OUTER HOUSE, COURT OF SESSION

[2021] CSOH 129

CA100/21

OPINION OF LORD ERICHT

In the cause

VENTGROVE LTD

Pursuer

against

KUEHNE + NAGEL LIMITED

Defender

Pursuer: Barne QC; Burness Paull LLP
Defender: Lord Keen of Elie QC; Brodies LLP

22 December 2021

Introduction

[1] The pursuer was the landlord and the defender the tenant of commercial premises at Kirkhill Industrial Estate, Dyce. The Lease contained a break option under which the tenant was entitled to terminate the Lease on payment of £112,500 "together with any VAT properly due thereon". The defender sought to exercise the option to terminate the Lease and made a payment of £112,500 but made no payment in respect of VAT. The issue in this case is whether the Lease was validly terminated, which turns on the question of whether any VAT was properly due on the £112,500.

The Lease

[2] The Lease was constituted by an exchange of missives dated 12, 13 and 22 December 2016 and took the form of a draft lease appended to the missives (the "Lease"). The term of the Lease was ten years subject to a break option. The rent was £450,000 per annum.

[3] The break option was in the following terms:

> "3.1…The Tenants shall be entitled to terminate this Lease on [ ] December 2021 [insert day prior to the 5th anniversary of the Term Commencement Date] (the 'break date')] provided that (i) the Tenants have served written notice on the Landlords to that effect and (ii) the Tenants have paid the sum of One Hundred and Twelve Thousand Five Hundred Pounds (£112,500) (together with any VAT properly due thereon) to the Landlords, in both cases (i) and (ii) no later than [ ] March 2021, time being of the essence, failing which the entitlement to terminate the Lease on the Break Date will not apply."

Although the draft lease appended to the missives had blanks it was common ground that in terms of that break option the defender was entitled to terminate the lease as at 3 January 2022, provided that the defender had fulfilled the conditions for exercising the break by 3 April 2021.

[4] Clause 4 of the draft lease provides *inter alia*:

> "4 **TENANT'S OBLIGATIONS**
>
> The tenants HEREBY bind and oblige themselves to observe and perform throughout the Term the following conditions, obligations and others…
>
> 4.2 **Interest on arrears**
>
> Without prejudice to any other right or remedy otherwise available to the Landlords, if the rents payable or any other sum due under this Lease (whether formally demanded or not) or any other sum payable by the Tenants under this Lease shall remain unpaid (for whatever reason (including where the Landlords have declined to accept rent so as not to waive any breach or alleged breach of covenant)) after the date when payment was due, to pay interest thereon at the Prescribed Rate from and including the date on which payment was due to the date of payment to the Landlords (both before and after any judgment)…
>
> 4.4 **Value Added Tax**

> 4.4.1 To pay to the Landlords on demand and to indemnify the Landlords on demand against any VAT in respect of any payments made or consideration provided by the Tenants under the provisions of this Lease or supplies made by the Landlords to the Tenants under the terms of, or in connection with, this Lease including without limitation any VAT arising as a result of the Landlords exercising an option to tax in respect of the Property pursuant to paragraph 2, Schedule 10, Value Added Tax Act 1994 and, in default of payment, the same shall be recoverable as rent in arrear.
>
> To pay to the Landlords on demand and to indemnify the Landlords on demand against all VAT input tax incurred by the Landlords in respect of supplies made to the Landlords (including supplies which the Landlords are deemed to make to itself) the cost of which the Tenants are obliged to reimburse to the Landlords under or by virtue of the terms of this Lease save to the extent that such VAT input tax is recovered by the Landlords."

Facts

[5] By Option to Tax dated 10 July 2013, the pursuer elected to charge VAT on rental of the premises with effect from 15 July 2013 in terms of paragraph 20 of Schedule 10 to the Value Added Tax Act 1994.

