Compensation and termination fees: VAT treatment of payments

Indirect Tax | OMB | Large Corporate



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The Post Office scandal involving sub-postmasters has raised issues about the tax treatment of compensation they received. What is the VAT treatment of early termination fees and compensation payments?

Key Points

What is the issue?

Since April 2022, fees for terminating a contract early have been subject to VAT if the payments within the contract are VATable; e.g. mobile phone supplies. The article considers other examples of compensation and termination fees that are VATable because they relate to supplies of services.

What does it mean for me?

If a business pays compensation, such as for damage caused to hired goods, it must not accept a VAT charge from the supplier if it is incorrect because HMRC can disallow its input tax claim. Input tax can only be claimed if VAT has been correctly charged in the first place.

What can I take away?

Always stand back and consider whether a payment relates to a supply of benefits in return for the payment, which means that it will be subject to VAT in most cases. The right to receive a benefit – such as a hotel room that you have prepaid – is a supply, even if you subsequently cancel it without enjoying the facility.

If any reader is still unaware about the basic facts of the Post Office Horizon saga, the outcome was that hundreds of self-employed sub-postmasters were sacked and forced to repay large sums of money to the Post Office because of massive cash discrepancies falsely identified by the Horizon computer system in the early part of the century. These postmasters are now being paid massive amounts of money to compensate them for both the financial losses they incurred and the personal turmoil they suffered.

I'll say no more – there is plenty of reading material on the internet – and ask a VAT related question instead. Are these compensation payments subject to VAT? The good news is that the answer is 'no' – but it is not always the case that compensation payments and termination fees are non-VATable. I'll consider some practical examples in this article.

Revised HMRC policy from April 2022

HMRC changed its interpretation of the legislation about termination fees in April 2022 because it considered the outcome of two tribunal cases heard several years earlier in the Court of Justice of the European Union (CJEU). Both cases related to assessments issued by the Portuguese tax authorities in relation to fees charged by mobile phone suppliers for the early termination of contracts. The CJEU agreed that the payments were directly linked to a supply of services from the mobile phone company to their customers and were subject to VAT.

There is a subtle difference between the cases. In *MEO* (Case C-295/17), the termination payment was equal to the full amount outstanding on the telephone contracts; while in the case of *Vodafone Portugal* (Case C-43/19), the final payment was discounted. However, the VAT outcome was the same; namely, that the court decided that the customers were getting a benefit in return for their payments – which was the right to exit the phone contracts early. The termination payments were standard rated. See ***Mobile phone contract cancelled early***.

Mobile phone contract cancelled early

ABC Accountants took out a three-year mobile phone contract in 2022, paying £3,000 per month plus VAT to the supplier. The partners now want to cancel the contract early because they need a better quality phone system for their staff from another supplier.

The existing supplier has agreed to accept a single payment of £12,000 to cancel the contract early. This fee will be subject to VAT because it is classed as an extra payment for the supply of the standard rated phones. However, ABC will be able to claim input tax, as long as they receive a proper tax invoice from the supplier.

Note: As explained in the article, the supplier has agreed to do something for ABC in return for the final payment; i.e. cancel the contract early. As the original contract related to a VATable supply of services, the termination payment will be subject to the same rate of VAT.

Business Brief

To confirm its revised policy, HMRC issued Revenue and Customs Brief 2(2022) on 7 February 2022:

- If a customer pays a fee to a supplier to terminate any contract early, the payment will be subject to VAT if the payments made within the contract were also VATable.
- HMRC’s previous policy was that a termination payment was always outside the scope of VAT because it did not relate to any ***specific*** supply of goods or services.

The new procedures will affect both payments received and made by a business to terminate contracts – see ***Termination of cleaning contract***. In this example, the significant issue is that the terminator – to quote the title of the 1984 film starring Arnold Schwarzenegger – makes exempt supplies so cannot claim input tax. If they had traded as an accountancy practice or legal firm – or any fully taxable business – the VAT charge would not be an extra cost.

Termination of cleaning contract

Vilimore Insurance Brokers has decided to terminate its cleaning contract with Spick and Span because it is relocating its business to a different part of the UK. There is a rolling two-year contract in place but the two parties have agreed a termination fee equal to six months of cleaning fees. Spick and Span will charge VAT because the cleaning services within the contract were VATable.

