VAT Public Clarification

VAT treatment of compensation-type payments

Issue

VAT is a tax on supplies of goods and services. Therefore, no VAT is due if no supply takes place. As part of business arrangements, businesses will often make payments to compensate each other for any loss, omissions or other wrongdoings. A question arises whether VAT is due on such payments.

Summary

Where a payment is not consideration for supply, no VAT is due on the payment.

Detailed discussion

Under Article 2 of the Federal Decree-Law No. 8 of 2017 on Value Added Tax (“VAT Law”), VAT is imposed, among other things, on taxable supplies of goods and services.

“Taxable supply” is defined in Article 1 of the VAT Law as a “supply of goods or services for a consideration by a person conducting business in the State, and does not include exempt supply”.

As a consequence, in order for an obligation to charge VAT to arise, there must be a supply of...
goods or services. If any payment does not relate to a supply of goods or services then the payment is not subject to VAT.

The question of whether or not a payment is consideration for a supply is the matter of fact. Typically, this requires the taxpayer to consider the underlying arrangements that give rise to the payment in order to determine whether the payee has provided anything in return for the payment.

Below, a number of situations are considered where a payment may or may not be treated as being consideration for a supply of goods or services. It should be noted that the purpose of the discussion is not to provide answers for all types of payments that might be made in such situations, but to give an example of principles that should be used in determining whether VAT should be due on compensation-type payments.

- A contractual payment to compensate for loss

An example of such a compensatory payment are “liquidated damages”. Liquidated damages are predetermined amounts that parties to an agreement designate during the formation of the agreement for the injured party to collect as compensation upon a specific breach – for example, for an early termination of a contract or a late performance. The purpose of such payments

المبالغ التعاقبية لتعويض الخسارة

من أمثلة دفعات التعويضات هي تعويض عن "أضرار محددة". الأضرار المحددة هي مبالغ محددة سلفاً من قبل أطراف الاتفاق أثناء التعاقد للسماح للطرف المتضرر بتسليم تعويض بناءً على مخالفات محددة، على سبيل المثال الإنهاء المبكر للعقد أو الإنجاز المتأخر.

ولا يكون هدف هذه الدفعات تقديم مقابل عن توريد سلع أو خدمات، وإنما هي لتعويض الطرف المتضرر عن خسارة في الدخل. ولذلك تكون هذه الدفعات خارج نطاق ضريبة القيمة المضافة.
is not to provide consideration for a provision of any goods or services but to compensate a party for loss of earnings. As such, the payments are outside the scope of VAT.

That does not, however, include where a contract allows a hotel guest to cancel a booking in return for a cancellation charge, as such charges are considered a cessation of a right, which are a supply of services and hence subject to VAT. This is regardless of whether the hotel room remains available to the guest or not.

- A payment to settle a dispute

Where a dispute is settled (e.g. in or out of court) and a payment is awarded to a party, it is necessary to consider the reason behind the payment in order to determine the VAT treatment. For example:

- Where a payment is to enforce a contractual term, the payment is consideration for the contractual supply to which it relates. For example, where a dispute regarding a price of goods is settled by requiring a contractual recipient of the goods to make a payment for these goods, the payment will be consideration for the supply of the goods and therefore subject to VAT.

- The payment referred to in Article 7, paragraph 1, of Law No. 8 of 2012 is not to provide consideration for a provision of any goods or services but to compensate a party for loss of earnings. As such, the payments are outside the scope of VAT.

مع ذلك، لا تضمن تلك المعاملة عقد حجز فندق يسمح للنزلاء بإلغاء حجزهم مقابل رسم إلغاء، حيث أن هذا الرسم يعتبر مقابل إيقاف الحق، والذي يعتبر توريداً لخدمات وبالتالي يخضع لضريبة القيمة المضافة. تكون هذه المعاملة بغض النظر عما إذا كانت غرفة الفندق لا تزال متاحة للضيف أم لا.

المبلغ المتعلق بتسوية النزاع إذا تم تسوية نزاع (سواء من خلال محكمة أو خارجها) وتقرر دفع مبلغ ما إلى أحد طرفي النزاع، فمن الضروري الأخذ في الاعتبار الأسباب وراء استحقاق الدفع لتحديد المعاملة الضريبية. فعلى سبيل المثال:

- إذا كان المبلغ لتنفيذ شرط التعاقد، فإن ذلك المبلغ يعتبر مقابل التوريد التعاقدي ذو الصلة. على سبيل المثال، إذا تم تسوية نزاع يتعلق بسعر سلع عن طريق مطالبة مستلم السلع (طرف التعاقد) بسداد قيمة هذه السلع، فإن المبلغ المطالب به هو مقابل توريد السلع وبالتالي سيكون خاضعاً لضريبة القيمة المضافة.
Where a payment is in the nature of damages or compensation for any loss suffered by a party, the payment is not consideration for any supply and is outside the scope of VAT. For example, a payment for loss of earnings or a payment of interest in respect for a late payment of contractual consideration would not be a consideration for any supply.

