The VAT conundrum

Both landlords and tenants should seek to protect themselves in anticipation of a possible change to the VAT treatment of service charges for common areas. Elizabeth Small and Alastair Robertson investigate

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'HMRC may be forced to alter its policy, and landlords and tenants should keep their respective positions under review.'

The First-tier Tribunal has requested a preliminary ruling from the Court of Justice of the European Union (ECJ) in *Field Fisher Waterhouse LLP v Revenue & Customs* [2011] on whether service charges paid as a condition of a commercial property lease attract VAT, whether or not an option to tax is made, because it is a separate supply and not a composite supply (ie in effect subject to VAT as though it were part and parcel of the rent charge).

If service charges are treated as a separate supply then an additional charge to VAT would arise on both commercial and residential properties even where the landlord has not opted to tax, or his option to tax is ineffective.

Current position

HMRC's long-held view (as set out in VAT Notice 742) is that, where a service charge is payable to the landlord for services connected with the external fabric of the building or its common parts, the service charge follows the VAT treatment of the rent (ie exempt from VAT if the landlord has not exercised the option to tax).

A recent ruling of the ECJ has cast doubt on HMRC's policy on the VAT treatment of service charges. In *RLRE Tellmer Property (Taxation)* [2009], the question arose whether a supply of cleaning services in relation to the common parts of a block of residential flats, supplied by the landlord but invoiced separately from rent, should be treated as part of a single supply of residential accommodation (which supply would be exempt), or whether it constituted a separate, taxable supply. The case was eventually settled by the ECJ, which determined that there were two separate supplies of letting and cleaning services. Accordingly, the taxable supply of cleaning services was subject to VAT notwithstanding that the letting supplies were exempt.

In Revenue & Customs Brief 67/09, issued on 27 October 2009, HMRC states that its current policy on the VAT treatment of service charges is unchanged following the decision of the ECJ in *Tellmer*. HMRC's guidance indicates that the current position is as follows:

- where a service charge is provided as a term of the lease and the services are provided by the landlord (or his agent), without tenant choice, the supply of property and services form a single (and exempt) supply; or
- where the tenant is required to pay a service charge, but the provision of the services does not arise under the lease or is provided by someone other than the landlord (or his agent), then the services will be a separate standard rated supply.

In its guidance, HMRC stress that the findings in *Tellmer* are consistent

Field Fisher Waterhouse LLP v Revenue & Customs
[2011] UKFTT 524 (TC)
RLRE Tellmer Property (Taxation)
[2009] EUECJ C-572/07

with existing UK policy and therefore no change to its policy is required. It states that the ECJ reached its judgment:

> because, on the facts of the case, the tenants… were not required to obtain the cleaning of the common parts from their landlord, but had a real option whether to ask their landlord to perform the cleaning of the common parts for additional consideration or to obtain those services themselves from a third party.

Commentary published after Brief 67/09 suggests that a number of practitioners believe that there was little or no justification for HMRC's assumption, given the facts of the case and the ECJ judgment itself. Field Fisher Waterhouse (the claimant in the case being taken to the ECJ), state that it has:

> been informed by the lawyer who acted for Tellmer that the services supplied by the landlord were supplied under the lease and there was no option in the lease for tenants to purchase the services from a third parties.

What should landlords and tenants do to protect themselves?

If the ECJ agrees with the analysis being advocated by Field Fisher Waterhouse, the facts in *Tellmer* would therefore correlate with provisions in a typical lease of commercial property in the UK. HMRC may be forced to alter its policy, and landlords and tenants should keep their respective positions under review.

Practical points for landlords

Landlords should seek to protect themselves contractually to ensure that if VAT is due on any service charge they will have the right to charge it to their tenants. If the lease is silent on the point then any service charge will be deemed inclusive of VAT and the landlord would end up bearing the cost. Where practicable, landlords should seek to amend old leases or agree new leases in order to ensure that VAT can be charged on service charges relating to common areas.

Landlords

Landlords of commercial property that is VAT opted are unaffected by this issue.

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Tenants

Where a tenant pays rent and service charge to a landlord, who has not exercised its option to tax, the service charge will normally be based on the landlord's costs in servicing the building, including the landlord's irrecoverable VAT on such costs. In these circumstances, a tenant will suffer a cost because their service charge includes hidden VAT that the tenant cannot recover.

- If service charges are treated as a separate supply, tenants who can recover VAT, but do not currently pay VAT on such service charges, may see this as an opportunity to increase their allowable input VAT and thus decrease their output VAT payments to HMRC. They could ask their landlords for a VAT invoice on these service charges in order to recover the input VAT incurred. In the case being taken to the ECJ, Field Fisher Waterhouse LLP have submitted a repayment claim for VAT on the service charge for four years (the time limit for backdated VAT assessments and claims) on the basis that the service charge should have been treated as standard rated. If their claim is successful, they will have more allowable input VAT and therefore have overpaid their output VAT to HMRC.

- Tenants who cannot recover VAT (eg financial institutions, insurance companies, healthcare organisations, local authorities and charities) should seek where possible to agree VAT inclusive fees for service charges. ■

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