EXTRA DIVISION, INNER HOUSE, COURT OF SESSION

[2022] CSIH 40
CA100/21

Lord Woolman
Lord Pentland
Lord Tyre

OPINION OF THE COURT

delivered by LORD TYRE

in the Reclaiming Motion

by

VENTGROVE LIMITED

Pursuer and Reclaimer

against

KUEHNE+NAGEL LIMITED

Defender and Respondent

Pursuer and Reclaimer: Dean of Faculty, Bremner; Burness Paull LLP
Defender and Respondent: Lord Keen of Elie QC; Brodies LLP
Intervener (Advocate General for Scotland, representing The Commissioners for Her Majesty's Revenue and Customs): R. Anderson; Office of the Solicitor to the Advocate General

6 September 2022

Introduction

[1] In December 2016 the reclaimer ("the landlord") and the respondent ("the tenant") entered into an agreement to lease premises at Kirkhill Industrial Estate, Dyce, Aberdeen. The lease was to be for a period of ten years, subject to a break option entitling the tenant to terminate the lease after five years. In order to exercise the break option, the tenant required, on or before a specified date, to give notice of termination and to pay the sum

of £112,500 "together with any VAT properly due thereon" to the landlord. Time was stated to be of the essence.

[2] By notice dated 23 February 2021, the tenant exercised the break option and remitted the sum of £112,500 to the landlord. After the last date when the option could have been exercised, the landlord intimated that it refused to accept that the option had been validly exercised because the tenant had failed to pay the sum of £135,000, including VAT amounting to £22,500, said to be due on the payment of £112,500.

[3] In this commercial action, the landlord seeks declarator that the purported exercise by the tenant of the break option was of no force or effect. By interlocutor dated 22 December 2021 the commercial judge repelled the landlord's first plea-in-law and refused to grant the declarator sought. The landlord now reclaims that decision. There is a cross-appeal by the tenant concerning the proper interpretation of the terms of the lease.

[4] The principal issues for determination are whether, as a matter of law, VAT was "properly due" on the break option payment and, if so, whether the Commissioners for Her Majesty's Revenue and Customs ("HMRC") would have been entitled to demand it from the landlord. In these circumstances, the court invited the intervener, on behalf of HMRC, to present submissions. That invitation was accepted and we are grateful to HMRC and to counsel for their assistance.

The relevant terms of the lease

[5] The lease was never executed. The parties agreed, however, that they were bound by the terms of a draft lease appended to the missives exchanged between them, and they have

conducted their affairs on that basis. The break option, in Clause 3.1 of the draft lease, was as follows:

> "… 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."

It is common ground that the clause should be interpreted as entitling the tenant to terminate the lease as at 3 January 2022, provided that it had fulfilled the conditions for exercising the option by 3 April 2021.

[6] Clause 4 of the lease, entitled "Tenant's Obligations", stated *inter alia* as follows:

> "The Tenants HEREBY bind and oblige themselves to observe and perform throughout the Term the following conditions, obligations and others:…
>
> **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."

VAT treatment of termination payments

[7] In order to determine whether VAT was "properly due" on the break payment, it is necessary to identify the relevant statutory provisions, case law and published HMRC guidance extant at the time when the option was exercised and payment made on 23 February 2021.

(i) Statutory provisions

[8] Value added tax is charged on any supply of goods or services which is a taxable supply by a taxable person in the course or furtherance of a business. A taxable supply is any supply of goods or services in the UK other than an exempt supply (Value Added Tax Act 1994 ("VATA"), section 4). The grant of an interest in or right over land is, as a general rule, an exempt supply in respect of which no VAT is chargeable. "Grant" is defined for these purposes in VATA Schedule 9, Group 1, note (1) as including "an assignment or surrender and the supply made by the person to whom an interest is surrendered when there is a reverse surrender". "[R]everse surrender" is in turn defined in note (1A) as "one in which the person to whom the interest is surrendered is paid by the person by whom the interest is being surrendered to accept the surrender".

[9] A person may, however, in accordance with the provisions of VATA Schedule 10, opt to tax any land. In that case the exemption in Schedule 9 is disapplied and VAT is chargeable on supplies in relation to that land. The land with which this case is concerned had been the subject of an option to tax dated 10 July 2013, and VAT was chargeable on rental payments made by the tenant to the landlord.

