

Termination fees

Do you owe tax on termination fees?

Generally, yes. The amount that a vendor bills a customer for the early termination of a contract or agreement is taxable in the same way that other payments made under the agreement were taxed.

Example 1

Stacey signed a 24-month cell phone service plan at \$40 per month with *Provider A*. However, she decided to switch to *Provider B* after 7 months. Under *Provider A's* service agreement, Stacey owed a \$680 termination fee. The fee was calculated by multiplying the remaining amount of months with the monthly bill amount (17 months x \$40).

In this case, *Provider A* must collect retail sales tax on Stacey's termination fee because charges for telecommunication services are retail sales. *Provider A* must include the termination fees in their gross income, which is reported under the Retailing B&O Tax and Retail Sales Tax.

Example 2

Larry entered into a one-year office lease. After 8 months, Larry broke the lease. He owed a \$1,000 termination fee. In this case, Larry's termination fee would be taxed in the same manner as his lease payments. However, the rental or lease of real property is not subject to Retail Sales Tax or B&O Tax (RCW 82.04.390 and WAC 458-20-118), so the lease termination fee was not taxable.

Example 3

Bert entered into a 2-year agreement with a cloud-based company for digital storage. After the first year, Bert terminated the agreement and owed a \$50 termination fee. In this case, the termination fee would be taxed in the same way as the payments for the digital storage were taxed. This means that the cloud-based company would report the termination fee under the Service and Other Activities B&O tax classification. Retail Sales Tax would not apply.

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