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## Payment due on the early termination of contract: Remuneration for a supply subject to VAT or out-of-scope indemnity? Decision on the case C-43/19

**17 July 2020**

**On 11 June 2020, the Court of Justice of the European Union (Court) ruled in the Vodafone Portugal case (C-43/19) that the amounts received by an economic operator for the early termination of a services contract, which has a tie-in period in exchange for advantageous commercial conditions for the customer, constitute the remuneration for a supply of services for consideration that are subject to VAT, and are not considered as indemnities out of the scope of VAT. Concerned businesses should pay attention to early termination payments, penalty clauses, or any similar clauses because a wrong VAT treatment may have substantial financial consequences; i.e., businesses will need to pay VAT on these amounts to the VAT authorities but will not usually be able to claim them from their clients.**

**Factual background**

Vodafone Portugal supplies electronic communication services, fixed telephony, and wireless internet access. Some of the service contracts with its customers include advantageous commercial conditions, usually related to the price payable for the contracted services subject to conditions that tie these customers in for a predetermined minimum period ("tie-in period").

If customers fail to comply with the tie-in period, they are obliged to pay an amount stated in the contract. Under national law, the amount to be paid in these cases should be calculated in proportion to the completed part of the tie-in period, based on the benefits granted to the customer under the contract that are identified and quantified therein. This amount may not exceed the costs incurred by Vodafone Portugal to install the service.

**Decision of the Court**

The discussions regarding the VAT qualification of payments due to early termination of contracts and, more broadly, around the VAT treatment that applies to indemnities, have been previously addressed by the Court in its landmark cases *Eugénie-les-Bains*[1] , *Air France*[2] and, more recently, *MEO*[3].

In the *Eugénie-les-Bains* case, the Court recognized the compensatory nature of a sum paid as a client deposit, in the absence of direct connection with the supply of any service for consideration.

In this case, when booking hotel services, the client pays a sum as a deposit. If the client exercises the available cancellation option, the hotelier would retain that sum as a fixed cancellation charge paid as compensation for the loss suffered as a result of the client defaulting. As it qualifies as an indemnity for VAT, this fixed cancellation charge is not subject to VAT.

In the *Air France* case, the Court decided that the full up-front payment of a non-refundable airplane ticket is subject to VAT even if the ticket is ultimately not used by the passenger. According to the Court's decision, the direct link between the service and the remuneration is not affected by the fact that the client does not use the airplane ticket and is not refunded. In this situation, it is concluded that there is no actual loss for the supplier that could give rise to an indemnity outside the scope of VAT.

On the other hand, in the *MEO* case, the Court ruled that the amount received by an economic operator due to a contract's early termination for the supply of services with a minimum commitment period, which corresponds to the amount the operator would have received if the contract had not been terminated, must be regarded as a remuneration for a supply of services for consideration and, as such, subject to VAT.

In addition, the Court considers two elements as not relevant for the VAT qualification. The first one is that the aim of the lump sum is to discourage customers from not observing the minimum commitment period. The second one is that this lump sum is classified under national law as a penalty.

Despite the factual background of the Vodafone Portugal case diverging from the *MEO* case (namely, regarding the calculation of the early termination payment), the Court followed the same reasoning of the *MEO* case to present its decision on the Vodafone Portugal case (as the case proceedings stayed pending until the conclusion of the MEO case and judgment).

Regarding the Vodafone Portugal case, the questions referred by the Tax Arbitration Tribunal to the Court asked, in essence, whether the amounts received by an economic operator in the event of early termination, for reasons specific to the customer, of a service contract with a tie-in period in exchange for granting that customer advantageous commercial conditions, constitute the remuneration for a supply of services for consideration.

The Court's arguments for its decision—that the amounts received by an economic operator in the event of early termination constitute the remuneration for a supply of services for consideration—can be summarized as follows:

- The amounts due by the customer for the contract's early termination reflect the recovery of some of the costs for the supply of the services that the operator has

[1] *Société thermale d'Eugénie-les-Bains, C-277/05, 18 July 2007.*
[2] *Air France-KLM, formerly Air France (C-250/14) and Hop!-Brit Air SAS, formerly Brit Air (C-289/14).*
[3] *MEO, C-295/17, 22 November 2018.*

provided to the customer, and that the latter is contractually committed to reimburse in the event of such a termination; and

- From the perspective of economic reality, the amount due on the contract's early termination seeks to guarantee the operator a minimum contractual remuneration for the service provided and, therefore, the amounts at issue must be considered to form part of the remuneration received by the operator for these services.

By considering that the amount payable in the event of early termination must be considered an integral part of the price that the customer committed to paying for the supplier to fulfill its contractual obligations, the Court clearly denied that such an amount would be comparable to a statutory payment, or would be intended to compensate the operator if the client terminated the contract, within the meaning of the *Eugénie-Les-Bains* case.

This decision confirms the Court's jurisprudence and the criteria outlined in the referred landmark cases. Indeed, the jurisprudence is relatively strict. Moreover, the VAT qualification is not bound by the national civil law and the legal qualification referred to by the parties in the agreements. Simply speaking, it is not enough to label an amount as an indemnity to ensure it will be treated as such.

A wrong qualification may have substantial financial consequences, especially regarding private clients. Indeed, the concerned business would have to pay the VAT to its national administration as a result of the requalification of the out-of-scope indemnity as a part of a remuneration subject to VAT. However, it will probably be impossible for the supplier to ask its clients to pay this VAT years after the end of the contractual relationship.
This decision is a reminder that a careful review of the contracts that foresee early termination payments, penalty clauses, or any similar clause is highly recommended.

# Your contacts

**Raphaël Glohr**
Partner – Indirect Tax – VAT
Tel : +352 45145 2665
rglohr@deloitte.lu

**Christian Deglas**
Partner – Indirect Tax – VAT
Tel : +352 45145 2611
cdeglas@deloitte.lu

**Joachim Bailly**
Partner – Indirect Tax – VAT
Tel : +352 45145 2824
jbailly@deloitte.lu

**Cédric Tussiot**
Partner – Indirect Tax – VAT
Tel : +352 45145 2604
ctussiot@deloitte.lu

Deloitte Luxembourg
20 Boulevard de Kockelscheuer
L-1821 Luxembourg

Tel: +352 451 451
Fax: +352 451 452 401
www.deloitte.lu



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