(ii) Case law

[10] In *Lubbock Fine & Co* v *Customs & Excise Commissioners* [1994] QB 571 (ECJ)), the landlord and tenant of office premises entered into an agreement whereby the tenant agreed to surrender the residue of its lease and return the premises to the landlord, in consideration of a payment of £850,000. No option to tax had been exercised in relation to the premises. The Court of Justice ruled (paragraph 9) that where a transaction such as the letting of land, which would be taxed on the basis of the rents paid, fell within the scope of an exemption provided for by the Sixth VAT Directive, a change in the contractual relationship had also to be regarded as falling within the scope of that exemption.

[11] Two decisions of differently-constituted VAT and Duties Tribunals concerned the same transaction between Croydon Hotel & Leisure Co Ltd and Holiday Inns UK Inc, which had as its purpose the termination of a hotel management agreement. In consideration of the sum of £2 million, Holiday Inns renounced the right to continue to manage the hotel for the remaining duration of the management agreement. The Commissioners assessed Holiday Inns to VAT on the basis that the payment was received as consideration for a taxable supply of services to Croydon. On appeal by Holiday Inns, a VAT Tribunal held ([1993] VATTR 321) that the payment was a payment of compensation, outside the scope of VAT, and allowed the appeal. In the meantime, Croydon in its VAT return deducted input tax on the payment to Holiday Inns. The Commissioners issued an assessment to recover the deduction and Croydon appealed. It was common ground that the VAT and Duties Tribunal hearing Croydon's appeal was not bound by the decision in the appeal by Holiday Inns. The Tribunal held ([1997] V & DR 254), applying *Lubbock Fine*, that the payment was made in consideration of a taxable supply of services consisting of the surrender by Holiday

Inns of its right to receive the management fees for the remainder of the term of the management agreement. Croydon's appeal was allowed.

[12] In *Central Capital Corporation Ltd* v *Customs & Excise Commissioners* (1995) VAT Decision 13319, *Lubbock Fine* was applied to a "reverse surrender", ie a payment by a tenant to a landlord to terminate a lease. The Tribunal held that the judgment in *Lubbock Fine* indicated that what governed the taxability or otherwise of any transaction in leasehold property was whether the grant of the original lease was taxable or not. In this case the grant of the lease had been an exempt supply and therefore the reverse surrender payment was also exempt.

[13] In *Lloyds Bank plc* v *Customs & Excise Commissioners* (1996) VAT Decision No 14181, the bank was the tenant of premises which the landlord had opted to tax. The landlord wished to re-develop the premises, and an agreement was reached that the bank would give up possession and make a payment to the landlord as compensation for lost future rent. With a view to attempting to avoid making a payment on which VAT would be chargeable, it was agreed that the bank would serve a notice of termination rather than surrendering its lease. A variation of the lease had to be entered into in order to insert an option to terminate. The variation was executed and the option to terminate the lease was immediately exercised. Accepting the Commissioners' submission that VAT was chargeable on the termination payment, the Tribunal held that it was necessary to consider the substance and reality of the transaction as a whole. It concluded, under reference to *Lubbock Fine* and the Tribunal decisions already mentioned, that the contemporaneous granting and exercise of the option and the payment under it amounted to a taxable supply of services by the landlord, in consideration of the payment made by the bank.

[14] In the course of its decision, the Tribunal in *Lloyds Bank* made the following observations:

> "The Commissioners add that it is their policy to accept that under a lease which allowed for termination *ab initio* payment of the amount due on termination fell outside value added tax. However, that policy was not necessarily correct and in any event here the lease was varied subsequently. The variation took place on the same day as the termination so that in substance and reality this was a 'reverse surrender'…"

Later in the decision the Tribunal noted:

> "It is relevant that the Commissioners agree that if the 'option for determination' or 'right of early determination' - both terms being used in the Deed of Variation - had been included in the original leases, the Commissioners would have followed their policy not to treat this as a taxable transaction. That policy, say the Commissioners, was not based on any provision of law or past decision, but was part of the Commissioners internal guidelines and available to taxpayers, although not in any published form…
>
> …The Tribunal accepts [counsel for the Commissioners'] statement 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.

