HMRC - VATSC92100 - Agreement With The Law Society’S Revenue Law Committee On VAT In Respect Of Third Party Cost Payments

The Indemnity principle

The Law Society Gazette article of October 1990 stated that when a person other than the solicitor’s own client is paying the solicitor’s costs, the liability of the paying party is one of indemnity only, and thus in itself outside the scope of VAT. In fact, such payment will only be regarded as outside the scope in certain circumstances, for example, as follows:

where following completion of litigation (or arbitration), one party is ordered to pay the other party’s costs;

where a party to a transaction undertakes to pay the other party’s costs, and the matter does not proceed to completion, so the costs are “abortive”.

However, there are other circumstances where the payment of costs by a third party is regarded as consideration for the supply for VAT purposes. One specific example of such a situation would be where a transaction obliges one party to be responsible for the costs of the other relating to that transaction, in which case payment will be regarded as part of the consideration for the supply (provided the transaction proceeds to completion).

It is worth restating the following general principles which apply when the payment is on an indemnity basis:

the solicitor whose costs are to be paid should deliver a tax invoice to his own client. If his client is not a registered taxable person, it is permissible to deliver a VAT inclusive bill without distinguishing the VAT element, although this would not be common practice;

if the solicitor’s client is a registered fully taxable person, and the supply of legal services is obtained for the purpose of the client’s business, the client will be entitled to an input tax credit in which case the indemnifying party need only pay the costs exclusive of VAT;

if the solicitor’s client is not a registered fully taxable person and cannot obtain input tax credit, the indemnifying party is liable to pay the costs and VAT as well. However, the indemnifying party cannot recover the VAT;

where the solicitor’s client is a partly exempt registered taxable person, paragraph (b) above applies only to the extent that the client can obtain credit for input tax. Paragraph (c) applies to the balance;

in no circumstances may a tax invoice be issued by the client’s solicitor to the paying party who is not in law entitled to receive an input tax credit as the services have not been rendered to him. The paying party should therefore receive a note of the other party’s costs in such terms that the note cannot be mistaken for a tax invoice issued to the paying party.

For solicitors’ services in insurance cases, please refer to previous guidance on this subject which has been published in the Law Society’s Gazette on 16 January 1985 and 15 January 1996.

When payment constitutes part of the consideration for the supply”

It is clearly stated in HMRC Notice 742 Land and Property paragraph 10.8 that payment by a tenant of a landlord’s costs incurred in respect of the grant of a lease or licence would be regarded as part of the consideration for the supply by the landlord to the tenant. The practical implications will depend on whether the landlord has elected to waive exemption from VAT in relation to the property. If no election to waive exemption has been made, the landlord would not be entitled to an input tax credit on his costs, so the tenant would be required to pay the gross costs including the VAT element: there will have been a taxable supply, so the tenant will not receive a VAT invoice and will be unable to recover an input tax the VAT he has paid to the landlord.

If the landlord has elected to waive exemption, so VAT is payable in respect of the rent or premium, the landlord can recover the VAT element of the costs, and the tenant will only be required to pay the net amount of the landlord’s costs, but to that net amount, the landlord will add a VAT charge.

In effect, the amount paid by the tenant would be the same whether or not the landlord has elected to waive exemption, but only if the landlord has done so will the tenant receive a tax invoice from the landlord, and be able to recover the VAT element if the tenant is a registered taxable person.

Change of policy

HMRC regard payment of costs which have been incurred by a landlord in respect of the exercise by a tenant of an existing right under the lease or licence as constituting part of the consideration for the supply by the landlord to tenant (and thus potentially subject to VAT as described in the paragraph above headed “When payment constitutes part of the consideration for the supply”). This represents a change from the agreed guidance published on 24 October 1990, and it has been agreed that the effective date for the new regime will be 1 December 1992. It is accepted that if, under the terms of the lease, a landlord cannot unreasonably withhold his consent to the tenant’s exercising a right, or where the tenant is permitted to exercise a right without the landlord’s consent, but subject to payment by the tenant of the landlord’s costs, this will be regarded as an existing right. However, where the landlord has absolute discretion as to whether consent is to be granted for the exercise of a right, payment of costs incurred by the landlord is regarded as consideration for a separate supply, on which the landlord will charge VAT unless the right sought to be exercised would constitute an exempt supply.

The contents of this article supersede the article which was published in the Law Society’s Gazette on 11 July 1990, entitled “VAT and notices of assignment” which should now be disregarded.

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