Ventgrove Ltd v Kuehne Nagel Ltd 2021 CSOH 129

A tenant in Scotland had validly exercised a break option even though it failed to pay VAT on the break premium.

01 April 2022

A tenant in Scotland had validly exercised a break option even though it failed to pay VAT on the break premium.

Facts

The tenant (KN) held a 10 year lease of premises in Scotland at a rent of £450,000 per annum constituted by an exchange of missives dated 12, 13 and 22 December 2016. KN had a right to terminate the lease on the day prior to the fifth anniversary of the term's commencement (3 January 2022) provided that, by 3 April 2021, KN had served written notice to terminate on the landlord (V) and had paid a break premium of £112,500 "together with any VAT properly due thereon". V had opted to tax the property back in 2013 (so VAT was properly charged and paid by KN on the rent due under the lease).

KN served a notice to terminate on 23 February 2021 and sent to V the sum of £112,500. On 4 June 2021, V's agents wrote to KN's agents stating that KN had not validly exercised the break option as it had failed to pay VAT of £22,500 on the break premium. KN in turn argued that, at the break date, there was no VAT that was "properly due" on the break premium.

Issue

Had KN validly exercised its break option even though it had not paid any VAT on the break premium?

Decision

KN had validly exercised its break option.

The judge referred to a 1996 tribunal decision (Lloyds Bank plc v Commissioners of Customs and Excise) in which it was accepted that policy at that time was not to treat the exercise of an option to terminate in a lease as a taxable transaction. In the judge's opinion, nothing had happened since then to change that view.

It was true that HMRC had indicated a change of policy in Revenue and Customs Brief 12 (2020). That revised policy was to treat compensation or early termination fees in a contract as generally liable for VAT. However, in January 2021, HMRC updated this Brief to make it clear that any change in policy was not to be given effect until a later date. This meant that, at the time of the payment of the break premium on 23 February 2021, the policy set out in the Lloyds case still applied.

The court decided that the purpose of the words "together with any VAT properly due thereon" was to ensure that if V had to account to HMRC for any VAT due on the break premium, the amount of that VAT would be paid by KN in addition to the break premium. The words were not there to enable V to obtain a windfall payment (which would happen if V charged VAT on the transaction, but was not required to account for that VAT to HMRC), nor were they there to provide a mechanism to frustrate the exercise of the break option.

Points to note/consider

1. Although this is a Scottish case (and not therefore technically binding in England and Wales), the wording used in the break clause is very similarly to the wording you would expect to find in a break clause in a lease of property south of the border. As VAT applies in a

uniform way across the whole of the United Kingdom, it must be likely that an English or Welsh court would have reached the same conclusion based on broadly similar wording.

2. HMRC's Brief in September 2020 caused many people to speculate that break premiums were now subject to VAT (where the landlord has opted to tax). HMRC announced in January 2021 that it will only apply its change of policy "from a future date" and, since this case was reported, updated guidance from HMRC on the subject of VAT on early termination fees and compensation payments has been published (to take effect from 1 April 2022) (Revenue and Customs Brief 2 (2022)). Unfortunately, this Brief does not deal expressly with the question of whether VAT is payable on break premiums. However, the wording of the guidance would seem to indicate that HMRC views VAT as payable on break premiums (where the landlord has opted to tax)
   Given how strictly break clause conditions are applied by the courts and given that HMRC's view on the issue has still not been expressly clarified, a prudent tenant may decide that it is preferable to pay VAT on the break premium, rather than run the risk of its exercise of the break option being declared invalid (especially if the tenant can fully recover the VAT). To illustrate this point, the possible VAT due in this case was £22,500. Failure to exercise the break option would, on the other hand, potentially have cost KN an extra £2.25 million in rent over the remaining 5 years of the term.
3. The VAT status of dilapidations payments made by a tenant to a landlord under a lease was also clouded in doubt by Revenue and Customs Brief 12 (2020). Fortunately, HMRC has now clarified that such payments are normally regarded as outside the scope of VAT (which had always been the conventional wisdom prior to 2020).

Contact

David Harris

Professional Development Lawyer

david.harris@brownejacobson.com

+44 (0)115 934 2019

Related expertise

Services

Real estate

Real estate litigation