

Overview of Dilapidations and Dilapidation Settlements

A tenant will ordinarily have obligations within its lease regarding the state and condition in which it is required to yield up the property, as well as general repairing, decorating and cleaning obligations. This is known as the tenant's dilapidations liability and a claim may be brought by the landlord if the tenant has failed to comply with such obligations when it returns the property.

Dilapidation claims are often dealt with by way of settlement agreement, rather than court proceedings, whereby a sum will be paid by the tenant to the landlord in full and final release of its dilapidations liability.

From a tenant's perspective, the tenant will want to ensure that the release is as wide as possible (including trying to extend the release to any breach of lease, for example to include any rent arrears). The landlord, on the other hand, will try to ensure the release is restricted only to those breaches relating to dilapidations. The final position will ultimately depend on negotiations between the parties and the wider the scope of the release, the more likely the landlord will insist on a larger settlement sum.

VAT on Dilapidations Settlement Sums

An area of contention between parties to settlement agreements can be whether a settlement sum should be exclusive or inclusive of VAT. This reflects that prior to 2020, no VAT was chargeable on dilapidations settlement payments, as they fell into an exemption. However, uncertainty was created in September 2020, when HMRC published the Revenue and Customs Brief 12 (2020): VAT early termination fees and compensation payments (2020 Brief).

The 2020 Brief broadened VAT chargeable transactions to include payments described as compensatory or early termination fees. Dilapidations payments were not specifically considered, so their future treatment remained unclear, but if compensation payments were to become subject to VAT, it followed that VAT could now be chargeable on dilapidation settlement payments. Rather frustratingly, on 25 January 2021, HMRC confirmed it would apply the updated VAT treatment from a future date but provided no specific date.

In February 2022, in Revenue and Customs Brief 2 (2022): VAT early termination fees and compensation payments (2022 Brief), HMRC introduced a revised policy, which is to apply from April 2022. The guidance will generally result in fewer payments being regarded as within the scope of VAT by HMRC.

HMRC's policy confirms that true dilapidation payments should not be treated as further consideration for the supply of a lease. Accordingly, such payments are not subject to VAT. HMRC can depart from this rule in individual cases if it finds evidence of value shifting from rent to dilapidation payment to avoid accounting for VAT.

Importance of Updated HMRC Guidance

The 2022 Brief provides some welcome clarity for the property sector and certainty for tenants and landlords alike.

From a tenant's perspective, where there is a large settlement sum wholly in respect of dilapidations to be paid that is stated to be exclusive of VAT, the updated HMRC guidance provides assurance that the tenant will not be hit by a further future payment at some unknown date. The sum paid to the landlord is then truly in full and final settlement of its liability. Similarly, if a settlement sum is to be inclusive of VAT, a landlord avoids the risk that it will lose part of the payment accounting for VAT and have less funds to go towards the cost of works on the property to remedy the tenant's breaches.

HMRC's guidance also reflects a common sense approach in the face of rent arrears that have accrued during COVID-19. By leaving itself the discretion to depart from the guidance in individual cases where there is evidence of value shifting from rent to dilapidation payment, HMRC makes it clear that this more favourable approach should not be used by parties to avoid paying VAT that is chargeable on rent payments under a lease.

If you have any further queries regarding dilapidation settlement agreements or dilapidations in general, please contact the property litigation team.

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