

VAT & the Property Sector - An Update

Since the introduction of VAT in the UK in 1973, business owners and their advisers have come to appreciate that this tax is complex and may have far reaching consequences in many business transactions not least in those involving property.

In view of that, careful consideration should be given to the issue of VAT at the outset of any deal involving property, and businesses should ensure they seek the appropriate advice at all stages of a particular transaction to reduce the risk of being caught out by matters that could adversely affect the profitability of a deal.

Legal advisers and businesses operating in the property sector should be aware of recent changes in UK VAT legislation introduced on June 1st this year to Schedule 10 of the VAT Act 1994. These changes can be seen as an attempt by the Government to simplify this complex area and have brought about some welcome changes to the system of VAT and property. Despite this, the issue is still capable of posing a problem for businesses which fail to seek appropriate advice and fully understand their obligations in this area.

VAT & Property

VAT is a tax imposed on the sale price of goods and services. Where a business is registered for VAT and sells or supplies something, they collect the VAT from the customer or client and then pass that sum onto HM Revenue and Customs (HMRC). The amount passed on to HMRC is however reduced by the amount of input tax that a company has suffered i.e. the amount of VAT that the company has paid for goods purchased by it.

Specifically regarding property, the VAT treatment will depend upon the nature of the transaction. Generally, the sale of commercial land and buildings will be exempt, except where the commercial premises being sold are less than three years old or where the seller takes the decision to waive the VAT exemption otherwise known as the seller 'opting to tax'.

The granting or assignment of a lease is treated in the same manner and will be exempt subject to the landlord's decision to 'opt to tax'.

Prior to the introduction of the option to tax on August 1st 1989, the courts determined it was unlawful for businesses to zero rate the construction and re-development costs of commercial property, meaning companies engaging in the construction or redevelopment of commercial buildings would have to pay VAT on the costs of acquisition and construction, without the ability to offset that. This problem has largely been overcome by the option to tax facility. By opting to tax, the commercial owner is able to convert what would otherwise be an exempt supply into a standard rated supply so that a developer can recover the tax incurred on the acquisition and development costs.

The key advantage to the option to tax is clear and could mean that where businesses are able to recover VAT on related costs, it can significantly improve the profitability of a property deal. Further, the option is a decision to be taken solely by the seller or landlord and it can be made on a building by building basis.

That said, disadvantages of the option do exist. Namely, once a property has been elected, it cannot be revoked for 20 years. In addition, it is not possible to opt to tax certain properties (i.e. those used for residential purposes) and in some circumstances, it is necessary to ask HMRC's permission before opting.

Commercially, landlords and vendors should be aware that by opting to tax a building, certain buyers or tenants may be discouraged. For example, those not registered for VAT or those who are not able to recover VAT such as banks, building societies and insurance companies would be hard hit by a landlord or seller opting to tax.

The main problem surrounding VAT and property arises in practice because the rules are often misunderstood. Businesses should be aware that opting to tax is a two stage process. Firstly, the vendor or landlord should decide whether to opt to tax. Bear in mind that it may not always be necessary to opt to tax. For example, where VAT was not charged on acquisition or where no development or construction is planned there may be little need to opt to tax. Secondly, in order to make it legally valid, it is necessary to notify HMRC's Option to Tax Unit in Glasgow within 30 days of the decision.

Failure to correctly opt to tax buildings can lead to disputes arising on two fronts. Firstly with the tenant or purchaser, who may upon identifying that an option to tax a particular building was ineffective, take action to reclaim VAT unlawfully charged or secondly with HMRC who may take action to pursue VAT wrongly reclaimed plus interest and penalties. A worrying point to note is that often large businesses have no reliable record of which properties they have opted to tax and therefore they are leaving themselves open to the possibility of disputes arising.

What are the recent changes?

Criticism has been directed at the option to tax system, and the recent changes introduced on June 1st 2008 have gone some way to make the system more user-friendly, straightforward and have introduced greater flexibility and certainty.