[6] By notice dated 23 February 2021 the defender gave the pursuer notice that it was exercising its option under clause 3.1 to terminate the Lease, with the termination date of 3 January 2022. On or around 23 February 2021, the defender sent by Bacs transfer to the pursuer's bank account the sum of £112,500.

[7] By letter dated 4 June 2021, the pursuer's agents wrote to the defender's agents referring to the letter of 23 February 2021 and stating that the break option had not been validly exercised as the defender had not made payment of £135,000 (ie £112,500 plus VAT thereon of £22,500). It went on to state: "We're holding £112,500. Please provide us with a note of your firms bank details in order that it can be repaid to your clients."

HMRC guidance etc

[8] New guidance on the VAT position of payments made for early termination of contracts was issued on 2 September 2020 in terms of Revenue Customs Brief 12 (2020) and VATSC05910, VATS05920 and VATS50930 but suspended on 25 January 2021 in terms of an update to Revenue Customs Brief 12 (2020)

Revenue and Customs Brief 12 (2020)

[9] Revenue and Customs Brief 12 (2020) includes the following:

> "**Revenue and Customs Brief 12 (2020): VAT early termination fees and compensation payments**
>
> **Purpose of this brief**
>
> To give an update on the VAT treatment of compensation and similar payments following recent judgments of the Court of Justice of the European Union (CJEU).
>
> **Who needs to read this**
>
> Anyone who charges their customers to withdraw from agreements to supply goods or services.
>
> **Background**
>
> VAT is a tax on the supply of goods and services. Previous HMRC guidance said when customers are charged to withdraw from agreements to receive goods or services, these charges were not generally for a supply and were outside the scope of VAT.
>
> Following the CJEU judgments in *Meo* (C-295/17) and most recently in *Vodafone Portugal* (C-43/19) it is evident that these charges are normally considered as being for the supply of goods or services for which the customer has been contracted for. Most early termination and cancellation fees are therefore liable for VAT. This is the case even if they are described as compensation or damages.
>
> **What has changed**
>
> HMRC guidance on charges described as compensation or early termination fees in a contract, have been changed to make it clear that they are generally liable for VAT.

For example, charges made when exiting one contract and entering into another to upgrade a mobile telephone package or handset are therefore liable for VAT.

This does not affect the tax treatment of full or part payments made on account for a taxable supply, which is explained in Revenue and Customs Brief 13/18

Businesses making supplies subject to the Tour Operators' Margin Scheme, can find out more information in the Revenue and Customs Brief 09/19

The new guidance can be found at VATSC05910, VATSC05920 and VATSC05930.

The guidance for VATSC06710, 06720 and 06730 has been withdrawn.

Action

Any taxable person that has failed to account for VAT to HMRC on such fees should correct the error.

Any taxable person that has had a specific ruling from HMRC saying that such fees are outside the scope of VAT should account for VAT on such fees received after the issue of this Revenue and Customs Brief."

Update to Revenue and Customs Brief 12 (2020)

[10] Revenue and Customs Brief 12 (2020) was updated on 25 January 2021 to include the following:

"**Revenue and Customs Brief 12 (2020): VAT early termination fees and compensation payments**

This brief gives an update on the VAT treatment of compensation and similar payments following recent judgments of the Court of Justice of the European Union (CJEU).

Details

After communication from businesses and their representatives, HMRC has decided to apply the updated VAT treatment set out in this brief from a future date.

We will issue revised guidance, and a new Revenue and Customs brief to explain what businesses need to do shortly. This will include guidance on what to do if they have already changed how they treat such payments because of this brief.

