HMRC - VATSC35600 - Liquidated Damages, Termination Of Leases Of Goods And Breaches Of Contract

Liquidated damages. Agreements that allow for early termination will invariably include related clauses that provide a formula for payment of compensation in the event of such termination. These amounts are generally to compensate for loss of earnings and are often referred to as liquidated damages. They are not consideration for supplies and are outside the scope of VAT.

Lease agreements for moveable goods commonly include clauses that allow lessees to terminate early but to pay liquidated damages as a result. Examples of this are vehicle finance leases that customers can cancel after an initial period of hire but, if so doing, must pay a termination sum to cover the loss of future rents. As indicated, such sums are not liable to VAT. However, an agreement with the leasing industry allows lessors to treat lease terminations generally as taxable supplies if they wish.

Breach of contract. It is also possible for leases and other agreements to terminate early if a particular event occurs such as the customer breaching the terms or the lessee or an associate business calling in receivers. The contract deems that such events cancel its terms or effectively allow the lessor to terminate as though there had been a breach. Again, any moneys deemed due as a result are damages and outside the scope of VAT.

The VAT tribunal decision in the case of Financial & General Print Ltd (LON/95/1281A) supports the above.

In this case Financial claimed input tax in respect of a payment following termination of its lease of a printing machine after going into receivership. It was assessed for the claim and appealed to the VAT tribunal.

The tribunal dismissed the appeal, holding that there had been no supply by the lessor in respect of the termination. The contract had specified that if the lessee went into receivership, the lessor could effectively treat this as a breach and terminate the lease. Under a further clause headed “Consequences of Termination” the lessee’s right to retain the goods ceased and the lessee had to pay the lessor various sums including lost rents and costs. There was no supply for VAT purposes in these circumstances, the monies being damages.

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