

Outsourcing of services by landlords leaves lessees paying VAT charges

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Property analysis: Daniel Dovar of Tanfield Chambers examines the case of *Ingram v Church Commissioners for England* which questioned whether VAT is payable on the salaries of staff employed by managing agents which is then passed on to the lessees through the service charge.

Original news

Ingram v Church Commissioners for England [2015] UKUT 495 (LC)

What is the background to this decision?

The appellant is a long lessee of a residential flat, the respondent the freehold owners.

Under the terms of their lease, the respondent had a variety of obligations, including an obligation to employ others (whether employees or agents) to fulfil their other obligations. They were entitled to incur such costs as were necessary and desirable to achieve these ends. Further, the lease stated that they were to be 'fully and effectually indemnified' in respect of their costs of adhering to their obligations.

The respondents employed agents (KF) to ensure that their obligations were complied with and this included KF employing caretakers and the like to maintain and look after the building. KF having incurred the cost of the caretakers, then invoiced the respondent the salary costs. The provision of this service attracted VAT which was charged to the respondent who in turn sought to recover it from the appellant.

What were the issues before the court?

The issue was whether those VAT charges should have been charged at all--either by KF to the respondent or the respondent to the appellant. If they did not need to have been paid by the respondent, then they should not have formed part of the service charge. The point being that if they were not payable, it would have been unreasonable for the landlord to have incurred them and therefore they would not be recoverable by way of service charge under the Landlord and Tenant Act 1985, s 19.

Whether or not VAT was payable on service charges depends on whether or not they were in the nature of rent. The significance being that VAT is not payable on the provision of residential accommodation (the Value Added Tax Act 1994, s 31 (VATA 1994)--although it can be included, at the landlord's election in respect of commercial property--see *Service Charges and Management: Law and Practice* by Tanfield Chambers 3rd Ed paras 10-012 to 10-015 as referred to by the judge).

In a straightforward scenario, the mandatory provision by the landlord of services closely aligned with the provision of accommodation will not attract VAT. However, it is different when a third party provides those services and charges the tenant VAT in respect of that. In that case, VAT Notice 48 paragraph 3.18 applies an extra statutory concession from payment of VAT. The concession applies to 'the upkeep of the dwellings or block of flats in which they reside and towards the provision of a warden, caretakers and people performing a similar function'.

The appellant contended that the concession meant that as the ultimate payer was the tenant, no VAT was payable all down the line.

The judge did not agree.

The crucial distinction in this case was that VAT was not being charged directly to the appellant. It was being charged to the respondent. The agent was charging the respondent VAT:

¹The disputed charges are sums paid by the respondents to KF or Promise for the provision of services supplied by KF or Promise to the respondents ie sums paid by the lessor to a third party for the provision of services by the third party to the lessor.' (para [35])

Where does this leave us as to the position around VAT and service charges?

Mandatory service charges paid by a residential occupier to the landlord which are in the nature of rent, being directly related to the tenant's right of occupation, are exempt from VAT by virtue of VATA 1994, s 31 and Sch 9, Pt II, Group 1 and it is not necessary to rely on the concession.

Mandatory service charges paid by a residential occupier which are not in the nature of rent because they are owed to a person who does not supply any accommodation fall within the concession and are therefore exempt from VAT provided they are paid 'towards the upkeep of the dwellings or block of flats in which they reside and towards the provision of a warden, caretakers and people performing a similar function for those occupants' but not otherwise.

The concession does not apply to optional services supplied by a landlord, managing agent or anyone else to a residential occupier.

The concession does not apply to any charges paid by the landlord (or other person levying the service charge) to third parties for the supply of services even though the cost of those services is passed on to a residential occupier through a service charge.

What are the practical implications of this decision?

As was pointed out by the judge at para [45]:

'The effect of this is that where a lessor employs staff directly and passes the cost on to the lessees through the service charge, no VAT is payable on those salaries. On the other hand, where the same staff are employed by a managing agent who invoices the lessor for those services, VAT is payable on the salaries which is passed on to the lessees through the service charge. Given that the standard rate of VAT is 20%, this could give rise to significantly increased service charges. That may potentially give rise to an argument as to the reasonableness of properties being managed in this way and that the VAT thus passed on via the service charge is not reasonably incurred for the purposes of s 19 of the 1985 Act. However, the appellant has not sought to raise such an argument in this case, to do so would require evidence and depend very much on the facts of the particular case. Thus it would be wrong of me to express any view about it.'

How should lawyers be advising clients in light of this decision?

To look carefully at the way services are provided and to evaluate if they can properly justify the increase in cost (through the payment of VAT) through outsourcing their staffing requirements.

Daniel Dovar of Tanfield Chambers specialises in real property and leasehold law with an emphasis on landlord and tenant. His practice encompasses possession and forfeiture proceedings, lease renewal, service charge disputes, disrepair, enfranchisement and all the other problems which frequently arise out of leasehold interests. As well as landlord and tenant matters, Daniel's practice includes real property related issues such as conveyancing disputes, property related professional negligence, rights of way and easements, constructive trusts and co ownership, options, boundary disputes, and adverse possession.

Interviewed by Barbara Bergin.

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