

## Construction Law Update

### A More Nuanced Approach: HMRC's Revised Policy on VAT Treatment for Early Termination Fees and Compensation Payments

Effective from 1 April 2022, HMRC has issued revised guidance on the treatment of VAT for termination and compensation payments. Read on for details of this more nuanced approach to VAT treatment.

#### Background

Guidance issued by HMRC in late 2020 brought many termination fees and compensation payments within the scope of VAT for the first time. This innovation attracted heavy criticism in the sector because:-

- It adopted a very wide interpretation of two CJEU judgments involving mobile phone contracts (*Meo* and *Vodafone Portugal*), which contradicted earlier HMRC policy.
- It was retrospective in effect such that VAT returns had to be amended for the previous four years for undeclared VAT now regarded as taxable.
- HMRC's policy was silent and offered little guidance on the VAT position for a number of payments common in the construction and real estate sector.

In response to this criticism, HMRC suspended its policy in January 2021; and in February 2022 issued its long-awaited revised guidance on the issue, in the form of Revenue & Customs Brief 2.

Effective from 1 April 2022, the new guidance takes a more nuanced approach to VAT treatment and in doing so, clarifies and narrows the scope of payments that will be subject to VAT when compared to those set out in HMRC's 2020 guidance. Going forward, as a general rule where customers are charged to withdraw from agreements to receive goods or services that are subject to VAT and this meets HMRC's new criteria (as explained below), these charges will attract VAT. In these circumstances this means that termination fees will be treated as further consideration for the contracted supply of goods or services and will be

charged at the same rate as the VAT-able related service.

The guidance does, however, recognise that there will be exceptions to this general rule (as explained below) and assessment on a case-by-case approach will always be necessary.

#### Direct Link and Reciprocity

Under HMRC's revised policy, for there to be a supply of goods/services that attract VAT, there must be a direct link between what is done by the supplier and the payment it receives for the same. There must also be reciprocity between the supplier and the customer which means that the customer must receive something from the supplier in return for payment.

The test for whether a direct link and reciprocity exists will be determined by reference to the VAT position of the underlying goods/services to which the termination fee or compensation payment relates.

#### Early Termination of a Contract

Where a customer terminates a contract, and this attracts an early termination fee, this will now be treated as further consideration for the supply of the same goods/services and subject to VAT. This will also be the case even where the contract – a lease, for example, does not incorporate a pre-existing right to terminate. In these circumstances, payment of an early termination fee is likely to be treated as a variation to the lease and VAT will apply where the underlying lease is itself liable to VAT. This is of course subject to the termination fee and the supply being sufficiently linked and reciprocal.

#### 'Punitive' Payments

The guidance also recognises that there will be exceptions to the rule; an example being punitive termination fees under a lease that are used as a deterrent and are not compensatory. This is because such fees are likely to lack the reciprocity required to

## Construction Law Update

link them to the supply and will thus be outside the scope of VAT.

Some payments may, however, be described as a penalty without being punitive. A late return penalty under a hire agreement where the penalty reflects the cost of hire is an example of this. Here, the 'penalty' is likely to be considered an additional fee for hire and thus further consideration for the same taxable supply.

To the contrary, a contract that includes an additional penalty for damage to a hired item would not be classed as further consideration for the same taxable supply. This is because the supplier does not consent to the customer damaging the item and is not something ordinarily to be expected as part of the supply. The penalty is thus not further consideration for the supply and does not have the necessary reciprocity.

When deciphering whether a fee is classified as 'punitive', a useful exercise, albeit not always conclusive, will be to compare the standard fee against the termination fee.

### Dilapidation payments

Whilst HMRC has re-affirmed its continuing policy that dilapidation payments will not usually attract VAT, it has warned that this will not be the case where it suspects that parties are value-shifting between dilapidation and rental payments to circumvent VAT liability. To avoid falling foul of this, parties to leases which are subsequently surrendered should ensure that any dilapidation payments are clearly documented to show what they consist of and how they have been calculated.

### Price Adjustment or Liquidated Damages

Whilst the distinction between price adjustment and liquidated damages as set out in HMRC's latest guidance is far from clear cut and will likely require further clarification, some principles can be drawn from the guidance regarding compensation.

In the ordinary course of events where a supplier breaches the terms of a contract and the customer pays less for the altered supply of services/goods, less VAT will be charged and the amount of VAT the supplier accounts for will be adjusted. In this type of transaction, the reduced consideration recompenses the customer for the altered supply and this payment will be sufficiently linked to the supply to be reduced consideration for the same contracted supply.

On the other hand, in circumstances where a supplier breaches the terms of a contract but is required to pay liquidated damages to compensate the customer, this payment will be outside the scope of VAT. This is because the payment will not be sufficiently linked to the supply of goods/services to be treated as reduced consideration.

In light of all of the above, it is clear that determining VAT treatment on a given supply will require assessment on a case-by-case basis in light of all the facts and circumstances of a given transaction.

### Analysis

These changes will impact businesses across the board who must ensure their systems and contracts are adapted to be compliant with the new guidance, which must be adopted no later than 1 April 2022.

To avoid falling foul of the new guidance and incurring potentially significant financial consequences, it is imperative that businesses take appropriate specialist advice on VAT treatment on a case-by-case basis. This is particularly important for those that have received written advice or a clearance from HMRC, which will now need reviewing to check they are still compatible with the new guidance.

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