

Possibility of VAT on compensation in the event of premature termination of a lease agreement

On July 3, 2019, the Court of Justice of the European Union ('CJEU') rendered judgment in the UniCredit Leasing EAD case ('UniCredit'; no. C-242/18). The most pertinent question in this case is whether the lessor can recover the VAT it paid to the Bulgarian tax authorities on all lease installments on the basis that it did not receive payment for all lease installments from the lessee and did also not receive the contractual compensation which replaces the lease installments that were still due.

The CJEU ruled that this was a case of so-called 'non-payment' and that, in the event of a non-payment that was 'reasonably likely', Member States would have to refund VAT already paid, even if a Member State had made use of the option offered by the VAT Directive not to grant a refund in the event of a non-payment.

It is important for Dutch practice that the CJEU confirms that the compensation which, in the present case, replaces all lease installments that are still due in the event of premature termination of the lease agreement must be regarded as VAT-taxable payment for the lease supply and not as non-taxable compensation for damages.

Background

On February 6, 2006, the legal predecessor of UniCredit ('lessor') concluded a lease agreement with Vizatel OOD ('lessee') in respect of a property.

This agreement had a term of 11 years against payment of a monthly lease installment. The same agreement provided that the lessor could terminate the agreement prematurely in the event of non-payment by the lessee of at least three lease installments and that it could demand compensation equal to the present value of all outstanding lease installments for the entire lease term, less the residual value of the asset.

At the beginning of 2008, the Bulgarian tax authorities imposed a VAT assessment on the total amount of lease installments due for the entire term of the agreement. The Bulgarian tax authorities thus appear to take the view that for VAT purposes the lease agreement should be regarded as the supply of a good, so that VAT is due on all (future) lease installments upon commencement of the lease agreement.

Although the lessor has continued to issue invoices (with VAT) for the monthly lease installments, the lessee has stopped paying the lease installments due since April 2009. Because the lessee did not comply with its obligations, the lessor unilaterally terminated the lease agreement with effect from June 6, 2015. The lessor subsequently asked the Bulgarian tax authorities for a (partial) refund of the VAT paid to the tax authorities by virtue of the VAT assessment.

CJEU judgment

Article 90 of the VAT Directive provides that the taxable amount (and thus the VAT due) is reduced in the event of cancellation, refusal or total or partial non-payment, or where the price is reduced after the supply takes place. However, the second paragraph of this Article provides that Member States may deviate from this provision in the event of total or partial non-payment.

Bulgarian VAT legislation does not contain any provisions allowing the taxable amount for VAT to be reduced in the event of non-payment. Bulgaria has therefore made use of the possibility of deviating from the obligation to reduce the taxable amount in the event of non-payment, so that the lessor cannot, in principle, rely on such a right.

The referring court asks the CJEU whether in the present case there is (i) a 'refusal' and thus a reduction in the taxable amount, or (ii) a 'non-payment' in respect of which the Member States are authorized to introduce derogations. In so doing, the referring court asks that particular attention is paid to the following circumstances:

- The termination of the lease agreement only applies to the future, so that the installments of the lease agreement that the lessee has not paid *before* the date of termination of that lease agreement remain due and the lessor may therefore still be able to (legally) claim them.
- The lessor is entitled to compensation equal to the present value of all lease installments due to the end of the term of the lease agreement, less the residual value of the asset.

The CJEU ruled that, with respect to the installments payable by the lessee *before* the date of termination, there is no question of 'refusal', but of 'non-payment'. According to the CJEU, the term 'refusal' refers to situations in which the debtor's obligation to repay its debt has entirely ceased to exist or has been definitively set at a certain level. On the contrary, according to the CJEU the non-payment has a non-definitive character. The CJEU confirmed that Bulgaria (now there is non-payment) may deny the right to a refund of VAT as long as the claim is not definitively irrecoverable.

However, in order to ensure tax neutrality, the national authorities must allow a reduction in the taxable amount if the taxpayer demonstrates that it is reasonably likely that the debt will not be repaid. The possibility to derogate under Article 90(2) of the VAT Directive cannot therefore be applied in such a case. The CJEU considers that Article 90(2) of the VAT Directive is only intended to remove uncertainty about the non-payment. In this case, it appears that the lessee has not paid for almost nine years. According to the CJEU, it thus appears to be proven that it is reasonably likely that the debt will not be paid. It is for the national authorities to assess whether this is indeed the case.

Lease payments due *after* termination of the lease agreement are replaced by contractual compensation. The Bulgarian tax authorities consider that the compensation is in reality not a (non-taxable) termination payment, but a (taxable) payment for the lease performance. The CJEU agrees. With reference to previous case law, the CJEU held that the compensation should be regarded as payment for a supply, since the compensation is equal to the amount that the taxable person would have received during the remaining term of the contract if the agreement had not been terminated. In principle, therefore, VAT is also due on the compensation.

Non-payment of the compensation also constitutes non-payment for the purposes of the VAT Directive. Here too, the taxable amount is reduced and the lessor can therefore still recover the VAT if it demonstrates that it is reasonably likely that the compensation will not be paid.

The referring court also wondered whether the right to a refund could be invoked if the VAT had become due by virtue of a final VAT assessment. The CJEU ruled that a reduction of the taxable amount that is fixed by means of a VAT assessment is permitted, even if this assessment has become final.

Analysis

In the Netherlands, pursuant to Section 29(1) VAT Act 1968, there is a right to a refund of VAT in the event of cancellation, termination, total or partial non-payment or in the event the price is reduced after the supply took place. The Netherlands has not made use of the possibility to implement special rules for cases of non-payment.

The right to a refund arises on the date when the cancellation, termination, dissolution, total or partial non-payment or the price discount is established, on the understanding that in the event of (partial) non-payment, the right to a refund is deemed to have arisen no later than one year after the date on which the refund has become due and payable. The legal options to reclaim VAT from the tax authorities in the event of non-payment are thus greater in the Netherlands than in Bulgaria. In the Netherlands, the VAT that has become due by way of a VAT assessment can also be reclaimed from the tax authorities for the aforementioned reasons if the conditions have been met.

For Dutch practice, it is particularly important that, according to the CJEU, the compensation that replaces the outstanding lease installments must be regarded as VAT taxable payment for the lease performance and (thus) not as non-taxable compensation. In practice, it is not easy to determine whether compensation is taxable for VAT purposes. When compensation is agreed in advance, the recent CJEU case law points towards VAT-taxable payment in the event of early termination of an agreement. This will nevertheless always have to be assessed on a case-by-case basis.

We recommend reviewing existing agreements with compensation agreed in advance in light of the CJEU's judgment in this case. This not only applies to lease agreements, but also to other agreements in which compensation has been agreed that is payable in the event of premature termination.

The tax advisors of Meijburg & Co's Indirect Tax Group would be pleased to help you identify the potential tax implications of this judgment. Feel free to contact one of them or your regular contact for more information.

Meijburg & Co
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