Due consideration

Edward Hellier explains how to determine whether a forfeited deposit or payment for an unused supply of goods or services is within the scope of VAT.

With the onset of the Covid-19 pandemic and the ensuing disruption to the economy there have been an increasing number of forfeited deposits and payments for supplies that are never made or used. Determining the correct VAT on those payments can be crucial to the success and survival of businesses.

A fundamental question in determining whether a taxable person is subject to VAT on money received is: why they have received that money? If monies are received as consideration for a supply then they may be subject to VAT, if they are received as compensation and not for a supply, then they will be outside the scope of VAT. However, this fundamental question is not always so simple to answer, particularly when an intended supply is never received; such as in the case of a forfeited hotel deposit or unused aeroplane ticket .

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This article will provide an overview of some of the key case law on the issue; examine changes in HMRC's approach in relation to hotel deposits; and identify some principles and factors that can be used in determining whether a payment is consideration for a supply.

Although I will primarily focus on forfeited hotel deposits, the principles discussed are applicable across different industries and payments. Note this article uses 'compensation' as shorthand for a compensatory payment that is not paid for the supply of any goods or services.

Key points

- Difference between compensation and consideration.
- In *Société thermale*, the CJEU found there was no link between the deposit paid and service to the customer.
- A right to benefit from services can be a supply of services.
- HMRC changed its policy on the treatment of hotel deposits.
- Case law and the contract are important when deciding whether a payment is consideration or compensation.

The law

Broadly speaking and as set out by Art 2(1) of the Principal VAT Directive, VAT is a tax on a supply of goods or services for consideration when made by a taxable person acting as such within the territory of a member state. In short, VAT is charged when someone pays for something and the VAT due is determined by reference to the amount paid. However, if there is not a direct and immediate link between the payment and a supply – such as when compensation is paid – the payment is not subject to VAT.

As ever in VAT however, a seemingly simple concept gives rise to a knotty problem: when does an amount paid by a would-be-customer, who does not use the service they have contracted for, constitute consideration, and when does it constitute compensation for the loss suffered by the would-be-supplier? The issue is addressed in various European and domestic cases which provide a very fine line that must be drawn to determine correctly whether money received is within the scope of VAT.

Société thermale

This matter arose in *Société thermale d'Eugénie-les-Bains v Ministère de l'Économie, des Finances et de l'Industrie* (Case C-277/05) [2008] STC 2470, a decision of the Court of Justice of the EU (CJEU) in the context of forfeited hotel deposits. In *Société thermale,* a French hotel collected deposits from customers when they reserved a room. That amount would either be deducted from the amount the customer paid for the accommodation or, if the customer cancelled their booking, retained by the hotel. If the hotel cancelled the booking, it would pay the spurned guest double the amount of the deposit. The question for the court was whether the deposit retained by the hotel after a customer cancelled their reservation was payment in consideration for a supply and therefore subject to VAT, or compensation for the loss suffered as a result of the default of the customer.

The French authorities argued that the deposit was a payment in consideration for the supply of the services of client reception facilities, opening a booking file, and entering into an understanding to reserve accommodation for the client.

The CJEU held that the deposit was compensation, not consideration, so outside the scope of VAT. There was not a direct and immediate link between the payment of the deposit and a service rendered to the customer. In coming to that conclusion the CJEU noted:

- a deposit is not a constituent element of a contract for accommodation, it is no more than an optional element within the parties' freedom to contract;
- the obligation to make a reservation arose from the contract for accommodation itself and not the deposit;
- the obligation of the hotel not to contract with anyone else in such a way as to prevent it from honouring its undertaking to the client arose from the contract, and was not reciprocal with the payment of the deposit;
- the *raison d'être* for hotel deposits is to mark the conclusion of the contract, encourage its performance and, as the case may be, provide fixed compensation; and
- the court's conclusion was supported by the fact that the hotel would be required to return the deposit to the customer, plus a further amount equal to the deposit, if the hotel cancelled the booking.

