
Real Estate Tip of the Week: Only genuine compensation payments are VAT exempt

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You've heard that there's no VAT due on compensation payments (such as those that settle dilapidations liability) but this depends on the exact nature of the payment. If it is purely compensatory, it will be outside the scope of VAT. However, if the recipient does something in return, it is likely to be a supply for VAT purposes.

So, where one party cancels a contract and pays 'compensation' for early termination, depending on how the deal has been structured, this could be the supply of a right to be released from the contract. If so, it will be subject to VAT. In contrast, where a tenant break in a lease provides for a compensation payment to be made to the landlord, VAT is not usually chargeable since HMRC takes the view that the landlord accepting a break does not amount to a VAT supply.

Watch out though where money is being paid to someone so it can then be used to make a compensation payment. For example, a tenant might agree to pay its assignee an amount which the assignee can later use to compensate the landlord for dilapidations at the end of the term. As such, the parties may have it in their heads that the payment is VAT exempt. However, if it is paid to the assignee, rather than directly to the landlord, HMRC will view the assignee as supplying a service of taking the lease in return for the payment. The payment will be subject to VAT regardless of any option to tax (*Customs and Excise Commissioners v Cantor Fitzgerald International*) and if the outgoing tenant cannot recover VAT as input tax, the VAT will be an absolute cost to it.

So, if you intend to pay money to someone so they can then use it to make a VAT exempt payment to someone else, ensure that you take specialist tax advice so you can structure the arrangement in the most tax beneficial way.

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