Note: Termination payments will still be subject to VAT, even if a payment is agreed by the two parties through a separate legal agreement; i.e. it is not relevant to a specific clause in an existing contract.

Commercial reality

What would be the situation if the wording on a sales invoice was changed from ‘termination fee’ to ‘compensation payment’?

It is generally accepted that a compensation payment is outside the scope of VAT – like the payments to the Post Office sub-postmasters – because there is no supply of goods or services being made. However, the chosen words are irrelevant if the commercial reality of a deal is different. If an invoice says, ‘I’m supplying hairdressing services but I’m actually doing VAT consultancy work’, it’s VAT consultancy that wins!

To directly quote from HMRC’s policy note VATSC05910 in its VAT Supply and Consideration manual:

> ‘Where a party agrees to do something in return for a fee, there is a supply. How that fee is described does not affect whether there is a supply

> for VAT. What matters is whether something is done and if there is a direct link between what is done and the payment received.’

In other words, it comes down to the usual VAT question: who is supplying what and to whom? Using words on a sales invoice such as ‘compensation payment’ or ‘payment for damages’ does not alter the VAT position if the commercial reality is different.

Practical examples

Here are three more examples of VATable termination payments.

1. Charge for returning a hired vehicle late

If a contract had been with a car hire company and the contract refers to an extra charge of, say, £15 per hour, for returning a vehicle after the deadline time, this payment is for additional hire services and is subject to VAT.

2. Access to a gym is denied because of a late or failed payment

VAT enthusiasts will recall the well-publicised case involving *Esporta Ltd v HMRC* [2014] EWCA Civ 155, which was finally resolved in the Court of Appeal.

The company signed up members for annual gym membership contracts, with monthly payments made in most cases. If any members stopped making their payments during the contract, they were denied access to the gym.

Esporta subsequently enforced the contract but claimed that the belated payments were outside the scope of VAT because the member couldn’t access the gym. The Court of Appeal agreed with HMRC that the payments were VATable on the basis that the member signed the contract to gain the right to access the gym for a year. A supply had therefore taken place and all payments were standard rated.

3. Hotel cancellation fees

If a guest has partly or fully prepaid for a hotel room – but fails to arrive and therefore forfeits their money – the money retained by the hotel is subject to VAT. This is because the hotel ‘made the room available’ for the customer, which is a

supply of services, and this outcome does not change if the guest fails to arrive. However, if the guest receives a refund, this is a credit and output tax can be adjusted.

For further information, see HMRC's Revenue and Customs Brief 13(2018), which refers to the VAT treatment of 'unfulfilled supplies' and also states that 'VAT is due on all retained payments for unused services and uncollected goods.' (See HMRC Supply and Consideration manuals: VATSC05910, VATSC05920 and VATSC05930.)

Payments that are not subject to VAT

To balance the books, many compensation and damage payments are still outside the scope of VAT, despite HMRC's revised policy from April 2022. The challenge is to stand back and ask the question: am I giving or receiving any benefits in return for this payment?

For example, if a guest rents an apartment on Airbnb and ruins the white carpet in the lounge by spilling red wine on it, any correcting payment made by the guest will not be subject to VAT because it is clearly a compensation payment to enable the apartment owner to either pay for a cleaner to deal with the problem or – worst case scenario – to buy a new carpet.

In these situations, the compensator should not accept an incorrect VAT charge from a supplier, even if the supplier helpfully provides a proper tax invoice to show that VAT has been charged. Input tax can only be claimed if VAT has been correctly charged in the first place.

Another common example of a non-VATable compensation fee is a charge made by hotels and similar establishments if a guest smokes in their room. Even though the charge might be described as a 'cleaning fee', there is no supply of services being made by the hotel to the guest. The reality is that it is a fine for breaching the terms and conditions of the hotel booking; i.e. it is outside the scope of VAT.

What about dilapidation payments?

A dilapidation payment is paid by a tenant to their landlord at the end of a lease to compensate the landlord for any repair work that is needed to restore to the building

to its original condition when the tenant first occupied the building.

Surprise, surprise. HMRC intended to treat these payments as being subject to VAT back in 2020 if a landlord had opted to tax the building in question but a U-turn swiftly followed. All dilapidation payments are still outside the scope of VAT and this outcome is helpfully confirmed by VAT Notice 742, para 10.12.

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