

*Liquidated damages (“LDs”) are pre-determined sums that become payable upon a breach of contract. In construction contracts, LDs reduce the evidential burden on the Employer, saving it the time and expense it would have to invest in a claim for general damages. The regime governing value added tax (“VAT”) on LDs is an important aspect of English construction contracts and should be in the mind of any Employer that wishes to exercise its right to levy LDs.*

## VAT Regime

VAT is payable on the supply of any goods or services that are made by a “taxable person”. A taxable person is a trader that is (or should be) VAT registered. A business is required to be VAT registered if it has a VAT taxable turnover of over £82,000. There is also the possibility of voluntary VAT registration for businesses whose VAT taxable turnover falls below this threshold. By virtue of its status as a taxable person, a business must, subject to the regime on exempt supplies, charge VAT on any supplies it makes and can deduct VAT from supplies it receives by way of business activity.<sup>1</sup>

## VAT on Damages

In the context of general damages, the key question for determining whether VAT is payable is whether an award for damages is: (1) compensatory; or (2) consideration for a supply. If the award for damages is purely compensatory it will fall outside of the VAT regime. However, if the award for damages represents consideration for an underlying supply of goods or services for which payment has not been received, such damages will be caught by the VAT regime.

## VAT on LDs

There is a fine line between compensatory damages and those which relate to an underlying supply. This distinction can often lead to complex litigation. Thankfully, in the specific context of LDs in construction contracts, there is clear guidance (the “Guidance”)<sup>2</sup> from Her Majesty’s Revenue and Customs (“HMRC”), making the position relatively straightforward.

LDs in construction contracts are by their very nature compensatory and the Guidance thus indicates that they will fall outside of the VAT regime. Paragraph 22.3 of the Guidance is of particular relevance to Employers as it notes that:

*If you receive liquidated damages, you are not receiving payment for a supply by you and no VAT is due on that amount.<sup>3</sup>*

Accordingly, as the purpose of LDs is usually to compensate the Employer for loss it has incurred as a result of delay caused by the Contractor, the Employer – assuming it is VAT registered – will not be required to account to HMRC for any VAT on LDs it receives from the Contractor.

The Guidance also notes that:

*If you are due to make a payment for liquidated damages and due to receive from the other party a payment for a supply made by you, you cannot reduce the value of your supply (and therefore cannot reduce the amount of VAT chargeable) even if you set the amounts off against each other.<sup>4</sup>*

The above paragraph is clearly aimed at the party making the supply; namely, the Contractor, requiring it to charge VAT. It should be noted, however, that the JCT Standard Building Contract places the Employer under an express obligation to pay VAT on top of the “Contract Sums”.<sup>5</sup> From an Employer’s perspective, the practical effect of the above paragraph, when read in conjunction with an unamended JCT contract, is best explained by way of an example:

- Employer (“E”) enters into a contract with Contractor (“C”) for the construction of a building.
- The total cost of the works is £100,000 plus VAT of £20,000.
- The construction of the building is delayed and E exercises its right to levy LDs of £10,000.
- E serves C with a payless notice, setting off the £10,000 in LDs against the £100,000 invoice.
- Although in practical terms, C will only be receiving a payment of £90,000, in the eyes of HMRC, the value of C’s services will remain at £100,000, meaning that E must still account for the full £20,000 in VAT to C.

<sup>1</sup> VBNB26000 - VAT Business and Non-Business activities: taxable persons with more than one activity.

<sup>2</sup> VAT Notice 708: buildings and construction.

<sup>3</sup> Ibid. paragraph 22.3.

<sup>4</sup> Ibid.

<sup>5</sup> See, clause 4.6.1 of the JCT Standard Building Contract.

The effect of the above should be applied consistently regardless of the amounts or method of payment. For example, it is common in construction contracts for Employers to pay Contractors on an interim basis. As such, the effect of LDs could, following a payless notice, reduce the total amount payable on one or more invoices to zero. Even if this is the case, the Employer must still account for VAT on the amount that would have been payable to the Contractor had the LDs not fallen due.

## Conclusion

In short, LDs do not affect the amount of VAT payable on work carried out by a VAT registered Contractor. In situations where an Employer has received payment for LDs, it will be under no obligation to account for VAT on those LDs. Employers should bear in mind, however, that in situations where payment of LDs by the Contractor is set off against the value of an invoice, the set off will not have the effect of reducing the overall amount of VAT payable to the Contractor.

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