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Indirect tax update

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Summary

Welcome to this week's Indirect Tax Update.

The Court of Justice has issued its judgment in the case of Vodafone Portugal (Vodafone). The case concerns whether VAT is due on amounts received by Vodafone from customers that have terminated their contracts early and before the end of the so-called 'tie-in" period.

Vodafone had accounted for VAT on the income but then lodged an appeal to the Portuguese courts arguing that the amount it received from the customer was outside the scope of VAT as it was compensation for loss of income. The argument is similar to that made in an earlier referral to the Court of Justice in the case of MEO (another Portuguese telecoms business). In that case, the court confirmed that VAT was due as the payment made by the customer was not compensation.

Vodafone argued that its case was different to MEO. In MEO's case, the amount received from the customer equated to the full consideration for the supply had the contract not been terminated. In Vodafone's case, the payment received was set by Portuguese statute and was limited to the cost of making the services under the contract available.

The Court considers that there is not really any difference from a VAT perspective and confirmed that VAT was rightly due.

Here in the UK, HMRC has been busy issuing Revenue & Customs Briefs. Revenue & Customs Brief 07/2020 announces a further delay to the implementation date for the reverse charge mechanism for construction services. This was originally planned for introduction in October 2019 but was delayed for 12 months to October 2020. HMRC has announced that, due to Covid 19, the implementation date is to be pushed back to 1 March 2021.

Readers will remember the VWFS case which concerned whether, in cases of sales of cars on HP, HMRC was correct to allow no input VAT recovery. HMRC has now issued Revenue & Customs Brief 08/2020 advising how input VAT should be claimed in the future by businesses that sell goods on hire purchase terms.

Court of Justice of the European Union – Vodafone Portugal - Judgment

Whether payments received on termination of a contract during a 'tie-in' period were liable to VAT or outside the scope as compensation

Vodafone Portugal (Vodafone) is the Portuguese subsidiary of the well known telecommunications business. It supplies telecommunication services including mobile networks, broadband services etc. Under its business model, it enters into contracts with customers for the provision of services and will often provide those services at a 'special' or discounted price provided that the customer agrees to be 'tied-in' to the contract for a specified period of time. In some cases, however, a customer will terminate the contract before the end of the tie-in period. In such circumstances, Vodafone will make a charge to the customer. This charge is calculated in accordance with Portuguese law and cannot exceed the cost to the supplier of making the service available to the customer. The amount received may not necessarily equate to the amount that would have been paid by the customer had the contract not been terminated. The Portuguese law also stipulates that, in light of the right of the supplier to recover some of its costs in this way, the levying of payments by way of damages or compensation shall be prohibited.

Nevertheless, having accounted for VAT on the amounts received, Vodafone appealed to the Portuguese courts arguing that, from a VAT perspective, the payments made by a customer who had terminated the contract before the expiry of the tie-in period should be regarded as outside the scope of VAT. In essence, the payments should be regarded as compensation and should not be regarded as consideration.

This argument had been aired in a similar case involving another Portuguese telecoms business (MEO). In that case, MEO argued that the payments were compensatory as damages for breach of contract. However, the Court of Justice dismissed that claim on the basis that under the terms of the contract between MEO and the customer, in return for payments set out in the contract (including termination payments) the customer was granted the right to use the services supplied by MEO. The fact that customer terminated the contract early or did not avail themselves of the rights granted did not change the nature of the payment from consideration to compensation or damages.

Vodafone considered, however, that it could distinguish itself from MEO. In MEO, the payments equated to the value that would have been paid by the customer during the remaining term of the contract whereas in Vodafone's case the amount it could charge was restricted by the Portuguese law which limited the charge to no more than the cost of providing the service to the customer.

The Court of Justice has now issued its judgment (11 June 2020). It considers that the method of determining the amount payable by the customer in cases where a contract is terminated early and before the expiry of the tie-in' period is immaterial. What matters is that the payments are set in the terms and conditions of the contract between the supplier and the customer. The only difference between MEO and Vodafone is the method of calculation but neither are compensatory or are damages for breach of contract. The Court considers that when a customer enters into a contract with Vodafone (or any other similar supplier of telecommunications services) it is, essentially, granted the right to benefit from those services and it does so in the full knowledge of how much it must pay by way of consideration. If a customer chooses not to avail themselves of the services or decides to terminate the contract early, this does not alter the fact that the right to the services was granted at the outset for the agreed consideration. The regular monthly payments are part of the contractual consideration payable by the customer to the supplier as are any early termination charges.

The Court also considered that there was no merit in Vodafone's claim that the payments represented compensation or damages as such a classification would be counter to Portuguese law which expressly stipulates that suppliers cannot levy payments by way of damages or compensation.

