

Recent changes to HMRC's policy on VAT and contract termination payments

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On 2 September HMRC announced a change in its policy on the VAT treatment of compensation and damages payments in the context of [early contract termination](#)¹. It's an important change to note for anyone making or about to make these types of payments coming out of a contract termination or dispute. The HMRC announcement was low on detail as to how this will be applied to various practical situations. It's to be hoped that HMRC will provide further guidance in due course, but in the meantime some headline points to note are as follows.

Background

Until this recent HMRC revision, payments that were purely compensation or damages could often be treated as outside the scope of VAT, although the VAT treatment of compensation and damages payments generally has not always been an exact science, as it's largely drawn from case law and HMRC's ongoing interpretation of that.

The change

As of 2 September, HMRC have changed their view on the VAT treatment of payments arising out of early contract termination. Following a couple of European cases (Meo (C-295/17) and Vodafone Portugal (C-43/19)), HMRC are now saying that most early contract termination and cancellation fees will be within the scope of VAT, and that this will be the case even if the payments are described as compensation or damages.

In its announcement on 2 September HMRC said: "HMRC guidance on charges described as compensation or early termination fees in a contract, have been changed to make it clear that they are generally liable for VAT." In its updated guidance, HMRC go on to say "it is only where there is no direct link between a payment and a supply of goods or services that it may be outside the scope of VAT."²

Some specific points or questions coming out of this general policy step change from HMRC include the following:

Liquidated damages

While previously HMRC's guidance had suggested that liquidated damages were outside the scope of VAT, their view has changed. They are now saying that although liquidated damages payments are designed to compensate, they are made as a result of events envisaged under the contract, and so are consideration for what's provided under the contract. That would mean they will often be subject to VAT.

Rate of VAT

This needs clarifying by HMRC. If we accept that a compensation payment for early contract termination may now be within the scope of VAT, is that automatically standard rated or does it follow the VAT treatment applied to the supplies provided in the underlying contract, which might for example be VAT exempt or zero rated rather than standard rated? From HMRC's wording so far on this, it seems the latter is more likely, namely that the VAT rate applied to the supplies made in the underlying contract would also apply to the compensation payment. But it's not crystal clear.

Is it retrospective?

Again not explicit in the HMRC guidance, there's a risk from how HMRC's revised VAT treatment has been phrased that it could be applied retrospectively over the last 4 years. That would be out of kilter with HMRC's usual approach on changes to tax policy, where you'd often find a forward looking change and some transitional arrangements. So further clarification from HMRC would be welcome.

This is not a blanket change to the VAT treatment of any and all compensation or damages payments, but could impact a wide range of contract terminations and disputes.

If you would like further details on this, please contact [Andrew Noble](#).

¹Revenue and Customs Brief 12/20 at <https://www.gov.uk/government/publications/revenue-and-customs-brief-12-2020-vat-early-termination-fees-and-compensation-payments/revenue-and-customs-brief-12-2020-vat-early-termination-fees-and-compensation-payments>

²Extract from section 05910, HMRC VAT Supply and Consideration Manual

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