



Value Added Tax

Consultancy Services

photo courtesy of the European Court of Justice

Residential Sector

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Background

In the current economic climate many developers and house builders will be thinking of letting rather than selling new dwellings they have built or converted from non-residential use, rather than leaving them empty until they find a buyer.

Such a change of plan will have entirely different consequences from a VAT perspective.

The sale of the freehold or long lease over 21 years of a new and some converted dwellings is zero rated, allowing full recovery of VAT on input costs in connection with the development.

In contrast, the letting of residential property is exempt. There is a potential additional cost because VAT incurred by the developer or house builder will not be recoverable to the extent that it relates to exempt supplies.

The potential problems this can cause are considered below but there may be a simple way around the problem.

Selling Before Letting

In advance of any letting, the developer or house builder could make the "first grant of a major interest" in the completed dwellings to a connected person who is not in the same VAT group. The sale would be zero rated and as a result avoid the need for the kind of adjustment discussed below.

The connected person would then let the properties until such time as they could be sold. The lettings would be exempt and there would be no right to input VAT deduction on ongoing costs including those relating to the eventual sale. However there would be no adjustment to the VAT deduction associated with the original construction.

Abuse of Rights

The problem with any type of tax planning in the post Halifax era is the uncertainty as to whether it will be challenged by HMRC as an abusive scheme from a VAT point of view.

In Revenue & Customs Brief 54/08, HMRC state that for an arrangement to be abusive it must, as well as saving VAT, produce a result contrary to the purpose of the VAT legislation.

In HMRC's view, the arrangement set out above does not produce a result contrary to the purposes of the legislation, but instead ensures that a transaction of the type envisaged takes place at the appropriate time: that is a zero rated supply such that no VAT cost (save on blocked goods such as washing machines) is associated with constructing a new dwelling.

However, HMRC make it clear that if the VAT recovery goes beyond that normally deducted in relation to a new dwelling, such as that on repair, maintenance or refurbishment costs, then the arrangement is likely to be challenged.

Letting Before Selling

Selling or granting a long lease over 21 years in a new and some converted dwellings is, as stated above, zero rated, allowing full recovery of VAT on input costs.

On the other hand, the letting of residential property is exempt, although the eventual sale of the dwellings should still be zero rated. The problem this causes occurs because VAT incurred by the developer or house builder will not be recoverable to the extent that it relates wholly or partially to exempt supplies.

The result is that the short term letting of dwellings prior to eventual sale may affect the developer or house builder's ability to fully recover VAT on land, construction and other input costs.

In these circumstances it may be necessary to do one or more of the following:

- Repay input VAT already recovered on returns previously submitted.
- Restrict input VAT recovery on present and future VAT returns.
- Agree a special method with HMRC for recovering future input VAT.

In addition, a business in receipt of VAT exempt rental income may also be required to restrict VAT recovery on overhead costs, especially if there are VAT return periods when there is no other income.

HMRC Guidance

In September HMRC published Revenue & Customs Brief 44/08 and Information Sheet 07/08, further explaining the VAT implications of temporarily letting dwellings before selling them as noted in the three bullet points in the last section above.

The potential claw back adjustment must be calculated as soon as the actual or intended use of the property changes from the original intention upon which input VAT recovery was based, i.e. when a decision is made to let prior to a later sale. The adjustment is a one-off event and there would only be a second adjustment if the property was never let.

The adjustment must be based on realistic expectations at the time and HMRC may ask for evidence such as valuation reports to show that the calculation is reasonable.

A developer or house builder who does not presently operate a partial exemption method can use any claw back calculation that produces a fair result. However, the preferred method calculates input tax recovery based on the estimated eventual sale value as a percentage of the estimated eventual sale value plus estimated short let premiums and rents. By prior agreement with HMRC an alternative method may be adopted where an existing partial exemption method produces an unfair result.

A developer or house builder who expects to continue to incur exempt input tax in current or future VAT periods will be required to adopt a partial exemption method and if not already partly exempt must apply either the standard method or agree a special method with HMRC.