CJEU: payments for early contract termination can be subject to VAT

On 22 November 2018, the CJEU decided that payments for early termination of a broadband contract, under certain circumstances, do not qualify as indemnities and are therefore subject to VAT (C-295/17, 22 November 2018, MEO – Serviços de Comunicações e Multimédia). From the judgment, it appears that the way in which the termination payment is defined is decisive in determining whether or not VAT must be charged.

Background

MEO (a Portuguese company) provides telecommunication services to its customers.

MEO ties customers into minimum contract periods. If a customer terminates their contract before the end of the contract period, MEO stops providing its services but still pursues clients to pay an amount equal to the rest of the minimum period.

As a result, MEO will receive the same amount of income as when the customer would not have terminated the contract. MEO did not charge VAT on these amounts, treating such charges as indemnities outside the scope of VAT.

CJEU ruling
According to the CJEU, the payment requested by MEO is a remuneration for a service and not compensation for damages. Hence, the payment must be subject to VAT.

The main driver for the CJEU to reach this conclusion is the fact that the amount that MEO receives remains exactly the same, whether or not the client terminates the contract before the end of the minimum duration. From an economic perspective, the parties are in exactly the same position and the VAT outcome should therefore be the same.

The fact that the payments are foreseen to dissuade customers from terminating contracts early, and that the commission paid to intermediaries is higher for contracts agreed for a minimum duration, does not impact this analytical view.

A similar reasoning was applied by the CJEU in 2015 (CJEU, C-250/14 and C-289/14), where it decided that the payment for a non-refundable airplane ticket is subject to VAT even if the ticket was not used.

In both cases, the supplier received exactly the same amount regardless of whether the contract was terminated early or there was a no-show by the customer. According to the CJEU, there is no actual loss for the supplier that could give rise to an indemnity outside the scope of VAT.

Impact

The judgment confirms that payments for early contract termination or cancellation of services are not automatically outside the scope of VAT, because the customer is not benefitting from the initially contracted service (anymore).

It is therefore key for companies charging contractual penalties for early termination to review their terms and conditions to define whether or not these can fall outside the scope of VAT.

Contacts

If you have any questions concerning the items in this alert, please contact your usual tax consultant at our Deloitte office in Belgium or:

- Johan Van der Paal, jvanderpaal@deloitte.com, +32 2 600 66 39
- Ivan Massin, imassin@deloitte.com, +32 2 600 66 52
- Danny Stas (Laga), dstas@laga.be, +32 2 800 70 11

For general inquiries, please contact: bedeloittetax@deloitte.com, + 32 2 600 60 00

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