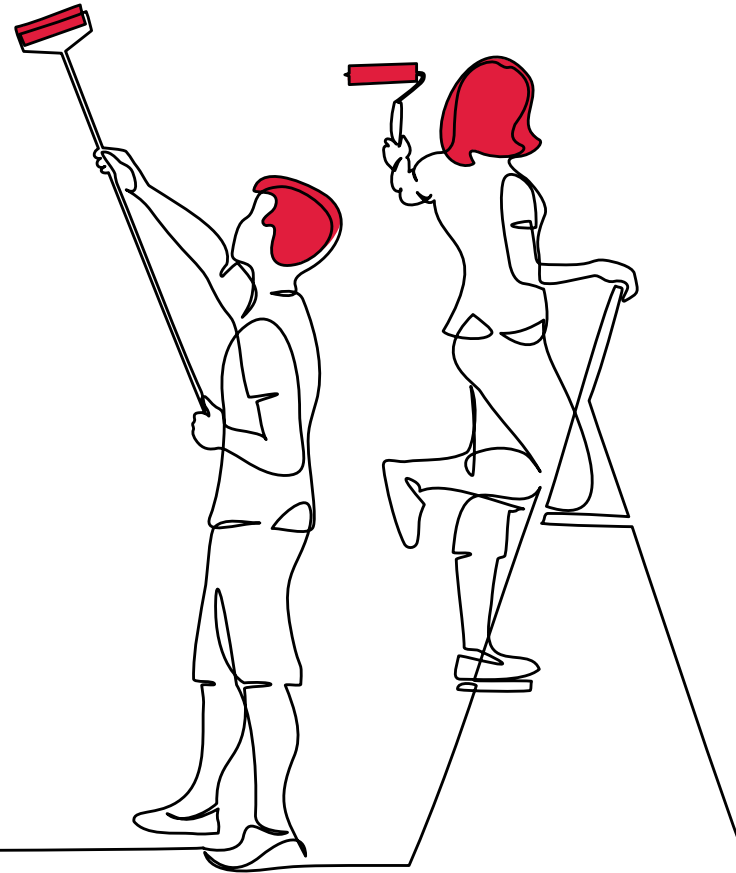


# End of Lease Obligations & Dilapidations



**Whilst the terms of each lease will be different, we have set out below a few things to consider when the term of a lease is coming to an end.**

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### **Yielding up process**

Tenants will need to comply with the repair and yielding up clauses contained in their leases. In particular, tenants should think about the following:

- You must return the premises in the state of repair and condition required by your lease. Is your repairing obligation limited to keeping the premises in the same state of repair and condition as it was in when you first took occupation, by reference to a photographic schedule of condition? If not, you are likely to be responsible for making good any damage to the property, even if it was there before you entered into the lease.
- Most leases require a tenant to redecorate the premises before the end of the term. Check whether you need your landlord's approval of the colours and materials that you propose to use.
- Some leases require a tenant to replace carpets or other floor coverings before the end of the term. Check whether this is a requirement in your lease.
- If you have made any alterations to your premises, check the terms of the lease and any licence for alterations to see whether you are required to remove those alterations before the end of the term. You may need to liaise with your landlord to check whether they require you to remove your alterations.
- You must remove any items that belong to you from the premises. This usually includes any items that you have fixed to the property as well as moveable items e.g. furniture, computer equipment etc. If you propose to leave any items at the premises, ensure that your landlord agrees to this in writing.
- At the end of the term you must return all keys to the Landlord.
- Most leases will require you to remove any signs that you have attached to your premises or elsewhere on the landlord's building or estate.

## Dilapidations

If a landlord does not think that a tenant has complied with its repairing obligations at the end of the term, the landlord may serve a terminal schedule of dilapidations on the tenant.

Under the Dilapidations Protocol, a Landlord is required to serve its schedule of dilapidations within a reasonable time, which will generally be within 56 days after the expiry of the lease. Once a schedule of dilapidations has been served, a tenant will then need to send a response within a reasonable time, which is generally a further 56 days after the landlord sent the schedule.

In order to prepare the response, a tenant will generally need to engage a surveyor. Once the response has been served there will be a period thereafter where a tenant's and landlord's surveyors will negotiate on a without prejudice basis to agree as many of the items in dispute as possible.

Under the terms of most leases, any costs that a Landlord incurs in preparing a schedule of dilapidations and negotiating a dilapidations settlement must be borne by the tenant.

The role of a tenant's surveyor will be to consider, review and narrow the tenant's obligations under the lease and the claimed costs and then focus on the key issue, which is 'what is the landlord's actual loss?'. A statutory defence is provided by section 18 of the Landlord and Tenant Act 1927 (**LTA 1927**) which falls in two limbs:-

1. A landlord's claim is capped at the loss of value to the landlord's interest in the property arising out of the disrepair – this is calculated by comparing the value of the premises in the state of repair required by the lease and the value of the premises in their actual state (this cap may be lower than the cost of works required to remedy the disrepair itself); and
2. A landlord's claim can be extinguished if it can be shown that the property is to be demolished and/or reconstructed.

**The above statutory defence does not apply to a breach of covenant to reinstate, redecorate or remove a tenant's items. Damages for a breach of covenant to reinstate, redecorate or remove a tenant's items will be the reasonable cost of doing the works plus loss of rent for the period until the works have been completed.**

Some tenants decide it is more profitable to operate from the premises until the end of the term and then deal with the dilapidations claim after the term has ended, rather than close the premises early to carry out the works. However, if a tenant decides to carry out the works itself before the end of the term, the tenant will be in control of the cost of the works and will avoid additional costs such as the landlord's fees for negotiating a dilapidations settlement agreement.

## Tax Treatment of Dilapidations

It is generally agreed that a dilapidations payment is a payment of damages because the tenant failed to comply with its obligations under the repairing covenant in the lease. However, the tax treatment of dilapidations payments can be complicated and largely depends on whether the payment is of a capital or income nature.

### Income receipt or capital receipt

The tax treatment of the landlord depends on whether:

- The dilapidations payment is a capital receipt or income receipt.
- The landlord re-lets, disposes of, or occupies the property.

### Landlord disposes of or occupies property

HMRC takes the view that the payment is treated as a capital receipt if, after receipt of the dilapidations payment, the landlord disposes of the property or occupies the property itself. This is because the payment is treated as a payment of compensation for failure to observe the terms of the lease so that the property reverts to the landlord in a dilapidated condition. The landlord is, therefore, subject to corporation tax on gains (or, in the case of individuals,

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**Disclaimer:** This note does not contain a full statement of the law and it does not constitute legal advice. Please contact us if you have any questions about the information set out above.

capital gains tax) on the payment received because there is a disposal of the landlord's right to sue for breach of covenant under the lease.

## **Landlord re-lets property**

Where the landlord re-lets the property without using the dilapidations payment to repair the property, the payment is generally treated as an income receipt of the property business. This is because the payment is likely to be treated as filling a hole in the landlord's profits and is compensation for the lower rent that the property can command in its dilapidated condition.

## **Deductions for dilapidation payments**

If the tenant uses the property for the purposes of its trade, a dilapidations payment is:

- Deductible for the tenant to the extent that the payment reflects repairs and the cost would have been allowable as a deduction if the tenant had carried out those repairs during the term of the lease.