

DILAPIDATIONS AND VAT SUPPLY

Recent publications by HMRC seem to have suddenly caused a degree of consternation in some parts of the legal, surveying and accountancy community, particularly amongst those engaged in the preparation of and management of dilapidations claims i.e. claims for damages for breach of contract in respect of repairing and other lease covenants. The Dilapidations Association has become aware that this has manifest itself by, for example, some chartered surveyors saying that it was likely they would need to reissue schedules of dilapidations on claims for damages being made after lease determination to incorporate claims for VAT where this had not previously been the case.

The background to this is that in September 2020, HMRC published a new 'Policy paper' entitled "Revenue and Customs Brief 12 (2020): VAT early termination fees and compensation payments" (since updated on 25 January 2021). HMRC's stated policy is to treat payments arising out of early contract termination as consideration for a taxable supply. Businesses must account for VAT on these fees. This applies in cases where the original contract allows for such an early termination, as well as when a separate agreement is reached leading to an early termination.

The trigger for this HMRC Policy Paper and some related revisions to the HMRC Internal Manual "VAT Supply and Consideration" (VATSC05910, VATSC05920 and VATSC05930) appears to have been a couple of judgments of the European Court of Justice in relation to tie in periods and the early termination of telecommunications contracts in Portugal.

Indeed, a number of commentators are suggesting that these cases were binding authority for the proposition that VAT would now become chargeable on all dilapidations damages settlements from 01 February 2021 (or that HMRC might change the rules to make this the case) where such suggestions and claims have caused the committee of the Dilapidations Association to scratch our heads and accordingly we have looked into matter further with what we hope is an objective and analytical eye.

Whilst we could see that such payments in telecommunications contracts might be analogous to a payment to be made by a tenant for exercising a right to terminate a lease early (though that too is potentially debatable) we struggled to see how they might be analogous to post lease determination dilapidations damages settlement sums agreed or awarded by the courts as some fear or seem to be claiming.

The first case is that of MEO — Serviços de Comunicações e Multimédia SA where on a request for a preliminary ruling the court held in November 2018:

"the predetermined amount received by an economic operator where a contract for the supply of services with a minimum commitment period is terminated early by its customer or for a reason attributable to the customer, which corresponds to the amount that the operator would have received during that period in the absence of such termination — a matter which it is for the referring court to determine — must be regarded as the remuneration for a supply of services for consideration and subject, as such, to value added tax."

The second is another request for a preliminary ruling in the case of Vodafone Portugal — Comunicações Pessoais SA where the court held in June 2020:

“amounts received by an economic operator in the event of early termination, for reasons specific to the customer, of a services contract requiring compliance with a tie-in period in exchange for granting that customer advantageous commercial conditions, must be considered to constitute the remuneration for a supply of services for consideration, within the meaning of that provision.”

Having considered the detail of these cases, the latest Policy Paper and updated Internal Manuals available from HMRC as referred to above, we have put together a flowchart which we think (and hope) distils and represents the current HMRC policy position vis a vis early termination payments for leases and dilapidations damages claims / payments.

Suffice to say that having done so, we are unconvinced that everything was/is about to change in terms of Dilapidations and VAT. Our understanding, as reflected in the attached flowchart is 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 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 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 and a supply by the Landlord where the payment sum attracts VAT at the prevailing rate.
4. 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 element of the payment will also constitute a contractual consideration liable to VAT.

We don't profess this to be the final word on the subject but rather, in the spirit of promoting professional engagement and discourse regarding dilapidations matters would invite anyone, particularly those dilapidations professionals who have been expressing a contrary view, to review the analysis and please let us know where you disagree with it and for what reasons.

In the meantime, we would venture to suggest that all indications are that it is largely business as usual for VAT and post lease determination dilapidations damages claims. But if you know better then please do let us know in the spirit of professional development of the dilapidations community as a whole.

When might payments to the Landlord relating to dilapidations result in a “supply” for VAT purposes?

