

Is payment for early termination of contract subject to VAT? (1) (2/39/20)

Compensation for loss is not subject to VAT but how do we know whether the amount that becomes payable if the customer terminates a fixed-term service contract through their fault, is a contract penalty, compensation for loss, or consideration for services? In their guidance [“VAT Treatment: Questions and Answers”](#) the State Revenue Service (“SRS”) explains that VAT is not charged on a contract penalty, down payment, deposit or compensation unless this is consideration for a supply of goods or services. This article explores two rulings in which the Court of Justice of the European Union (“CJEU”) explains how to assess whether compensation received is essentially consideration for services.

Compensation for loss is not subject to VAT

In the broadest sense of this phrase, compensation for loss has been historically treated as payment not subject to VAT. Amounts that customers have to pay or that are withheld from an agreed payment before the supply of services where a fixed-term contract is terminated or where the service is not used, are usually treated as compensation for loss and are not subject to VAT in practice.

This position is based on the CJEU’s ruling C-277/05 (*Société thermale d’Eugénie-les-Bains*) of 18 July 2007, which assessed whether a deposit paid by the customer for accommodation services and kept by the service provider if the customer cancels the reservation is subject to VAT or whether this is a fixed amount of compensation for loss which is not subject to VAT. When the customer books a period of stay, the hotelier collects a deposit. A defaulting customer loses the deposit but a defaulting hotelier refunds double the amount.

The CJEU finds that the deposit is not a constituent element of the accommodation contract and cannot be treated as consideration for the reservation. The service provider’s obligation to reserve a place at the hotel arises from the accommodation contract, not from the deposit. Similarly, the accommodation service cannot be treated as consideration for the deposit. The CJEU finds that the deposit does not represent consideration for supplying a distinct, independent service.

The CJEU states that the deposit –

1. shows that the parties have entered into the service contract,
2. urges the parties to perform the contract, and
3. serves as a fixed amount of compensation for loss suffered on default because the deposit releases one party from the obligation to prove the amount of loss if the other party defaults.

The CJEU also finds that the deposit is not a partial payment for the accommodation service, and once the customer cancels the reservation, the deposit represents compensation for loss, not consideration for services.

Rulings C-295/17 (MEO) and C-43/19 (Vodafone Portugal)

The latest CJEU case law shows that many of the payments that have so far been treated as compensation should be treated as consideration for services subject to VAT.

For example, in its ruling C-295/17 (MEO) the CJEU finds that the possibility of a payment being classified as a contract penalty or compensation for loss under national laws is not relevant in assessing whether the payment is consideration for services. This finding is confirmed by the CJEU's ruling C-43/19 (Vodafone Portugal).

More details of the two proceedings:

- In its ruling C-295/17 (MEO) of 22 November 2018 the CJEU assessed whether a payment the customer has to make for early termination of a fixed-term contract, even if the supply of services has already been stopped through the customer's fault, should be treated as compensation for loss or consideration for services. MEO was a provider of telecommunications services. Some of the customer contracts stipulated that the contract binds the customer for an agreed minimum period. The fixed-term contracts provided for lower monthly charges but stipulated that if the services are disconnected through the customer's fault before the contract expires, the customer must pay an amount that matches the monthly payment multiplied by the number of months remaining until the end of the contract. In other words, the compensation matched the amount MEO would have received during the remaining period of the contract.
- In its ruling C-43/19 (Vodafone) of 11 June 2020 the CJEU dealt with a similar question. Vodafone, too, was a provider of telecommunications services and entered into fixed-term service contracts that allowed a special price for the services subscribed by customers during the fixed-term contract. Like the MEO case, the contract stipulated payment of compensation if the customer defaults on the minimum period of using the services for any reason within the customer's control. A key difference in this case was that the amount of compensation was set according to the Portuguese Electronic Communications Act and was calculated in proportion to the part of the minimum service period that had ended, and the compensation could not exceed the costs Vodafone had incurred in preparing for the supply of services.

(to be completed next week)