Until that guidance is issued businesses can either:

- continue to treat such payments as further consideration for the contracted supply
- go back to treating them as outside the scope of VAT, if that is how they treated them before this brief was issued"

VATSC05910

[11] VATSC05910 is as follows:

> **"VATSC05910 – Consideration: Compensation and liquidated damages that are consideration: When are compensation payments consideration for a supply?**
>
> Whether a payment is for a VAT supply depends on whether anything is done in return for consideration. Where a party agrees to do something in return for a fee there is a supply. How that fee is described does not affect whether there is a supply for VAT. What matters is that something is done and there is a direct link between what is done and the payment received (see VATSC05100).
>
> Payments that might or might not be compensation do not arise in a vacuum. In a VAT context the recipient of such fees will be a VAT-registered business, making (or intending to make) supplies in the course or furtherance of business for a consideration – and indeed it will be reclaiming VAT as input tax on its purchases on that basis.
>
> The fundamental test of whether there is the necessary direct link between a supply and the consideration will already have been satisfied as regards a VAT-registered trader's normal income. Thus, the question will be, why isn't other income it has received also within the scope of VAT, particularly if it is from the same customer? To illustrate this point, as the Court of Appeal commented in *Esporta Ltd* v *Revenue and Customs* [2014] EWCA Civ 155:
>
> > '31… I cannot see how as a matter of principle, and looking at the contract at the time it was made, the default provisions in the contract should affect the underlying analysis of the services that are to be provided in the consideration for the fees. The default provisions are just that – steps that are taken when, unexpectedly, the member fails to comply with his payment obligations. They would not be expected to change the nature of the services that are to be supplied in consideration of the payments the member has agreed to make.'
>
> Historically HMRC took the view that payments described as compensation were typically outside the scope of VAT. The main authority for this was the CJEU case of *Société thermale d'Eugénie-les-Bains* (C-277/05). In the very particular circumstances arising there the Court concluded that the deposit received by the hotel was not a part payment for the accommodation, and when a customer cancelled a booking it was to be treated as compensation rather than consideration for a supply. In

March 2019 we updated our guidance on deposits following newer CJEU authorities, where the court found that similar payments were consideration – see VATSC05822.

More recent case law further indicates that a lot of payments described as compensation are actually consideration for supplies.

In MEO-C295/17 the CJEU found that the fact that payments may be categorised as contractual penalties or compensation under national law was irrelevant to the question of whether there was a supply for consideration. In *Vodafone Portugal* – C43/19 the Court confirmed that position saying:

> 'In the context of an economic approach, an operator determines the price for its service and monthly instalments, having regard to the costs of that service and the minimum contractual commitment period… the amount payable in the event of early termination must be considered an integral part of the price which the customer committed to paying for the provider to fulfil its contractual obligations.'

It is only where there is no direct link between a payment and a supply of goods or services that it may be outside the scope of VAT. An example of this is the case of *Mohr* v *Finanzamt Bad Segeberg* (case C-215/94). In this case the German and Italian Governments argued that there was a clear and direct link between payments made by state authorities to farmers to cease milk production. The court ruled that the payments were outside the scope of VAT. This was because the authorities were paying out money for a wider good. They did not directly benefit from the action taken by the farmer and so did not consume any service. There was therefore no supply, and so there was no consideration liable to VAT."

VATSC05920

[12] VATSC05920 is as follows:

"VATSC05920 – Consideration: Compensation and liquidated damages that are consideration: Compensation payments: Early termination of contracts

HMRC'S policy is to treat payments arising out of early contract termination as consideration for taxable supply. Businesses must account for VAT on these fees. This applies in cases where the original contract allows for such a termination, as well as when a separate agreement is reached.

This is supported by the CJEU decision in *MEO*-C295/217, which concerned the treatment of early termination fees within contracts for telecommunication services. The Court held that the fact there is a clause in the contract requiring the customer to pay the remaining fees, means the supplier is receiving further consideration for the original supply. The fact that the customer is no longer making use of that supply is irrelevant.

The more recent case of (#) *Vodafone Portugal*- C-43/19 endorsed that view, even where the amount payable is not equal to the amount that would have been due had the contract been fulfilled. The court said –

> 'Article 2(1)(c) of Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax must be interpreted as meaning that 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.'

