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Non Performed Contracts in European VAT in the Light of the Newest Jurisprudence of the CJEU

by

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Abstract

The European system of VAT was developed in the 1950s. The majority of transactions involved the supply of goods, and suppliers and consumers used to meet face by face.

Nowadays many service providers offer the possibility to the customer, that the consumer pays before the actual service is provided. In many cases the customer does not use the right attributed from the agreement between the parties and the money is kept by the service provider. In some scenarios, there is a termination of the contract and the service is no longer provided to the final consumer.

As VAT aims to be general tax, consumption is a crucial element for the taxable transactions. How does the Court of Justice of the European Union understand the consumption in the context of non-performed contracts? Should money kept by the service provider be subject to VAT? Or do such transactions fall outside the scope of VAT?

The relevant VAT rules together with the Court of Justice of the European Union case law are applied to get a uniform answer.

Preface

This research is performed during the Master studies at School of Economics and Management, Department of Business law, Lund University. I would like to express my sincere gratitude to Lund University and LEPL International Education Center of Georgia for their financial support and for providing me with this unique chance to pursue my Master studies in Sweden.

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Abbreviation list

AG	Advocate General
Art.	Article(s)
CJEU	The Court of Justice of the European Union
EU	European Union
i.e.	For example
OECD	The Organisation for Economic Co-operation and Development
Para	Paragraph
Paras	Paragraphs
VAT	Value Added Tax
VAT Directive	Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax [2006] OJ L 347 of 11 December 2006

1. Introduction

1.1 Background

The European Union (EU) has evolved throughout the decades for a framework to a politic and economic Union with widespread competence and ambitious objectives in several fields, including taxation. Specifically, turnover taxes were among the first taxes to be harmonized in what would become the EU.

The legal basis and need for the establishment of a single market were implied in the Treaty establishing the European Community.[1] The measures were already taken into consideration to guarantee the Common Market.[2] Preamble of the first Value Added Tax Directive[3] stated that establishing a common market in which there is a healthy competition and whose characteristics are similar to those of a domestic market presupposes, *inter alia*, turnover taxes that will not distort conditions of competition or hinder the free movement of goods and services.[4] The relevance of the harmonization process finalized with the VAT Directive is easily understandable when considering that only in 2014 VAT generated a total of EUR 976.9 billion in tax revenue within EU.[5]

To determine what constitutes a taxable transaction is crucial in order to levy taxes from the goods or services provided by the taxable persons acting as such. Only in cases where a supply is a taxable supply, the VAT Directive be applicable.[6] Not all supplies of goods and services necessarily lead to the taxation of a transaction.[7] Pursuant to recital 5 of the preamble to the VAT Directive, VAT should be levied in a general manner to achieve the highest degree of simplicity and neutrality.[8] Article 2 of the VAT Directive lays down the scope of VAT. According to the article 2 of the VAT Directive, there are four different kind of taxable transactions *i.e.* supplies of goods, intra-community acquisition of goods, supplies of services and importation of goods.[9] Article 1(2) explicitly stipulates that

[1] The "Treaty of Rome" of 25 March, 1957.
[2] The "Treaty of Rome" of 25 March, 1957, Article 99 states that the Commission shall consider hot the legislation of the various member states concerning turnover taxes, excise duties and other forms of indirect taxation, including countervailing measures applicable to trade between Member States, can be harmonized in the interests of the common market.
[3] First Council Directive 67/227/EEC of 11 April 1967 on the harmonization of legislation of Member States concerning turnover taxes.
[4] Claus Bohn Jepersen – *Intermediation of Insurance and financial Services in European VAT* – Chapter 3, page 75.
[5] TAXUD, Study and Reports on the VAT Gap in the EU-28 Member States, 2015/CC/131, Warsaw, 23 August 2016, p. 8.
[6] Jasmin Kollmann – *Taxable Supplies and Their Consideration in European VAT With Selected Examples of Digital Economy* – Chapter 3, page 34.
[7] *Ibid.*
[8] Marta Papis-Almansa – *Insurance in European VAT On the Current and Preferred Treatment in the Light of the New Zeeland and Australian GTS system* – Chapter 3, page 112.
[9] Article 2(1)(a)-(d) of the of the COUNCIL DIRECTIVE 2006/112/EC of 29 November [2006] OJ L 347 of the common system of the value added tax.

VAT is a tax on consumption. Being a tax on consumption, ultimately paid by final consumers and collected by businesses is one of the core features of the VAT systems around the world.[10] Any activity, performed by a taxable person, must be carried out for consideration, in order to be regarded as taxable for the VAT purposes.

The VAT Directive[11] plays a fundamental role in developing a rational and complete framework of rules for EU VAT. Even though several topics remain open for debate. One of those issues occurs, when a customer pays for the service, before it actually has been provided by the taxable person.

Article 2 of the VAT Directive states that a supply of goods for consideration within the territory of a Member State by a taxable person acting as such shall be subject to VAT.[12] A transaction only constitutes a taxable supply if it is carried out for consideration.[13] The term 'supply for consideration' does give a rise to many questions as the term is not defined in the VAT Directive. In modern economic reality, it is very likely that a customer pays for the service before it has been provided to them. Buying a flight ticket, paying a deposit for a hotel service, even buying products in the grocery shop are the examples of when the final consumption has not taken place yet. In many cases customers have the possibility to cancel a contract or return the product. In such situations, it is difficult to conclude whether or not a concerned transaction should be subject to VAT.

Over the years, relevant guidance in addressing the issue has been provided by the case law of the Court of Justice of the European Union (CJEU).[14] The CJEU has delivered several judgments on VAT issues concerning cancelation, or when a customer does not use his/her right which has been obtained by purchasing services or goods provided by a taxable person. On these occasions, the CJEU has developed case law where it studies the existence of a direct link,[15] between the service provided and remuneration received. However, several uncertainties still remain on the subject of taxable transaction in cases when the services are not used by the final customer, or when there were a termination of a contract. The issue and its significance can be highlighted by the fact that the CJEU still has several cases every year to address and give the guidance to the national courts on how the issue should be interpreted. The recent judgment from the CJEU on

[10] Marta Papis-Almansa – *Insurance in European VAT On the Current and Preferred Treatment in the Light of the New Zeeland and Australian GTS system* – Chapter 3, page 113, see also OECD International VAT/GST Guidelines on Neutrality (2011).
[11] Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax [2006] OJ L 347 of 11 December 2006.
[12] Article 2(1) A - Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax [2006] OJ L 347 of 11 December 2006.
[13] Jasmin Kollman – *Taxable Supplies and Their Consideration in European VAT With Selected Examples of the Digital Economy* – Chapter 4, page 84.
[14] In future, the Court of Justice of the European Union will be referred as the CJEU.
[15] The concept of the direct link will be analyzed in the chapter 3.

the Case *MEO - Serviços de Comunicações e Multimédia SA*[16] is rising controversies which gives reasons to review the issue comprehensively.

1.2 Aim

How does the Court of Justice of the European Union (CJEU) understand the consumption in VAT in the light of the newest jurisprudence, in the context of non-performed contracts? The objective of this thesis is to examine and analyze how non-performed contracts should be treated under the VAT regime and answer the question. The issue will be examined in the light of legal character of VAT and fiscal neutrality.[17] For this occasion, the direct link test provided by the CJEU in the cases when there was no service used by the final consumer or when there was a cancellation will be analyzed. The European system of VAT was developed in the 1950s, at a time when only brick-and-mortar shops existed. Majority of transactions involved supply of goods, and suppliers and consumers used to meet face by face.[18] The law, as it stands, can hardly cover all scenarios, especially when in a modern world new possibilities are introduced every day. The focus of this Master's thesis is set on transactions which did not take place or transactions that have been cancelled either by the customer or by the service provider.

1.3 Method and materials

To fulfill the aim of the thesis, the traditional legal dogmatic method[19] is applied. The basis for the analysis is the valid sources of law, especially the current VAT Directive. The legislation is interpreted with the guidance of the judicial practice, primarily by applying the CJEU case law. Legal doctrine in the form of articles published papers, textbooks and commentaries are consulted and analyzed to give a more comprehensive point of view on the legal questions arising. The basis for this thesis is EU law. The CJEU has been dealing with the issue for a very long time. The EU harmonized the main aspects of VAT by issuing several directives. Old directives have been amended and replaced with new ones, which brought current VAT Directive. Those changes have not affected the concept of a supply of consideration. Therefore, previous cases are still relevant, even though those judgments have been issued before the current Directive.

1.4 Delimitation

Firstly, the thesis is conducted under the assumption that the reader has a background in tax law and VAT law, so that the basic concepts of VAT law

[16] Judgment in *MEO - Serviços de Comunicações e Multimédia SA*, C-295/17, EU:C:2018:942.
[17] General principles of VAT, such as general tax on consumption and fiscal neutrality will be analyzed in chapter 2.
18 Jasmin Kollmann – *Taxable Supplies and Their Consideration in European VAT With Selected Examples of Digital Economy* – Chapter 1, page 1.
[19] See Sjoerd Douma - *Legal Research in International and EU Tax Law* (Kluwer 2014), page 17.

are not explained and discussed in detail. Secondly, since the research question concentrates on the VAT Directive and consumption in the meaning of European VAT on services where there is not a final consumption but rather the expenditure of consumption, the focus of the thesis will be on European VAT. The concept of a direct link and consumption has been discussed on many occasions[20] and therefore, not all the cases regarding the direct link and consumption will be discussed for the purpose of this Master thesis. As this Master thesis concerns consumption in the cases, when the agreed service has been terminated, or where the consumer did not use the service. Only selected cases[21] will be discussed which relate to the legal questions arising from the legal issue.

For the purpose of this Master thesis, only transactions in the form of supply of services will be analyzed. Even though the concept of supply for consideration is related to both, goods and services, supply of goods for the consideration can be determined easier.[22] Hence, supply of goods is out of the scope of this research.

Furthermore, this Master's thesis will not deal with vouchers, which enjoy a special treatment. The issues of unredeemed vouchers is a related and interesting topic in itself. Whether unredeemed vouchers create a consideration for VAT purposes is a completely independent subject to discuss.[23]

1.5 Outline

As a starting point, the author sets out the framework for understanding general principles of VAT Directive, such as tax on consumption and fiscal neutrality (Chapter 2). The next chapter determines the direct link concept

[20] For example see Oskar Henkow – *Financial Activities in European VAT a Theoritical and Legal Research of the European VAT System and the Actual and Preffered Treatment of Financial Activities*, Marta Papis-Almansa – *Insurance in European VAT On the Current and Preffered Treatment in the light of the New Zeeland and Australian GST System*, Jasmin Kollman – *Taxable Supplies and Their Consideration in European VAT With Selected Examples of Digital Economy*.

[21] The main purpose of this Master's thesis is to understand and analyze how does the Court of Justice of the European Union understands consumption in a specific area, namely non-performed contracts. Therefore, cases that has been chosen concerns only the situations, when there is a non-performed contact, or termination of the contract between the parties. The cases that has been chosen to introduce direct link are the ones, which created the concept of the direct link in the taxable transactions and those cases have been used by the CJEU in the many future cases. Therefore, only the cases in which the concept of the direct link has been defined and developed will be analyzed in chapter 3.