Air France and MEO

In contra-distinction to *Société thermale* are two later decisions of the CJEU. The first is *Air France-KLM and another v Ministère des Finances et des Comptes publics* (Cases C-250/14 and C-289/14) [2016] STC 1451 and the second *MEO - Serviços de Comunicações e Multimédia SA v Autoridade Tributaria e Aduaneira* (Case C-295/17).

In *Air France* the CJEU held that when a customer buys a ticket to fly on an aeroplane but is a 'no-show', the ticket price represents consideration subject to VAT. The service supplied by the airline for that consideration is the right of the customer to benefit from the transport contract, regardless of whether they use that right.

MEO concerned a Portuguese telecoms company. When customers signed up for a telephone contract they agreed to pay monthly subscription fees for a minimum period. If the customer cancelled the contract before the end of that time they were required to pay MEO an amount equal to their monthly subscription fee multiplied by the number of months left until the end of the minimum period. So, if they paid €10 a month and had five months left until the end of the minimum contract period when they cancelled they would be required to pay MEO €50. The court held that that amount was not compensation but consideration paid for the provision of telecoms services by MEO regardless of whether the customer took advantage of the right to benefit from those services.

Notably in these cases:

- the amounts received were the same as would have been received had the customer taken advantage of their rights under the contract – the court noted this in *MEO* in particular;
- the CJEU decided that the supply of a right to benefit from services can itself be a supply of services; and
- the link between the payment for a right and the supply of that right is not broken by the customer failing to use it.

Bass plc and Esporta

The domestic cases of *CCE v Bass plc* [1993] STC 42 and *CRC v Esporta Ltd* [2014] STC 1548 adopt a similar approach, in addition *Esporta* provides some commentary on *Société thermale*.

Bass plc concerned a hotel that operated a system whereby a customer who reserved a room and intended to arrive by 6pm would have a room kept for them until that time. Alternatively, if a customer wished to arrive after 6pm then they could obtain a guaranteed room. If they took that option but never turned up then they would be required to pay a 'no-show fee' equal to the price of a night's lodgings net of VAT. So if the fee was £115, the no-show fee would be £100 and the hotel would treat the amount as not subject to VAT. In line with the later CJEU cases, the High Court held that this fee was consideration paid for the supply of making a room available.

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The Court of Appeal's decision in *Esporta* was also broadly consistent with the later CJEU case law. In short, the case concerned monthly payments made in arrears by members of a gym when they had failed to pay on time, and so had been blocked access to the facility. The court held that these payments, which were paid under the contract, were consideration paid in return for the right to use the gym, contingent on making the monthly payments on time.

These cases show:

- simply because a customer does not avail themselves of a right, does not change their payment from being consideration to compensation;
- 'cancellation, like non-payment, only changes the services that a payment is to be made in return for, when it prevents those services ever being provided' (*Esporta*);
- one must look to the contract to determine the rights and obligations created – although with the check of economic reality;
- 'if the deposit is expressed to be payable as part of the consideration for the first night's stay, then there is no adequate direct and immediate link between the payment and the service, if the room is cancelled. In that case no accommodation will ever be provided' (*Esporta*). However, to the extent that the Court of Appeal was here describing the treatment of a payment on account for a supply that is not eventually provided, see the discussion of *Firin OOD* below, which would take precedence;
- if the deposit fee is an administration fee then it is in return for a service (*Esporta*); and
- if the deposit is part payment for a room and the customer is a 'no-show', the payment is consideration for the service of keeping a room open for the guest (*Esporta*).

HMRC's change in policy

Against this background, and by virtue of *Revenue and Customs Brief 13/2018* which came into force from March 2019, HMRC changed their guidance concerning the VAT treatment of hotel deposits. HMRC explain that this is due to the decisions of *Air France* and *Firin OOD v Direktor na Direktsia 'Obzhalvane i danachno-osiguritelna praktika' – Veliko Tarnovo pri Tsentralno upravlenie na Natsionalnata agentsia za prihodite* (Case C-107/13) [2014] STC 1581.

