HMRC - VATSC35400 - Early Termination Of Contracts

Two conflicting tribunal decisions on exactly the same facts give some idea of the difficulties of determining the correct VAT status of payments arising out of early contract termination.

Holiday Inns

The first of these is the decision in the appeal of Holiday Inns (UK) Ltd [1993] VATTR 321.

In this case Holiday Inns (HI) managed a hotel on behalf of the owner, Croydon Hotel & Leisure Company Ltd (CHL). CHL wished to terminate the management agreement early but the contract did not allow it to do so. As a result the parties entered into a separate agreement to terminate. After some lengthy negotiations, the agreement was effected and CHL paid £2m to HI.

CHL wished to reduce the cost of this settlement by treating part of the payment as VAT (which it recovered as input tax) on the basis HI had made a supply of granting CHL the right to terminate. Customs agreed and HI appealed against this. The tribunal found that, although drawn up years apart, the termination agreement constituted a part of the original management agreement, effectively inserting a termination clause in the latter. As this meant CHL already had the right to terminate, it could not have purchased the right from HI so there had been no supply for VAT purposes.

As a result of this decision, HMCE sought to obtain repayment of the input tax that CHL had claimed. CHL appealed, leading to the tribunal decision of Croydon Hotel & Leisure Ltd (LON/93/2061A).

The tribunal, working on the same facts as those in the earlier hearing, nonetheless found the termination agreement and £2m payment did represent a supply for VAT purposes - one of restoring the hotel to the owner unencumbered by the presence of HI. The ECJ’s decision in the case of Lubbock Fine & Co C-63/92 (that had come out after the previous tribunal decision) was cited as a reason for taking a different line.

Lloyds

A further decision of the VAT tribunal in Lloyds Bank plc (LON/95/2525) has provided additional guidelines in this area of the tax.

In this case Lloyds sought an early termination of a lease it held on a property. As with the agreement in the Holiday Inns/ Croydon Hotel case, the lease did not provide for such early cancellation. Lloyds and its landlord therefore agreed a variation to the lease, setting out terms for early termination and a sum to be paid to the landlord as compensation. Because the parties effected the early termination on the same day as agreeing the variation, the tribunal did not see the decision in Holiday Inns as applicable (there had been a considerable gap between the two events in that case). The tribunal found that there had been a supply by the landlord of granting and exercising an option to terminate the lease in return for a payment by Lloyds and its vacating the premises.

Conclusion

It is apparent from the direction of these cases that:

There is no supply for VAT purposes of “the right to terminate” or other such service where a contract originally contains a clause allowing the parties to terminate early in lieu of compensation for perceived losses arising from the termination.

However, there will be supplies where no such right exists and agreements have separately to be reached properly to terminate the contracts. This is so even if there is much talk of monetary ‘compensation’ in these agreements.

It is also possible that a supply takes place even when there is a right to terminate but a period of notice of the termination is required. In such circumstances one party may seek the right to waive the period of notice, producing a result similar to those in the Croydon Hotel and Lloyds cases.

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