Finally, the Tribunal observed:

> …In so far as the Commissioners have taken the position that compensatory payments in the form of liquidated damages provided for in the original terms of agreements for leases should be outside the scope of value added tax the Tribunal finds that the transaction of 9 September 1994 cannot in the normal use of words be described as part of the original agreement. It was a later agreement…"

[15] More recently, the VAT treatment of termination payments has been considered by the Court of Justice in two cases concerning payments to terminate mobile phone service contracts. In the first of these, *MEO* v *Autoridade Tributária e Aduaneira*, Case C-295/17 (22 November 2018), the service contracts provided that, in the case of termination before the expiry of the agreed minimum commitment period at the request of customers, MEO was entitled to compensation equivalent to the full amount of subscription fees up to the end of the minimum commitment period. The Court ruled that the early termination of the

contract by the customer did not alter the economic reality of the relationship between the customer and MEO. The amount payable for non-compliance with the minimum commitment period was therefore payment for the services provided by MEO, regardless of whether the customer exercised the right to benefit from those services until the end of the period.

[16] The issue was revisited in *Vodafone Portugal* v *Autoridade Tributária e Aduaneira*, Case C-43/19 (11 June 2020). The facts were similar except that the service contracts provided for payment, on early termination by the customer, of compensation quantified by reference to benefits received by the customer but in respect of which Vodafone had as yet received no payment. The Court ruled, following its decision in *MEO*, that from the perspective of economic reality, the amount due on early termination of the contract sought to guarantee the operator a minimum contractual remuneration for the service provided, and therefore formed part of the remuneration received by the operator for those services. Contrary to the impression that might have been created by the reasoning of the Court in *MEO*, it was irrelevant that the amount of compensation received by the supplier did not equate to the income that it would have received if the contract had not been terminated early.

(iii) HMRC guidance

[17] Guidance on the view of HMRC as to the proper application and interpretation of VAT law is issued in various forms. For some years, HMRC have published internal manuals containing guidance prepared for their own staff. The material in these manuals reflects HMRC's view of the law as it stood at the date of publication. Amended or supplementary guidance is published if there is a change in the law or in HMRC's interpretation of it. From time to time HMRC also issue business briefs setting out their

view on a point of interpretation of VAT law; this is sometimes done in order to draw attention to a change in the official view.

[18] The internal HMRC manual entitled "VAT Land and Property" (as published since 2016) contains the following section, with the sub-heading "VATLP02400 - Supply: surrenders and reverse surrenders":

> "A surrender occurs when a landlord pays a tenant to give up his lease or licence before the term of the agreement has expired. The supply by the tenant to the landlord is exempt unless the tenant has opted to tax the building, in which case it is standard rated.
>
> From 1 April 1989 all surrenders were treated as a standard-rated supplies in the UK. But, the matter was taken to the European Court of Justice by Lubbock Fine (CJEC C63/92), a firm of accountants, and the Court ruled that surrenders are in fact exempt under what is now Article 135 (1)(l) of the Principal VAT Directive (subject to exclusions and the option to tax).
>
> The term 'reverse surrender' is used where a tenant pays a landlord to take back a lease. HM Customs and Excise had historically maintained that a 'reverse surrender' was a taxable supply by the landlord of releasing the tenant from its obligations under the lease. However, to regularise the position, the Value Added Tax (Land) Order 1995 formally restored surrenders to Schedule 9 and added reverse surrenders to it, so that both were formally recognised as being capable of falling within the exemption.
>
> However, in the case of Central Capital Corporation Ltd (VTD 13319), the Appellant challenged HM Customs and Excise's position that reverse surrenders were standard rated until the change of law in 1995. The Tribunal upheld the appeal, finding that:
>
> - a landlord made a supply when he agreed to accept the surrender of his tenant's lease in return for payment,
> - the supply was exempt by virtue of Article 135(1)(l) of the Principal VAT Directive.
>
> We accepted the analysis of the Tribunal. It was accepted that reverse surrenders were, like surrenders, exempt, since the introduction of the tax, with the option to tax available from 1 August 1989.
>
> Many people find surrenders and reverse surrenders confusing. The following table will help you to determine the liability of the supply:

SUPPLY	**LIABILITY**
SURRENDER\Landlord pays tenant to surrender the existing lease	EXEMPT* supply by the tenant
ASSIGNMENT\Third party pays a tenant to assign the existing lease	EXEMPT* supply by the tenant (the assignor)
REVERSE SURRENDER\Tenant pays landlord to take back the lease	EXEMPT* supply by the landlord
REVERSE ASSIGNMENT\Tenant pays third party to take away lease	STANDARD RATED supply by the third party (the assignee)
REVERSE PREMIUM\Landlord pays a prospective tenant to accept the lease	STANDARD RATED supply by the prospective tenant (unless the payment is for no more than agreeing to accept a lease)

* - STANDARD RATED if option to tax is exercised by the person making the supply (unless the option is disapplied)…"

[19] Another HMRC internal manual entitled "VAT Supply and Consideration" contains more general guidance relating to compensation payments on early termination of contracts. In its current version, the guidance makes reference to the decisions in *MEO* and *Vodafone Portugal*. A version of the guidance as it stood at 23 February 2021 has not been produced. In the current section VATSC05910, with the sub-heading "Consideration: Compensation and liquidated damages that are consideration: When are compensation payments consideration for a supply?", it is noted:

> "Historically HMRC took the view that payments described as compensation were typically outside the scope of VAT…
>
> More recent case law… indicates that some payments described as compensation or damages are nevertheless actually consideration for supplies."