[22] For example as Pr. Ben Terra notes some goods can be consumed fully and immediately, like a glass of milk or a sandwich. According to him, the tax is not concerned with the adventures of the product, i.e. whether the milk is consumed or has turned into sour.

[23] For further discussions please see: Terra& Terra *"The value of the voucher directive on the EU VAT treatment of vouchers"* – Work Journal of VAT/GST Law, vol. 6, no. 1, 2017, Bijl "*The European Union's New VAT Rules for Vouchers: The Emperor's New Clothes?"* International VAT Monitor, November/December 2016, Millar *"Illusory Supplies and Unacknowledged Discounts: VAT and Valuation in Consumer Transactions"* British Tax Review, Ni. 2, pp 153-184, 2003, Sabrina Popp, *"VAT Treatment of Unredeemed Multi-Purpose Vouchers"* Submitted for HARN59 (Unpublished) Gorka Echevarria Zubeldia *"VAT Recoverability of Unredeemed Single Purpose Vouchers"* International VAT Monitor, September/December 2017 pp 359-361.

developed by the Court of Justice of the European Union (CJEU) for taxable transactions (Chapter 3). From there, the author gives a brief explanation about the concept of the legal relationship, developed by the CJEU (Chapter 4). The author engages in a critical analysis of the CJEU decisions, relating to treatment of deposits, distinction between the deposit and prepayments, treatment of no show, treatment of not used service and cancellations, pointing out unresolved issues in that area and posting an analytical approach for addressing the issue (Chapter 5). From this point, what is the concept of consumption under the CJEU case law in non-performed contracts, relating to services will be analyzed (Chapter 6). Finally, a summary of the author's conclusions is provided (Chapter 7).

1.6. Definition of non-performed contracts

Non-performed contracts can exist in many situations. Non-performed contracts can exist when a customer prepays for the service or good and later has a change of mind and returns the product or cancels the agreed contract. In such case the money is returned to the customer and the VAT situation has to be reversed. Even though the VAT Directive does not include a special provision for such situation. A general rule stipulates, if goods or services are not provided and money is returned to the customer, there is no supply of consideration. Regarding this Master's thesis, non-performed contracts mean, that the agreed service has been canceled, terminated, or the service was not used by the final consumer and the money has been kept by the service provider. Should this money kept by the service provider be subject to VAT? Further analysis will try to get an uniform answer to this question.

2. VAT as tax on consumption and the scope of VAT Directive

Since VAT is meant to be a general tax on consumption, the VAT Directive gives VAT a wide scope.[24] The general principle of VAT is that it should be levied on all services supplied for consideration by a taxable person.[25] The transfer of the right to dispose of tangible property as owner or the supply of services is only taxable if occurs for consideration.[26] VAT is based on *quid pro quo* principle.[27] Article 1 of the Sixth Directive[28] states 'General tax on consumption exactly proportional to the price of the goods and services.'[29]

[24] Prof. Dr. Ad Van Doesum, Prof. Dr. Herman Van Kesteren, Prof. Dr. Gert-Jan van Norden – *Fundamentals of EU VAT LAW*, chapter 3, page 123.
[25] *Ibid.*
[26] *Ibid,* page 128.
[27] *Ibid.*
[28] Article 24(1) of the of the COUNCIL DIRECTIVE 2006/112/EC of 29 November [2006] OJ L 347 of the common system of the value added tax.
[29] Article 1 of the of the COUNCIL DIRECTIVE 2006/112/EC of 29 November [2006] OJ L 347 of the common system of the value added tax.

The concept of consumption in VAT is not only related to the economic consequences of tax application. It has legal significance for the determination of the scope of VAT.[30] According to the CJEU case law where consumption does not take place, the transaction remains outside the scope of application of VAT.[31]

Article 2 of the VAT Directive provides that a supply of goods, intra-community acquisitions and supplies of services for consideration are subject to VAT.[32] The scope of VAT is limited by its character as tax on consumption.[33] Goods or services must be supplied to identifiable customers in order to have consideration.[34]

As an indication of the character of VAT, the word "consumption" may cause misunderstandings. Some goods can be consumed fully and immediately, like a glass of milk or a sandwich. The consumption of other goods is a continuous process. A turnover tax should not be concerned with "consumption" in this sense. Instead, the expenditure, in order to attain consumption is the relevant criterion to be considered.[35]

The principle of equal treatment is a fundamental principle in Union law.[36] Fiscal neutrality[37], as a general principal of VAT, plays an important role to ensure equal treatment to the businesses which are in the same situation. The principle of fiscal neutrality does not allow similar items, which are in competition with each other to be treated differently, for VAT purposes.[38] Two items can be considered as similar, when they have similar characteristics and they meet the same needs from the point of view of the customer.[39] It is clear that the principle of fiscal neutrality is strongly connected with the objective of the common market and the fundamental rights protected by the treaty.[40] The principle of VAT as a neutral tax was developed by CJEU as the principal of fiscal neutrality. To secure neutrality in competition, in the sense that within each country similar goods should

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[30] Marta Papis-Almansa – *Insurance in European VAT On the Current and Preferred Treatment in the Light of the New Zeeland and Australian GTS system* – Chapter 3, page 114.
[31] Prof. Dr. Ad Van Doesum, Prof. Dr. Herman Van Kesteren, Prof. Dr. Gert-Jan van Norden – *Fundamentals of EU VAT LAW*, chapter 3, page 123.
[32] Article 2(1)(a)-(d) of the of the COUNCIL DIRECTIVE 2006/112/EC of 29 November [2006] OJ L 347 of the common system of the value added tax.
[33] AG Opinion in *Mohr / Finanzamt Bad Segeberg* C-215/94, EU:C:1995:405 para. 27.
[34] *Ibid.*
[35] B.J.M. Terra & J. Kajus, -*Introduction to European VAT (Recast)* – Chapter 7, page 128
[36] Judgment in *Klensch / Secrétaire d'État,* C-201/85, EU:C:1986:439 para. 9.
[37] Fiscal neutrality, as one of the most important principles for EU VAT has been discusses for many occasions. For further information, please see inter alia OECD international VAT/GTS guidelines drafts / Guildines on Neutrality December 2010, Marta Papis - *Principles of Law: Function, Status and Impact in EU Tax Law* - Online Books (Last Reviewed: 1 April 2014) - *The Principle of Neutrality in EU VAT*, Jose Manuel Macarro Osuna – *Non-Reduced Rates for E-Books: Has the ECJ Allowed a Violation of Fiscal Neutrality?* International VAT Monitor July/August 2016
[38] Judgment in *Commission of the European Communities VS. French Republic*, C-481/98, EU:C:2001:237 para. 22.
[39] Judgment in *The Rank Group plc,* C-259/10 & C-260/10, EU:C:2011:719, para. 23.
[40] Claus Bohn Jepersen – *Intermediation of Insurance and financial Services in European VAT* – Chapter 3, page 75.

bear the same tax burden, whatever the length of the production and distribution chain.[41] The principle of fiscal neutrality means that VAT should not influence business decisions, nor consumer decisions.[42]

Equal treatment means that every business entity who is in competition with each other should be treated equally for VAT purposes. As mentioned before, modern economic reality and its complexity creates complications, *i.e.* cancelation possibilities, certain amount of time to return the product and furthermore, paying in advance for the services which might not be used at the time when the service is performed. This leaves a lot of questions open for the tax authorities, should they tax such transaction? And more importantly, does the consumption exist when a person does not use their right acquired by paying for the service?

To have a clear, uniform answer to those questions, it is important to have well established rules, in order to guarantee the principle of fiscal neutrality.

3. The concept of a direct link in a taxable transactions

Article 2 (1) (A) describes the legal requirements for taxable transaction, to be taxed for VAT purposes.[43] Those criteria are:

- Supply of goods for consideration
- Within the territory of a Member State
- By a taxable person acting as such;

Those elements establish the legal requirements for a transaction to be subject to VAT. It should be mentioned that the CJEU's case law is the most efficient and valuable source of law relating to the concept of supply for consideration.[44] The CJEU has established a very solid concept of a direct link in taxable transactions. The concept of a direct link established by the CJEU has been used in all of following case.[45]

Problematic issues need to be addressed, when it comes to defining 'supply for consideration' as every case and facts are complex and individual and

[41] Judgment in *Hong-Kong*, C-89/81, EU:C:1982:12, para 6.
[42] Cf. Kleerup, Kristofferson & Öberg (2016) page 24
[43] Article 2(1)(a)-(d) of the of the COUNCIL DIRECTIVE 2006/112/EC of 29 November [2006] OJ L 347 of the common system of the value added tax
[44] Article 266 of The treaty of the Functioning of the European Union states that The Court of Justice of the European Union shall have jurisdictions to give preliminary rulings concerning the interpretation of the treaties.
[45] The concept of a direct link has been developed by the CJEU and has been citied in many cases afterwards. For this occasion, only the cases which created and refined the concept of the direct link will be analyzed. Furthermore, this Master's thesis does not concern the concept of a direct link as such, but for better understanding VAT treatment of non-performed contracts it is important to evaluate direct link concept.

VAT Directive does not establish what can be considered as 'supply for consideration'. The direct link test has been introduced by the CJEU around the 90s and the CJEU has been supporting the well-established case law ever since, but several ambiguities still exist. There must be a direct and immediate link between the consideration paid and the taxed activity.[46]

To be considered as a taxable transaction, a supply has to be made for consideration. Where the activity in question consists exclusively of providing service for no direct consideration, there is no legal basis of assessment and the service is therefore not subject to VAT.[47] The direct link test is the main test for defining consideration for VAT purposes.[48] The direct link between the service and the consideration received, is a fundamental element of the VAT system.[49] Only if there is a direct link between the supplies by the taxable persons and the payments by the consumer, the spending of the customers are a measure of their consumption.[50]

Not all transactions carried out by a taxable person are subject to VAT.[51] A supply is only taxable if it is effected for consideration.[52] It is settled CJEU case law that a 'transaction for consideration' requires a direct link between the supply and the consideration actually received by the taxable person.[53] If there is no direct link, the activity falls outside the scope of VAT.[54] The CJEU's message is clear: not every link is a "direct" link![55]

Normally, the determination of a direct link between a consideration and a supply does not give rise to difficulties. However, there are situations in which it can be rather complicated.[56]

The CJEU has referred to the direct link requirement in many cases which concerned consideration for VAT purposes. In the case *Apple and Pear Development Council*[57] the CJEU was asked whether the exercise by the *Apple and Pear Development Council* of its statutory functions and the imposition on growers of an annual charge constituted the supply of services