Comment – The Court of Justice has ruled that, in an economic context, a supplier determines the price for its service and monthly instalments, having regard to the costs of that service and the minimum contractual commitment period. The amount payable in the event of early termination must be considered an integral part of the price which the customer committed to paying for the provider to fulfil its contractual obligations. Given the Court's earlier judgment in the MEO case, this judgment does not come as any real surprise. Businesses with similar contractual tie-in periods may wish to take note of the two judgments.

Revenue & Customs Brief 07/2020

HMRC announces deferment of reverse charge for construction services

HMRC has announced (5 June 2020) that the implementation date for the reverse charge for construction services is to be deferred again. Originally, the mechanism was due to be implemented with effect from 1 October 2019. However, even though HMRC gave affected businesses almost a year's notice, there were many businesses that simply were not ready for this change so HMRC announced a deferral of the implementation date to 1 October 2020.

In the meantime, the construction industry, along with many industries and sectors have been severely hit by the Covid-19 pandemic. As a result, HMRC has decided to delay the implementation date by a further 5 months. The reverse charge for construction services will, therefore now be introduced on 1 March 2021.

The implementation date has been deferred by a Statutory Instrument which has also amended the rules of the scheme when it is finally implemented. Under the terms of the scheme, the reverse charge requirement will not apply if the purchaser of the particular construction services is regarded as an 'end-user'. In other words, if the customer is to use (or consume) the building or works for its own purposes (e.g. for its own occupation) it will be regarded as an 'end-user'. The amendment to the rules confirms that, to create certainty for both parties, the 'end-user' will need to notify his supplier in writing before any supply is made. Suppliers will, therefore, need to ask their customers to provide such notification before the service is completed, any invoice is issued or any payment is received in relation to the supply.

Given the global pandemic and the effect it has had on the construction sector, it seems a sensible decision to defer the implementation of this measure. Businesses should take the opportunity to ensure that accounting systems and contracts are amended to take account of the new requirements well before implementation date.

Comment

Generally, it is the supplier of goods or services that is required under VAT law to charge and account for VAT. However, in certain circumstances, Member States are entitled to designate the customer as the person responsible for paying the VAT that would, otherwise, be due from the supplier. This is generally invoked where the tax authority perceives that there is a threat to the collection of the revenue.

HMRC announced the reverse charge for construction services in 2017 as it considers that there was a significant risk to the revenue.

The deferral of implementation to March 2021 will be welcome news in the sector. Businesses will now also be required to notify their suppliers in writing if the wish to be exempt from the reverse charge because they are regarded as an 'end –user' of the services in question.

Revenue & Customs Brief 06/2020

Change to partial exemption VAT treatment

HMRC has issued Revenue & Customs Brief 08/2020 (10 June 2020) in response to the Court of Justice judgment in the case of Volkswagen Financial Services (UK) Ltd (VWFS). Readers will recall that, in that case, HMRC took the view that VWFS was not entitled to reclaim input VAT it had incurred on its overheads because, even though it accepted that VWFS made both taxable and exempt supplies, it considered that the company consumed the overheads only in the making of exempt supplies of finance. HMRC reached this conclusion because VWFS (like many other motor dealers), made all of its profit from the supply of finance. HMRC argued that because the cars sold on finance were traded on at cost, none of the overhead costs were incorporated in the price of the car so there was no direct link between the inputs and the taxable outputs.

The Court of Justice dismissed HMRC's argument. It ruled that the inputs were general overheads and were thus attributable to both taxable and exempt supplies. The fact that a business (like VWFS) allocated all of its overhead costs to its exempt supplies of finance was irrelevant.

HMRC's Revenue & Customs Brief 08/2020 provides HMRC's view on how the judgment will impact partial exemption methods in the UK for businesses that sell goods on hire purchase. The Court of Justice ruled that a values based method of apportionment should be used unless a more precise 'special' method is available. HMRC has said that it is not possible to come up with an acceptable special method so that UK business will be required to use an outputs method. The method to be used essentially includes the value of the asset being sold as a percentage of the value of the asset plus finance costs (interest payable etc). HMRC confirm that this partial exemption method will be the preferred method for the industry. However, according to HMRC, it will not be a compulsory method, and businesses can continue to apply any fair and reasonable partial exemption method already agreed with HMRC.

Comment

In the VWFS case, VWFS argued that the method of apportionment of its overhead input VAT should be based on the fact that there were two transactions for each supply (one being the taxable supply of the vehicle and one being the exempt supply of finance). This produced a 50/50 apportionment.

On the other hand, HMRC allowed no input VAT recovery but the Court of Justice has said that this approach in in clear contravention of the VAT Directive.

HMRC's Brief now accepts that the previous stance was incorrect but has concluded that it has not been possible to identify a more precise method than one that is based on output values.

The method suggested by HMRC will be regarded as the preferred method going forward albeit that use of the method will not be compulsory. Businesses that have negotiated a special method will be entitled to continue using it.

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