Early termination payments are also taxable when there is no pre-existing right to terminate in the original contract. The VAT tribunal judgment in *Lloyds Bank plc* (LON/95/2525) supports this. Lloyds sought an early termination of a lease it held on a property. The lease did not provide for such early cancellation. Lloyds and its landlord therefore agreed a variation to the lease, setting out terms for early termination and a sum to be paid to the landlord as compensation. The tribunal found that there had been a supply by the landlord of granting and exercising an option to terminate the lease in return for Lloyds making a payment and vacating the premises."

VATSC059390

[13] VATSC05930 provides:

"**VATSC05930 – Consideration: Compensation and Liquidated damages that are consideration: Liquidated damages**

Liquidated damages

Agreements that allow for early termination will invariably include related clauses that provide a formula for payment of compensation in the event of such termination. These amounts are generally expressed as being compensation for loss of earnings and are often referred to as liquidated damages. HMRC guidance previously suggested these were outside the scope of VAT. In the light of *MEO* and *Vodafone Portugal* these are consideration for supplies (see VATSC05910 and VATSC05920).

Although the payments are designed to compensate, they are made as a result of events envisaged under the contract. They are therefore part of the agreement and are consideration for what is provided under it.

> Lease agreements for moveable goods commonly include clauses that allow lessees to terminate early but to pay liquidated damages as a result. Examples of this are vehicle finance leases that customers can cancel after an initial period of hire but, if so doing, must pay a termination fee to cover the loss of future rents. HMRCs previous guidance suggested these were outside the scope of VAT but under an agreement with the leasing industry allowed lessors to treat lease terminations as taxable supplies if they so wished. The CJEU judgments in *Vodafone Portugal* and *MEO* make clear that such payments are taxable (see VATSC05910 and VATSC05930.
>
> Breach of contract
>
> It is also possible for leases and other agreements to terminate early if a particular event occurs such as the customer breaching the terms of the lessor or an associate business calling in receivers. Contracts may say such events cancel their terms or effectively allow the lessor to terminate as though there had been a breach and require a fee to compensate the lessor. As with other payments envisaged under a contract this is further consideration for a supply (see VATSC05980)."

Submissions

[14] The case called before me for debate.

Submissions for the pursuer

[15] Senior counsel for the pursuer invited the court to sustain its first plea-in-law and grant decree *de plano* in terms of the first conclusion of the summons, which was:

> "1. For Declarator that the purported exercise by the Defender on 23 February 2021 of the Break Option in terms of a Lease between the parties relative to 1/3 Howe Moss Drive, Kirkhill Industrial Estate, Dyce (the 'Property') is null and void, and of no force or effect."

[16] He submitted that the court should adopt a strict approach as to whether the conditions prescribed for the valid service of the notice had been met (*Mannai Investment Co Ltd* v *Eagle Star Life Assurance Co Ltd* [1997] AC 749). As the pursuer had opted to tax, VAT was chargeable. It was clear from Revenue and Customs Brief 12/20 that VAT was chargeable on the payment of £112,500. No demand in terms of clause 4.4.1 was required

because the demand was already there in the wording of the Lease. As time was of the essence under clause 3.1, the demand could not take place after the option had been exercised. Clause 4.2 made it clear that a liability, including a liability to pay VAT, can arise in circumstances where there had been no formal demand. Further, the pursuer had not elected to accept the payment without VAT.

[17] Counsel further submitted that the defender's case of personal bar was irrelevant. There was no duty on the pursuer to tell the defender in advance of 3 April 2021 that it had failed to validly exercise the break option (*Mannai Investment Co Ltd, William Grant and Sons Ltd* v *Glen Catrine Bonded Warehouse Ltd* 2001 SC 901 at paragraph 49, *Chitty on Contracts* (33rd edition) paragraph 7-018). The pursuer had not done anything to induce any particular belief in the defender which the pursuer was under a duty to correct. The pursuer had no way of knowing in advance of 3 April whether or not the defender would choose to make payment of the VAT. He further submitted that the defender could not make out a case of reliance. The reason for non-payment was the defender's belief that no VAT required to be paid: nothing that the pursuer did induced that belief. In any event, it would not have been reasonable for the defender to have relied on the pursuer's silence as signalling the pursuer's acceptance that the break option had been validly exercised.