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[46] Ben Terra, Julie Kajus - *Introduction to European VAT (Recast),* chapter 8, page 163.
[47] Marta Papis-Almansa – *Insurance in European VAT On the Current and Preferred Treatment in the Light of the New Zeeland and Australian GTS system* – Chapter 3, page 119.
[48] *Ibid,* page 120.
[49] Prof. Dr. Ad Van Doesum, Prof. Dr. Herman Van Kesteren, Prof. Dr. Gert-Jan van Norden – *Fundamentals of EU VAT LAW*, chapter 3, page 128.
[50] *Ibid.*
[51] Herman Van Kesteren - *Taxable and non-taxable transactions* In Michael Lang, *Recent developments in value added tax 2016*, page 210.
[52] *Ibid.*
[53] *Ibid.*
[54] Oskar Henkow – *Financial Activities in European VAT A theoretical and Legal Research of the European VAT System and the Actual and Preferred Treatment of Financial Activities* – Chapter 3, page 61.
[55] *Ibid.*
[56] *Ibid.*
[57] Judgment in *Apple and Pear Development Council*, C-102/86, EU:C:1988:120.

effected for consideration.[58] Commercial growers of apples and pears were required to pay a subscriptions to the Council which was set up by the statutory instrument in 1966.[59] The commissioners of Customs and Excise decided that those subscriptions were not made as consideration for the services provided by the Council. Consequently, the Council could not deduct input VAT.[60] The CJEU took the view that the concept of a supply of services effected for consideration within the meaning of Article 2 of the Sixth Directive requires the existence of a direct link between the service provided and the consideration received.[61] The CJEU noted that the charges were payable because of a statutory obligation and not under a contract. It followed that mandatory charges imposed of the growers did not constitute consideration, as there was no direct link between the service provided and the remuneration received.[62] From this case, it is clear that activities in the general interest rather than in the interest of identifiable recipients are not subject to VAT. [63]

Thus, the CJEU in case *Apple and Pear Development Council* constituted that a supply of services effected for consideration requires a direct link between the service provided and the consideration received. The importance of the direct link in a taxable transaction has been emphasized by the CJEU in every following case.

In *Apple and Pear*, it was easy to identify whether or not the mandatory charge constituted a consideration. The CJEU pointed out that the charges were obligatory, not subject of an agreement and therefore there was no direct link between the service provided and the consideration received. As seen in *Apple and Pear Development Council* the direct link test is very useful as a way of determining whether something that can loosely be described as payment amounts to consideration for VAT purposes.[64]

The CJEU case *Jürgen Mohr*[65] concerned subsidies that were granted for discontinuation of milk production.[66] The subsidies were granted by national authorities and were given to farmers who agreed to no longer produce milk.[67] The main purpose of the subsidies were to balance the supply and demand on the market and at the time of the main proceedings production of milk exceeded the demand on the market.[68] The question in

[58] *Ibid,* para 6.
[59] *Ibid*, para 3.
[60] *Ibid,* para 2.
[61] *Ibid,* para 11.
[62] *Ibid,* para 17.
[63] Prof. Dr. Ad Van Doesum, Prof. Dr. Herman Van Kesteren, Prof. Dr. Gert-Jan van Norden – *Fundamentals of EU VAT LAW*, chapter 3, page 129.
[64] Deborah Butler – *The usefulness of the 'direct link' test in determining consideration for VAT purposes*, EC tax review 2004-3, page 101.
[65] Judgment in *Jürgen Mohr*, C-215/94, EU:C:1996:72.
[66] *Ibid,* para 12.
[67] *Ibid,* para 3.
[68] *Ibid,* para 14.

the main proceedings was whether a subsidy should have been subject to VAT.[69] The CJEU noted that the undertaking given by a farmer who discontinued the milk production does not entail either for the Community nor for the competent national authorities any benefit, which could have been considered as a service. Therefore, the CJEU answered the question in the negative, stating that such a payment does not constitute consideration for VAT purposes.[70] The CJEU discarded the transaction, stating that it remained outside the scope of VAT, on the basis of an independent argument, namely lack of consumption in the first place.[71]

The Case *Jürgen Mohr* illustrates the main idea of the VAT Directive. The supply of services will only be subject to VAT if it gives rise to consumption. According to *Jürgen Mohr* case it can be constituted that 'consumption' is an unconditional element for the VAT liability. As the AG Jacobs pointed out in the opinion, the scope of VAT is nevertheless limited by its character as a tax on consumption.[72]

In the case *R. J. Tolsma*[73] the CJEU was asked by the national court if the service which consists of playing music in the public highway, for which no payment is stipulated but payments are still received, can be regarded as a supply of services effected for consideration for VAT purposes.

R. J. Tolsma used to play barrel organ in public highways in the Netherlands. During the musical performance he offered by passing pedestrians a collection tin for their donation. Mr. Tolsma also sometimes knocked on doors of houses and shops asking for donations.[74] Mr. Tolsma received a tax assessment and was required to pay VAT for the sums collected from the performances. Mr. Tolsma argued that activities cannot be regarded as consideration for VAT purposes.[75]

The CJEU stated that the term 'supply of services effected for consideration' should be seen in its context and must be taken into account on the other provisions of the Sixth Directive and also CJEU's case law. The CJEU stated that supply of services are effected 'for consideration' and hence, taxable only if there is a legal relationship between the provider of the service and the recipient pursuant to which there is a reciprocal performance.[76] The CJEU stated that there should be a direct link between the service provided and the consideration received.[77]

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[69] *Ibid,* para 12.
[70] *Ibid,* para 22.
[71] Marta Papis-Almansa – *Insurance in European VAT On the Current and Preferred Treatment in the Light of the New Zeeland and Australian GTS system* – Chapter 3, page 115.
[72] AG Opinion in *Jürgen Mohr,* C-215/94, EU:C:1995:405 para. 27.
[73] Judgment in *R. J. Tolsma*, C-16/93, EU:C:1994:80.
[74] *Ibid,* para 3.
[75] *Ibid,* paras 4-5.
[76] *Ibid,* para 14.
[77] *Ibid,* para 13.

The CJEU additionally considered that there was no agreement between the parties and passers-by made a donation voluntarily. According to the CJEU's reasoning, passers-by do not request music to be played for them. The fact that Mr. Tolsma expects to collect money by playing in public highways does not constitute sufficient grounds to consider his service for consideration, as there is no legal relationship between the parties.[78] Therefore the CJEU concluded that the service which was disputed between the parties did not constitute consideration for the VAT purposes. [79] In the judgment, the CJEU further explained that in order for the necessary direct link to be present, there must be an obligation to pay that results from a legal relationship between the parties.[80]

In this case the AG Lenz had the same idea. Considering that VAT is a general tax on consumption exactly proportional to the price of the goods and services, the AG stated that in principle the activity is taxable only in the case of operations which contain an element of contractual exchange.[81] In addition, the AG defined a direct link, stating that the link must be such that a relationship can be established between the level of the benefits and the amount of the consideration.[82] Furthermore, according to the AG opinion, payments by the passers-by are a subjective value. There is no relationship between the service and the consideration defined by the parties.[83] The AG constituted that since there is no agreed exchange of the service and consideration, the service should not be the subject to VAT.[84]

Having a legal relationship as a prerequisite for the existence of a taxable supply has been a constant requirement followed by the CJEU in its case law, starting with the judgment in *R. J. Tolsma.*[85] In the *Tolsma* case, the circumstances in the main proceedings were quite simple. Supplied service by musician Tolsma and consideration was easily established by the CJEU. The problem in the case was the interpretation of the nature of the concerned transaction. In the case the CJEU has followed the case law established before, but in the *Tolsma* case CJEU has offered new element for a direct link test. The CJEU constituted that legal relationship between the parties is crucial to consider whether the transaction falls within the scope of VAT directive. It should be noted that in *Tolsma* case, the CJEU did not change the course of the concept, but brought more arguments to

[78] *Ibid,* paras 19-20.
[79] *Ibid,* para 20.
[80] Marta Papis-Almansa – *Insurance in European VAT On the Current and Preferred Treatment in the Light of the New Zeeland and Australian GTS system* – Chapter 3, page 121.
[81] AG opinion in *R. J. Tolsma,* C-16/93, EU:C:1994:16, para 13.
[82] *Ibid,* para 14.
[83] *Ibid,* para 23.
[84] *Ibid,* para 27.
[85] Yanista Radeva – *VAT implications of Cancellation Charges: New Substance-over-Form Rule?* - International VAT monitor January/February 2019, page 4.

guide Member States how the concept of the direct link should be understood.

Following *Tolsma*, the direct link test means that there must be an obligation to pay that results from a legal relationship between the parties.[86] *Apple and Pear Development council* shows, though, that this is not in itself sufficient.[87] There must be a reciprocal relationship between the parties. Perhaps this requires a supplier of services to be able to prevent any individual who does not pay from benefiting the service.[88]

Therefore, according to the outcome of *R. J. Tolsma* case the test that is essential to define whether or not there is a supply for consideration, it should first ascertain if there is a legal relationship between the parties and if there is a direct link, between the service provided and the payment, received. The VAT is a general tax on consumption, consequently, the consumption must exist in order to classify the service as a taxable service provided by the taxable person to the final consumer. Moreover, according to the well-established case law, supplies of goods or services are subject to VAT, rather than payments.[89]

The direct link is not to be recognized if it is substantiated that (i) although the number of supplies is fixed and known in advance the consideration is variable; (ii) the consideration is fixed and known in advance, but the number of supplies is variable; (iii) the complete pricing fluctuates in such way that both the supply and the consideration may vary in an independent and uncoordinated manner and are subsequently not known or calculable in advance; (iv) both payments and the supply are fixed and known in advance but the payment simply does not stem from the supply.[90] The CJEU's case law also indicates that the direct link test is satisfied even if the service provided takes form of ensuring availability to perform another service, or a right to benefit from a service, regardless of whether the party decides to use the service or not.[91] The case law confirms that EU VAT should be considered as a tax on consumption expenditure and not a tax on actual consumption as such.[92]

Consequently, the criteria which have been introduced by *R. J. Tolsma* case is the concept of a direct link in concluding whether a supply is effected for consideration or not. This concept guarantees that the scope of the VAT directive is limited to the transactions which should be subject to VAT.

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[86] Deborah Butler – *The usefulness of the 'direct link' test in determining consideration for VAT purposes*, EC tax review 2004-3, page 93.
[87] *Ibid.*
[88] *Ibid.*
[89] Judgment in *BUPA hospitals LTD*, C-419/02, EU:C:2006:122, para 50.
[90] Herman Van Kesteren, *Taxable and non-taxable transactions* In Michael Lang, *Recent developments in value added tax 2016*, page 215.
[91] Marta Papis-Almansa – *Insurance in European VAT On the Current and Preferred Treatment in the Light of the New Zeeland and Australian GTS system* – Chapter 3, page 122.
[92] Judgment in *Kennemer Golf & Country Club*, C-174/00, EU:C:2002:200

The concept of the direct link which has been relied upon by the CJEU in many cases still plays an important role in determining whether a supply is made for consideration or not. The CJEU still referred to the direct link concept in the case *European Commission Versus Austria.*[93] The dispute in the main proceedings concerned royalty payments to an author of an original work of art who sold their copyrights but still received income from resale of their original work. The CJEU again defined that for the consideration there should be a direct link between the service provided and consideration received.[94] The CJEU observed that the author does not take any part in the negotiation process and cannot influence the price. The author cannot even deny the transactions, even if he/she does not like the contract.[95] The fixed amount that the author received is guaranteed from EU legislation and therefore, there is no legal relationship between the fixed amount received by the author and the remuneration paid.[96]

Therefore, it can be concluded that the CJEU has been following the same method since the issue became questionable for the VAT purposes.

