

Capital allowances in dilapidations claims

Joseph Skinnard addresses a landlord's obligation to mitigate its losses

In the course of a typical lease-end dilapidations claim, a landlord will be challenged to not only prove and substantiate the losses claimed, but also to take measures to mitigate such losses. This, for instance, may include where they need not remove a tenant's fit-out in a case where it will be of use and appeal to a new tenant. This also includes the landlord seeking to recover any VAT proposed to be expended on works claimed, where the landlord can then recover that VAT through their trading activities. On this same premise, then, it would seem to follow that a landlord could reasonably be challenged to account for capital allowances when quantifying their claimed loss.

Capital allowances

Capital allowances and the associated tax implications are a specialist area, one that is subject to change and warrants specific advice. In simple terms, capital allowances are a mechanism whereby specific items of capital or revenue expenditure can be offset from a company's taxable profit at an enhanced rate (up to 150% of the sum expended) and thus reduce the company's corporation tax bill accordingly. There is no legal requirement to claim for capital allowances, but with the currently proposed corporation tax increase to 25% as of 1 April 2023, we may well see heightened interest.

Those dealing with dilapidations matters (eg landlords' surveyors preparing claims) are guided by the Pre-Action Protocol for Claims for Damages in Relation to the Physical State of a Tenancy (the Dilapidations Protocol), and, in turn, the RICS Dilapidations Guidance Note (7th edition). To paraphrase such guidance, the documents set out that the landlord's quantified demand should be restricted to an accurate representation of the landlord's likely loss, and that this does not always equate to the cost of works.

Mitigation

Consequential losses should also be considered, as well as the landlord's ability to recover VAT. With VAT, the typical VAT-registered landlord will present in their claim that they are going to do works and pay VAT on that work, but do not include VAT in the claim as they know they can recover it. If considering a sum that this



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landlord is firmly able to recover through capital allowances relating to those same works, then it logically follows that the corresponding sum should be deducted from the landlord's claim, and indeed they should do this under their obligation to mitigate loss.

Generally, when considering if a landlord's loss has been suitably mitigated/evidenced (diminution valuations aside), questions are asked as to whether works have gone through a formal tender process to evidence good value; if market tested rates have been used for costing the schedule; if alternative schemes are likely; or if reletting without undertaking the full works has been attempted. Working this same basis forwards, where there is an established legal and feasible means of a landlord reducing their net expenditure – hence net "loss" – through capital allowances, then surely a tenant is within its rights to expect their landlord to mitigate in this way and allow for this in their dilapidations claim. Indeed, in line with the other requirements in the Dilapidations Protocol, it may be considered appropriate for landlords' surveyors, as a matter of course, to seek clarity on their clients' tax positions and ability to recover in line with their endorsement.

Application in practice

To give some context of how this might apply, take a landlord who is known to have made use of capital allowances through contributions previously made towards an incoming tenant's fit-out. When dealing with the end of lease claim and the associated endorsed works, it would be reasonable to assume the landlord will again claim capital allowances through incurring qualifying capital expenditure on the applicable

dilapidations works. Contextualising this with a very basic example of the type of recovery available (situation depending) in cash terms, but not considering any other allowances being claimed:

- The landlord's dilapidations works includes £50,000 of floor covering replacement.
- The whole £50,000 spend on floor coverings currently falls within the 130% "super deductions" pool, therefore, the landlord could deduct £65,000 (£50,000 x 130%) from their taxable profit sum at the end of year one.
- Here then, the landlord will avoid paying 19% corporation tax on £65,000 in that given tax year, so a real cash saving of £12,350 (£65,000 x 19%).
- Deducting this from the expenditure on the floor coverings reduces the net spend to £37,650 (arguably then the landlord's actual loss).

While this is one relatively small example – and noting that true calculation of capital allowances goes beyond the simple outline above – when extrapolated to allow for all applicable items in the dilapidations claim, the respective reduction in the landlord's overall net loss could be very substantial, and certainly warrants further scrutiny.

From a tenant's perspective, this would also appear to provide a valuable tool in seeking to establish the landlord's actual intentions, ie: "You are claiming you are going to be replacing carpet, doing HVAC works, stripping out partitions, decontaminating the yard/hardstandings, etc – have you considered which 'bracket' of capital allowances each item of work falls into and will the associated tax recovery be accounted for in the quantified demand?"

Taking this further, it would then seem reasonable for a tenant to insist that their landlord categorises each of their items of claim to allow for capital allowances to ensure the landlord's true loss is reflected.

With the potential for market uncertainty on the horizon, it is difficult to know how the government might look to revise the current capital allowances available. However, with increasingly difficult economic times ahead, tenants will be seeking to challenge landlords' dilapidations claims using any means possible, with this potentially providing a very valuable tool in their arsenal.

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