Submissions for the defender

[18] Senior counsel for the defender submitted that the liability for the payment of VAT rested with the pursuer. Any obligation on the defender to indemnify the pursuer against any VAT under the Lease was a matter of contract. The payment which the contract required to be made for the exercise of the break clause was £112,500. The purpose of the reference to VAT was to protect and indemnify the pursuer against any claim for VAT from

HMRC. The ability of the pursuer to demand an indemnity in respect of VAT was not intended by parties to the contract as a means of invalidating the exercise of the break clause. As at the date when the defender exercised the break clause HMRC did not require the supplier, being the tax payer, to account for VAT.

Analysis and decision

[19] This case turns on the question of whether there was "any VAT properly due" on the payment of £112,500.

[20] The answer to that question would previously have been straightforward. HMRC's policy was that no VAT was due where, as here, a break option was contained in the original lease. Their policy was recorded in the 1996 decision of the VAT and Duties Tribunal in *Lloyds Bank plc* v *Commissioners of Customs and Excise* LON 95/2424:

> "the Commissioners agree that if the option for determination or right of early determination...had been included in the original leases, the Commissioners would have followed their policy not to treat this as a taxable transaction……The Tribunal accepts... that it is the Commissioners present policy not to treat the exercise of an option to terminate within an original lease as a taxable transaction, although, as that policy is based neither on a provision of law or on decided authority, it does not bind the Tribunal."

The option to terminate the Lease was included within the Lease. Under that policy the payment of the £112,500 would not have been a taxable transaction and no VAT would have been due on it. As no VAT was due, then in order to exercise the option in terms of the Lease, payment of £112,500 would have been sufficient and it would not have been necessary to pay any additional sum for VAT thereon.

[21] The issue which then arises is whether anything has happened between the *Lloyds* case and the notice of 23 February 2021 to change the position. In my opinion there has been no such change.

[22] There has been no case in which a court or tribunal has considered whether the exercise of an option to terminate within an original lease is a taxable transaction. There have been no UK court or tribunal decisions on the matter. There have been two decisions of the European Court of Justice in relation to compensation payable by the customer for termination of fixed-period telecommunications contracts prior to the end of the fixed period: *MEO Serviços de Comunicações e Multimédia SA* v *Autoridade Tributária e Aduaneira* (Case C-295/17) EU:C:2018:942 (issued on 22 November 2018) and *Vodafone Portugal – Comunicações Pessoais SA* v *Autoridade Tributária e Aduaneira* (C-43/19) [2021] S.T.C. 1975 . These cases are not directly in point. They relate to compensation for failure to complete the minimum contractual term, calculated as the whole of the remaining monthly charges (*MEO*) or the costs incurred by the supplier (*Vodafone*). That is not the same situation as a contractual entitlement to bring a contract to an end after a specified period upon payment of a fee. In *MEO* the court held that 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 which corresponds to the amount that the operator would have received during that period in the absence of such termination must be regarded as the remuneration for a supply of services for consideration and subject to VAT (para 57). The Lease was not terminated prior to the expiry of a minimum period, but at the end of a minimum period. The £112,500 does not correspond to the amount of rent that the pursuer would have received had the Lease run for its full term of ten years at a rent of £450,000 per annum. In *Vodafone* the court held that amounts received by an economic operator in the event of early termination 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

(para 50). The defender did not fail to comply with a tie-in period: in February 2021 the initial tie-in period had expired and the defender had a contractual right to bring the Lease to an end by exercising the option.