[20] On 2 September 2020, HMRC issued Revenue and Customs Brief 12 (2020) ("RCB 12") entitled "VAT early termination fees and compensation payments". The

purpose of the brief was stated to be "to give an update on the VAT treatment of compensation and similar payments following recent judgements of [the Court of Justice]".

The brief stated *inter alia*:

> "**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.
> …
>
> The new guidance can be found at VATSC05910, VATSC05920 and VATSC05930.
>
> The guidance for VATSC06710, 06720 and 06730 has been withdrawn."

[21] On 25 January 2021, HMRC updated RCB 12 with a further brief in the following terms:

> "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."

The commercial judge's decision

[22] Having narrated the terms of the guidance contained in various HMRC publications (although not the section from the VAT Land and Property manual set out above; it is not clear whether he was referred to it), the commercial judge observed that the case turned on whether there was "any VAT properly due" on the payment of £112,500. In his view the answer would previously have been straightforward: HMRC's policy, as recorded in *Lloyds Bank plc* (above), was that the exercise of an option to terminate that was included in the original lease was not within the scope of VAT. The question was whether anything had happened between the *Lloyds Bank* case and the exercise by the tenant of the break option to change the position.

[23] In the commercial judge's opinion there had been no such change. There had been no case in which a court or tribunal had considered whether the exercise of an option to terminate within an original lease was a taxable transaction. The two European mobile phone cases were not directly in point because they related to compensation for failure to complete the minimum contractual term, which was not the same as a contractual entitlement to bring a contract to an end after a specified period upon payment of a fee. The tenant in the present case had not failed to comply with a tie-in period: in February 2021 the initial tie-in period had expired and the tenant had had a contractual right to bring the lease to an end by exercising the option.

[24] In September 2020 HMRC had indicated a change in policy, but on 25 January 2021 they had altered their position to make clear that the change was not to be given effect until a later date. The effect was that at the time of the payment of £112,500 on 23 February 2021, the policy as set out in the *Lloyds Bank* case, ie that exercise of an option in the original lease was not to be treated as a taxable transaction, still applied. Taxpayers did not require to account for tax on such transactions. It followed that as at the date of the exercise of the option, there was no VAT properly due to HMRC on the £112,500. The option had been validly exercised.

[25] For the sake of completeness, the commercial judge explained what he would have done if he had found against the tenant in relation to the meaning of "any VAT properly due". He would have rejected an alternative argument by the tenant that VAT was not due until demanded: the requirement to pay VAT was clearly set out in clause 3.1 and a separate demand was not necessary. He would, however, have allowed the action to proceed to proof before answer on the tenant's case of personal bar, based on telephone conversations during the period between the date when the option was exercised and the cut-off date for its exercise, which according to the tenant had induced it to proceed on the basis that the option had been validly exercised. He would also have allowed proof before answer on the tenant's averment that by accepting the payment of £112,500 and retaining it without comment and complaint until after 3 April 2021, the landlord had elected to receive it without VAT.

Submissions for the parties

Landlord

[26] On behalf of the landlord it was submitted that as a matter of law VAT had been properly due on the break option payment. The starting point was the decision in *Lubbock Fine* which, although concerned with whether a surrender payment was taxable or exempt, proceeded on the basis that there was a supply within the scope of VAT. There was no difference in principle between a break option contained in the original lease and one which was inserted by amendment of the lease. In each case, a payment made by a tenant to terminate the lease was a payment in consideration of a supply by the landlord consisting of the surrender of the landlord's entitlement to future rent. Alternatively, it was additional consideration for the original supply of the leased subjects. The analysis in *MEO* and *Vodafone Portugal* was applicable to the present case: the Court had emphasised that economic and commercial reality were more important than the description of a payment as compensation, and those cases were both concerned with options to terminate contained in the original contracts. The word "properly" in the lease meant "lawfully".

