



# Income outside the scope of VAT

**Neil Warren** considers common sources of income where there is no output tax liability

**L**et's start this briefing with a challenge: can you think of 10 sources of income received by a business or organisation that are not subject to VAT, excluding exempt items? You must also exclude zero-rated items (books, newspapers, children's clothing etc) because this would not be a correct answer - you are still being charged VAT when you buy something that is zero-rated, but at a rate of 0%.

## **DONATIONS**

The subject of VAT and donations sometimes rears its head at tribunals, usually when HMRC thinks that an arrangement does not

### Example 1: genuine donations

Big Bank Ltd has donated £5,000 to Manchester Rugby Club towards the fund for its new stand. The club will give credit to the bank in its next match day programme, and also the club chairman will make a special announcement before the game to thank the bank for its generosity.

This donation is outside the scope of VAT and not subject to output tax. HMRC accepts that an acknowledgement of the donation in a programme or local press is not an advertising benefit that could be standard-rated.

represent a genuine donation because the donor is receiving tangible benefits in return for his or her payment. See Example 1, which shows a genuine donation arrangement.

To develop the scenario at Example 1, what would be the situation if Big Bank Ltd insisted on acquiring the right to purchase the club's allocation of international rugby tickets for games at Twickenham as a condition of the £5,000 payment? The bank is now gaining a tangible benefit in return for its payment, more than just a simple acknowledgement of thanks by the club, which means it would now be standard-rated, rather than outside the scope of VAT (assuming the club is VAT-registered, of course).

### REFUNDABLE DEPOSITS

It is very common for a tenant to pay a deposit to a landlord at the beginning of a rental agreement - a holding sum of money that will be returned to the tenant at the end of the agreement as long as he or she leaves the property in good condition and is up to date with the rent. This money is classed as a 'refundable deposit' and therefore not subject to VAT even if the landlord has opted to tax the property and will charge VAT on future rent.

Note that if a deposit represents an advance payment towards standard-rated goods or services to be supplied at a future date, the payment creates a tax point for VAT purposes, and an output tax liability based on the payment date.

### DILAPIDATION PAYMENTS

I dealt with one situation where a tenant vacating a property needed to pay £150,000 to the landlord at the end of his rental agreement as a 'dilapidation payment'. The landlord wanted to add 20% VAT to this charge because he had opted to tax the property in question, which would increase the payment to

£180,000. The landlord took the view (with some logic) that all of his income connected with an opted property must be subject to 20% VAT.

However, the good news is that no VAT is payable on dilapidation payments because there is no supply of goods or services from the landlord to the tenant. The payment represents a claim for damages by the landlord against the tenant's 'want of repair' (see para 10.12, VAT Notice 742).

It is important that a business does not pay incorrectly charged VAT, even if it gets a tax invoice from a supplier. This is because HMRC could block an input tax claim (a claim must be based on the correct rate of tax for the supply or payment in question), instructing the business to get a VAT credit from the supplier instead.

### COMPENSATION PAYMENTS

The treatment of this is shown in Example 2.

### CANCELLATION CHARGES

If a business makes a charge to a customer for cancelling an order, then the cancellation charge is outside the scope of VAT. Think of hotel bookings where the hotel keeps the money paid up-front by guests who have either cancelled their booking or don't show up on their expected day of arrival.

However, the hotel must be careful with the rules of unjust enrichment. If it has charged a deposit of £50 plus VAT, then the 'plus VAT' no longer due must be refunded to the customer who has paid the VAT rather than be retained by the business.

### OTHER SOURCES OF INCOME

So far I have given five sources of income that are not subject to VAT, so let me quickly add another four:

- payments made to a business in relation to insurance claims;
- dividend income;
- grant income where no goods or services are supplied by the recipient of the grant, eg, a lump sum of money paid by a local authority to a charity to help the charity with its general overheads; and
- fines and penalties, eg, income received by a hotel when it fines guests for smoking in one of its non-smoking rooms.

With regard to grant income, note the case of *Woking Museum and Arts and Craft Centre v HMRC* TCO3315. Here, a charity successfully challenged HMRC's view that income it received from Woking Borough Council was outside the scope of VAT. The

### Example 2: compensation payments

A taxi business had a new garage door fitted to the building where all of the cars are kept, and the door had a faulty connection. It collapsed on the head of one of the drivers, who needed hospital treatment. The garage door company repaired the door but then gave a payment of £1,000 to the taxi business for the suffering caused to the driver.

The payment of £1,000 is not taxable because it is not relevant to any goods or services provided by the taxi firm to the garage door company and is outside the scope of VAT as a compensation payment.

charity charged VAT on the basis that it was providing and managing a museum facility to Woking residents on behalf of the council. If HMRC's view had been successful, the charity would have been blocked from claiming input tax on costs.

### PLACE OF SUPPLY

I still get accountants call me with place of supply queries, with questions along the lines of: "I've got a client who is doing some consultancy work for a business client based in Sweden. Is his fee zero-rated?"

In this situation, there is no zero-rating or VAT exemption involved - you will not find consultancy services listed in either Sch 8, VATA 1994 (the zero-rated schedule) or Sch 9 (the exemption schedule). In this situation, the overseas business status of the customer means the income is outside the scope of VAT under the general rule for B2B (business to business) services, ie, the place of supply is Sweden. The VAT will be sorted out in Sweden with a reverse charge calculation made by the customer based on the Swedish rate of VAT.

### FLAT RATE SCHEME (FRS)

Finally, if any of your clients use the FRS, then none of the income sources mentioned in this article are subject to FRS tax, and are also excluded from Box 6 (outputs) of each VAT return submitted by an FRS user. However, FRS tax is unfortunately due on zero-rated and exempt business income, which is not good news for many businesses, eg, a builder doing work on new houses. ■



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