

Our Ref: DA-HMRC.01

16 February 2021

By Recorded Delivery

HM Revenue and Customs – **VAT Written Enquiries**

123 St Vincent Street

Glasgow City

Glasgow

G2 5EA

United Kingdom

Dear Sirs,

1. **HMRC Policy Paper: Revenue and Customs Brief 12 (2020): VAT early termination fees and compensation payments (Updated 25 January 2021)**
2. **HMRC Internal Manual: VAT Supply and Consideration VATSC 05910, 05920 & 05930**
3. **HMRC Guidance: Land and property (VAT Notice 742)**

Commercial Lease ‘Dilapidations’ and VAT Supply – Clarification Request

I write on behalf of the Dilapidations Association, of which I am a management committee chair (see <http://dilapidationsassociation.com/leadership.html>). I am tasked by the Dilapidations Association with raising a number of questions with HMRC in relation to the above HMRC Policy and publications that appears to have caused a degree of confusion and debate within our membership which is drawn from the legal, accounting and surveying community.

The confusion that has arisen relates to the treatment for VAT purposes of a tenant’s liability for damages for breach of contract following the termination of a lease contract in circumstances where the tenant has failed to undertake repairs as required by the terms of the contract (“dilapidations”).

Such payments are conventionally made by tenants as a consequence of a judgment in respect of damages which is made by a court or alternatively as a result of agreement reached by the landlord and tenant as to the extent of the tenant’s liability for damages for breach of contract. Since September 2020, when HMRC published the Policy Paper “Revenue and Customs Brief 12 (2020): VAT early termination fees and compensation payments”, the Dilapidations Association has become increasingly aware that some members of the wider legal, accounting and surveying community have been issuing articles and website publications proclaiming that as of 01 February 2021, **all** “dilapidations” compensation payments by a tenant to a landlord are going to be treated by HMRC as being the payment of a contractual consideration by the tenant to the landlord in return for a supply by the landlord that will attract VAT, i.e. that all dilapidations payments will be treated as consideration for a taxable supply.

This perception within parts of our wider community appears to have taken hold and the ‘rumour mill’ surrounding such a perception has even lead to some large surveying firms acting on behalf of landlords on dilapidations damages claims writing to the former tenant’s and their advisers and informing them that from 01 February 2021, VAT at 20% may be added to the damages claim.



Having looked very carefully at the HMRC publications referred to above, the Dilapidations Association currently considers that such a community perception is not justified, correct or compatible with a correct interpretation of the law relating to the payment of damages.

The Dilapidations Association is aware that HMRC has been engaging with the likes of the British Property Federation (“the BPF”) on this issue and yet there seems to have been little headway since September 2020 in calming community chatter and providing sufficient clarity to allow the community to understand HMRC’s VAT treatment policy and intentions for dilapidations damages payments.

For the benefit of the wider community, the experts and specialists within the Dilapidations Association would like to engage with HMRC in this regard and to this end we request that HMRC confirm that our understanding of HMRC policy and rules for the VAT treatment for “Dilapidations” as set out further below and in the enclosed flowchart is correct, or alternatively advise if HMRC considers that the Dilapidations Association has perhaps misunderstood any aspect of this issue and provide appropriate clarification so we can in turn convey this official clarification to our members.

The issues may usefully be summarised as follows:

- a. **Does a payment of damages for breach of contract in relation to repairing covenants in a lease constitute consideration for a vatable supply in circumstances where it is made:**
 - i. **Where a lease contract expires by passage of time; or**
 - ii. **Where a lease contract is brought to an end early without payment of an early termination payment; or**
 - iii. **Where a lease contract is brought to an end early by way of a payment for the early termination, where the early termination does not include an element of payment for agreed dilapidations damages; or**
 - iv. **Where a lease contract is brought to an end early by way of a payment for the early termination where the early termination payment does include an element of payment for agreed dilapidations damages.**

From our reading of the aforementioned HMRC Policy Paper, Internal Manual, the EUCJ and other case law referred to therein, we understand that the key aspects of those documents related to the HMRC policy on VAT treatment of a payment made by one party to a contract to the other party to the contract specifically to bring about the early termination of that contract.



We also understand that any such payment required by a contractual clause allowing the early termination of the contract by the parties is treated by HMRC as being “consideration” paid in return for a “supply” and so attracts VAT on that early termination payment.

We understand that this is the case irrespective of whether the sum being paid was defined in the contract as being either a fixed amount, or a sum calculable by a formula or otherwise determined by some otherwise contractually agreed method.

We also understand that for VAT and supply purposes, HMRC’s policy is that it is irrelevant how that payment is described in the contract and any contractual definition labelling the contractual payment as being for compensation and/or liquidated damages, and/or a premium, and/or a fee, and/or a charge etc. does not alter the fact that a contractual consideration payment is to be made in return for a contractual supply (the early termination).

A critical point in our understanding of the above is the fact that the consideration payment to be made must be a payment required under an express term/clause of the contract. Therefore, where no such payment clause exists in the contract in question, there is simply no contractual basis for any consideration payment to be made by either party and in such circumstances, there can be no consideration for a contractual “supply” that would attract VAT.

We understand that such basic core principles apply irrespective of what the nature of the contract is.

Does HMRC agree that our understanding of the core principles of relevance to the aforementioned HMRC Policy Paper and Internal Manual are correct?

If not, what subtleties and key criteria does HMRC consider we might have missed and what clarification can HMRC provide?

Dilapidations Payments, Supply and VAT:

On our current understanding as set out above, and as a matter of principle, the Dilapidations Association can see and recognises how such HMRC policies and VAT internal manual rules **might** apply to commercial lease contracts being terminated early by the parties, such as by way of a deed of variation, the exercising of a break option and/or by the parties reaching a contractual agreement to surrender the lease etc.