4. The concept of legal relationship

A transaction only constitutes a taxable supply according to Article 2 of the VAT Directive, if it is carried out for a consideration.[97] Whether goods or services are supplied for consideration, needs to be determined in accordance with the underlying legal relationship between the provider of the supply and the recipient.[98] The legal relationship has a significant function in the taxable transaction. It can be used to specify supply and to determine who the parties of a supply are.[99] Reciprocity is another key element for investigating the existence of a legal relationship between parties.[100] Reciprocal performance of activities under contract is of importance, not only in order to decide whether a supply falls within the scope of VAT, but also in order to define the relevant supply and the taxable amount for VAT purposes.[101]

As part of the concept of the direct link is developed by the CJEU, there must be a legal relationship between the person receiving money and the person(s) paying it.[102] The CJEU in *Tolsma* case introduced a new approach

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[93] Judgment in *European Commission Vs. Republic of Austria,* C-51/18 19, EU:C:2018:1035
[94] *Ibid,* para 44.
[95] *Ibid,* para 48.
[96] *Ibid,* para 49.
[97] Jasmin Kollmann – *Taxable Supplies and Their Consideration in European VAT With Selected Examples of Digital Economy* – Chapter 4, page 84.
[98] *Ibid.*
[99] *Ibid,* page 85.
[100] *Ibid,* page 87.
[101] Oskar Henkow – *Financial Activities in European VAT A theoretical and Legal Research of the European VAT System and the Actual and Preferred Treatment of Financial Activities* – Chapter 5, page 178.
[102] B.J.M. Terra & J. Kajus -*Introduction to European VAT (Recast)* – Chapter 8,, page 173.

to test whether there was a supply for consideration or not, namely legal relationship between parties and reciprocal performance.[103] By introducing those two criteria, the CJEU has refined the direct link test, previously established with other judgments from the CJEU. The CJEU did not give any further explanation of what creates the legal relationship between the parties.

According to the CJEU, the uncertain nature of the provision of any payment is such as to break the direct link between the service provided to the recipient and payment which may be received.[104] The concept of a legal relationship has been criticized. The requirement of a legal relationship results in unintended non-taxation of private expenditure. It seems difficult to argue that the voluntary payment to an organ grinder, as *R. J. Tolsma* case is not in respect of, in response to or for the inducement of the supply of the service.[105]

Legal relationship from a civil law perspective, can exist on several occasions. First and foremost, a legal relationship between parties exist when there is a binding agreement between them, such as a contract, or an oral agreement if the civil law allows to make such a binding agreement without a written contract. Secondly, the legal relationship might exist when there are statutory obligations, etc.[106] Even though the concept of the legal relationship can be addressed from the civil law perspective, various interpretations may be inferred from the concept of the legal relationship for VAT purposes. It is open to diverging interpretations on how to treat different kinds of transactions for VAT purposes.

In *Town & County Factors LTD*[107] case the CJEU stated that 'legal relationship' can be something that does not have to be a binding agreement. In *Town & County Factors LTD*, the legal relationship involved a contractual clause that prescribed that the supplier's obligations were binding in honor only.[108] The CJEU concluded that non-binding relationships like as *Town & County Factors LTD* may fulfill the criterion of a legal relationship. The CJEU also stated that no legal relationship in the

[103] Judgment in *R. J. Tolsma*, C-16/93, EU:C:1994:80, para 14.
[104] B.J.M. Terra & J. Kajus, -*Introduction to European VAT (Recast)* – Chapter 8, page 174.
[105] *Ibid.*
[106] Most of the countries whose jurisdiction comes from a Roman law family follow the same concept. The rules given in the civil code of Germany for example draws the line between the legal relationship that normally comes from the contract and the legal relationship which is based on the rule of law. For example a person who harms another person is liable to compensate the latter for his harm, including all the expenses for the medical activities, etc. Manufacturer has liability to compensate customer, who suffered from the harm by purchasing the product, even when there was no contractual relationship between the parties. Such rules can be found in the German Civil Code and Georgian Civil code for example. The main distinction between those two is that when we are dealing with contractual relationship we have parties who agree upon something very specific and such an obligation comes directly from the contract, but in statutory obligations the legal obligation which later would create legal relationship between the parties is defined by the law. In both cases, legal relationship is binding for the parties.
[107] Judgment in *Town & County Factors LTD*, C-498/99, EU:C:2002:494
[108] *Ibid,* para 8.

Tolsma sense exists, because the obligation on a provider of services is not enforceable, where the impossibility of seeking enforcement of that obligation derives from an agreement between the provider of the services and the recipient.[109] Therefore, the criterion of a legal relationship does not depend on a possibility of enforceability.[110]

As Advocate General Stix-Hackl explained in the opinion[111] the criterion of 'legal relationship' is not to be understood in isolation as meaning a particular specific legal characteristic which a transaction must display. The 'legal relationship' concerns rather the link between supply and consideration.[112] Whether there is a 'legal relationship' in the *R. J. Tolsma* sense, cannot depend on the presence of specific legal characteristics, in particular contractual or procedural ones, such as enforceability in legal proceedings. Since the conditions for the existence and content of legal relationships vary according to national legal systems, that would also be incompatible with the principle of fiscal neutrality.[113]

In the light of the above-mentioned cases, it can be derived that the direct link test and it's one criteria 'legal relationship' is rather vague and not easily explainable. It can be concluded that these complications more or less have been solved by the CJEU's case law development. It can be concluded that the criterion 'legal relationship' for VAT does not depend on the same criterion which is given in the civil law nature. 'Legal relationship' exists for statutory obligations but such obligation merely creates a supply for consideration, as it is coming from the law by itself. Furthermore, if there should be a binding agreement between the parties for the civil law and all the criteria should be established by the contract, for VAT, it is not obligatory to have a binding agreement between the parties, to consider the existence of a legal relationship.

Therefore, it can be concluded that the direct link test includes the criterion of a legal relationship. It must be noted that the objective of the direct link concept is the criteria that there should be supply for consideration.

5. Deposits, cancellation, Services not used and no show treatment under CJEU case law

5.1. Treatment of Services Not Used

In *Kennemer Golf & Country club*[114] case there are 800 members. Members of the club must pay an annual subscription fee as well as an admission fee.

[109] *Ibid,* para 23.
[110] *Ibid.*
[111] AG opinion in *Town & County Factors LTD*, C-498/99, EU:C:2001:494.
[112] *Ibid,* para 37.
[113] *Ibid,* para 38.
[114] Judgment in *Kennemer Golf & Country Club*, C-174/00, EU:C:2002:200.

Non-members may use the golf course and the associated facilities in return for the payment of a daily subscription fee. There were several questions in the main proceedings, but for the purpose of this master's thesis, only the second question will be analyzed.

The second question in the main proceedings concerned whether the golf club should pay VAT from the annual subscription fee, in cases when a member paid an annual fee, but did not regularly use the association's facilities.[115]

The CJEU noted that service for a consideration exists only when there is a direct link between the service provided and the consideration received.[116] In *Kennemer Golf & Country club*, the CJEU considered that the service provided by the association are constituted by making the club available to its members, on a permanent basis and of sport facilities as well associated advantages and not by a particular service provided at the members' request.[117] Therefore, by making its facilities available to the customers, there is a direct link between the service provided and the consideration received, whether or not the customer exercises his/her right or not.[118]

As the AG stated in the opinion[119] the service provided in exchange for the fee is not the use made, but the opportunity to make use, of the facilities.[120] The service is directly linked to the payments.[121]

Consequently, when the consumer does not exercise the right, obtained by the agreement between parties, the payment will still be subject to the VAT, as long as the service provider made the agreed service available for their customers.

5.2. Treatment of deposits

In the case *Société thermale d'Eugénie-les-Bains*[122] the CJEU had to define again the treatment of VAT on the services that did not take place at the end of the day. *Société thermale* established in France, was engaging in the thermal establishments, including the provisions of hotels and restaurant facilities. *Société thermale* collects deposits and sums paid in advance by clients when reserving the rooms. Those sums are either deducted from the amount to be paid for the accommodation or kept by *Société thermale* when clients cancel their reservations.[123] Tax authorities were of the opinion that VAT should have been paid on those deposits kept by the service provider

[115] *Ibid,* para 36.
[116] *Ibid,* para 39.
[117] *Ibid,* para 40.
[118] *Ibid.*
[119] AG Opinion in in *Kennemer Golf & Country Club*, C-174/00, EU:C:2001:694.
[120] *Ibid,* para 31.
[121] *Ibid,* para 32.
[122] Judgment in *Société thermale d'Eugénie-les-Bains*, C-277/05, EU:C:2007:440.
[123] *Ibid,* para 10.

when the clients canceled their accommodations.[124] The question that the CJEU had to answer was if the deposits paid by the clients and kept by the service provider when clients exercised their right to cancel the reservation can be regarded as consideration for the supply of services.[125]

The CJEU noted that there should be a direct link between the service provided and the consideration received. [126] The conclusion of a contract and the resulting existence of a legal link between the parties do not usually depend on the payment of the deposit. The CJEU noted that deposit is not a constituent element of a contract for accommodation.[127] Moreover, according to the CJEU, the payment of a deposit by a client does not oblige a hotel to serve clients. Such an obligation comes directly from the contract of accommodation.[128]

The CJEU referred to the general principles of civil law, stated that honoring the contract arises from the contract by itself and it is not depending on the penalty or something else, therefore there is no direct link between the service rendered and the consideration received.[129] The CJEU went further in characteristics of the deposit, stated that the fact that the deposit paid by the client can be deducted from the accommodation price confirms that there is no independent and identifiable service. [130]

According to the CJEU findings, deposit payment implies a presumption that the contract exists. Secondly, it encourages the parties to perform the contract.[131] The CJEU summarized the case, stating that firstly, the deposit does not constitute independent service for consideration and secondly, in case of cancellation it is a fixed amount of money, intended to offset the consequences of the non-performance, the payment should not be subject to the VAT.[132]

The AG opinion on that case[133] was completely different from the judgment. The AG came to the conclusion that there were two services, one was the accommodation as a principal thing and the deposit as an ancillary service, as payment of the deposit does not constitute an end for the customer, but it means a better enjoyment of the principal service supplied.[134] The AG stated that paid deposit remains in any case and in the event of cancellation, a service that is entirely distinct from the principal service. The AG

[124] *Ibid,* para 12.
[125] *Ibid,* para 16.
[126] *Ibid,* para 19.
[127] *Ibid,* para 21.
[128] *Ibid,* para 23.
[129] *Ibid,* para 26.
[130] *Ibid,* para 26.
[131] *Ibid,* para 30.
[132] *Ibid,* para 35.
[133] AG Opinion in *Société thermale d'Eugénie-les-Bains*, C-277/05, EU:C:2006:555.
[134] *Ibid,* para 23.

considered that as paying a deposit is an ancillary service it should share the treatment of the principal feature for the VAT purposes.[135]

For the purposes of compensation, the AG also had a different view. According to AG opinion, even though the deposit was agreed to be a fixed amount, it is not necessarily directly linked to the loss of the company, as the plaintiff in the main proceedings argues. The plaintiff does not need to prove that they actually suffered a loss, or in any case, when there is no loss at all, they have to return the money to the customer.[136] The AG concluded his opinion that the concept of supply of services for consideration within the meaning of the Sixth Directive, must be interpreted in the lights of objective criteria by having regard to the objective character of the transaction in question.[137]

This was one of the very first cases when the CJEU had to deal with the service which did not take the place at the end of the day. As the AG pointed out in the opinion, all the circumstances must be examined when dealing with the concerned transaction. In this case, the CJEU examined all the circumstances from the VAT Directive and also from the basic civil law approach to get the conclusion. As the CJEU pointed out, regarding service as a subject to VAT, there should be a legal relationship between the parties and a direct link between the service provided and the consideration received. There was a legal relationship, such as a preliminary agreement for the accommodation service, but it independently did not constitute a service by itself. The CJEU declared that all obligations arising from the accommodation contract and not from the payment of the deposit. Payment only gives a presumption that the contract exists, but without the actual accommodation contract, there is no service provided to the final consumer.