In summary the changes include:

- A new provision for incorrectly opted buildings to be reversed within a certain period
- Simplification of the system where businesses have numerous opted buildings
- New rules for opted buildings held in a VAT group registration
- New rules regarding revocation of the option to tax
- A new procedure for commercial buildings being sold where they are intended to be used as residential buildings
- A provision for the automatic lapse of the option to tax after six years where a business ceases to have an interest in the relevant property.

These changes do not leave the system without potential pitfalls and businesses and their advisers should be alert to the fact that VAT remains an issue that should be given appropriate attention.

As part of the changes, the ability of a business to tax land and buildings on it separately has been removed. In principle, the changes now mean that if a company opts to tax land and then builds on it, the option should automatically apply to that building and in the same way, where an opted building is demolished and new construction work follows, that new building will be covered by the existing option to tax.

This is however a contrast from the policy that HMRC used to operate, whereby land and buildings on it could be opted separately and in order to retain flexibility in this area, a provision will be adopted which will allow a newly constructed building and the land on which it stands to be excluded from the effect of a previous option to tax. This demonstrates that despite the changes to simplify the system, VAT is still a complex area of law and highlights the need for advice to be sought in all property deals.

Changes have also been introduced into the system for revoking the option to tax. A business may automatically revoke an option to tax at any time after the 20 year period has expired, subject to the business satisfying certain conditions. These conditions are technical and businesses will need advice for each specific opted building to assess whether the conditions for revocation have been met.

In addition, HMRC will require confirmation of this from a responsible person. This re-enforces the need for businesses to involve their advisers where they wish to revoke an option to tax. As is the case when making the option to tax, businesses must notify HMRC in order for a revocation to be legally valid. Businesses should be alert to the fact that where the correct procedure is not followed for revocation, this could lead to HMRC demanding the VAT unpaid plus interest and penalties.

A further issue which has caused problems for the property sector is where a seller has opted to tax a commercial building (on which it has paid VAT on acquisition and then undertaken construction works) that is then sold to a buyer that wants to convert it for residential use. Where the purchaser fails to make it clear to the vendor before exchange of contracts, that they intend to convert the building for residential use, the seller would be locked into making an exempt supply and would have to repay HMRC significant sums in respect of the VAT on the costs incurred.

The changes on June 1st 2008 address this issue. It is now necessary for a purchaser in this scenario to provide a vendor with a certificate before exchange of contracts as notification that they intend to convert the opted commercial building into one for residential use. This will enable the parties to be fully aware at an early stage that the option to tax will be dis-applied and gives them the opportunity to negotiate the sale price with VAT in mind and therefore reduces the likelihood of the deal falling apart.

Where no such certificate is produced before exchange of contracts, the seller's option to tax will remain and VAT will be payable on the sale price.

Advisers should note that where various parties are involved in the acquisition of premises where the ultimate purchaser intends to convert the building into one for residential use, each party will be required to provide a certificate down the chain. This is an important development that those acquiring commercial land or buildings for residential use should be fully aware of. Failure to do so may lead to significant problems and cost implications.

A further matter that the recent changes address affects those companies which tax their buildings under a single option to tax. The changes will enable companies to convert these single global options into a new format where a single option in respect of a portfolio of properties can be converted into lists of properties where companies can revoke or opt to tax on a property by property basis. A clear indication of an injection of greater flexibility into the system but an obvious risk arises and companies should keep accurate records of those buildings that they have opted to tax and those that they have not.

The recent changes discussed will introduce some much needed flexibility into the system of VAT and the property sector. That said, the pitfalls that have existed since the introduction of the option to tax in 1989 still remain, not least in the context of businesses still being required to correctly notify HMRC of their decisions regarding opted buildings and land. The recent changes place new obligations on purchasers of commercial land to be used for residential purposes and it is now, more than ever important that businesses seek advice whenever they engage in transactions involving property.

Contact us

Please feel free to contact us if you would like further information on any aspect of our work.

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