[23] In September 2020 HMRC indicated a change in its policy. The change was referred to in Business Brief 2020 and set out in VATSC05920. The policy changed from that set out in the *Lloyds* case to the following:

> "HMRC's 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 a termination, as well as when a separate agreement is reached." (VATSC05920)

However, on 25 January 2021 HMRC altered its position and updated the Business Brief to make it clear that the change in policy was not to be given effect until a later date:

> "After communication from businesses and their representatives, HMRC has decided to apply the updated VAT treatment set out in this brief from a future date. We will issue revised guidance, and a new Revenue and Customs brief to explain what businesses need to do shortly."

[24] The effect of this was at the time of the payment of the £112,500 on 23 February 2021 the policy as set out in the *Lloyds* case still applied. That meant that at that time HMRC policy remained that an option which was in the original lease was not to be treated as a taxable transaction. The proposed change in HMRC policy, which would have meant that HMRC started to treat options in the original lease as taxable transactions, had not come into force.

[25] The nub of the argument at the debate was the correct interpretation of the phrase "together with any VAT properly due" in clause 3.1 of the Lease. The defender's position was that VAT was not due as it was not due under HMRC policy. The pursuer's position was that the HMRC policy was no more than guidance and VAT was due.

[26] In my opinion the purpose of the words "together with any VAT properly due thereon" was to ensure that if the pursuer required to account to HMRC for VAT on the payment of the £112,500, the amount of that VAT would be paid by the defender in addition to the £112,500 so that the pursuer received that sum in full and did not have to deduct VAT from it: had these words not been included, the £112,500 would have been treated as a VAT inclusive sum. It was not the purpose of these words to enable the landlord to get a windfall payment, as would occur if the landlord charged VAT on the transaction but was not required to account for that VAT to HMRC because of HMRC's policy that the transaction was not taxable. Nor was it the purpose of these words to provide a mechanism to frustrate the exercise of the option. Accordingly, the phrase "any VAT properly due thereon" means any VAT properly due to HMRC.

[27] As at the date of the exercise of the option, there was no VAT properly due on the £112,500 to HMRC. The policy of HMRC remained that the transaction was not chargeable to VAT. Tax payers did not require to account for tax on such transactions. The change in policy had been withdrawn. I find that the option was validly terminated and refuse the declarator sought.

[28] I would add that this result will not prejudice the pursuer if at a later date HMRC retrospectively changes its policy. In that event, the defender will be liable under the indemnity in clause 4 of the Lease to pay to the pursuer any VAT which then becomes due. The point in this case is whether at the time of the exercise of the option in February 2021 VAT was due, and for the reasons set out above it was not.

[29] That is sufficient to decide the case but for the sake of completeness I would briefly set out my views on what I would have done had I found against the defender on the meaning of "any VAT properly due."

[30] I would have rejected the defender's argument that VAT was not due until demanded. In my view the requirement to pay any VAT is clearly set out in clause 3.1 of the Lease and a separate demand is not necessary.

[31] I would have allowed the case to proceed to proof before answer on the defender's case of personal bar. The defender's case is that there was a conversation between Nathan Feldman on behalf of the pursuer and the defender's property director shortly after the notice was served about continuing the Lease on new terms; that conversation proceeded on the basis that the Lease had been validly terminated; and that conversation induced the defender not to make an additional payment for VAT prior to the cut-off date for exercising the option and constituted an election. The pursuer sought to have the personal bar case excluded from probation on the basis that there was no duty on the pursuer to tell the defender that it had failed to validly exercise the break option, there was no case of reliance and that nothing the pursuer did induced the defender's belief. The defender has averred sufficient in relation to these criticisms for the matter to have proceeded to proof before answer. I would also have allowed the case to proceed to proof before answer on the defender's case of election, which proceeds on the basis of that conversation and the failure of the pursuer to try to return the £112,500 or otherwise challenge the validity of the exercise of the option until after the cut-off date for its exercise.

Order

[32] I shall uphold the defender's third plea in law, repel the pursuer's first plea in law and refuse declarator. I reserve all questions of expenses in the meantime.