

## VAT TREATMENT OF TERMINATION PAYMENTS – IMPLICATIONS FOR LEASES OF MOVEABLE ASSETS

### INTRODUCTION

Following recent European litigation, HMRC has announced a change to its practice in relation to the VAT treatment of early termination fees and similar payments, which will impact (*inter alia*) leases of moveable assets, including vehicles, machinery and other equipment. This change is particularly unwelcome in the COVID-19 era where there are likely to be more contract terminations than usual.

### BACKGROUND

HMRC's previous policy was that early termination payments payable under existing termination provisions in an agreement were outside the scope of VAT on the basis that they were compensatory in nature. This treatment applied to termination payments by lessees to voluntarily terminate their leases early, but under an agreement with the leasing industry, HMRC allowed lessors to treat such payments as subject to VAT if they wished. The position was different where an agreement had to be amended to include a termination right, in which case the payment was generally subject to VAT.

HMRC's new policy, which arguably casts the VAT net too widely, is that all payments made on the early termination of agreements (including leases), where such termination is pursuant to a contractual termination right and the payment is provided for in the agreement, are potentially subject to VAT even if they are described as compensation (e.g. for loss of profits) or as liquidated damages. Their logic is that if such payments arise as a result of events envisaged under a contract, they form an integral part of the consideration for the services provided under it.

### IMPACT

VAT should only be chargeable on termination payments where the underlying supplies under the agreement are subject to VAT. The new rules should not, for example, apply to leases where the rentals are outside the scope of VAT (under the general place of supply rules) or the assets benefit from zero-rating (such as "qualifying aircraft" used by airlines chiefly operating on international routes and "qualifying ships") or exemption (such as fixtures where the lessor has not opted to tax). Particular attention will need to be given to lease terminations involving rail assets, vehicles and other equipment (e.g. containers), where no such specific relief is available.

The impact of the new rules will be felt most by businesses making termination payments who are unable to recover all their VAT and by lessors/other

#### Key issues

- HMRC change in practice regarding VAT treatment of early termination payments
- Classification of payment as compensation or liquidated damages not relevant
- Underlying supply must be subject to VAT; qualifying aircraft and ships exemptions still apply
- Review VAT charging clause and any tax indemnity in relevant agreement
- HMRC plan to apply change in practice retrospectively, subject to 4-year assessment period limitation
- Lessors and suppliers of rolling stock and other assets should undertake due diligence on their leases and other agreements

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suppliers who are unable to pass on the VAT cost to their lessees/customers under the terms of their agreements (e.g. leases where the VAT charging clause only applies to rental payments and/or other agreements where the tax indemnity may not be sufficiently broad).

It is important to note that this change does not override the general rule that VAT is only payable where a party agrees to do something in return for consideration, so the VAT position should always be considered by reference to the precise terms of the agreement and the circumstances under which the payment arises.

### **TIMING**

Unusually, HMRC has announced that the new practice applies retrospectively (unless HMRC has given a specific ruling on a particular transaction) despite the obvious case for a business to claim that it had a legitimate expectation that VAT would not be chargeable in reliance on HMRC's previous published guidance. In any case, this is subject to the general limitation period of four years in which HMRC may issue an assessment.

### **ACTION**

If a business has not charged VAT on a termination payment received within the past four years under an agreement (e.g. a lease) where the charges (e.g. rentals) are ordinarily subject to VAT, it should consider the impact of the new rules. Penalties may be due if reasonable steps are not taken to inform HMRC after an error has been discovered. Further, certain businesses which have made termination payments may be able to recover VAT which should have been treated as included in the payment.

In addition, suppliers should review the terms of their agreements to check which types of payment may be affected by the new rules and to make sure that they are able to charge their customers VAT on such payments going forwards. Given the potential for rolling stock lease terminations in the context of the DfT's Emergency Recovery Measures Agreements and changes to franchise expiry dates, rolling stock lessors should review their lease provisions now.

*If you wish to discuss any of the issues outlined in this briefing, please contact the Clifford Chance contacts listed below or your usual Asset Finance contact.*

## CONTACTS



**Simon Corzberg**  
Director - VAT

**T** +44 20 7006 8945  
**E** [simon.corzberg@cliffordchance.com](mailto:simon.corzberg@cliffordchance.com)



**David Saleh**  
Partner

**T** +44 20 7006 8632  
**E** [david.saleh@cliffordchance.com](mailto:david.saleh@cliffordchance.com)



**Dan Neidle**  
Partner

**T** +44 20 7006 8811  
**E** [dan.neidle@cliffordchance.com](mailto:dan.neidle@cliffordchance.com)



**Paul Carrington**  
Partner

**T** +44 20 7006 8124  
**E** [paul.carrington@cliffordchance.com](mailto:paul.carrington@cliffordchance.com)

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London, E14 5JJ

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