5.2.1. Distinction between deposits and payments on account

Deposits must be distinguished from payments on account, referred to also as "prepayments".[138] The general rule of the chargeable event is given in the VAT Directive.[139] According to Article 63 of VAT Directive the chargeable event shall occur and VAT shall become chargeable when the goods or the services are supplied.[140] The VAT Directive also indicates that where a payment is to be made on account before the goods or services are supplied, VAT shall become chargeable on receipt of the payment and on the amount

[135] *Ibid.*
[136] *Ibid,* para 28.
[137] *Ibid,* para 34.
[138] Marta Papis-Almansa – *Insurance in European VAT On the Current and Preferred Treatment in the Light of the New Zeeland and Australian GTS system* – Chapter 3, page 130
[139] Article 63 - of the of the COUNCIL DIRECTIVE 2006/112/EC of 29 November [2006] OJ L 347 of the common system of the value added tax.
[140] Article 63 - of the of the COUNCIL DIRECTIVE 2006/112/EC of 29 November [2006] OJ L 347 of the common system of the value added tax.

received.[141] In that case, payments of consideration are directly linked to the supply of goods or services made before the goods or services supplied.[142] Unlike deposits they trigger VAT liability.[143] Payments on account are made for a well-defined service that will be supplied later.[144] The CJEU has discussed prepayments in many cases.[145]

5.3. Treatment of no show

In the joined case *Air France-KLM, Hop!-Brit Air SAS*[146] the issue was what kind of treatment should have been used to the payment of the tickets, which was not used by the consumer. There were two kind of tickets, firstly non-refundable and second type with a possibility to change the date. When the possibility to change the ticket expired and the non-refundable ticket prices were not subject to VAT according to the applicant in the main proceedings.[147]

The CJEU again referred to the settled case law and stated that there should be a legal relationship and reciprocal performance between the parties in order to stipulate VAT liability.[148] The CJEU stated that the first element, in order to VAT become chargeable *i.e.* legal relationship exists from the very moment when the customer buys the ticket. By purchasing the ticket, customer gets all the rights which is scheduled in the contract, including the right to travel, to get your luggage transported, etc.[149]

However, it is possible to perform such services only if the passenger of the airline company turns up on scheduled time. Therefore, those above-mentioned rights exist at the time of the purchase of the ticket and it does not matter whether a passenger exercises this right or not.[150] The CJEU also stated that where the passenger has paid the price of the ticket and the company confirms that a seat is reserved for a passenger, the sale is final and definitive.[151] Therefore, the service is independent and identified for that purpose. The CJEU also stated that the price paid by the consumer does not constitute compensation for the harm suffered by a company, but it is a remuneration, even where the passenger did not use the transport.[152] Later

[141] Article 65 - of the of the COUNCIL DIRECTIVE 2006/112/EC of 29 November 2006 of the common system of the value added tax.
[142] Marta Papis-Almansa – *Insurance in European VAT On the Current and Preferred Treatment in the Light of the New Zeeland and Australian GTS system* – Chapter 3, page 130
[143] *Ibid.*
[144] Jeroen Bijl – *Supplies for EU VAT Purposes: Reflections on Air France – KLM and Vouchers* - International VAT Monitor May/June 2015, page 136.
[145] For further discussion please see inter alia Judgment in *BUPA Hospitals and Holdsborough Developments*, C-419/02, EU:C:2006:122, Judgment in *Ofrey Balgaria EOOD*, C-549/11, EU:C:2012:832.
[146] Judgment in *Air France-KLM and Hop!-Brit Air SAS*, C-250/14, C289/14, EU:C:2015:841.
[147] *Ibid,* paras 9-11.
[148] *Ibid,* para 22.
[149] *Ibid,* paras 25-26.
[150] *Ibid,* para 28.
[151] *Ibid,* para 33.
[152] *Ibid,* para 34.

on, the CJEU stressed that in the event of a no-show, the airline company which sells a transport ticket does fulfill its contractual obligations by putting the passenger in a position to claim his rights to the services provided for the transport contract.[153]

In this case, the CJEU repeated what was established in the previous case law, especially in *Kennemer Golf & Country Club* case. For the consideration, according to the settled case law, it is not essential if the customer exercises his/her right, obtained from the concerned transaction, but the decisive factor is that the customer has an opportunity to do so. Comparing that outcome to the case of Case *Société thermale d'Eugénie-les-Bains*, it can be derived that while dealing with the transactions that did not take place, especially concerning transactions supplied in the form of the services, the CJEU takes two different approaches. When the conducted contract between the parties is final and the customer has an opportunity to use the service paid for, there is a consideration, while when the contract is not final and it is depending on another performance between the parties, such was in the case in case *Société thermale d'Eugénie-les-Bains,* when parties ought to fulfill accommodation contract, there is no consideration for the VAT purposes.

Although the case raised several opinions, before it was decided, professor Schenk states that even if the purchaser of the ticket does not show up, the flight will likewise take place.[154] Opposition to this argument, the author thinks that from an EU VAT perspective, the taxable event is not an airplane flying from A to B.[155] Jeroen Bijl was convinced that the sale of an air transportation ticket should not be considered as supply of a 'right' *i.e.* right to transportation because in his view, the supply of a 'right' from a VAT perspective is a supply of a service of a different nature.[156]

Those divergences prove that it is not an easy task to determine the existence of a direct link in a concerned transaction and therefore assume which outcome would be given by the CJEU. The CJEU set the rules for such transactions – the airline company which sells a transport ticket fulfills its contractual obligations where it puts the passenger in a position to claim his rights to the services provided by the transport contract.[157] It is irrelevant whether the customer actually decides not to benefit from the agreed service.[158] The judgment thus provided an elegant answer to what should be

[153] Jeroen Bijl – *Air France – KLM: The SAFE Equivalent for Service?* - International VAT monitor March/April 2016, page 96.
[154] Jeroen Bijl – *Supplies for EU VAT purposes, Reflections on Air France – KLM and Vouchers* - International VAT monitor May/June 2015, page 136.
[155] *Ibid.*
[156] Jeroen Bijl – *Air France – KLM: The SAFE Equivalent for Service?* - International VAT monitor March/April 2016, page 96.
[157] Jeroen Bijl – *Air France – KLM: The SAFE Equivalent for Service?* - International VAT monitor March/April 2016, page 96
[158] *Ibid.*

considered "the supply of a service"[159] The CJEU defined the term of "the supply of a service". This supply can be paid for before the service is actually supplied. The actual supply is made when the supplier enables its customer to actually benefit from the agreed service.[160]

5.4. Treatment of cancellations

5.4.1. Facts of the case

In the case *MEO- Serviços de Comunicações e Multimédia SA*[161] the CJEU had to define again, the consequences for the VAT treatment of termination of the contract. *MEO* is a company, established in Lisbon, providing telecommunication services on Portuguese territory.[162] Part of his activity, *MEO* offers customers internet access, television and multimedia on favorable terms, in the form of lower monthly subscription fees.[163] These contracts stipulate that in the case of deactivation of the goods and services before the expiry of the agreed minimum commitment period at the request of customers, or for a reason which is attributable to them, *MEO* is entitled to receive compensation. In case of early termination, *MEO* receives the same amount, which it would normally receive if the contract was not terminated before the expiration date. Also, the customer is liable to pay compensation, even in the case where they fail to pay the agreed monthly subscription fee.[164] The CJEU has been asked whether such scenario should be regarded as payment for a supply of services for consideration within the meaning of Article 2(1)(c) of the VAT directive, and as such be subject to VAT. [165]

5.4.2. Findings of the CJEU

While answering the question the CJEU referred to well established case law, constituting that supply of services are carried out 'for consideration' only if there is a legal relationship between the parties.[166] For the direct link test, the CJEU referred to *Air France-KLM, and Hop! Brit-Air* case, where it defined that regardless the fact if the customer uses the right attributed from the agreed contract or not, the existence of a right to use the service, which is provided by the taxable person constitutes the direct link between the payment received and the service made available by the taxable person acting as such.[167] The CJEU questioned whether the amount due for failure to comply with the minimum commitment period, corresponds to the

[159] *Ibid,* page 97.
[160] *Ibid.*
[161] Judgment in *MEO - Serviços de Comunicações e Multimédia SA,* C-295/17, EU:C:2018:942.
[162] *Ibid,* para 10.
[163] *Ibid,* para 11.
[164] *Ibid,* paras 12-14.
[165] *Ibid,* para 38.
[166] *Ibid,* para 39.
[167] *Ibid,* para 40.

payment for the service.[168] The CJEU referred to the calculation method in case of early termination of the contract and concluded that *MEO* in principle receives equal income, which it would have received if the customer had not terminated the contract prematurely.[169] The CJEU also mentioned that the contractual terms have a great importance in categorizing a transaction as a taxable transaction, but it is necessary to bear in mind the case law of the CJEU according to which consideration of economic and commercial realities is a fundamental criterion for the application of the common system of VAT.[170] Therefore, the fact that there is an early termination of the contract does not alter the economic reality of the relationship between *MEO* and its customer, because *MEO* still receives the same amount which it would normally have received.[171]

