The VAT clause. In the normal commercial context it can be difficult to get excited about it. So much so that it can be relegated to the status of boilerplate ‘insert standard wording here’ status. It’ll often look something like this:

‘All amounts expressed in this agreement to be payable by any party to any other party which (wholly or partly) constitute the consideration for a supply for VAT purposes shall be deemed to be exclusive of any VAT which is chargeable on such supply, and accordingly, if VAT becomes chargeable on any such supply the recipient shall pay to the other party (in addition to and at the same time as paying any other consideration for such supply) an amount equal to the amount of such VAT (on the prompt provision of an appropriate VAT invoice).’

And most of the time that’s quite sufficient for most purposes – especially where you’re not expecting any actual VAT to actually arise. Where you can get into difficulties, though, is on focusing on the VAT clause where there may be a real cashflow cost if the parties are not crystal clear on what they’re agreeing.

A particular area of difficulty is in the reimbursement of expenses, where one party agrees to pick up certain costs of the other. Many contracts will be silent on the question of how those expenses should be dealt with for VAT purposes. You might commonly see a clause that looks something like this:

‘Supplier may recoup from Client any reasonable and documented expenses. Supplier shall submit a claim for expenses at the same time as its invoices are despatched to Client.’

The problem with this type of wording is that, since there’s more than one way of dealing with expenses for VAT purposes, this can lead to confusion between the parties, incorrect VAT returns and (occasionally) one party economically benefiting at the other’s expense. It is a problem common to several areas of industry, and may be dealt with differently in the various sectors. It is a problem common to several areas of industry, and may be dealt with differently in

Mr A Client
Let’s look at the case of Mr A Client. Mr Client and I are sitting in his offices, looking at a flip chart on which we’ve just drawn Figure 1.

‘I’m a bit worried we may be losing out,’ says Mr Client. ‘My company Client Co receives various services from Outsource Co. Sometimes Outsource Co incurs expenses in the provision of their work for us, and we reimburse them for the cost. But I think they may be overcharging us.’

‘Well, what are you being charged?’ I ask. ‘Say Outsource Co has to buy an item to carry out its work and pays £120 (£100 plus £20 VAT). What does Outsource Co claim back from you?’

‘I thought we were reimbursing them the net cost of £100,’ says Mr Client, ‘but we seem to be being charged £144. What’s going on?’

‘There’s different ways of dealing with expenses, depending on the scenario, the intentions of the parties and the VAT analysis. In some commercial situations one party may give an indemnity for net costs and expenses, with the VAT element of the expense being left out of account on the basis that the claimant can recover it from HMRC themselves, or claimable only to the extent it is irrecoverable by the claimant. Where the payment is compensatory in nature it should generally be outside the scope of VAT.

You were thinking you were paying £100, so this reimbursement method of recouping cost is probably what you were thinking of, but it may not be appropriate to your situation, especially if there is any possibility that HMRC may challenge the treatment of the payment. If Outsource Co were making exempt supplies, it would not matter whether the payment was compensatory (so outside the scope of VAT) or additional consideration as part of the wider supply (exempt) – no VAT would be due in any event.

Since Outsource Co’s supplies are subject to VAT, we need to consider recharging instead of reimbursement ie, on-charging expenses to a client plus VAT as part of one’s own supply. HMRC advocate cost recharging as the most appropriate method to use when a supplier wants...
Many contracts will be silent on the question of how [outsourced] expenses should be dealt with for VAT purposes

to itemise its own business costs to a customer on its invoices. If Outsource Co are charging you £144, then it sounds like they were recharging you their gross out of pocket cost. Ignoring VAT recovery, once they pay Supplier Co, they are effectively out of pocket by £120. When they recharge that cost to you, they are folding that cost into their own supply and it becomes an element of their charges to which VAT then applies i.e, the £120 becomes itself subject to VAT at 20%, making the total cost £144 (£120 plus £24 VAT). But they seem to have also charged us VAT on things that were never VATable in the first place! Look at these receipts they sent us – this expense here was £50 and Supplier Co didn’t charge them VAT because it wasn’t applicable. But they’ve charged me £60 (£50 plus £10 VAT). That can’t be right, surely?’

Figure 2: How much should Outsource Co receive from Client Co?

<table>
<thead>
<tr>
<th>Amount</th>
<th>Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>£100</td>
<td>1 - Reimbursement</td>
</tr>
<tr>
<td>£120</td>
<td>2 - Recharge net cost</td>
</tr>
<tr>
<td>£144</td>
<td>4 - Recharge out of pocket cost</td>
</tr>
</tbody>
</table>

Figure 3: Conditions for disbursement treatment

<table>
<thead>
<tr>
<th>Condition</th>
</tr>
</thead>
<tbody>
<tr>
<td>1: Outsource Co pays Supplier Co on Client Co’s behalf and acts as its agent</td>
</tr>
<tr>
<td>2: Client Co receives, uses or has the benefit of the goods or services Outsource Co pays for on its behalf</td>
</tr>
<tr>
<td>3: it is Client Co’s responsibility to pay for the goods or services, not Outsource Co’s</td>
</tr>
<tr>
<td>4: Outsource Co has permission from Client Co to make the payment</td>
</tr>
<tr>
<td>5: Client Co knows that the goods or services are from another supplier, not from Outsource Co</td>
</tr>
<tr>
<td>6: Outsource Co shows the costs separately on its invoice</td>
</tr>
<tr>
<td>7: Outsource Co passes on the exact amount of each cost to Client Co when it invoices it</td>
</tr>
<tr>
<td>8: the goods and services Outsource Co pays for are additional to whatever it bills Client Co for doing itself</td>
</tr>
<tr>
<td>9: the costs are not used and/or consumed in Outsource Co’s own business in the course of supplying its goods or services to Client Co.</td>
</tr>
</tbody>
</table>

‘I’m afraid it is. If expenses are recharged, it’s irrelevant that the expense did not incur VAT initially or incurred VAT outside the UK at a different rate. Recharging expenses is just a way of itemising costs incurred by Outsource Co’s own business in the course of supplying its services to Client Co, highlighting particular elements of its overall supply to show how the consideration is calculated. Since Outsource Co’s own supply is subject to UK VAT, VAT is due on the “expense” in the same way as on the rest of the fees charged for the services provided even though the original expense might not be VATable, or might have been supplied outside the UK.’

