VAT: early termination fees, compensation payments and dilapidations

Indirect Tax

22 February 2022

HMRC has published Revenue and Custom Brief 2 (2022), notifying that with effect from 1 April 2022 its policy on early termination fees and similar payments is changing. All businesses must adopt the revised treatment no later than 1 April 2022.

Background

In our March 2021 edition (www.taxadvisermagazine.com/RCB12/20), we set out changes in VAT treatment for compensatory arrangements following the publication of Revenue & Customs Brief 12/20: *VAT early termination fees and compensation payments* on 1 September 2020 (tinyurl.com/499z9zk5). In this brief, HMRC took the position that most early termination, cancellation fees, compensation and damages would be taxable if the underlying supply was also taxable. The brief also stated that, if affected, the requirement to account for VAT had retrospective effect.

Following stakeholder feedback – including from the CIOT and ATT – HMRC revised RCB 12/20 on 25 January 2021, announcing that the changed position on the VAT liability in relation to early termination, cancellation fees, compensation and damages would only apply from a future date to be announced. Following this revision, the CIOT, ATT and other stakeholders continued to engage with HMRC on the VAT liability and the scope of the intended changes. Over summer 2021, stakeholder feedback was sought on draft guidance.

What’s happened now?

Revenue and Custom Brief 2 (2022) (tinyurl.com/2p9253nu) confirms that fees charged when customers terminate a contract early will be regarded as further consideration for the contracted supply. Taxpayers must adopt this revised policy by no later than 1 April 2022. However, the new guidance, which can now be found in the VAT manual (see paragraph references below), also limits the scope of RCB 2/22 so dilapidation payments continue to be normally outside the scope of VAT (see also paragraph 10.12 in VAT Notice 742 (tinyurl.com/2m3nrh39)).

New pages in VAT manual

HMRC's VAT supply and consideration manual is updated with the following pages:

- VATSC05910: *When are compensation payments consideration for a supply?* tinyurl.com/2p9f6zy7
- This guidance includes a general overview and confirmation that dilapidations are normally outside the scope of VAT.
- VATSC05920: *Early termination of contracts* tinyurl.com/2p8w6t4x
- Following CJEU decisions in MEO (Case C-295/17) and Vodafone Portugal (Case C-43/19), the VAT position for early termination fees is that it is treated as further consideration for the contracted supply where the payments are linked to that supply.
- VATSC05930: *Liquidated damages* tinyurl.com/yypcvtmw

This includes examples of where liquidated damages may be taxable or outside the scope of VAT.

Continued engagement

The CIOT has received member queries and feedback about the new guidance and will continue to engage with HMRC. If you have feedback, please contact technical@ciot.org.uk.