We can also understand that in any of the above early lease termination circumstances, if the early termination of the lease is conditional on a contractual payment having to be made by the tenant to the landlord then such a contractual early lease termination payment could meet the criteria in the above HMRC



policy paper and VAT internal manual criteria as being a consideration payment made in return for a supply and so the payment sum, however so calculated or determined would attract VAT.

But equally we understand that if the contractual provisions of the lease allowed for the early termination of the lease contract by one or other party **without it being conditional on a consideration payment being made**, then in those circumstances we understand that the lease would determine early but there would be no contractual payment that could be classed as consideration and no financial element to the early contract termination “supply” that could attract VAT.

In this situation the landlord might still have a claim for damages against the tenant in relation to the repairing covenants.

We understand that if there is no early termination of a contract, including a lease contract, and the contract determines by effluxion of time, then the HMRC Policy Paper: Revenue and Customs Brief 12 (2020): VAT early termination fees and compensation payments (Updated 25 January 2021) does not apply.

Equally, we understand that if a contract, including a lease contract, determines early in accordance with a contractual provision but that the early termination is not conditional on an early termination payment being made, then HMRC Policy Paper: Revenue and Customs Brief 12 (2020): VAT early termination fees and compensation payments (Updated 25 January 2021) does not apply.

In addition, we understand that if a contract, including a lease contract, determines early in accordance with a contractual provision but that an aspect of one of the parties’ liabilities, such as a tenant’s liability for dilapidations under a lease, is excluded (or not included) from any contractual early termination payment then HMRC Policy Paper: Revenue and Customs Brief 12 (2020): VAT early termination fees and compensation payments (Updated 25 January 2021) does not apply to the contractually excluded element of liability which does not comprise part of the early termination payment and remains to be adjudicated.

We understand that in such other lease termination circumstances outlined above, the parties to the determined/terminated contract may still have the right after termination of the contract to pursue a civil action for damages against each other where they believe they have suffered a damage as a direct consequence of the other party having failed to fully honour, observe and perform the covenants and conditions of the contract during the contract term.

In those circumstances any dilapidations damages payment ordered by a court or agreed between the parties would not attract VAT.



Accordingly, we understand that HMRC recognises and clearly distinguishes between;

- a) civil actions for damages claims for breach of contract, and
- b) consideration payments and a supply made under the terms of a contract.

More specifically and in the context of any civil action for damages claim being made by a landlord in any of the 'other lease determination' circumstances referred to above, we understand that it remains HMRC's official position that, in accordance with paragraph 10.12 of the HMRC VAT Notice 742 and long-established law:

"A dilapidation payment represents a claim for damages by the landlord against the tenant's 'want of repair'. The payment involved is not the consideration for a supply for VAT purposes and is outside the scope of VAT."

Conclusion: Dilapidations and VAT Supply:

In relation to "dilapidations" damages and in light of the above we understand that the HMRC policy, internal manuals and VAT Notice 742 have the combined effect that:

1. Where a lease determines at the end of the contractual term there is no supply of a service to which a VAT payment would be attached. Any subsequent judgment or settlement in relation to "dilapidations" damages is not a payment for such a supply and does not attract VAT.
2. Where a lease determines early without any requirement of a payment by the tenant to the landlord as consideration for the termination then there is no consideration for the supply of a service to which a VAT payment would be attached. Any subsequent judgment or settlement in relation to "dilapidations" damages is not such a consideration for a supply and does not attract VAT.
3. Where a lease determines early any payment that is to be made by a tenant to a landlord as consideration for the premature termination of the lease contract will result in the payment of a contractual consideration by the tenant for a supply by the landlord where the payment sum attracts VAT at the prevailing rate.

Where such a payment, as detailed in 3 above, includes a payment in relation to "dilapidations" current guidance from HMRC would seem to indicate (rightly or wrongly) that that element of the payment will also constitute a contractual consideration liable to VAT. As a matter of principle, the Dilapidations Association does not consider that this is correct as a dilapidations payment is of a completely different nature to a contractual early termination payment. If this is the correct interpretation of HMRC current guidance we would welcome further discussion with HMRC on this point.



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In the interests of trying to explain our understanding as set out above, and in the hope of trying to clear up any wider community understanding, the Dilapidations Association has prepared the enclosed flowchart guide that we believe reasonably reflects our understanding and application of the HMRC policy paper, VAT Internal Manual and VAT Notice 742.

Does HMRC agree that our summary understanding as detailed above and enclosed flow chart guide of the core principles of relevance to the aforementioned HMRC Policy Paper and VAT Internal Manual and VAT Notice 742 so far as they relate to “dilapidations” are correct?

If not, what policy, criteria or law does HMRC consider we might have missed? and what clarification would HMRC offer to correct our and our members’ understanding?

Further Consultation:

We look forward to receiving HMRC’s written clarification and response to the points and questions raised above and trust it will be provided at the earliest opportunity.

In the meantime, the Dilapidations Association is keen to provide assistance to HMRC to help clear up the any current legal, accounting and/or surveying community misunderstanding on the above matters and would welcome being consulted and involved in any further HMRC consultation process on this matter give the extensive breadth and depth of specialist knowledge and expertise the management committee and our members can offer on issues relating to Dilapidations.

Yours faithfully,

T N Davis FRICS *RICS Registered Valuer*

CHAIR

For and on behalf of the Dilapidations Association

Encs.: Flowchart Guide: “When do payment to Landlord relating to dilapidations result in a “supply” for VAT Purposes?”

(see also <http://dilapidationsassociation.com/memberspublications.html> to download a PDF copy of the above flowchart)

Cc by email: The Committee and Board of Directors of the Dilapidations Association