[27] If a payment was chargeable to VAT, that could not be altered by HMRC guidance. In any event the landlord's approach was consistent with the guidance extant at the material date. The exercise of the break option was a reverse surrender which, according to the table in VATLP02400 (above), would be treated by HMRC as a standard-rated supply where, as here, the landlord had opted to tax the property. No change had been made to this guidance by anything issued by HMRC prior to the date when the option was exercised. The indications in *Lloyds Bank* of a contrary policy that was "not necessarily correct" were not a sound basis for a conclusion that as a matter of law VAT was not chargeable on the break payment.

[28] As regards the tenant's contention that HMRC could not have recovered VAT on the break payment from the landlord because the landlord would have had a legitimate expectation that VAT would not be charged on it, this had not been pled. In any event, in order to create a legitimate expectation, the taxpayer (in this case the landlord) would have to be able to point to a clear statement that tax would not be charged. There was no such statement. It would have to be shown that charging VAT on the payment would amount to an abuse of power by HMRC: *R (Hely Hutchinson)* v *Revenue & Customs Commissioners* [2018] 1 WLR 1682. That was not the case here, where HMRC guidance at VATLP02400 stated that it would be regarded as consideration for a taxable supply.

HMRC

[29] On behalf of HMRC it was acknowledged that any guidance issued was HMRC's interpretation of the law and not the law itself. *Lubbock Fine* was the relevant authority as regards termination of a lease. The general principle was that termination for consideration would be regarded in substance as a surrender of the supply made by the landlord which involved a change in the contractual relationship. Where the landlord had opted to tax, the consideration for the termination would be subject to VAT at the standard rate. In so far as HMRC guidance was concerned, the relevant section was VATLP02400. *Vodafone Portugal* was not concerned with a lease of immovable property.

[30] The Commissioners were not only entitled but obliged not to follow guidance that they considered to be wrong. The effect of their decision in January 2021 to suspend the guidance in RCB 12 was that there was no up to date guidance on the implications of *Vodafone Portugal*, and so to leave matters as they had been before RCB 12 was issued.

[31] It was premature to consider questions of legitimate expectation or public law principles in relation to a decision that might be made by HMRC in the future. It was to be noted, however that guidance in relation to leases of immovable property had remained unchanged during the material period, and that the suspension of RCB 12 did not amount to a "direction" with which taxpayers were obliged to comply.

[32] For these reasons HMRC did not support the reasoning or the conclusion of the commercial judge in relation to the Commissioners' policy position or the law.

Tenant

[33] On behalf of the tenant it was submitted that the commercial judge had correctly decided that the case turned on whether there was any VAT properly due on the break option payment. The question was whether the landlord would have been assessed to VAT on the payment. It was clear that it would not. The narrative in *Lloyds Bank* of HMRC's policy demonstrated that a distinction fell to be drawn between a reverse surrender on the one hand and the exercise of a right conferred in the original lease on the other. The latter was a unilateral act. The analysis in *Lubbock Fine* (which, contrary to what was still stated in HMRC guidance, pre-dated the decision in *Lloyds Bank*) was not therefore in point. As a matter of law, the payment was outside the scope of VAT.

[34] Even if that were wrong, the landlord would have had a legitimate expectation that HMRC would adhere to the policy narrated by counsel acting on their behalf in *Lloyds Bank*. Had HMRC sought to depart from their own guidance in this regard and charge VAT on the break payment, the landlord would have had a clear basis to challenge the assessment on the ground that it was not properly due. The powers of a tribunal hearing an appeal against the assessment included power to quash or vary a decision by HMRC on the basis of the

public law defence of legitimate expectation. This was not a situation in which the landlord would have had to show abuse of power: that test applied where a taxpayer arranged his affairs in reliance on guidance from HMRC that was later withdrawn. In the present case there had been no change of policy by HMRC prior to the date when the break option payment was made. There was no reason to expect that the landlord would have faced any assessment to VAT on the payment.