Taking into consideration all the above-mentioned criteria, the CJEU concluded that *MEO* makes its service available to the customers and by enabling the customers to benefit from the service, within the meaning of the case *Air France-KLM, and Hop! Brit-Air*, and the cessation of that service is not imputable to it.[172] The CJEU added that even though the payment can be characterized as damages to make good the loss suffered by *MEO*, the nature of the consideration paid by the customer would be changed, depending on whether or not the customer decides to use the service, which was also the case in *Société thermale d'Eugénie-les-Bains.* Consequently treating customers who decides to use the service for the whole commitment period and the ones, who terminate the contract before the expiration date differently, would be different treatment for the purposes of VAT.[173]

Thus, the CJEU concluded that "predetermined amount received by an economic operator where a contract for the supply of services with a minimum commitment period is terminated early by its customer, or for a reason attributable to the customer, which corresponds to the amount that the operator would have received during that period in the absence of such termination, a matter which it is for the referring court to determine – must be regarded as the remuneration for supply of services for consideration and subject as such to VAT."[174]

5.4.3. The AG opinion

As the Advocate General Julian Kokkot mentioned in the opinion[175] a similar question has been raised by the CJEU in its case-law so-called

[168] *Ibid,* para 41.
[169] *Ibid,* para 42.
[170] *Ibid*, para 43.
[171] *Ibid,* para 44.
[172] *Ibid,* para 45.
[173] *Ibid,* paras 46-47.
[174] *Ibid,* para 57.
[175] AG Opinion in *MEO - Serviços de Comunicações e Multimédia SA,* C-295/17, EU:C:2018:413.

compensation for non-use of benefit in *Société thermale d'Eugénie-les-Bains*, and *Air France-KLM and Hop! Brit-Air*, and those questions have already been discussed, but this reference for a preliminary ruling gives the CJEU opportunity to further develop the case-law.[176]

In the case of so called compensatory payments, compensations or damages, it always has to be clarified why and for what purpose the money is paid in order to assess whether a supply of service for consideration has been made for VAT purposes.[177]

The AG briefly described the main reasons why *Société thermale d'Eugénie-les-Bains* and *Air France-KLM and Hop! Brit-Air* cases had the different outcome, constituting that in the latter one the contract was final and the price paid by the passenger who did not take the flight was equal to the total price to be paid. [178] AG emphasized that compensation when there is a lack of damage would not be justified.[179]

AG mentioned that the present case, *MEO* is in the middle of those two decisions. It is clear that after deactivation of the contract by *MEO* the customer will not receive any service, however the money paid by the customer is exactly the same amount which would have been paid by the customer, if there would not be a termination of the contract.[180] The AG concluded that the fact that the contract is over is irrelevant. Also, payments after termination of a contract may still be related to previous contractual service.[181] The AG considered that the compensation would normally always have to be lower than the agreed net price.[182] The AG questioned of what kind of damages would have been covered by the payment after the termination and secondly she stated that the agreement between the parties was very clear from the very beginning. It was clear that *MEO* would have received the same amount, regardless of the termination or fully used service by the customer.[183] Those arguments are supported by an economic analysis of the contractual structure of *MEO*. The CJEU itself recognizes the importance of economic reality in VAT law.[184] For the VAT law it makes no difference if the customer pays 100 Euro per month for a 24 month contract or 2400 Euro immediately as one-time payment and then decides not to use the internet anymore.[185] Consequently, the AG came to the conclusion that those payments should be subject to VAT.[186]

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[176] *Ibid,* para 3.
[177] *Ibid,* para 39.
[178] *Ibid,* para 42.
[179] *Ibid.*
[180] *Ibid,* para 43.
[181] *Ibid,* para 44.
[182] *Ibid,* para 45.
[183] *Ibid,* para 48.
[184] *Ibid,* para 49.
[185] *Ibid,* para 50.
[186] *Ibid,* para 60.

5.4.4. Analysis

As the AG mentioned, case *MEO* was somewhere between *Société thermale d'Eugénie-les-Bains* and *Air France-KLM and Hop! Brit-Air*. The case *Société thermale d'Eugénie-les-Bains* has been discussed in the previous chapter[187] and there will not be further analysis of the case, it is just worth to mention that there was no actual contract between the parties according to the CJEU. In the case *Air France-KLM and Hop! Brit-Air* there was an agreement between the parties, all the details were decided upon at the purchase of the ticket and the purchase was final. There was no conditional dependent for the parties, such it was a case in *Société thermale d'Eugénie-les-Bains* case. The accommodation was depending on the contract, not on the deposit according to the CJEU reasoning.

The existence of a legal relationship was not questionable in the present case, as the agreement between the parties were conducted and all the conditions were agreed between the parties, such as a monthly payment and even the terms of cancellation and the consequences of nonpayment by the customer. It should be noted that the existence of a legal relationship is one of the criteria for the direct link concept and the merely existence of a legal relationship is insufficient grounds to conclude that there is a supply for consideration. It is noteworthy, that, unlike the *Société thermale d'Eugénie-les-Bains* and *Air France-KLM* cases, the CJEU's considerations related to the presence of a direct link as a prerequisite for taxable treatment of the payment are rather concise in the present case. [188]

As the AG mentioned at the beginning of her opinion, even though that kind of question has been raised before the CJEU in the past, this case was a good example for further developments on the cancellation charges. The CJEU had the possibility to define even clearer the criteria of the direct link, but as mentioned before, it is barely discussed in the present case.

The existence of a legal relationship was not questionable in the present case, but the characteristic of the legal relationship varies from the beginning of the contract and after the termination. The whole situation changes as the contract which has been agreed before and the main, identifiable service i.e. telecommunication service does not exist anymore. Since the *R. J. Tolsma* case, the CJEU has continuously stated that a supply of service is effected for consideration and hence is taxable only if there is a legal relationship between the provider of the service and the recipient pursuant to which there is reciprocal performance.[189]

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[187] Please see 5.2.

[188] Yanista Radeva – *VAT implications of Cancellation Charges: New Substance-over-Form Rule?* - International VAT monitor January/February 2019, page 13.

[189] Yanista Radeva – *VAT implications of Cancellation Charges: New Substance-over-Form Rule?* - International VAT monitor January/February 2019, page 14, see also: R.J. Tolsma, supra n. 4, at para. 14, UK: ECJ, 20 June 2013, Case C-653/11, *Her Majesty's Commissioners of Revenue and Customs*

The nature of a legal relationship after the termination of the contract has been changed and there was no providing service to the customers. All the rights attributed from the contract by the customers, *i.e.* receiving telecommunication services and the internet access did not exist anymore, as the contract has been terminated. Comparing this scenario to *Air France-KLM and Hop! Brit-Air* there was a different issue in the main proceedings. It was clear from the files presented to the CJEU that there was no cancellation by the passenger or from the Airline company and the passenger simply did not use the service, which they were enabled to use by the taxable person. There were no changes in the actual agreement between the parties. As the CJEU mentioned in the judgment, the sale of the ticket was finalized at the moment of the purchase and it was final.

In the judgment *Paul Newey*,[190] also referred to in the *MEO* Case, with respect to the importance of the contractual terms in categorizing a transaction as taxable, the CJEU ruled that "it is necessary to bear in mind the case law of the Court according to which consideration of economic and commercial realities is a fundamental criterion for the application of the common system of VAT".[191] Seeking to acknowledge the economic substance of the transaction, the CJEU ruled that the contractual terms may be disregarded for VAT purposes in cases which do not reflect the economic and commercial reality, but constitute a wholly artificial arrangement set up with the sole aim of obtaining a tax advantage.[192]

Therefore, in the case *Paul Newey* the CJEU established that the contractual terms may be disregarded in cases when a taxable person aims to obtain a tax advantage. The contractual position normally reflects the economic and commercial reality of the transaction and in order to satisfy the requirements of legal certainty, contractual terms should be taken into consideration. Sometimes, certain contractual terms do not wholly reflect economic and commercial reality. This happens mostly when particular contractual terms constitute a purely artificial arrangement which does not correspond with the economic reality of the transaction.[193] Legal arrangements that have been put in place in a rather artificial way with the apparent purpose of obtaining tax advantage are to be opposed.[194] It may be conceived that each person should be aware of the fact that if he does not act in line with his contractual arrangements taxes will be levied on the basis of real facts.[195]

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v. Paul Newey t/a Ocean Finance, para. 40, ECJ Case Law IBFD; and UK: Judgment in *MacDonald Resorts Ltd,* C-270/09, EU:C:2010:780 para. 16, ECJ Case Law IBFD. See also R.E. Krever, What's in a Name? Prepayments, Deposits, Vouchers and Options, supra n. 12, at sec. 3.

[190] Judgment in *Paul Newey,* C-653/11, EU:C:2013:409.

[191] Yanista Radeva – *VAT implications of Cancellation Charges: New Substance-over-Form Rule?* - International VAT monitor January/February 2019, page 14.

[192] *Ibid.*

[193] Judgment in *Paul Newey,* C-653/11, EU:C:2013:409, paras. 43-45.

[194] Herman Van Kesteren, *Taxable and non-taxable transactions* In Michael Lang, *Recent developments in value added tax 2016*, page 221.

[195] *Ibid,* page 226.

The principle of abuse of rights should only be applied where legal arrangements are fully executed but are still artificial compared to what is "normal" or "real" in daily business.[196] The comparison that is made under the application of the abuse of rights principle is between the taxable person at issue and the person who designed their legal arrangements in a less artificial way (normal business practices.)[197]

Thus, disregarding contractual terms according to the settled case-law can only be justified when such terms intend to create a wholly artificial arrangement and aim to obtain a tax advantage. In the present case *MEO*, the CJEU did not question whether such cancellation fees were intended to obtain a tax advantage. However, arguments to the contrary can be derived from the facts and it can be concluded that the contract was conditional, *i.e.* the existence of the contract to provide telecommunications services was depending on the payment from the customer. After terminating the contract there is no actual supply of services, neither the possibility to use the service by the consumer. Therefore, the payment should have been considered as compensation, not the payment for the supply for consideration.

Furthermore, the CJEU emphasized the fact that *MEO* always received the same amount which it would normally receive if the contract would not have been terminated by the customer. This argumentation of VAT treatment on cancellation charges is determined primarily based on the economic reality of the transaction.[198] Therefore, it can be assumed that the cancellation fee would always be subject to VAT when its amount is identical to the amount of the purchase price of the service, irrespective of the existence of a legal relationship between the parties.[199]

As the AG mentioned in her opinion, payments after termination of a contract may still be related to previous contractual service. This assumption is correct, as the cancellation fees do not exist without the actual contract in the first place. The nature of the payment, as mentioned before changes as soon as there is a termination of the contract. Therefore, the CJEU should have looked whether such fees create wholly artificial arrangement and only if the answer to that question would be yes disregarded the contractual terms.

The nature of the contract conducted between parties, always takes into consideration the possibility of cancellation. Cancellation is the term of the contract, which is provided by the most civil codes.[200] Thus, how does the

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[196] *Ibid.*
[197] *Ibid.*
[198] Yanista Radeva – *VAT implications of Cancellation Charges: New Substance-over-Form Rule?* - International VAT monitor January/February 2019, page 14.
[199] *Ibid.*
[200] For example if one of the parties to a bilateral contract breaches an obligation arising from the contract (In the present case the obligation to pay for the agreed service) then the other party to the

possibility of cancellation creates the wholly artificial arrangement, when this right is provided by the law?

