

Dilapidations & VAT: The Taxing Truth

James McAllister, Director of The Dilapidations Consultancy, sets the record straight on VAT in Dilapidation Claims.

Introduction

Let's start with a fact: Dilapidations is outside the scope of VAT as far as HM Revenue & Customs are concerned. So there we have it, VAT need not feature in dilapidation claims and settlement agreements. If only it were that simple.

Whilst VAT technically has no place in dilapidations, for reasons that shall become clear, there are instances where an allowance for VAT can legitimately be included, despite HMRC's seemingly clear and robust view on the matter.

Damages v Supply of Services

The position of HMRC on VAT in dilapidation claims is set out in section 10.10 of Notice 742 (Land and Property). This is because it is a payment in settlement of damages and not 'consideration' in return for a 'supply' for VAT purposes. This stands to reason: a tenant paying the Landlord an agreed sum for having failed to return the property in the condition they had covenanted under contract, is not, therefore, paying the Landlord in return for 'supply' of goods and services. This is irrespective of the 'elected' VAT status of either the Landlord or the Building.

So when does VAT apply to dilapidations claims? Whilst VAT never actually applies to dilapidations, in reality there are situations where an allowance for VAT can be included on the settlement figure, known as 'compensation in lieu of VAT'. This principle can be applied where the Landlord is genuinely at risk of suffering an otherwise irrecoverable loss to the value of VAT on any work he undertakes through the tenant's default, but will, of course, depend on the elected status of the building.

VAT Status – The Building

Looking firstly at the VAT status of the subject building, all Landlords have the option to keep the building exempt (aka 'unelected') or to waive the natural exemption and thus 'elect' the building for VAT; this is also known as 'opting to tax'. The tenant will know the VAT status of the building from the outset since they will either pay VAT on their rent or they will not. This is the simplest way Surveyors negotiating dilapidation settlements can adduce the VAT status of the building.

Building: Exempt

Where the Landlord has retained the exemption, meaning no VAT was charged on the rent, and assuming the tenant failed to deal with any dilapidation works prior to lease expiry, then the Landlord may wish to undertake the claimed works himself. On the basis the building is exempt from VAT (no VAT charged on rental income) the Landlord will not be required to file a quarterly VAT return in which ordinarily any VAT incurred on the payment of legitimate business related expenses (known as input tax) can be offset against VAT owed to HMRC where charged on the supply of goods and services, i.e. rent (known as output tax). Accordingly, the exempt status of the building will mean that any VAT the Landlord incurs on materials and labour in undertaking the works is effectively lost as it cannot be offset against output tax.

In dilapidations parlance this is deemed to be an 'irrecoverable loss'. This loss then needs to be addressed or else the Landlord will have incurred extra expense resulting from the tenant's failure to observe their repairing obligations. The value of this loss (currently 20%) can then be recovered from the tenant within the dilapidations settlement as 'compensation in lieu of VAT'.

Building: Exemption Waived

Conversely, if the Landlord has 'waived the exemption', and in so doing charges VAT on rent, then he will be in a position to offset VAT on any subsequent works expenditure (input tax) against VAT owed to HMRC on any income derived from the property (output tax). Therefore, no loss is suffered for any VAT outlay on the works the tenant ought to have undertaken, and as such, 'compensation in lieu of VAT' cannot be added to the dilapidations claim as an irrecoverable loss.

VAT Status – The Landlord

Contrary to the belief of many Surveyors, the VAT status of the Landlord is irrelevant as far as the treatment of VAT on dilapidation claims is concerned. The Landlord may be personally unregistered for VAT purposes, but might hold the property under a limited company for that property alone, and in so doing, opt to register the building for VAT. Each building is therefore unique and sweeping generalisations as to the applicability of compensation in lieu of VAT to dilapidation settlements based on the registered status of the Landlord should not therefore be made. There is one exception, however, and that is financial institutions. Some organisations fulfil the role as Landlord through either freehold owned property stock or as head tenant where the regulated status of their core financial business means they are unable to claw back VAT on any works expenditure whatever their status, or indeed the elected status of the building. In those circumstances, the inability to offset input tax against output tax, even where exemption has been waived, will mean VAT does present a genuine loss which is likely to be included in any dilapidations settlement.

Realistic Prospect of Implementing Works?

