
Opinion Statement FC 2/2023 on the VAT Treatment of Compensation Payments

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1. Background

It is clear from the case law of the Court of Justice that not all compensation payments are subject to VAT. The difficulty is determining the demarcation line between cases that give rise to a liability and those that do not. The demarcation is not just potentially significant in determining whether a payment paid to a supplier is subject to VAT but also on the related question of whether a compensation payment made by a supplier should be considered to result in a reduction in the consideration for a supply.

2. Cases showing that not all payments are subject to VAT

In Case C222/81 *BAZ Bausystem AG v Finanzamt München für Körperschaften*, the Court considered that it would be wrong to view interest awarded by a Court to compensate for late payment as consideration for a supply. No VAT liability was also considered to arise in Case C-277/05 *Société thermale d'Eugénie-les-Bains v Ministère de l'Économie, des Finances et de l'Industrie*. That decision was concerned with whether VAT was chargeable on deposits for staying at a hotel. Advocate-General Poiares Maduro considered that the deposits should be considered consideration for a reservation service. The Court disagreed with this conclusion. The Court observed that the hotel had a contractual obligation to provide the accommodation irrespective of the payment of the deposit. It also observed that under French law the forfeited deposit satisfied any claims for damages unlike under some other national laws where the forfeited deposit might just partly satisfy such claims. It also formed that basis of any claims by the customer. It considered that the deposit was therefore not consideration for a reservation service. At paragraph 23-26 it observed that:

“23. Moreover, the payment of a deposit by the client, on the one hand, and the obligation of the hotelier, on the other, not to contract with anyone else in such a way as to prevent it from honouring its undertaking towards that client cannot—contrary to the French government's submission—be classified as reciprocal performance, because the obligation in those circumstances arises directly from the contract for accommodation, not from the payment of the deposit.

24. In accordance with the general principles of civil law, each contracting party is bound to honour the terms of its contract and to perform its obligations thereunder. The obligation to fulfil the contract does not therefore arise from the conclusion, specifically for that purpose, of another agreement. Nor does the obligation of full contractual performance depend on the possibility that otherwise compensation or a penalty for delay may be due, or on the lodging of security or a deposit: that obligation arises from the contract itself.

...

26. Since the obligation to make a reservation arises from the contract for accommodation itself and not from the payment of a deposit, there is no direct connection between the

service rendered and the consideration received (*Apple and Pear Development Council* (paras 11 and 12); *Tolsma* (para 13); and *Kennemer Golf* (para 39)). The fact that the amount of the deposit is applied towards the price of the reserved room, if the client takes up occupancy, confirms that the deposit cannot constitute the consideration for the supply of an independent and identifiable service.”.

Then at paragraphs 32 and 34-35 the Court observed that:

“32. Whereas, in situations where performance of the contract follows its normal course, the deposit is applied towards the price of the services supplied by the hotelier and is therefore subject to VAT, the retention of the deposit at issue in the main proceedings is, by contrast, triggered by the client's exercise of the cancellation option made available to him and serves to compensate the hotelier following the cancellation. Such compensation does not constitute the fee for a service and forms no part of the taxable amount for VAT purposes (see, to that effect, as regards interest applied on account of late payment, *BAZ Bausystem AG v Finanzamt München für Körperschaften* (Case 222/81) [1982] ECR 2527, paras 8 to 11).

...

34. Furthermore, the rule that, where non-performance of the contract is attributable to the hotelier, the sum returned is to be double the amount of the sum paid as a deposit supports the classification of that deposit as fixed compensation for cancellation and not as remuneration for the supply of a service. In such circumstances, the client is obviously not providing any service to the hotelier.

35. Since, on the one hand, the deposit paid does not constitute the fee collected by a hotelier by way of genuine consideration for the supply of an independent and identifiable service to his client and, on the other hand, the retention of that deposit, following the client's cancellation, is intended to offset the consequences of the non-performance of the contract, it must be held that neither the payment of the deposit, nor the retention of that deposit, nor the return of double its amount is covered by art 2(1) of the Sixth Directive.”.

