Ventgrove Ltd v Kuehne and Nagel Ltd – VAT treatment of break penalties

In October 2020, we reported that HMRC had indicated a change in its policy on the treatment of VAT in respect of leasehold break penalties/early termination fees.

HMRC sought to remove their previous distinction between (1) payments made where there was no pre agreed right to terminate in the contract (which it viewed as payments for the supply of land and potentially within the scope of VAT) and (2) where one party had a pre agreed right in return for making a specified payment to the other (which it viewed as not being a supply and outside of the scope of VAT).

The September 2020 guidance issued by HMRC (Revenue and Customs Brief 12 (2020) and also set out in VATSC05920) confirmed that provided a direct link existed between the payment and supply, payments made for the early termination of contracts would usually be regarded as consideration in return for a supply and such payments (including break penalties) would fall within the scope of VAT. HMRC's guidance note also indicated that the change to VAT liability would have retrospective effect (although no clarification on what that meant was given).

In December 2021, the decision in the Scottish case of ***Ventgrove Ltd v Kuehne and Nagel Ltd*** was handed down. Although a Scottish case, the opinion of Lord Ericht provides insightful general commentary on the status of HMRC's guidance.

The case of *Ventgrove* related to a lease of a commercial premises. The lease contained a break option. The tenant was entitled to exercise the break option and terminate the lease on payment of £112,500 to the landlord "*together with any VAT properly due thereon*". The tenant sought to exercise the break option and paid the fee

due. No payment in respect of VAT was made by the tenant to the landlord. The landlord disputed that the tenant had validly exercised the break option as no VAT on £112,500 had been paid (the landlord had elected to charge VAT on rental of the premises). The landlord sought to rely on Revenue and Customs Brief 12 (2020).

Crucially for the tenant, on 25 January 2021, HMRC updated Revenue and Customs Brief 12 (2020). HMRC made it clear that the change in policy was not to be given effect until "a future date". At the time when the tenant exercised the break option on 23 February 2021, the original (pre 2020) policy applied to VAT – as recorded in the 1996 decision of ***Lloyds Bank plc v Commissioners of Customs and Excise LON 95/2424***.

That case set out that where a break option is contained within the original lease, the exercise of that break option and the payment by the tenant to the landlord of a fee would not be treated as a taxable transaction. As no VAT was due to HMRC in *Ventgrove*, there was accordingly no "*VAT properly due thereon*" payable by the tenant to the landlord.

HMRC's revised guidance from September 2020 remains unimplemented. Further, following communication with HMRC, the Law Society reported in January 2021 that there would be no retrospective effect for revised VAT treatment of early termination fees and compensation payments.

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