Decision

The status of HMRC guidance

[35] The status of guidance issued by HMRC was described by Lewison LJ in *Leeds City Council* v *Revenue & Customs Commissioners* [2016] STC 2256 at paragraph 4 as follows:

> "…There are many problems of interpretation arising out of the VAT code and HMRC provide the public with their own interpretation of points of difficulty; and information about the practice they adopt in various areas. These are variously contained in Notices, Business Briefs and the VAT Manual. They are not law: they are no more than HMRC's interpretation of the law. …"

In *Revenue & Customs Commissioners* v *KE Entertainments Ltd* [2020] STC 1402, the Supreme Court rejected the taxpayers' argument that a business brief published by HMRC "required" the VAT due on bingo participation fees to be calculated in a particular way. Delivering a judgment with which the other Justices concurred, Lord Leggatt stated (paragraph 60):

> "…[T]o suggest that the business brief 'required' bingo promoters to use the session by session basis of calculation ascribes to guidance published by HMRC a status which it does not have. Such guidance is not capable of imposing on taxpayers an obligation to calculate tax in a particular way. It represents only HMRC's view or interpretation of the law and, if a taxpayer disagrees with HMRC's view, it can appeal from a decision or assessment based on that view to a tribunal whose function it is to give authoritative interpretations of the law …"

[36] It was, however, acknowledged in *KE Entertainments Ltd* (paragraph 59) that HMRC guidance was capable of generating a legitimate expectation on the part of a taxpayer that a

particular policy or practice would be followed, and that the law would protect that expectation by preventing HMRC from acting in a way that frustrated it. But there are important limitations on the circumstances in which an expectation aroused in the taxpayer can be said to be a legitimate one giving rise to enforceable rights in law. As Bingham LJ observed in *R* v *Inland Revenue Commissioners, ex parte MFK Underwriting Agencies Ltd* [1990] 1 WLR 1545 at 1569, "[t]he taxpayers' only legitimate expectation is, prima facie, that he will be taxed according to statute, not concession or a wrong view of the law …". If HMRC find that they need to alter guidance, a taxpayer can only rely on the legitimate expectation that it created where it would be so unfair as to amount to an abuse of power: *R (Hely Hutchinson)* (above), Arden LJ at paragraph 45.

Issues for determination

[37] Applying what has been said to the question whether the break option was validly exercised, the issues for determination are:

(i) whether as a matter of law VAT was properly due on the break option payment; and

(ii) if so, whether the landlord nevertheless had a legitimate expectation that HMRC would not treat the payment as consideration for a taxable supply on which VAT was chargeable.

(i) Was VAT chargeable on the payment?

[38] We conclude that the break option payment was consideration for a taxable supply of land by the landlord to the tenant, and was accordingly chargeable to VAT.

[39] The starting point is the judgment of the Court of Justice in *Lubbock Fine*. The decision is briefly stated, at paragraphs 9 and 10:

> "9. Where a given transaction, such as the letting of immovable property, which would be taxed on the basis of the rents paid, falls within the scope of an exemption provided for by the Sixth Directive, a change in the contractual relationship, such as termination of the lease for consideration, must also be regarded as falling within the scope of that exemption.
>
> 10. Consequently, the reply to be given to the tribunal is that the term 'letting of immovable property' used in article 13(B)(b) of the Sixth Directive to define an exempt transaction covers the case where a tenant surrenders his lease and returns the immovable property to his immediate landlord."

We agree with the Tribunal in *Croydon Hotel & Leisure Co Ltd* (at paragraph 51) that the Court's use of the words "such as" demonstrates that it intended the principle stated to be of wide application. We also share the view of the Tribunal in *Lloyds Bank* that there is no reason to attribute a narrow meaning to the word "surrender" in the judgment, and that what the Court is seeking is symmetry between the creation of an interest in property by way of a lease and a change in that contractual relationship leading to the return of the property to the landlord by surrender or termination.

[40] The tenant sought to distinguish *Lubbock Fine* on the basis that it was concerned only with changes in the contractual relationship resulting from an agreement which was separate from and subsequent to the lease, and was not concerned with the exercise of rights conferred by the lease itself. That was the distinction noted by the Tribunal in *Lloyds Bank* as explaining the policy of HMRC not to treat the exercise of an option to terminate contained in the original lease as falling within the scope of VAT. It is doubtful, standing the broad statement of principle in *Lubbock Fine* and the fundamental requirement to have regard to economic reality, whether the policy described in *Lloyds Bank* ever had any sound foundation. In any event, by the time of the exercise of the break option, the matter had

been put beyond doubt by the decisions of the Court of Justice in the two mobile phone cases.

