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Amounts received by Telecom operator in the event of early termination of a commercial contract, which contained a minimum commitment period for customer, is treated as consideration for supply of service, even if the contract is ended by the customer on his volition.

Vodafone Portugal v Autoridade Tributária e Aduaneira
(Case C 43/19) (ECJ, 11 June 2020).

- Providing services to customers by obliging them to tie in with the supplier for a definite period is common in telecom sector. The customers, under such contracts are given certain benefits (especially special discounts and concessional rates) for agreeing to be loyal to a service provider for a definite period.

- Vodafone Portugal also offered services under such contracts to their customers. Contracts between Vodafone and customers provided that in case of failure on the part of customers to comply with tie –in period, Vodafone is entitled for a certain amounts as provided in respective contracts.

- Vodafone, was thus collecting amounts from customers who opted to move out of service contract before completion of tie in period. Vodafone did not pay VAT on such amounts. On revenue investigation, though such amounts were paid, the legality of same was questioned by Vodafone. Vodafone supported non applicability of VAT on payments on the ground that the amounts received from defaulting customers, for violation of contractual terms, did not constitute consideration for supply of any goods or services.

- Vodafone also argued that the tie-in clause included in the contracts concluded by Vodafone Portugal is a penalty clause similar to a 'liquidated damages clause'. Revenue argued that the amount represented consideration and hence liable for VAT.

- The determination of liability revolved around the scope of taxable supply. As per European VAT Directive (Article 2(1)(c)) , supply of service for a consideration within the territory of a Member State by a taxable person acting as such is liable for VAT.

The interesting principles relied on by ECJ while upholding the nature of payment as consideration liable for VAT are as follows:

- **Direct link between supply and consideration** : There should exist legal relationship of provider and recipient between the parties pursuant to which there is reciprocal performance, the remuneration received by the provider of the service constituting the actual consideration for an identifiable service supplied to the recipient. payment of the amount in question is made in the context of a legal relationship characterised by reciprocal performance between the services provider and its customer and that, in that framework, that payment constitutes a contractual obligation for the customer.

- **Consideration formed when right is derived by customer to benefit from the service offered**: Consideration in a transaction is formed by the right derived by the customer to benefit from fulfillment of obligations arising out of a contract, irrespective of whether the customer uses that right or not. Thus, supply is made by the supplier of services when it places the customer in a position to benefit from the supply, so that the existence of the abovementioned direct link is not affected by the fact that the customer does not avail himself or herself of that right.

- **The amounts recovered do not constitute sum of pending installments or amount supplier would have received in the absence of termination** : There is a rational basis for computation of amount to be recovered from defaulting customers. This formula is prescribed as per conditions laid down under national law regarding Electronic communication. Such amounts cannot exceed the costs incurred by the service provider in the context of the operation of those services and must be proportionate to the benefit granted to the customer.

- **Economic reality of transactions shows what is recovered from customer is cost incurred for providing service.** An operator determines the price for its service and monthly installments, having regard to the costs of that service and the minimum contractual commitment period. Therefore 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 fulfill its contractual obligations.

- **Amount is not in the nature of damages**, since collection of damages on termination of contract is prohibited by National regulation.

SOME INTERESTING PROPOSITIONS FROM OTHER JURISDICTIONS

- UK

  HMRC in their VAT Guidelines VATSC06720 states the position as there is no supply for VAT purposes of "the right to terminate" or other such service where a contract originally contains a clause allowing the parties to terminate early in lieu of compensation for perceived losses arising from the termination.

- INDIA

  Under Service Tax, till the negative list regime, the issue regarding the nature of consideration had to be determined with reference to specific definition and taxable clause of each service category.

- With introduction of negative list and all encompassing definition of 'service', it became difficult to analyse appropriate an amount as consideration or compensation. The problems were complicated with introduction of category 'tolerating an act' in list of declared services.

- On the one hand, we had a set of cases which relied on the principle that *the consideration agreed and the service activity to be undertaken should be direct and clear. Unless, it can be established that a specific amount has been agreed upon as a quid pro quo for undertaking any particular activity, it cannot be assumed that there was a consideration agreed upon for any specific activity so as to constitute a service." (Mormugao Port Trust* v. *Commissioner of Customs, Central Excise and Service Tax, Goa*; 2016 TIOL 2843 CESTAT Mum, *Jaipur Jewellery Show* v. *CCE & S.T., Jaipur*-1, 2017 (49) S.T.R. 313 (Tri.).

- We also saw another set of cases, the most recent of which is CST Vs. Repco Home Finance Limited 2020-VIL-309 CESTAT CHE-ST which held that the foreclosure charges collected on termination of loans prior to agreed loan period are in nature of damages and hence not liable for service tax . The larger bench has analyzed the issue in detail and has relied on following principle in support of non levy of service tax :
- *breach of contract gives rise to damages and that the closure of loan before the regular term is a unilateral act of borrower in repudiating the contract and breach of one of the essential terms of agreement.*
- *the foreclosure charges are not consideration for performance of lending service but is a condition of contract to compensate for loss of expectations interest, when loan is terminated prematurely.*
- *foreclosure charges are compensation for disruption of service not consideration for provision of service.*
- *presence of a damage clause in a contract does not mean that the party has been given an option ot violate the contract. Therefore act of foreclosure is not an optional performance.*

- The confusion created under Service Tax is carried forward to GST by incorporating 'tolerating an act' as a category of service under Entry 5(e) of Schedule II of CGST Act, 2017.

- From the history of Advance Rulings so far under GST, we understand that the inclination is to treat collection of liquidated damages, as consideration for tolerating an act and fix liability under Entry 5 (e) of Schedule II. Therefore liability for damages are treated as constituting a separate supply, though flowing from a contract for supply of service or goods.

(To cite a few : *Maharashtra State Power Generation Company Ltd.* - 2018 (13) G.S.T.L. 177 (A.A.R. - GST). *In Re: Rashtriya Ispat Nigam Limited 2020 (32) G.S.T.L. 492 (A.A.R. - GST - A.P.), In Re : North America Coal Corporation India Private Limited 2018 (18) G.S.T.L. 525 (A.A.R. – GST, In Re. Bajan Finance Limited* 2019 (29) G.S.T.L. 95 (App. A.A.R. – GST, In Re: TP Ajmer Distribution Limited 2019 (23) G.S.T.L. 60 (App. A.A.R. - GST))

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THOUGHTS

- ***It is true that the difference between a payment that amounts to compensation for breach of contract or consideration for a supply is not always straightforward.***

- ***But whether the lack of clarity, permits artificial division of terms of a contract in to two distinct components – one for supply for which contract is entered in to and another for damages, capable of attracting levy of tax under 'tolerating an act' independently ?***

- ***Any contract, whether written or oral, involves rights and responsibilities for each party. The right of one party is always protected by obligating the other party to fulfill his part. Whether the payments contemplated for not fulfilling obligations or violating rights of other party can be paired with the main supply and be treated as composite supply ?***

- ***Can the measure of assessment of damages, for example, damages equivalent to amounts due for remaining term of a contract, change the nature of payment as consideration for supply ?***

- ***Since there are various types of commercial arrangements, each arrangement has to be analysed independently on facts and settled principles may be applied only on basis of such factual analysis.***