The whole argumentation of the CJEU has relied on the fact that *MEO* always receives the same amount, regardless if they provide service to the whole amount of time determined in the contract, or in case of termination. What outcome would have been from the case, if the *MEO* concluded the contracts in the manner when the cancellation fee would not have been the same amount, but for example 1 Euro less? In that case, *MEO* always has the possibility to change the contractual terms and introduce a new one, where they will not receive the exact same net amount from the customer and therefore, it will be still questionable whether such fees should be subject to the VAT regime.

Such argumentation provided by the CJEU might be in opposition to fiscal neutrality, as mentioned before. Fiscal neutrality, as a general principle of VAT law should be applied in the manner, where the businesses and customers decisions will not be influenced by the VAT treatment. In such a scenario as in the present case, such a decision might be influenced by the outcome and taxable person might conduct contract in a new way, where the whole argumentation of the CJEU will be abolished, by simply getting a little bit less net income from the cancellation fee, instead of what they would have got if the termination would not take place at all.

The present case also can be compared to *Kennemer Golf & Country club* case. There were similar facts like in the *Air France-KLM, Hop!-Brit Air SAS* case, where the subscribers were paying an annual fee and were not using the service provided by the Golf club. In this case, the CJEU mentioned that subscribers had the possibility to use the service, which was available for them by the Golf club and therefore, the consequence was that as long as the customer has the possibility to use the service, it creates supply for consideration, even though customer might decide not to exercise the right. The fee paid by the customers were annual and therefore, a contract was final at the moment of the purchase. In that case, the contract was not conditional, as it was not depending on monthly payment. In the present case, the contract was conditional and even more, when there was termination, after that moment there was no possibility for the customers to actually use the service, consequently the service was not available for them by the *MEO* and technically, their right did not exist anymore after the

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contract may repudiate the contract. This right is guaranteed by Georgian Civil Code article 405(1). If, in the case of a reciprocal contract, the obligor does not render an act of performance which is due, or does not render it in conformity with the contract, then the oblige may withdraw from the contract, if he has specified, without result, an additional period for performance or cure. This right is guaranteed by German Civil Code section 323(1) and if the nature of the breach of duty is such that setting a period of time is out of the question, a warning notice is given instead- German Civil Code 323(3). German Civil Code goes even further, by stating in Section 280(1) that if the obligor breaches a duty arising from the contract, the oblige may demand damages for the damage caused thereby.

termination of the contract. Subsequently, there was no actual supply of the telecommunication service because the customers were paying the cancellation fees and also they did not have the possibility to decide whether they wanted to use the service or not, even though there was an actual payment made by them.

A direct link between a supply and consideration received can easily be established if both the number of supplies and the related payments are fixed.[201] The direct link between a supply and its compensation also remains intact if parties – in their legal relationship – anticipate changes of circumstances and their potential effect on the pricing of the product.[202] Thus, at the very least the pricing should be fixed and easily predictable from the legal relationship, or the changes should be indicated by the parties in their existing legal relationship, namely contract. The changes should apply to the pricing of the product. In the present judgment, the changes between parties was fixed by the cancellation possibility indicated in the contract, but the element of the product after terminating the contract is lost.

According to the settled case law the direct link is absent if the payment depends on additional performance by the supplier and is also subject to certain degree of uncertainty.[203] This judgment creates a guidance of an absence of a direct link, where there is no final and fixed legal relationship between the parties and constitutes, that if the payment depends on an additional performance from the supplier, there is no direct link. Additional performance, namely supplying the service in the present case *MEO* was depending also on the payments from the customer. This question remains uncertain what if the additional performance from the supplier is depending on the activities of the customer?

Furthermore, the AG questioned of what kind of damages would have been covered by the payment after the termination. The same question has been raised by AG Poiares Maduro in the case *Société thermale d'Eugénie-les-Bains*, where he mentioned that the plaintiff disputed that the claim that the sums paid by its customers as a deposit constitute direct consideration for the reservation service which it provides. The AG questioned that there was no actual proof that the hotel really had the loss in case of no show. Furthermore, the AG constituted that there is no provision that the hotelier is obliged to return money to its customers, in case there was no actual loss.[204] In the judgment the CJEU mentioned that given the fact that compensation

[201] Yanista Radeva – *VAT implications of Cancellation Charges: New Substance-over-Form Rule?* - International VAT monitor January/February 2019, page 14.
[202] *Ibid,* page 215.
[203] *Ibid*; see also – Judgment in *Pavlína Baštová*, C-432/15, EU:C:2016:855, para 35.
[204] AG Opinion in *Société thermale d'Eugénie-les-Bains*, C-277/05, EU:C:2006:555, paras 27-29.

is fixed, it is only to be expected that the amount of that loss may be higher or lower than the amount of the deposit retained by the hotelier.[205]

There was no further development on the issue of loss neither in *Société thermale d'Eugénie-les-Bains*, nor in the *MEO* case. The CJEU briefly mentioned that there is a possibility in *Société thermale d'Eugénie-les-Bains* case that the loss might be lower than the fixed deposit but still, considered that the amount received by the hotelier should not be subject to VAT. According to this reasoning, does the exact same amount received by *MEO* can constitute loss for the termination of the contract? This question is not addressed in the present judgment but according to the CJEU, the actual loss cannot be disputed by *MEO*, because it receives exactly the same net amount, therefore, loss as such cannot be displayed in those circumstances.

For the good functioning of the VAT system, it is required that VAT must be applied in a manner, that is – as far as possible – in harmony with the actual economic situation.[206] The case has been decided only from an economical point of view, but a lot of questions have been left open, such as what would happen if there is a difference between what *MEO* would have received in case of no termination and it actually receives when there is a termination. The main line from the present case can be summarized in the following statement – If the amount after cancellation is exactly the same as the taxable person would have received in case of no termination, the amount should always be subject to VAT.

How the CJEU will develop the same concept in the cases it is still remains to be seen, but the judgment might encourage taxable persons to create contract, where in case of termination they would not get exactly the same net amount of money and therefore argue that it is actual compensation and not the money received for supply for consideration. This approach seems to create wholly artificial arrangements, rather than what was created by *MEO* in his contracts. This kind of approach will create a loophole in terms of aiming tax benefit, because the present judgment does not change *Société thermale d'Eugénie-les-Bains* approach, but it is rather a new approach from an economical point of view.

Furthermore, it is worth to mention, that in the present case the concept of consumption is rather disregarded, than discussed in terms of actual consuming telecommunication services provided by *MEO*. Transactions falling within the scope of the common system of VAT must imply consumption.[207] As Oskar Henkow notes in some cases *i.e. Jürgen Mohr*,

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[205] Judgment in *Société thermale d'Eugénie-les-Bains*, C-277/05, EU:C:2007:440, para 33.
[206] Herman Van Kesteren, *Taxable and non-taxable transactions* In Michael Lang, *Recent developments in value added tax 2016*, page 225.
[207] Oskar Henkow – *Financial Activities in European VAT A theoretical and Legal Research of the European VAT System and the Actual and Preferred Treatment of Financial Activities* – Chapter 3, page 60.

the CJEU rather than looking at whether there was a direct link between service provided and the consideration received, gave considerable weight to the fact that no consumption was present.[208] Only transactions involving consumption are relevant for VAT.[209] Sometimes, both the supply and the payment are clearly defined and not subject to any uncertainty. However, it may well be that the sums of money that are received by the supplier and the services provided are simply not sufficiently linked to each other to create a direct link.[210] If according to the settled case law, the service which is provided cannot create a clear direct link, how this affects the fact that after the termination of the contract there was no provided service at all? The element of consumption needed to be addressed in the present case.

6. The meaning of consumption in the non-performed contracts for the services

The question remains what should be understood as consumption for the purposes of the VAT Directive.[211] In general use of language, consumption can be defined as the act of using goods or services.[212] For the purposes of VAT, it needs to be kept in mind that, in general, the term consumption only covers final use.[213] Consequently, only a benefit that accrues to the end-users can be deemed consumption in the meaning of the VAT Directive.[214] It can be noted that it is not the event of consumption that fulfills the VAT definition of consumption, but rather the aim that goods or services are intended to be consumed.[215]

A supply of consideration is taxable and falls within the scope of the VAT Directive when it is performed by a taxable person.[216] It has been advocated that the legal view of VAT stresses its character as a tax on transactions performed by VAT registered entities for consideration.[217] When analyzing the nature of VAT, economics put significantly less emphasis on the formal requirements and the concepts rooted in civil law.[218] The VAT Directive sets the limits of the system by including within its scope productive

[208] *Ibid.*
[209] Jasmin Kollmann – *Taxable Supplies and Their Consideration in European VAT With Selected Examples of Digital Economy* – Chapter 2, page 18.
[210] Herman Van Kesteren, *Taxable and non-taxable transactions* In Michael Lang, *Recent developments in value added tax 2016*, page 217.
[211] Jasmin Kollmann – *Taxable Supplies and Their Consideration in European VAT With Selected Examples of Digital Economy* – Chapter 2, page 18.
[212] *Ibid.*
[213] *Ibid.*
[214] Oskar Henkow – *Financial Activities in European VAT A theoretical and Legal Research of the European VAT System and the Actual and Preferred Treatment of Financial Activities* – Chapter 3, page 75.
[215] Jasmin Kollmann – *Taxable Supplies and Their Consideration in European VAT With Selected Examples of Digital Economy* – Chapter 2, page 19.
[216] Marta Papis-Almansa – *Insurance in European VAT On the Current and Preferred Treatment in the Light of the New Zeeland and Australian GTS system* – Chapter 3, page 130.
[217] Marta Papis-Almansa – *Insurance in European VAT On the Current and Preferred Treatment in the Light of the New Zeeland and Australian GTS system* – Chapter 3, page 133.
[218] *Ibid.*

activities of taxable persons acting as such, when they give rise to supply of goods or services for consideration. Nevertheless such activities must be linked to consumption.[219] From the legal point of view, only a particular kind of consumption should be burdened by VAT. Lawyers maintain that the VAT is a tax on consumption expenditures rather than on, more broadly, consumption activities.[220] The service will not be covered by the concept of a "taxable transaction" if there is no benefit supplied to an identifiable consumer, or identifiable group of consumers.[221] The lack of consumers of a particular service means that there is a lack of consumption and this in turn means the lack of a taxable supply of goods or services.[222]

Not surprisingly, VAT is the most prevalent form of consumption tax in the world.[223] VAT aims to be a broad-based tax levied on final consumption.[224] As Article 1(2) of the VAT Directive constitutes, EU VAT is a general tax on consumption.[225] However, the term "consumption" itself, is not defined in the VAT Directive.[226] The purpose of a turnover tax is, in short, to tax goods destined for personal consumption. In other words, it taxes goods on their way to a consumer.[227] Since a general tax on consumption is a tax on the expenditure of individual consumers, there should be a relationship between the tax burden and the amount spent by the taxpayer.[228]