[41] *MEO* and *Vodafone Portugal* both concerned the exercise of options to terminate which were contained in the original contract, the only material difference between the two being the method of calculation of the sum payable on termination by the customer to the supplier. In *Vodafone Portugal*, the Court analysed the termination payment as follows:

> "37. On the one hand, Vodafone commits to providing to its customers the supplies of services agreed in the contracts concluded with them and under the conditions stipulated in those contracts. On the other hand, its customers commit to paying the monthly instalments provided for under those contracts and also, if necessary, the amounts due where those contracts were terminated before the end of the tie-in period for reasons specific to those customers.
>
> 38. In that context, as the referring court makes clear, those amounts reflect the recovery of some of the costs associated with the supply of the services which that operator has provided to those customers and which the latter committed to reimbursing in the event of such a termination.
>
> 39. Consequently, those amounts must be considered to represent part of the cost of the service which the provider committed to supplying to its customers, that part having been reabsorbed within the monthly instalments, where the tie-in period is not complied with by those customers. In those circumstances, the purpose of those amounts is analogous to that of the monthly instalments which would, in principle, have been payable if the customers had not benefited from the commercial benefits conditional upon compliance with the tie-in period.
>
> 40. It must, therefore, be held that, from the perspective of economic reality, which constitutes a fundamental criterion for the application of the common system of VAT, the amount due upon the early termination of the contract seeks to guarantee the operator a minimum contractual remuneration for the service provided…"
>
> 41. Consequently …where those customers do not comply with that tie-in period, the supply of services must be regarded as having been made, since those customers are placed in a position to benefit from those services.
>
> 42. In those circumstances, the amounts at issue in the main proceedings must be considered to form part of the remuneration received by the operator for those services…"

[42] There is nothing in these judgments that renders them inapplicable to supplies of land where the option to tax has been exercised. On the contrary, the principle of economic reality is fundamental to the VAT treatment of all supplies, including the supply of land by way of lease. Applying the reasoning of the Court in *Vodafone Portugal* to the circumstances of the present case, the sum paid by the tenant to allow it to exercise the break option was part of the consideration received by the landlord for the taxable supply consisting of the lease of the premises. The analysis may be somewhat different where the landlord's right to payment arises in terms of an agreement which post-dates the original lease, but the VAT outcome will be the same because the economic reality is the same. As the Court observed at paragraph 48, to treat such a payment as compensation falling outside the scope of VAT would not accord with the economic reality of the transaction.

[43] In so holding we differ from the view of the commercial judge. He distinguished *MEO* and *Vodafone Portugal* on the ground that in the present case the tenant did not fail to comply with a minimum tie-in period but exercised a right to bring the lease to an end. We do not regard that distinction as material in the present context. In each case the economic reality is that one party to a contract is exercising a contractual right to bring the contract to an end, by making a payment to the other party that would not have been payable if the contract had continued to run to a termination date envisaged in the original contract. For this reason we find the *MEO* and *Vodafone Portugal* cases to be in point and determinative of the question whether in the present case VAT was "properly due" on the break option payment.

(ii) Did the landlord have a legitimate expectation that VAT would not be charged?

[44] The tenant's argument founded upon legitimate expectation was presented for the first time in its note of argument for the reclaiming motion. There are no pleadings in support of it, and it was not argued before the commercial judge. With some hesitation we allowed the argument to be presented, but it was unsatisfactory that it was introduced at such a late stage. Had it been raised earlier, the tenant would have been expected to specify in its pleadings the exact provenance and terms of the representation that it contended the landlord would have been entitled to rely upon to resist any claim by HMRC for VAT on the break option payment. In the course of the hearing of the reclaiming motion, senior counsel for the tenant confirmed that the argument was based solely upon the statements by counsel regarding HMRC policy recorded (as set out at paragraph 14 above) by the Tribunal in *Lloyds Bank*. We proceed on that basis.

[45] As regards the test to be applied in assessing the landlord's legitimate expectation, we reject the tenant's argument that the landlord could have resisted a claim by HMRC without having to contend that the claim was so unfair as to amount to an abuse of power. The authorities referred to at paragraph [36] above are applicable to the circumstances of this case. The landlord could have had no legitimate expectation that it would be taxed according to a wrong view of the law, once the erroneous foundation of the policy described in *Lloyds Bank* had been made clear by the decisions in *MEO* and *Vodafone Portugal*. Even if the Commissioners' policy in relation to termination payments provided for in the original lease had been "clear, unambiguous and devoid of relevant qualification" (cf Bingham LJ in *R* v *Inland Revenue Commissioners, ex parte MFK Underwriting Agencies Ltd*, above), it would not be so unfair as to amount to an abuse of power to depart from it in circumstances where it was shown by binding judicial authority to have been wrong.