These decisions make it clear that not all payments paid for compensatory reasons can be considered consideration for supplies. They also make it clear that there are two issues that need to be considered. The first is whether the taxable person can be considered to have rendered a supply. The second is whether there can be considered a sufficiently direct link between the payment and the alleged supply. Because of the harmonised basis of the tax, these issues cannot be purely determined by reference to concepts of national law, although they clearly form part of the context against which the issues need to be assessed.

3. Cases where the Court has considered a VAT liability has arisen

Whether there is a supply and a direct link between a payment and that supply will inevitably be dependent on the facts. It is accordingly no surprise that the Court considered that VAT was chargeable on non-refundable sales of flight tickets even if the customer did not fly in C-250/14 and C-289/14 *Air France-KLM and another v Ministère des Finances et des Comptes publics*. The Court, at paragraph 28, considered that the supply was “of the passenger's right to benefit from the performance of obligations arising from the transport contract, regardless of whether the passenger exercises that right, since the airline company fulfils the service by enabling the passenger to benefit from those services”. Because the tickets were non-refundable the Court at paragraph 29 did not consider that the price paid could be considered an indemnity for any harm.

As a consequence, the airlines “cannot claim that the price paid by the 'no-show' passenger and retained by the company constitutes a contractual indemnity which, since it seeks to compensate for a harm suffered by the company”. The Court, at paragraph 32, observed that the airline would receive a windfall if the payment was considered to be outside the scope of VAT because the airline would be retaining the VAT element of the flight charge, which it would have had to account for as VAT if the passenger had flown. That made it clear that the retention was not intended to compensate for loss but was remuneration for the ticket sale. The Court also considered that VAT was chargeable when the payment was made.

The Court also reached a similar conclusion in C-295/17 *MEO – Serviços de Comunicações e Multimédia SA v Autoridade Tributária e Aduaneira* and Case C-13/19 *Vodafone Portugal – Comunicações Pessoais SA v Autoridade Tributária e Aduaneira*. Both these cases concerned “penalty” payments for the early termination of telephone contracts which in many cases had been entered into on promotional terms in consideration for a tie in period. In both cases, the Court considered the payments were taxable.

In the *MEO* case the payment was the same as what would have been paid if the contract had not been terminated prior to expiration of the tie in period. For that reason, the Court, at paragraph 46, observed that the payment could not be considered damages to make good a loss, since the payment would then be expected to be for a different amount, basically claiming that early termination had not alter economic situation of MEO, which obtained the same amount in either case.

In *Vodafone Portugal* the payment was a lesser amount than if the contract had not been terminated. However, by entering the contract and giving the customer access to its networks a supply had been made. The payments were also considered to be consideration for those supplies. The Court, in *Vodafone Portugal*, at paragraph 38, observed that “those amounts reflect the recovery of some of the costs associated with the supply of the services which that operator has provided to those customers and which the latter committed to reimbursing in the event of such a termination”. At paragraph 39, it observed that the payment was therefore “analogous to that of the monthly instalments which would, in principle, have been payable if the customers had not benefited from the commercial benefits conditional upon compliance with the tie-in period”. So,

the payments were considered by the Court to be referable to past supplies that had been rendered to the customer.

It is important to observe that in both cases there was clearly a supply of telecommunication services. The payments were also viewed by the Court as being a reward for those services. The Court viewed that payments as consideration for a service because the customer had a right to benefit from the fulfilment of the contract, irrespective whether customer uses this right, and the Court did not view the payments as being of a compensatory nature.

It may also be significant that the payments in both the *MEO* and *Vodafone Portugal* cases were made under the contract. Indeed, this was a point that the Court placed some reliance upon in *C-242/18 UniCredit Leasing' EAD v Direktor na Direktsia 'Obzhalvane i danachno-osiguritelna praktika' – Sofia pri Tsentralno upravlenie na Natsionalnata agentsia za prihodite (NAP)*, where a leasing contract made provision for a payment of compensation on early termination equal to the rents that would have been payable had there been no termination subject to adjustments for the residual value of the asset. In considering the amount to be consideration for a supply of services, the Court, at paragraph 75, placed reliance on the fact that the amount payable was “determined at the time of conclusion of the contract” and was calculated by reference to the rental payment under the contract¹.