The revised policy is now to be found in the HMRC's *VAT Supply and Consideration Manual* at VATSC05820 *et seq*. In short, and as set out by the *Brief*, the new policy is that 'VAT is due on all retained payments for unused services and uncollected goods'. The manual explains that the department's old policy was predicated on *Société thermale* and *Bass plc*, but that with the arrival of the decisions in *Air France* and *Firin OOD* that policy had to change to reflect the new jurisprudence of the CJEU.

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The guidance helpfully provides examples when HMRC believes that the amounts received by a hotel would represent consideration for a supply, including:

- guaranteed rooms or reservations when the customer pays for a hotel room regardless of whether they occupy it; and
- a reservation guarantee whereby the customer provides credit card details to reserve a room and payment is taken only when the customer is due to turn up.

Importantly, and perhaps misguidedly, however the guidance makes no mention of circumstances when a deposit, or some other amount paid by a would-be-customer would not constitute consideration. So it should be treated with care and the principles and factors below considered before deciding whether a payment is consideration or compensation for VAT purposes.

Firin-OOD

Before coming to those principles, it is worth noting that HMRC has also predicated the change in policy on the CJEU decision *Firin-OOD*. The reason for relying on this case, as mentioned in some other commentaries, is not immediately obvious.

Firin-OOD covers somewhat peculiar circumstances in Bulgaria. Firin was a company that had made an advance payment to buy wheat and made a VAT deduction for that sum. However, the supply was never made and Firin was not refunded the money. The Bulgarian tax authority challenged the deduction in the national courts and the CJEU on the basis the supply had not been made and the invoice was part of a fraudulent scheme because the supplying company was not licensed to sell wheat under Bulgarian law.

The case, therefore, primarily concerns whether the deduction received by Firin should be adjusted by the Bulgarian authorities, the CJEU ruling that it should. In deciding this, the CJEU held that that conclusion was not altered by the fact that the VAT payable by the supplier had not itself been adjusted.

As part of this reasoning the CJEU endorsed a statement in the Advocate-General's opinion that said, broadly, when a supplier is liable for VAT by dint of payment on account, they are liable to pay VAT on that money received, even if they do not make the supply, unless and until they refund the amount paid. It is this on which HMRC is relying when it makes the statement in the guidance at VATSC05822:

> 'Article 65 of Directive 2006/112 makes clear that a payment made prior to the issue of an invoice or the basic tax point, creates a chargeable event. VAT therefore becomes due at that point. This VAT may only be reduced if the consideration is subsequently reduced and the payment refunded (Art 65 of Directive 2006/112).
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> 'Our revised policy is therefore, to allow adjustments to VAT paid on consideration for taxable supplies to be made only if a refund is made (and only to the extent of the refund – ie if 50% of the deposit is refunded then only 50% of the VAT accounted for can be adjusted).'

As an example, suppose Henry agrees to buy £115 worth of widgets for use in his VAT-registered business from Katherine. She issues him an invoice, which he pays on account. Katherine, however, never supplies the widgets to Henry. HMRC's guidance is here saying that Katherine would still be liable to account for the VAT on the money she has received from Henry unless and until she refunded him his money.

The example can also be brought across to hotels. Katherine enters an agreement to rent a room for a night from Henry Hotels, she pays £115 on account for the room irrespective of whether she uses it. In the event, Henry Hotels has to cancel her reservation. HMRC's guidance is here saying that Henry Hotels would have to pay VAT on that amount unless and until it refunded the money paid by Katherine, and only to the extent that it refunds the money.

While this is clear guidance, it is important to note that the analysis set out above still requires a prior step. If the payment made by Katherine to Henry Hotels were a deposit like the one in *Société thermale*, and not a payment on account for use of a room, so not in the first place consideration for a supply, the money would not be within the scope of VAT at all. If that were the case whether or not Henry Hotels in fact refunded all or some of the deposit would not be relevant for calculating its VAT liability.

The first question must therefore be whether the payment – be it a payment on account or otherwise - is consideration for a supply. To answer that question, the relevant principles and factors are set out below.