‘Okay. But going back to our other example, they’ve charged me £144 and the actual expense ignoring the VAT is £100. I can recover the £44 of VAT, right?’

‘Unfortunately, no, because only £24 of the £44 is actual VAT from Client Co’s perspective. As far as Client Co is concerned, it’s paying an extra £120 for Outsource Co’s main services, plus VAT on that of £24. The fact that the £120 may reflect an amount of embedded VAT that Outsource Co has itself suffered is irrelevant. The £20 of VAT is on a supply made by Supplier Co to Outsource Co, and only Outsource Co (if anyone) can reclaim it as input VAT.

You might expect Outsource Co to be able to recover the £20 VAT itself, and a key point here is to get to the bottom of its VAT recovery position because it could be recharging either its net cost (£100) or its gross out of pocket cost (£120). There’s no difference in the VAT analysis – either way they’ll charge VAT at 20% (£20 or £24) – but commercially it can make a big difference given that Client Co can only recover the actual VAT on the supply received from Outsource Co (not any embedded VAT).

If it can recover the VAT, then there’s an element of windfall benefit to it here if you haven’t agreed that it can mark up the expense ie, it is recouping £120 for something that actually only costs it £100.

If it cannot recover the VAT, again it comes down to a question of whether, commercially, you were willing to suffer the economic cost of its non-recovery, or if that should be for it to bear.

There could be several reasons why Outsource Co is not recovering the £20 VAT. It may consider HMRC will dispute its VAT credit claim. Commercially, it may feel it is just not worth the bother – if Outsource Co is processing thousands of small expense claims, and/or the expenses relate to offshore costs where the VAT is incurred in another EU country, it may be technically recoverable but the effort of doing so (especially in relation to cross-border costs) is sufficiently arduous for the administrative costs to render it uneconomic.

This would make the cash cost to Outsource
Co £120 not £100 as the appropriate amount on which to apply VAT at 20%. In certain sectors – the provision of temporary workers and IT outsourcing are particular examples – it can be common practice to recharge the full £120 (plus £24 VAT on top). In others – such as construction – practice varies but it is not uncommon for a client in a good bargaining position to refuse to pick up any embedded VAT (so a recharge of only £100 plus VAT of £20).

What does your contract with them say?'

'Well,' says Mr Client, 'we didn’t bother with much of a VAT clause – just standard stuff about Outsource Co billing for its services plus VAT and providing invoices. On expenses, I think the contract just says that Outsource Co will be reimbursed any reasonable expenses for which receipts are provided, as long as they submit their claim for expenses at the same time as their invoice. Now I come to focus on it, it’s not very clear, is it? Are there any other ways we could be dealing with the expense?'

'Yes, although these are not likely to be applicable or advisable in your circumstances. Let’s look at Figure 2. We’ve discussed reimbursement and recharging. It is also possible to treat an expense as a ‘disbursement’.

Basically this means that Outsource Co would receive the supply from Supplier Co on Client Co’s behalf and then pass on the £120 cost to Client Co.

This differs from recharging in that it does not form part of Outsource Co’s own supply – so, importantly, although the disbursement is shown on the invoice to Client Co the expense is left out of account when VAT is calculated by Outsource Co on its own services.

‘It’s quite unusual to treat an expense as a disbursement, for several reasons.

First, there’s some requirements that have to be met before HMRC will accept the expense is disbursed – see Figure 3.

While they look simple in principle, in practice it can be harder to evidence whether they are satisfied (especially if there is any question as to whether they are normal business costs used by the outsourcer in providing its own services to its client).

Second, it is best avoided unless the end client is a VAT exempt entity or the supply is not VATable, simply because the VAT recovery otherwise often tends to go wrong in practice: the supplier’s invoice will most commonly be addressed to the outsourcer not the client, so it is possible no-one can claim the VAT credit on the original supply – not the client, because they are not the addressee of the invoice, and not the outsourcer because they do not receive the supply if they treat it as a disbursement (they are merely an agent).

Some industries do apply disbursement treatment in their invoicing arrangements – the legal services market is the most obvious example – but it is best avoided where it is not market practice lest argument with HMRC ensue.

In circumstances where the parties want to achieve the same economic effect as disbursement, it is more common (and better from the VAT perspective) for the outsourcer to act as procurement agent and arrange for the supplier to make their supply directly to, and invoice directly, the end client.

The effect is broadly identical but this way, all the VAT documentation should be in order, there should be no problems with VAT recovery, and the client has direct redress against the supplier in the event of any fault.

In the construction industry, for example, where clients may need to acquire goods as part of a wider project, this is often used as a neat solution to avoid arguments about the appropriate recharge amount.

In your scenario, though, it is not likely to be a viable solution given that Outsource Co is consuming the costs and expenses billed by Supplier Co in its own business.’

‘Well, you’ve certainly given me a lot to think about,’ says Mr Client, ‘and I won’t view the VAT clause quite the same way again. I think we’d better talk to Outsource Co about how its VAT recovery is supposed to be working and what they think they’re recharging....’