

VAT and Termination Payments – A New Dawn for HMRC Brings a Dark Night for Taxpayers

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HM Revenue and Customs (HMRC) has adopted a new position regarding VAT on contractual termination payments and cancellation fees.

Background

HMRC previously viewed these payments as being outside of the scope of value-added tax (VAT), but now states that such payments are within the charge to VAT where the original supplies under the contract were taxable supplies. These changes were announced in Revenue and Customs Brief 12, published last month, and are reflected in updates to HMRC internal manuals.

Latest Developments

HMRC's justification for its change in approach comes from two recent judgements in the Court of Justice of the European Union ('CJEU'): *Meo (C-295/17)* and *Vodafone Portugal (C-43/19)*. Both cases refer to telecoms services. In *Meo* there was a clause in the customer's contract requiring it to pay outstanding fees following early termination of its contract. As a result, the supplier was deemed to have received further consideration (i.e., the termination payment) for the original supply (the telecommunication services). The CJEU came to a similar conclusion in *Vodafone Portugal*.

Rationale for Court's Decision

HMRC infers from these cases that consideration payable on early termination 'must be considered an integral part of the price which the customer committed to paying for the provider to fulfil its contractual obligations', even if the amounts are not equal to the amounts that would have been due should the contract have run its full course without early termination, and that it is irrelevant that the customer is no longer using the supply in question. HMRC also states in their manual that payments may still be within the charge to VAT despite describing such payments as liquidated damages or payments for breach of contract. HMRC draws on the *Lloyds Bank plc ([1996] BVC 2875)* case to confirm that even if the original contract does not have a built-in termination mechanism, payments made by way of termination can still be taxable.

HMRC acknowledges that in some limited circumstances a payment can be outside the scope of VAT where the reason for termination has no connection to the service being provided. This is only likely to be the case where the service is connected to a state or local authority.

Impact

This change of position will be of particular note to clients operating in the real estate sector, as 'break' fees, whether envisioned by the original lease or not, may now be within the charge to VAT. The previous established position was that break fees included within the original drafting of the lease would be outside the scope of VAT. Similarly, payments made after exchange of contracts to release either party from the contract, where VAT would have been

payable on completion of the contract in question, may also now be within the charge to VAT. The VAT treatment of premiums paid by the tenant for a lease surrender remains unchanged: it follows the treatment of the underlying lease.

Retrospective Application

Most seriously of all for clients is the fact that the changes above appear to have retrospective effect, and clients that have ‘failed to account for VAT to HMRC on such fees should correct the error’, unless HMRC provided a specific clearance in respect of the contract in question. Unless such clearance has been obtained (in which case the change only takes effect from the date of the Brief, 2 September 2020), HMRC can look back four years from the end of the VAT accounting period in which the termination period was made – hypothetically as far back as 1 July 2016. Clients should carefully consider whether any payments made or received in the last four years should be reassessed for VAT liability.

Going Forward

Clients should note that the following factors have no bearing on the fundamental position that VAT is payable on termination payments:

- how such payment is labelled (consideration, compensation a termination payment, a break fee etc.);
- whether the contract makes provision for such payments;
- whether the customer is still using the supply; or
- whether the payment bears any relation to the amount due were the contract to run its natural course; and
- what HMRC manuals stated prior to this policy change – one takeaway from another recent case (*Aozora* ([2019] EWCA Civ 1643)) is that caution should be taken when seeking to rely on HMRC manuals.

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