Where a payment is in return for granting a right then the payment is consideration for the supply of the right and may be subject to VAT. For example, a person may agree to allow another person to use its property (including intellectual property) in return for a payment, the payment is consideration for the supply of the right to use the property.

A fine or penalty charge may be imposed for contravening terms of an agreement, performing an unlawful act or otherwise be imposed, usually by government bodies, for breaches of statutory obligations. True fines and penalties are not consideration for any supply and therefore outside the scope of VAT. For example:

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- **Payment for damaged goods**

Where a person has damaged or lost goods belonging to another person (for example, damaging a leased car), it may be required to make a payment to compensate for the damage or loss. Where the payment is compensation and for breaching pre-existing terms of a contract, it is unlikely to be consideration for a supply and therefore would be outside the scope of VAT.

A contract may stipulate that a party must make a payment if it breaches a term of the contract. The payment made as a result of a breach of a contract is in the nature of damages and therefore also outside the scope of VAT.

A fine or penalty may be imposed by a government authority for an unlawful act – for example, a speeding fine or fine for incorrect parking. The purpose of such fines is to punish the wrongdoer for the act and the party imposing the penalty is not making any supply in respect of the payment. Therefore, no VAT is due on such fines and penalties.

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- الدفع مقابل السلع التالف

إذا قام الشخص بإتلاف أو خسارة ملصق شخص آخر، على سبيل المثال: إتلاف سيارة مستأجرة، فقد يطلب منه دفع مبلغ للتعويض عن الضرر أو الخسارة.

إذا كان المبلغ المدفوع هو بمثابة تعويض لانتهاك شروط العقد المنصوص عليها مسبقًا، فإن غير المرجح أن يكون هذا المبلغ مقابل لتهريب، وبالتالي سيكون خارج نطاق ضريبة القيمة المضافة.
In other circumstances, there is likely to be consideration for a supply – for example, where a customer breaks a good and is obliged to take title to it, the payment the customer makes would represent consideration for a supply of goods, and so would be subject to VAT.

Holistic analysis

In summary, in determining whether or not a payment is consideration for any supply, it is necessary to consider the contractual and legal arrangements in full to determine the reason for the payment. Thus, it may be necessary to consider whether:

- the payment is consideration for any previously agreed goods or services;
- the payment is consideration for any newly created supply of goods or services;
- the purpose of the payment is to adjust a previously agreed consideration for a supply;
- a party is granting a right to another party in return for a payment;
- a party is promising not to exercise a right in return for a payment;
- a party is giving something up in return for a payment.

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Translation:

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- a party is promising not to exercise a right in return for a payment;
- a party is giving something up in return for a payment.
In considering whether a payment is consideration for a supply or is in the nature of compensation, it is important to ignore the labels or titles the parties give to a payment. For example, a description of an administrative payment as a “penalty” or a “compensation” will not prevent the nature of the payment from being consideration for a supply.

This Public Clarification issued by the FTA is meant to clarify certain aspects related to the implementation of the Federal Law No 7 of 2017 on Tax Procedures, Federal Decree-Law No 8 of 2017 on Value Added Tax and their Executive Regulations.

This Public Clarification states the position of the FTA and neither amends nor seeks to amend any provision of the aforementioned legislation. Therefore, it is effective as of the date of implementation of the relevant legislation, unless stated otherwise.

This clarification aims to provide some clarification concerning the implementation of the Federal Law No 7 of 2017 on Tax Procedures, Federal Decree-Law No 8 of 2017 on Value Added Tax and their Executive Regulations. However, it neither amends nor seeks to amend any provision of the aforementioned legislation. Therefore, it is effective from the date of implementation of the relevant legislation, unless otherwise stated.

When considering whether a payment is consideration for a supply or is in nature of compensation, it is important to ignore the labels or titles given by the parties to a payment. For example, a description of an administrative payment as a “penalty” or “compensation” will not prevent the nature of the payment from being consideration for a supply.