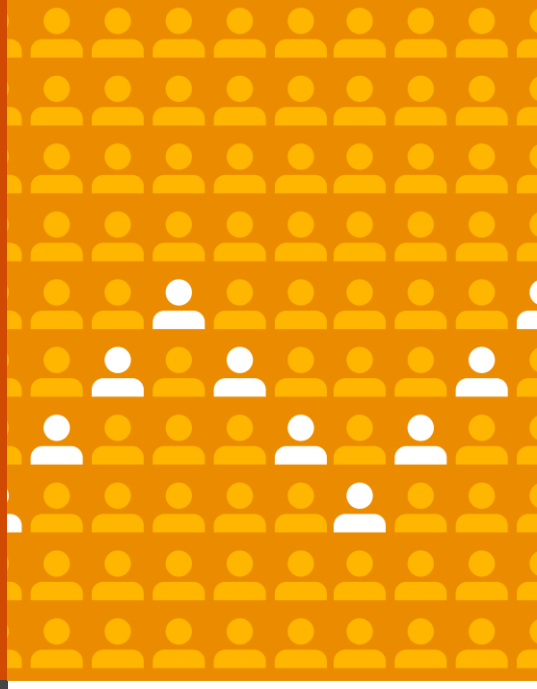
The Spanish Supreme Court rules on the impact of hedging derivative transactions in the calculation of the VAT pro-rata



We analyzed the Spanish Supreme Court's ruling in the case concerning the impact on the calculation of the VAT pro-rata, both for transactions involving the sale of shares and for hedging derivatives

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The Spanish Supreme Court has finally issued a judgment in a case that has to be with the impact that both sales of shares and hedging derivatives transactions could have in the calculation of the VAT pro-rata. The judgment, long awaited by all, is the first pronouncement of this type on the incidence on VAT of derivative products and, undoubtedly, the reactions will be immediate. It has been worth waiting for.

The three issues on which the appeal had focused were: i) which financial transactions deserve the consideration of "incidental" and, therefore, should be excluded from the pro-rata calculation; ii) whether the "incidental" nature should be appreciated both in the sale of shares held in group companies and in the subscription of financial derivatives; iii) if the contracting of financial derivatives by the appellant is a provision of services subject to VAT that must be therefore included in the calculation of the pro-rata; and, in relation to this last question, what is the taxable base to be included in the denominator.

In the Court's opinion, in the case of a Holding company that actively participates in the management of its subsidiaries, to which it provides services, the sale of holdings in group companies cannot be classified as "incidental". Indeed, the Court concludes that in the case of the appellant, the sale of shares in group companies does not only constitutes an economic activity, but also an essential and main facet of its business activity, which is incompatible with its alleged incidental nature.

Quite the opposite, considering the specific circumstances of the case, the Court's conclusion is very different regarding transactions with financial derivatives. In the opinion of the Supreme Court, insofar as they do not constitute transactions attributable to the company as a business activity in respect of which it becomes liable for the VAT, they should not be included in the calculation of the pro- rata percentage.

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It is an incontrovertible fact in the present case that the Holding company contracts derivatives with financial entities for the sole and exclusive purpose of covering its exposure to both exchange rate and interest rate risks, in relation to the different operations that it carries out as part of its regular business. The appellant does not offer such instruments on the market and does not have an authorization to do so.

The company only contracts the derivative product with a financial entity, for which it pays a price. Subsequently, upon maturity or in advance, it liquidates the underlying and generates, depending on its evolution, a positive or negative financial flow, which, the Court indicates, in no way means by the fact that said flow is positive, that the appellant is supplying services that must be taxed. The price of the derivative should not be confused with the settlement of the underlying.

The Holding company does not provide any services, even more so the activity carried out around the contracting of financial derivatives is purely instrumental, since it only guarantees risks derived from the activity that is its own. For the reasons stated, the pronouncement regarding the taxable base is not any longer required.

All companies that have made some kind of adjustment to their pro-rata in the past as a result of contracting financial derivatives, must review their position and determine whether, in light of the specific circumstances of their case, any type of claim should be made in defense of their interests.

For more information, don't hesitate to contact our indirect tax specialists.