In *C-90/20 Apcoa Parking Denmark A/S v Skatteministeriet*, the Court adopted a similar approach to advertised penalty charges for unauthorised parking. The Court considered that the general terms and conditions for the use of the car parks created a legal relationship between the driver and the operator, which included obligations to pay the penalty fees, which the Court considered therefore had a direct link to the parking services provided: see paragraphs 41-43. The Court defined this relationship, at paragraph 34, as “contractual”. It observed that the charge arose from a legal relationship between parking place operator and the motorist who used that space: see paragraphs 27-28. The Court considered that this conclusion was supported by the fact that the fees represented 35% of its turnover, which demonstrated that the fees derived from an activity being conducted on a continuous basis. It distinguished *Case C-277/05 Société thermale d'Eugénies-Bains v Ministère de l'Économie, des Finances et de l'Industrie* on the basis that there was no supply in that case. The Court also considered that the fact that the fee was classified as a penalty as a matter of Danish law could not be determinative because it was concerned with EU law concepts. A similar approach has also been taken by Advocate General Kokot in her opinion in

¹ The Inner House of the Court of Session referred to this point in its decision in *Ventgrove Ltd v Kuehne + Nagel Ltd* [2022] CSIH 40, [2022] STC 1765 per Lord Tyre at para 41. The Court in that case considered that a charge arose on the exercise of a break clause in a lease. In *A v Luxembourg* (2020 Talch08212), the Luxembourg Tax Tribunal considered that an award made to a cyclist by the Tribunal for Arbitration in Sport for wrongful suspension of the cyclist's contract should be subject to VAT. The Tribunal placed some reliance for the fact that the award was calculated by reference to the remuneration he would have received if he had not been suspended. However, we are doubtful if the Tribunal was correct in considering that there is a true analogy to *C-259/17 MEO*. In *C-259/17 MEO* there was an express provision directed at the payment if there was an early termination of the contract during the minimum commitment period. For that reason, it is suggested that the payment in *MEO* possibly had more of a remunerative quality and there was a clearer direct link than in *A v Luxembourg*. We understand that there has been an appeal in the *A v Luxembourg* case.

Case C-677/21 *Fluvius Antwerpen v MX*, where she considered that payments for the illegal consumption of electricity should be subject to VAT.

4. Conclusions

These cases make it clear that penalty and prepayment charges can in some cases be taxable if they are consideration for a supply. However, it is important to observe that in all these cases there was clearly a supply, being the seat in the aircraft, access to the telephone networks or parking facilities. The Court also considered that the payments could be viewed as being consideration for those supplies, rather than purely compensatory. Therefore, different considerations should apply when these conditions are not satisfied. The fact sensitivity of these issues is also important to emphasise, because some tax authorities have sought to suggest that prepayments or cancellation payments, for example for a supply of goods, can be taxed even though no goods have been supplied. In particular:

- (i) the Czech tax authorities have sought to argue that cancellation payments for orders for goods should be taxable as a supply of services when a supplier of the goods was required to use specified components and manufacturing processes and was entitled to a payment under the contract for early termination linked to the purchase price of the components after deducting their resale value;
- (ii) HMRC in their guidance at VATSC05822 observe that an adjustment can only be made for VAT charged on a prepayments for both supplies of goods and services if there is a refund.

In most cases where goods are ordered but no supply then occurs, it is considered that no supply occurs. When this occurs as a result of the fault of the customer, it is considered that any payments which the supplier receives and which are intended to compensate him for the loss should not be considered to be taxable consideration for that reason, since it is a precondition to liability that there should be a supply and no supply has been made. An example of such a case would be a dilapidations payment made by a tenant to a landlord at the end of a lease on account of damage during the course of a lease.

