

Policy change – R&C Briefs 11 and 12/2020

(Lecture B1225 – 13.47 minutes)

Early termination fees and compensation payments – R&C Brief 12/2020

HMRC issued a Brief on 2 September 2020, stating its new policy that early termination fees and compensation payments that relate to contracts are now subject to VAT in most cases. The previous policy was that the payments were outside the scope of VAT because they did not relate to a specific supply of goods or services.

This issue is important for both suppliers and customers. A VAT charge will not be claimable as input tax by a business that makes exempt supplies, or is partially exempt. And suppliers receiving compensation fees could be faced with a large assessment for VAT owed on past supplies, as the policy change is retrospective.

Example

Mary trades as an insurance broker and is dissatisfied with the services provided by the office cleaners at her premises. She has decided to cancel the contract but must pay a termination fee equal to six months of cleaning fees to the supplier. HMRC now regards the charge by the cleaners as being subject to VAT, even though no cleaning work will be done in return for this payment. This will be an extra cost to Mary because her insurance business is partially exempt and cannot fully claim input tax.

The Brief states that fees will still be subject to VAT, even if the payment is agreed by the two parties through a separate agreement, i.e. it is not relevant to a specific clause in an existing contract.

CJEU tribunal cases

HMRC's policy has changed because it has reviewed the outcome of two VAT tribunal cases heard in the Court of Justice of the European Union (CJEU) and decided its own interpretation of the legislation was incorrect.

The first case Meo (C-295/17) related to payments made by customers with mobile telephone contracts, who had to make a one-off payment to escape a contract early. The charge was reasonable because the customer had received a discount on the deal because of the extended period of the contract. The Portuguese tax authorities assessed Meo for output tax on the payments but Meo claimed they didn't relate to any actual supply of services and should not be subject to VAT. The CJEU agreed with the tax authority that the payments related to remuneration for a supply of services. The mention of the payment being a 'penalty' for early termination was irrelevant. The other case was Vodafone Portugal C-43/19 with similar principles.

The difference between the two CJEU cases was that in the Meo case, the customer had to make a full compensation payment to cancel their mobile phone contract ie paying the same amount of money as if the contract had continued until it expired.

In the Vodafone Portugal case, there was a specific formula used to determine how much compensation the customer needed to pay – this would be less than the full contract value. But the VAT outcome was the same: the remuneration received by both companies directly related to a VATable mobile phone contract and tax was therefore payable on the cancellation fees.

HMRC guidance

If your clients provide any services where early termination fees and compensation payments are earned, it must review the VAT position urgently.

HMRC has issued new guidance about the changes: VAT Supply and Consideration Manual: VATSC05910 to VATSC05930.

Policy change is retrospective

HMRC has confirmed that the change in policy announced in the Brief is retrospective. The exception is if a business has received a past ruling from HMRC confirming that its termination fees and compensation payments are not subject to VAT. In such cases, the revised policy must be applied from the date of the Brief i.e. from 2 September 2020.

A business must adjust errors for the last four years where output tax has been understated, using the usual VAT correction procedures: VAT Notice 700/45. This is unexpected because HMRC's own manuals previously stated that these payments were outside the scope of VAT.

But the manuals are not VAT law and HMRC says that it must apply the law correctly. The previous incorrect guidance has been removed from the manuals.

A telephone ruling from HMRC should be acceptable as evidence of a past ruling, as long as you or your clients kept the call reference number that should have been provided by the officer. Even if you do not have a call reference number, it is likely that HMRC will be able to find details of the call on their system via your client's VAT registration number.

Input tax

The issue of termination fees and compensation payments is not only important for your clients who must decide if they should charge VAT on the fees they have received in the past and will receive in the future.

It is also important if you have clients who have cancelled or terminated contracts but cannot fully claim input tax on their expenses, i.e. their business is exempt or partially exempt. The VAT charged by the supplier whose contract has been cancelled will be an extra cost to your clients' business.

Even if your clients can claim input tax because their business is fully taxable, it is always important to check if VAT charged made by a supplier is correct. Input tax cannot be claimed on incorrectly charged VAT.

Descriptions are no longer the key issue

In the past, a question about the VAT liability of a source of income would be influenced by the use of words in contracts and on invoices such as 'cancellation fee,' 'termination payment,' 'penalty for ending contract early.' However, this approach can no longer be adopted - to quote directly from HMRC's Supply and Consideration Manual VATSC05910:

"Whether a payment is for a VAT supply depends on whether anything is done in return for consideration. 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."

"Most early termination and cancellation fees are therefore liable for VAT. This is the case even if they are described as compensation or damages."

Guidance note VATSC05920 confirms that VAT is due even if a separate cancellation agreement is made between the parties, i.e. outside the terms of the original contract.

Compensation payments in other situations

Despite the radical change of policy by HMRC, there will still be some compensation payments that will be outside the scope of VAT. For example, penalties and fines that are charged as a result of customer behaviour will still be VAT free in most cases.

Example

Seaside Guest House has a policy that if a guest smokes in their room, the hotel will apply a cleaning charge of £100. This is a compensation payment to the hotel for the extra cleaning costs caused by the guest's misdemeanour. There is no supply of goods or services by the hotel to the guest and the payment will be outside the scope of VAT.

In this situation, there is no termination fee or compensation payment that directly relates to a contract for services between the two parties. This is a useful issue to consider when reviewing the VAT liability of income received by your clients.

Lease variations - R&C Brief 11/2020

It is quite common at the moment for landlords to offer rent discounts to tenants to help with the financial problems caused by the Covid-19 crisis. In most cases, the discount offered will be reflected in a reduced rental payment. The motive for the discount is so that the landlord is not faced with an empty building and no income if the tenant goes bankrupt or has to cease trading. In some cases, the reduced rent might be conditional on the tenant having to perform a separate service or services in return for the discount. These services might be subject to 20% VAT. An example will illustrate the issue:

Example

The owner of a commercial warehouse has not opted to tax the building and therefore the rent charged to the car dealer tenant who trades there is not subject to VAT i.e. exempt rental income.

As a result of the Covid-19 crisis, the landlord has agreed to reduce the rent by £5,000 per month for the next 12 months and £2,000 per month for the following six months.

A condition of the discount is that the tenant must redecorate the entire building and also have new windows put into the main showroom. These expenses would normally be paid for by the landlord.

In this situation, the work performed by the tenant has a monetary value to the landlord – not all of the £72,000 of rent discount but perhaps a percentage of it. If the landlord had opted to tax the building, it would not be a problem because they could issue cancelling sales invoices (plus VAT) for ‘extra rent’ and ‘building improvement works’ i.e. no net loss of tax to HMRC. But the exempt rent creates a VAT loss to HMRC.

Extracts from Business Brief:

“If, however, the tenant agrees to do something in exchange, this could be classed as a payment for a supply by the tenant to the landlord - unless they are only agreeing to accept the normal responsibilities of a tenant, such as paying rent. If the tenant agrees to do something more, it is likely that:

- the tenant is making a supply and the rent reduction will be the value of the supply – whether the supply is taxable or exempt will depend on what the tenant agrees to do, in the same way as if they were being paid to do it;
- the landlord must account for the VAT as though the rent was still being paid if they have opted to tax the property.

If both supplies are taxable at the standard rate:

- the amounts of VAT due on each supply are likely to be the same;
- the landlord and tenant will need to issue VAT invoices to each other if either of them is registered for VAT”.

Contributed by Neil Warren