

VAT on termination and compensation payments

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The COVID-19 pandemic has led to many businesses seeking to terminate contracts early (by force majeure or otherwise), often in exchange for an early termination payment.

A key consideration for parties terminating their contracts is whether such payments are subject to VAT. Similarly, parties who wish to sue or claim compensation for breach of contracts (for example for non-performance due to the pandemic) should be mindful of the VAT position.

Termination payments

On 2 September 2020, HMRC published [revised guidance](#) on the subject to clarify and provide that fees and compensation paid for the early termination of a contract (including a lease) are normally to be treated as consideration for a taxable supply of the goods or services for which the customer had contracted and should, therefore, generally be liable to VAT, whether or not the original contract provided for early termination.

This would traditionally have been the case in circumstances where the contract did not expressly provide for a right to terminate early and the parties agreed to early termination in exchange for a termination payment - the payment was usually subject to VAT on the basis that there is a provision of a supply in the grant of a 'a right to terminate'.

Termination payments under contracts silent as to VAT would generally be deemed to be included in the payment and the recipient will end up with less money than anticipated (unless a term could be implied through custom and practice).

Compensation or other payments in settlement of claims

Historically damages or other compensation paid on the exercise of a termination right under a force majeure clause, or other clause within the original agreement specifically drafted to provide for early termination, was unlikely to attract VAT, as the right to terminate already existed in the original agreement and could not be said to have been supplied at a later date (although VAT may still have been relevant). However, under the new guidance these payments will also be within the scope of VAT.

The new guidance provides that early upgrade fees and liquidated damages are consideration for supplies. Similarly, payments that a customer is required to make under a contract for breaching that contract and entitling the supplier to terminate the contract are treated as consideration for a supply.

This extends the previous exception to the general rule that where the claim relates to a payment that was withheld for vatable goods or services (perhaps because it is argued that goods are defective or services are not performed as agreed) the 'settlement payment' in respect of this type of claim is effectively part payment of the consideration for the original goods or services supplied and previously invoiced, and is therefore usually subject to VAT.

It also expands the existing rule that 'compensation' payments are generally subject to VAT where the payment is for a future supply of goods or services which would be otherwise be subject to VAT in any event.

This scenario typically arises where the settlement payment is conditional upon, or the settlement agreement contains obligations relating to the supply of goods or services, which in the normal course of business, would fall within the VAT regime, for example the continuing future use of appropriated IP rights.

A business seeking to terminate or sue on a contract should first consider carefully its VAT position, particularly in light of the new HMRC guidance – as a general rule VAT is likely to be chargeable on any payment made to terminate the contract.

For all your queries relating to VAT on termination and compensation payments, call corporate partner, Victoria Holland today.

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