However, the case law also provides examples which prove that the existence of consumption test and direct link test do not necessarily lead to the same result.[229]

Delimitation of the notion of consumption for VAT purposes requires reference to the context of the VAT Directive. In that respect taxable persons, economic activity, supply of goods or services and consideration should be taken into consideration when defining consumption.[230] Consequently, the concept of consumption is a criterion which is separate from the direct link criteria and its four elements. Therefore, only the question if there is a direct link between the service supplied and the remuneration received does not solve the problem. Final answer should come from the question if there is an actual consumption for the VAT

[219] *Ibid.*
[220] Sijbren Cnossen – *A VAT Primer for Lawyers, Economists and Accountants* – Tax Analysts - page 38.
[221] Marta Papis-Almansa – *Insurance in European VAT On the Current and Preferred Treatment in the Light of the New Zeeland and Australian GTS system* – Chapter 3, page 115.
[222] *Ibid.*
[223] Sijbren Cnossen – *A VAT Primer for Lawyers, Economists and Accountants* – Tax Analysts - page 34.
[224] Giorgio Beretta – *VAT and Sharing Economy*, World Tax Journal August 2018, page 392.
[225] Article 2(1)(a)-(d) of the of the COUNCIL DIRECTIVE 2006/112/EC of 29 November [2006] OJ L 347 of the common system of the value added tax.
[226] Giorgio Beretta – *VAT and Sharing Economy*, World Tax Journal August 2018, page 393.
[227] B.J.M. Terra & J. Kajus, -*Introduction to European VAT (Recast)* – Chapter 7, page 125.
[228] *Ibid,* page 127.
[229] Marta Papis-Almansa – *Insurance in European VAT On the Current and Preferred Treatment in the Light of the New Zeeland and Australian GTS system* – Chapter 3, page 126.
[230] *Ibid,* page 134.

purposes. The direct link concept can be easily fulfilled, for example in the case *Société thermale d'Eugénie-les-Bains*, where there was an agreement between the parties. Therefore there was a legal relationship,[231] but there was no actual consumption in this case.

As the legal character of VAT constitutes that VAT is a general tax on consumption which is levied on the expenditure of individual consumers, it should not matter when and if the consumption takes place at all inasmuch as the tax should be levied as soon as expenditure by a final consumer occurs.[232] However, if the consumption takes place matters for the application of VAT, which can easily be proved by the enormous amount of the cases, which solely concerned only if the consumption existed and therefore, if the concerned transaction should have been subject to VAT.

As mentioned before, in some cases consumption is immediate and therefore it does not rise any questions, but in scenarios where we deal with services, especially which allows service provider to receive money for the future services, it is not always easy to answer the question.

As outlined, VAT is a general tax on expenditure of consumption and not a consumption itself, which has been confirmed by the CJEU in many cases. As long as the final consumer has a right to use the service, which he/she paid money for, the consumption exists, regardless if they decide to use the service or not.

Therefore, for the cancelled and non-performed contracts, it can be summed up that the concept of consumption developed by the CJEU is quite straightforward. If a consumer has a possibility to use the service, there is a consumption. Consequently, in a cases where there is no show, cancelation of the contract or terminating it, a taxpayer should always check the possibility from the consumers perspective. As long as they fulfilled the direct link criteria[233] and they fulfilled all the obligations which was binding for them according to the legal relationship which existed between them, they should always tax from the remuneration they receive from that consumer.

In that regard the *MEO* case was not in consistency with previously established case law by the CJEU. The argumentation and the lines of reasoning from previous case law by the CJEU has been disregarded in the present case, as the CJEU did not check and did not give significance importance of the fact that the final consumer was not able to use the service anymore. Consequently, the *MEO* case should be criticized.

Further developments on the issue are necessary, especially in terms of consumption when it comes to non-performed contracts. Such a line of

[231] Discussed in the chapter 5.2.
[232] Mariya Senyk – *Territorial Allocation of VAT in the European Union* – Chapter 2, page 56.
[233] Discussed in the chapter 4.

reasoning is to be relevant in the near future, when the CJEU will perform its requested assessment and judgment on the *Vodafone Portugal* case. *Vodafone Portugal* concludes various service contracts for electronic communication, internet access and television. In contracts with customers, the conditions are specified and quantified and a minimum contract duration is set, the amount to be paid in the event of non-compliance being calculated on the bases of the aforementioned benefits and proportion to the already expired part of the minimum contract duration. The amount to be paid may not exceed the costs incurred by Vodafone for the installation of the service. Vodafone argues that the amount received is not a consideration, since payment is made after termination of the contract and its sole purpose is to compensate for the damage suffered as a result of the non-compliance and early termination of the contract.[234] In the above-mentioned case, the CJEU has a possibility to define consumption for non-performed contracts, as the consumption has not been discussed in the *MEO* case extensively.

7. Conclusions

Although the CJEU has considered the existence of a consumption as one of the decisive criteria for establishing whether a transaction falls within the scope of application of the VAT Directive, the case law on the meaning of the concept of consumption for VAT purposes is not extensive.[235]

The concept of consumption especially becomes complicated when there is a cancellation of the agreed service. Identifying consideration and valuing it are two essentially separate issues[236] According to above mentioned case analysis it can be summarized the existence of a legal relationship is crucial for establishing direct link but the direct link is not enough itself. From the judgments by the CJEU on the direct link test it also follows that VAT is a tax on expenditure for private consumption rather than consumption activities as such.[237]

How does the direct link test is applied when it comes to non-performed contracts? The CJEU in general was able to address the issue quite well. Throughout case law the CJEU developed two main approaches. If the agreement between the parties is final and it cannot be changed even though the final consumer decides not to use the service, there is a service provided and therefore, concerned transaction falls within the scope of VAT, as the

[234] Request for a preliminary ruling from the Tribunal Arbitral Tributário (Centro de Arbitragem Administrativa — CAAD) (Portugal) lodged on 24 January 2019 — *Vodafone Portugal* — Comunicações Pessoais, SA v Autoridade Tributária e Aduaneira, Case C-43/19.

[235] Marta Papis-Almansa – *Insurance in European VAT On the Current and Preferred Treatment in the Light of the New Zeeland and Australian GTS system* – Chapter 3, page 116.

[236] Deborah Butler – *The usefulness of the 'direct link' test in determining consideration for VAT purposes* - EC tax review 2004-3, page 100.

[237] Marta Papis-Almansa – *Insurance in European VAT On the Current and Preferred Treatment in the Light of the New Zeeland and Australian GTS system* – Chapter 3, page 127.

final consumer was able to use the right obtained from the legal relationship conducted between him/her and the service provider.

The second approach developed in the case *Société thermale d'Eugénie-les-Bains*[238] the CJEU developed that if the contract is not final and providing agreed service is depending on something else, namely the contract of accommodation in this specific case, the deposit received and kept by the hotelier does not constitute consideration for VAT purposes. Therefore, while defining if in case of termination of the contract the money received by the service provider constitutes consideration for VAT, it should be looked if the contract was final and if the final consumer obtained expenditure of consumption. If the answer is no, then it can be assumed that there is no consideration, as a consumer does not have the right to use the service provided by the taxable person.

It is arguable that the law on consideration contains a number of anomalies, since there are cases in which apparently slight differences in the way a transaction is organized can make a significant difference to the tax treatment.[239] The direct link test introduced and developed by the CJEU is not self-explanatory, but is rather vague.

In the latest judgment *MEO*, the CJEU disregarded the concept of consumption, stating that the service provider still received the same amount as they would normally get, if the contract would not be terminated and therefore, compensation was subject to VAT. It seems that the CJEU took the view that if the cancellation fee amount is identical to the amount of the purchase price of the service, irrespective of the existence of a legal relationship between parties, the cancellation charge would always be subject to VAT.[240] Furthermore, the CJEU mentioned that the legal nature of the cancellation charge under the applicable national law is also irrelevant for VAT purposes and VAT treatment on the cancellation charges should be determined based on the EU VAT legislation.[241] The new development from the CJEU raises the question whether we are currently facing a new, pioneering substance-over-form concept in the field of VAT that applies even in the absence of indications of artificial arrangements aiming to obtain tax advantages.[242]

The principle of fiscal neutrality[243] indicates that the VAT treatment should not influence business and customer decisions. Any service provider can design their offer in the manner they want to, which is guaranteed by the

[238] The case has been discussed in the chapter 5.
[239] Deborah Butler – *The usefulness of the 'direct link' test in determining consideration for VAT purposes*, EC tax review 2004-3, page 95.
[240] Yanista Radeva – *VAT implications of Cancellation Charges: New Substance-over-Form Rule?* - International VAT monitor January/February 2019, page 15.
[241] *Ibid.*
[242] *Ibid.*
[243] See chaptet 2.

freedom of contractual relationship.[244] Therefore any service provider has the freedom to choose how they draw the offer to the customer, including the freedom to decide the cancellation charges. According to the latest judgment *MEO*, cancellation charges will be taxable if they are exactly the same to the amount, the service provider would normally receive if there was not a termination. What if the *MEO* or any other service provider decides to change the amount of the cancellation fee and make it less, then it is determined for the actual service? Those questions remain unanswered from the latest judgment, as the whole argumentation from the CJEU is relied on the fact that *MEO* did not have the actual damage, as the amount was always the same. If the service providers decide to do so, this would be exactly the influence from the VAT treatment and from the latest judgment from the CJEU.

This case was a very good chance to discuss about the nature of loss. The CJEU did not include argumentation about loss in the *MEO* case, they only briefly mentioned that the loss might be lower or higher than the amount of the deposit retained by the hotelier in the case *Société thermale d'Eugénie-les-Bains.*[245] It is hard from the taxpayer to claim that the loss they suffered from the termination could not be covered by the exact amount of the money they would normally receive, but for the bigger picture, it is important to have the concept of the loss in such cases, for a neutral treatment.

Furthermore, the VAT Directive does not contain any provision directly relating to cancellation charges and compensations. Therefore judgments from the CJEU are particularly important.[246]

As mentioned before, having established a direct link does not automatically mean that there is a consumption. The cases discussed above show that it is not an easy task how the concept of a supply for consideration should be understood and applied. A slight difference in arranging taxable transactions, business offers can make a huge difference in the taxation, as the *MEO* case has proved.

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[244] Freedom of contract has always been respected by the law, which gives a possibility parties to decide terms and the conditions of the legal relationship they intend to create. The principle of freedom of contract indicates that subjects of private law are free to enter into contracts and determine their content within the scope of the law. They may also conclude contracts that are not prescribed by law, but do not contravene it. This is guaranteed by Georgian Civil Code article 319(1). Furthermore, Manfred Peck in his study of the significant aspects of German Contract Law mentions that freedom of contract is a right protected by the basic law.

[245] Judgment in *Société thermale d'Eugénie-les-Bains*, C-277/05, EU:C:2007:440, para 33.

[246] Dr Joep Swinklels – *Cancellation Charges and Compensations under EU VAT* – International VAT monitor November/December 2008 – page 430.

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