

Winners and Losers: HMRC Revises Policy on VAT Treatment of Fees and Compensation for Early Termination of Contracts

March 1, 2022

HM Revenue and Customs (HMRC) now considers that charges made by businesses to their customers to withdraw early from agreements to supply goods or services are payments for a supply and potentially subject to value added-tax (VAT).

In its new [Revenue and Customs Brief 2 \(2022\)](#) (RCB 2 (2022)) published on 7 February 2022, HMRC announced that it is reconsidering the VAT treatment of fees and compensation charged when customers terminate a contract early. According to the new policy, such fees and compensation will now be regarded as further consideration for the contracted supply and be liable for VAT. For example, if a customer is charged a fee for exiting a mobile phone contract early, or if they terminate a car hire contract early, such fees would be considered as payments for a supply and would therefore be liable for VAT irrespective of whether the payments were described as compensation or damages.

RCB 2 (2022) policy will replace previous policy changes announced in Revenue and Customs Brief 12 (2020) (RCB 12 (2020)) in September 2020, and all businesses are required to adopt the revised policy by 1 April 2022, even if they have a prior ruling from HMRC saying that such fees were outside the scope of VAT.

Background

Historically, HMRC guidance stated that the payments charged to customers for early termination of a contract were outside the scope of VAT. This was because these payments were understood to be compensation for loss of earnings rather than consideration for a supply. One authority for this position was the Court of Justice of the European Union (CJEU) case of [Société Thermale d'Eugénie-les-Bains \(C-277/05\)](#). In that case, the CJEU concluded that the deposit received by a hotel was not a part payment for the accommodation, and when a customer cancelled a booking, the payment of the deposit was to be treated as outside the scope of VAT as it was compensation rather than consideration for the supply of accommodation.

However, following recent judgments in [Meo \(C-295/17\)](#) and [Vodafone Portugal \(C-43/19\)](#), it is evident that some of these payments described as compensation or damages are actually consideration for the supply of goods or services. In light of these developments, HMRC changed its position and notes that the revised policy, RCB 2 (2022), will result in fewer payments being subject to VAT than the policy set out previously in RCB 12 (2020).

What is the new test?

Whether a payment becomes subject to VAT or not will depend on whether anything is being done in return for that payment. Where a party agrees to do something in return for a fee, there is a supply, regardless of whether this fee is described as compensation or damages. The key is whether something is done and if so, whether there is a direct link between what is done and the payment received (i.e., is there some element of reciprocity between the supplier and the customer?). For example:

- payments for early termination of a contract, or following a breach by the customer, that cover the cost to the supplier of making the supply available, or are equivalent to what would have been charged had the contract run as envisaged, will typically be linked to that supply, irrespective of whether or not the contract

allowed for early termination. So, if a car is hired for a week and is due to be returned by, say, 9:00 a.m. on a Monday but is not returned until 5:00 p.m. on the following Tuesday, a payment for late return will normally be charged. Generally, these charges are designed to both deter the person hiring the car from returning it late and to compensate the hire company for the additional use. Under the revised policy, the charge will now be subject to VAT as it is for the supply of the car (i.e., there is a direct link between the payment and the supply), and the customer is aware that an additional charge will be made and how much that charge will be or how the charge will be calculated. Although the use goes beyond that which is agreed with the customer at the outset of the contract, the charge is considered an additional fee for hire because it would have been the amount the supplier would have received during that period. Even if the payments exceed the cost to the hire company of making the supply but are broadly equivalent to what the customer would have paid had the contract not terminated, the payments would still be consideration for the supply and subject to VAT;

- however, where the termination payment is substantial and punitive (to discourage breaches of the contract rather than to compensate for lost income), the payment will be outside the scope of VAT because there is no direct link between the payment and the supply and the reciprocity needed to link the payment to the supply is lacking. Accordingly, it is the level of the fees chargeable for breaching a contract that will determine whether or not it is subject to VAT.

The updated [HMRC manual](#) distinguishes between additional charges for unexpected events (for example, the write-off of a hired car) and a common occurrence (such as additional payments for returning a hired car late). Where a supplier charges a fee to compensate for an unexpected event, this fee will not be considered as consideration for a supply as there is no reciprocity between the parties, even if the contract envisages the possibility of the event occurring. However, if a payment is made for a common occurrence, it would be taken as consideration (unless it is substantial and punitive) and be subject to VAT.

What about dilapidation payments in the property sector?

Dilapidation payments generally exist to ensure landlords are not of pocket if the buildings they lease to tenants are not returned in the agreed condition at the end of the lease. It is arguable to say that tenants' dilapidation payments to landlords are not sufficiently linked to the supply of the lease to be regarded as further consideration for it. The situations that could precipitate dilapidation payments are varied and do not provide clear-cut direct linkages between payments and supplies. Due to this uncertainty, HMRC notes that it will not treat dilapidation payments as further consideration for the supply of a lease and will continue this [policy](#) unless it finds evidence of value shifting from rent to dilapidation payment in order to avoid accounting for VAT.

Next steps

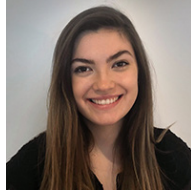
Businesses that have adopted the revised VAT treatment for payments that are further consideration for supplies should continue to treat these supplies in accordance with the revised policy. Any business that adopted the treatment outlined in the RCB 12 (2020) guidance and accounted for VAT on transactions, which under this new guidance are outside the scope of VAT, may correct the error on their next VAT return.

CONTACTS

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