Whether the works to remedy the claimed breaches *have been done*, *might be done* or are *unlikely* to ever be done are all central to the issue. The difference between whether the works are likely or unlikely to be done will have a significant impact on the eligibility of the Landlord to successfully claim compensation in lieu of VAT on the settlement, provided of course the aforementioned criteria is also met. It stands to reason that if the Landlord has absolutely no intention of undertaking any such works post-lease expiry, then there will be no incurred 'irrecoverable loss' in the form of VAT, so the claim should not include for it: *Elite Investments v TI Bainbridge Silencers Ltd (No.2)* [1987].¹ It is worth noting, that this does not preclude the Landlord from successfully claiming the remainder of the dilapidations damages, assuming loss has been proven elsewhere. It is anticipated that in the absence of any forthcoming information from the Landlord, the burden of proof will fall upon the tenant to demonstrate that the likelihood of the Landlord getting his hands dirty is fanciful, until the passage of time speaks for itself.

If, on the other hand, the Landlord is able to demonstrate a genuine intention to undertake the works, or better still, having already carried them out, then the additional claim for compensation in lieu of VAT on top of damages for the works is likely to be enforceable as a legitimate basis for compensating loss: *Drummond v S&U Stores* [1981]² and *Sun Life Assurance Plc v Thales Tracs Ltd (formerly Racal Tracks Ltd)* [2001].³

¹ [1986] 2 E.G.L.R. 43; (1987) 283 E.G. 747.

² [1981] 1 E.G.L.R. 42; (1980) 258 E.G. 1293

³ [2001] EWCA Civ 704; [2001] 1 W.L.R. 1562; [2002] 1 All E.R. 64.

Accounting For VAT in Dilapidations

The above sets out the basis upon which VAT can be included in dilapidations settlements, which is fine in principle, but a further hurdle arises when it comes to the practicalities of raising the invoice. Unless the settlement has been agreed on a handshake with a cheque to follow, most dilapidation settlements, certainly among large commercial organisations, will need to be processed through the accounts, usually culminating in the raising of an invoice. The problem then arises when the VAT column awaits completion, when, of course, the claim was settled on the basis of a lump sum in 'full and final settlement'. Obviously, if the Landlord has legitimately claimed VAT on the settlement then there will be no VAT entry on the invoice since the Building will not be an 'elected' entity. As stated above, the ability to add VAT to the settlement arises out of the Landlord having no other means of offsetting or recouping this loss. Equally, if the Landlord is expecting to apportion part of the settlement as VAT on the invoice (i.e. 'elected' for VAT) then the chances are he shouldn't be claiming it in the first place through the ability to offset input tax against output tax.

The real complication arises where the invoice is being raised either by a management company or agent on behalf of the Landlord, or where the Landlord's own holding company is VAT registered and is processing the accounts of an interest that isn't registered, suddenly the VAT figure is difficult to position. Where the Landlord and their business interest is unregistered, this is quite simply a single lump sum figure and VAT need not be mentioned. Where the Landlord is registered and the building is unregistered then a lump sum figure without a breakdown for VAT may not be possible, so the total claim may need to be 'netted back' accordingly. This adds a further problem in that the accounts will then show VAT on income (output tax) thereby creating an obligation to pay HMRC when the whole purpose of its recovery was to compensate the Landlord (as far as the unelected building is concerned) for the inability to recover VAT on works expenditure by any other means.

Therefore, careful consideration needs to be given to the invoice procedure, and where the process is likely to be complicated, as above, it is advisable to have an alternative invoice arrangement or statement for the purpose of the dilapidations settlement, which after all, is settlement of damages rather than supply of goods and services.

Listed Buildings

VAT in listed buildings adds a further potential complication in that repairs are standard rated, but improvements do not attract VAT, provided they follow consent and are undertaken by a VAT registered contractor. However, improvements are unlikely to feature in a dilapidations claim, unless as a natural consequence of repair (*Minja Properties Ltd v Cussins Property Group Plc* [1998])⁴, or where necessary to achieve a 'once and for all' cure to an ongoing disrepair (*Elmcroft Developments Ltd v Tankersley-Sawyer* [1984]);⁵ thus repairs will be treated for VAT in the normal way, and subject to the conditions set out above.

Conclusion

VAT should not therefore be considered as a foregone conclusion on each and every dilapidations settlement. For *compensation in lieu of VAT* to be properly administered and legitimately claimed, due consideration should be given to the elected status of the building, whether the works are likely to be done, and whether the status of the Landlord means the cost of VAT on the implementation of works would amount to a loss irrecoverable by any other means.

It is important to bear in mind the principle in all dilapidations claims settled by way of damages: the Landlord cannot claim what he has not lost.

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⁴ [1998] 2 E.G.L.R. 52; [1998] 30 E.G. 114.

⁵ [1984] 1 E.G.L.R. 47.