In support of their approach, HMRC have placed reliance on the decision of the Court of Justice in C-107/13 *FIRIN OOD v Direktor na Direktsia 'Obzhalvane i danachno-osiguritelna praktika' – Veliko Tarnovo pri Tsentralno upravlenie na Natsionalnata agentsia za prihodite*. However, it is considered that HMRC's reliance on that decision is misplaced. In that case FIRIN OOD was seeking to recover input tax on a payment for goods that were not delivered. HMRC consider that this decision is helpful to their analysis but their analysis glosses over the fact that the Court considered that FIRIN OOD in fact had no right to recover input tax on its payment because there had been no supply. The Court observed that:

“52. In a situation such as that in the main proceedings, in which it is apparent, according to the information provided by the referring court, that the supply of goods in respect of

which FIRIN made a payment on account will not be made, it must be concluded, as the Advocate General has observed in point 35 of her Opinion, that a change in the factors used to determine the amount of the deduction has thus occurred after the VAT return was made. Therefore, in such a situation, the tax authority may require adjustment to be made to the VAT deducted by the taxable person”.

As far as output tax liabilities are concerned, the Court, at paragraphs 54-55, observed that it was for the supplier to take appropriate corrective actions. So, on a proper reading, the decision is in fact supportive of the conclusion that a supplier in such circumstances has no liability when he retains sums as compensation because there has been no supply. In the generality of cases, the decision also suggests that it cannot be correct to view a prepayment for the supply of goods as also resulting in a supply of services, since *FIRIN OOD* would then have had a right of recovery for that reason if its payment could be considered a payment for a supply of services. This conclusion is also consistent with the Court’s reasoning in Case C-277/05 *Société thermale d'Eugénie-les-Bains v Ministère de l'Économie, des Finances et de l'Industrie*, where the Court considered that on the facts of that case it would be wrong to view the deposit as consideration for a reservation service.

The *Apcoa* case makes it clear that some penalty payments may be consideration for a supply. However, we also do not consider that it would be correct to view all penalty payments as consideration. So, for example, we would suggest that payments paid by customers as a penalty for late payment or on account of an act of a third party should not be considered consideration. Each case will depend on its facts. However, it will clearly be significant if the payment does not impact on the quality of what is supplied to the customer and does not result in the customer obtaining any additional rights. With both compensatory and penalty payments, both these points will support the conclusion that there is an insufficiently direct and immediate link between the payment and any supply. For these reasons, the payment of a penalty when there is nothing corresponding to a supply should not give rise to a liability. In the *Apcoa* case members of the public were benefiting from being able to park their car. However, many penalties are imposed in situations where there is no corresponding benefit, and in such cases no liability should arise for that reason.

We also do not consider that all prepayments should be considered as consideration for a service of obtaining the right to receive the final supply. The Court in *KLM/Air France*, *MEO* and *Vodafone* justified the charge on the basis that the advance payments were for the “right to performance of transport services”, “service of enabling passenger to benefit from those services”, “seat reserved for particular passenger” or “right of customer to benefit from the fulfilment of the contract”. However, *Société thermale d'Eugénie-les-Bains v Ministère de l'Économie, des Finances et de l'Industrie* and *FIRIN OOD* in our view illustrate that not all prepayments are subject to VAT on this basis. In *MEO* and *Vodafone* the customers were gaining access to the network on favourable terms. The situation was therefore similar to a customer who is charged for downloading an e-book and who has received a service whether or not he subsequently chooses to look at the book. Different considerations will apply in other cases where it is not realistic to analyse the customer as receiving anything.

Similar considerations should apply when determining whether a payment by a supplier to its customers should be considered a reduction in the consideration for a supply. We do not consider that the customer can sensibly be considered to be rendering any form of supply when he accepts a payment in satisfaction of a claim against a supplier.

Another potentially important issue relates to the recovery of input tax. We do not consider that the payment of compensation that is outside the scope of VAT should necessarily have an impact on rights to recover input tax. For example, in a case where a customer agreed to make a payment to a supplier to cancel an order, this should not have an impact on the supplier's ability to recover input tax on its costs.

CFE hopes that the views set out in this Opinion Statement can be useful and remain available for any queries concerning the Statement.