Practical application

In HMRC's manual, in particular in its examples, there is little recognition of the facts and circumstances which were present in *Société thermale* or the factors identified in the other cases that draw a line between amounts retained as compensation and those that constitute consideration for a service supplied.

As such, it is wise for any practitioner to read HMRC's manual with some caution, and to consider the above case law when deciding whether what has been received is a payment for consideration or compensation.

The correct determination of whether an amount paid is subject to VAT requires an analysis of the contract and obligations between the parties. Broadly speaking, when the money is a payment on account for a defined supply or is a payment for a right to a supply it will be within the scope of VAT even if the customer never enjoys the use of the underlying services or goods they have contracted for. When the payment is not made in return for an obligation on behalf of the other party, but instead is an amount of liquidated damages for the cancellation of the contract it will be compensation and outside the scope of VAT. To make that determination requires a close analysis of the facts and relevant contracts and, in so doing, the following principles may be relevant:

- Is the amount paid equal to what would have been paid had the customer availed themselves of the services available to them? This is found in *Air France*, *Bass plc*, *Esporta*, and is highlighted in *MEO*. Although this may not be determinative, it is certainly indicative of whether a customer has paid for a service of which they have then failed to take advantage, or compensated the would-be-supplier for their loss.
- Is the reason the service was not used because the customer failed to take advantage of the rights available to them, such as in *Air France*? That would indicate that the money paid *is* consideration.
- Is the reason that the payment is made or retained because the underlying contract is terminated, leaving the parties to the contract without any rights under the contract itself? In *Esporta* this is suggested as an example of when the payments would be compensation. In that case, the fact that monthly subscription fees had to be paid under the contract - rather than as damages for its breach - suggested they were in fact consideration.
- What is the *raison d'être* behind the payment of the monies? Is it to conclude a contract, encourage its performance and/or to set liquidated damages? As in *Société thermale,* that would suggest the amount paid is a form of fixed compensation.
- What happens if the would-be-supplier cancels the supply? As noted in *Société thermale*, the fact that the hotel had to refund double the deposit in such a circumstance supported the analysis that the deposit was not consideration for a supply, but instead a fixed amount of compensation. That it was repaid double specifically supports a conclusion that the deposit was not a payment on account.
- How does the contract between the parties typify the payment in question, and how does it typify the supply being made? In *Esporta* the fact that the payment was core a term of the contract allowing the gym to invest in proper facilities was noted, and can be compared to the CJEU's analysis of the *Société thermale* deposit which was typified as an optional element of the deal. In *Esporta,* the payor was supplied with the right to use the facilities as long as they paid the membership fees on time; in *Société thermale* the customer's rights did not arise from the payment of the deposit but the obligations arising out of the contract. However, any contractual analysis will need to be tempered by checking that it conforms to the economic reality of the deal.

Planning point

A careful analysis of the contract and parties' obligations is important when deciding the nature of the supply and purpose of the payment.

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These factors will help in determining whether a payment is *for* a supply and so subject to VAT. The approach of the courts in *Société thermale* and *Esporta* suggests that this requires a careful analysis of the contract and the specific source of the obligations of the parties to determine the exact nature of the supply and the purpose of the payment.

Final thoughts

In determining whether monies paid are consideration for a supply and so potentially subject to VAT, the fundamental question that must be answered is whether there is a direct and immediate link between the payment and the supply of goods or services. In essence, what is this money paid *for*?

There is a fine line between determining whether there is consideration for a supply or compensation (as defined in this article). As made clear by *Esporta* and *Société thermale* this will in large part require a close examination of the rights and obligations arising under the relevant contract. HMRC's guidance, while useful, should be tested on an individual basis against the underlying principles illuminated by the relevant case law.

The line between a payment being consideration or compensation may be a thin one, but the impact it can have on businesses can be vast, and as such merits serious consideration. ●

Author details

Ed Hellier is a barrister and practises from the Chambers of John Gardiner QC at 11 New Square. He can be contacted by email: ed.hellier@11newsquare.com.

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