[46] In any event the passages in *Lloyds Bank* relied upon by the tenant would not have amounted to a sound basis for any legitimate expectation on the part of the landlord that no VAT would be charged on the break option payment. In the first place, the policy was not published by HMRC as guidance; it was simply reported in observations which did not affect the outcome of the *Lloyds Bank* case itself. Secondly, it was expressly acknowledged in that case by the Commissioners, through counsel, that the policy was "not necessarily correct". Thirdly, in the most relevant published HMRC guidance, namely VATLP02400, there was no mention of such a policy. The guidance in relation to reverse surrenders, ie that payments by tenants to landlords to take back the lease are either exempt or, if the landlord had opted to tax, standard-rated, was (and remains) unqualified: there was nothing there to suggest that HMRC would treat payments provided for in the original lease as outside the scope of VAT.

[47] Nor could the issuing and subsequent revisal of RCB 12 have created a legitimate expectation that the break option payment would be so treated. The brief itself recognised that the *MEO* and *Vodafone Portugal* decisions had made clear that termination fees were within the scope of VAT, and required taxpayers who had had a ruling from HMRC that such fees were outside the scope to account for VAT on fees received after the date of the brief. The update postponed the beginning of application of the guidance in RCB 12, and allowed businesses to go back to treating termination fees as outside the scope of VAT if that is how they had treated them before the brief was issued but there is nothing before the court to suggest that the landlord was in such a position.

[48] In holding that no VAT was properly due on the break option payment, the commercial judge placed weight on the policy of HMRC recorded in *Lloyds Bank*, observing at paragraph [27] of his opinion that, as at the date of exercise of the option, "the policy of

HMRC remained that the transaction was not chargeable to VAT", and that "[t]ax payers did not require to account for tax on such transactions". In doing so he fell into error in regarding the answer as having been determined by the terms of HMRC policy recorded in *Lloyds Bank*, rather than by application of the relevant statutory provisions and authoritative case law. For the reasons we have given, we find that VAT was indeed "properly due" on the break option payment. It follows that the option was not validly exercised by the making of a payment which did not include the VAT chargeable on it. The reclaiming motion must be allowed.

[49] After this reclaiming motion had been taken to avizandum, HMRC drew the court's attention to another paragraph (VATSC06720) in its manual entitled "VAT Supply and Consideration", referring to the tribunal decisions including *Lloyds Bank* and stating that it was apparent from the direction of these cases that there was no supply for VAT purposes where a contract originally contained a clause allowing the parties to terminate early in lieu of compensation for perceived losses arising from the termination. VATSC06720 was one of the paragraphs of guidance withdrawn by RCB 12. According to HMRC it was not available on the online version of the manual after 2 September 2020. It was not mentioned in the commercial judge's opinion or in the parties' submissions to this court. It was not founded upon by the tenant as a representation upon which the landlord could have relied to resist a claim for VAT on the break option payment. In any event by the time of exercise of the break option, the policy reported in *Lloyds Bank* had been shown by ECJ case law to be wrong in law, and the same would have applied to the withdrawn guidance. For these reasons we attach no weight to it.

The tenant's cross-appeal

[50] It was submitted on behalf of the tenant that the commercial judge had erred by rejecting its argument that VAT was not payable unless and until demanded by the landlord. If the landlord were able to treat the break option payment as further consideration upon which VAT might be properly due, the tenant would have no means of knowing this unless a demand for VAT was made. No demand had been made. Clause 4.4.1 applied, imposing an obligation of indemnity on the tenant in respect of any VAT due on the break option payment.

[51] On behalf of the landlord it was submitted that the commercial judge's opinion on this matter was correct. No demand was required because the obligation to pay any VAT properly due was embedded in the option itself.

[52] The commercial judge correctly rejected the tenant's argument. Although the terms of clause 4.4.1 are sufficiently broad to include VAT chargeable on a break option payment, clause 3.1 is explicit and unequivocal in requiring any VAT properly due to be included in the payment, with time being stated to be of the essence. As the landlord submitted, the clear meaning of clause 3.1 cannot be affected by the existence, elsewhere in the lease, of a catch-all indemnity in relation to VAT chargeable on supplies made by (or to) the landlord in connection with the lease.

Disposal

[53] We shall allow the reclaiming motion and recall the commercial judge's interlocutor dated 22 December 2021. We shall (a) sustain the landlord's second plea-in-law to the extent of excluding from probation the second, third and fourth sentences in Answer 8, and (b) repel the tenant's first and third pleas-in-law. It was common ground between the landlord

and the tenant that the action will now require to proceed to proof before answer on the tenant's pleas of election and personal bar, and we shall remit the cause to the commercial judge to proceed as accords. The cross-appeal is refused.