

The New VAT on Property Rules –

*The Time
is Now*

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Deloitte discuss the imminent arrival
of the new VAT on property system.

Introduction

After much discussion and debate the new rules for VAT on property will come into force on 1 July 2008. These rules represent root and branch change of the Irish VAT on property system and will potentially affect all businesses and property investors.

The new system can be broken down into;

- Sales rules
- Lettings rules
- Capital Goods Scheme
- Transitional Rules
- Waiver of exemption
- Special rules for residential properties

We will look at each component in turn and highlight the key points that you need to know when trying to apply the VAT rules to a property transaction.

The “Sales Rules”

As the name suggests the sales rules apply to sales of properties so the first question that you have to answer is “what is a sale?”

A sale is basically the transfer of the ownership of the property. This could be a transfer by way of the transfer of a freehold or the transfer of a very long lease.

After July the sale of all properties will be subject to VAT unless they come within one of the five specific exemptions. So when applying the VAT rules to a sale you have to ask does the sale come within one of the following exemptions and if it does not then you have to charge VAT on the sale.

These are the exemptions and when they will apply:

Category of Exemption	Description
Undeveloped Land	<p>Undeveloped land is basically green field land. It is land that has no work done to it.</p> <p>Please note that there is an exception to the exemption if the undeveloped land is sold in connection with an agreement to develop the land.</p>
Old Property	<p>An Old Property is a property that has not been completed or developed in the 5 years prior to the sale.</p> <p>Completed is a very important and very specific definition in VAT law. At a very basic level a property will only be completed where it:</p> <ul style="list-style-type: none"> – is fit for the purpose for which it is designed; – is ready to move into or “occupy” – has all the necessary utilities connected up. <p>“Developed” also has a very specific meaning for VAT purposes and land will be developed if:</p> <ul style="list-style-type: none"> – you carry out any construction, alteration, reconstruction, extension or demolition of any building in the land; or – you carry out any engineering work or other operation in, on, over, or under the land to adapt the land for materially altered use. <p>You have to be careful when applying the definition of development as it has a wider meaning in the VAT world than it has in the day to day use of the term.</p> <p>You should note that an Old Property can include a completed building or other completed facility. For example a factory could be an old property so could a golf course as could a road.</p>
Old Building	<p>An Old Building is a building that has not been completed or significantly developed in the five years before the sale.</p> <p>An Old Building differs from an Old Property because if the Old Building was completed more than five years ago then the sale of the building will be exempt unless it has been “significantly developed” in the last five years.</p> <p>Significant development means development which:</p> <ul style="list-style-type: none"> – adapts or intends to adapt the property for a materially altered use; <p>OR</p>

Category of Exemption	Description
	<ul style="list-style-type: none"> – costs more than 25% of the sales price of the property. <p>A building can still be exempt as an “Old Building” even if it has been developed since the latest completion as long as that development is not significant development.</p> <p>A significant development of the property is treated as a new completion of the property.</p>
Second Hand Property	<p>A Second Hand Property is a property that has been completed in the last 5 years and not developed since the latest completion and in respect of which the following two conditions are met:</p> <ul style="list-style-type: none"> – the property has been occupied for 24 months since the latest completion of the property; <p>AND</p> <ul style="list-style-type: none"> – there has been a previous sale of the property on which VAT was charged and that was a sale between unconnected persons. <p>Occupied is another very important term in VAT law. It is a very specific term but broadly speaking a property will be occupied when:</p> <ul style="list-style-type: none"> – it is fully in use for the purposes for which the planning permission was given; <p>OR</p> <ul style="list-style-type: none"> – where the property is let it is occupied by the tenant. <p>Again you should also note that a Second Hand Property can include a completed building or other completed facility.</p>
Second Hand Building	<p>A Second Hand Building is a building that has been completed in the last five years and not significantly developed since that completion and in respect of which the following two conditions are met:</p> <ul style="list-style-type: none"> – the property has been occupied for 24 months since the latest completion of the property; <p>AND</p> <ul style="list-style-type: none"> – there has been a previous sale of the property on which VAT was charged and that was a sale between unconnected persons. <p>You will note that a building can still be exempt as a “Second Hand Building” even if it has been developed since the latest completion as long as that development is not significant development.</p>

Option to Tax for Sales

If a sale is exempt because it comes within one of the above categories you can opt to tax the sale. This means that you can choose to charge VAT on the sale even though you don't have to charge VAT on the sale.

This option to tax is a joint option. Both the seller and purchaser have to agree that VAT will be charged on the sale.

Because both parties have to agree to opt the issue as to whether or not to opt will often be a vexed one. Indeed in many cases it will be one of the key issues in the property deal. Basically, contention will arise because it will generally be in the seller's best interest to opt and in the purchaser's best interest not to opt.

Sellers will often want to opt to tax sales because it means that they will not have to pay back any VAT that they have recovered on acquiring or developing the property.

Purchasers will often resist opting in order to remove any possibility that they will have a VAT cost in the future as a result of making an exempt sale or letting of the property. After all if you were not charged VAT in the first place then it cannot be clawed back from you in the future.

It is beyond the scope of this article to analyse the myriad of interdependent factors upon which the decision to opt to tax will rest. Suffice as to say that with every exempt property sale both parties to the transaction will have to resolve the thorny issue of whether to opt to tax. Deal brokers will often be heavily involved in this decision.

Lettings Rules

After 1 July 2008 all occupational leases will be treated the same. They will be exempt from VAT.

Landlords will not charge VAT on rents and they will not be entitled to recover VAT on acquiring, developing or maintaining the property.

However, a landlord may opt to tax a letting. This means that the landlord will have to charge VAT on the rent but it can recover VAT that it is charged on acquiring, developing or maintaining the property.

There are some points you should note on the option to tax for lettings.

- The option is at the landlord's discretion
- The option is on a letting by letting basis. A landlord can opt to tax one lease and not opt to tax another.
- A lease can be opted and "de-opted" at any stage by the landlord. There is a lot of flexibility built into the option.
- The option is exercised by including a clause in the letting agreement or by issuing a separate written notification to the tenant.

- When an option to tax is exercised the landlord must account for VAT on the rents or on any premium at the standard rate of VAT (21%).

When can you not opt to tax a lease?

There are certain situations in which you cannot opt to tax a lease or where an existing option to tax will be terminated. These are:

- Where the property is used for residential purposes,
- Where the landlord is connected to the tenant, *unless* the tenant is entitled to deduct at least 90% of the tax chargeable on the rent, or
- Where the landlord is connected to the person who occupies the property.

Not being able to tax a letting or having an existing option to tax cancelled can have very serious consequences. It may mean that you will have to repay the VAT or a part of the VAT that you recovered on acquiring or developing the property.

Connected Person Provisions

Because the penalty is so severe a landlord needs to be very careful to check that he is not connected to his tenant or to the occupant of the property. The landlord needs to check this for every year the property is let.

Applying this check will be both difficult and time consuming for many landlords. This is because the definition of a connected person is both broad and nebulous. On the legislative definition it is very difficult to know where the boundaries of connectivity actually lie.

The Revenue Guide gives a general definition of when individuals will be connected and when companies will be connected. This definition is indicative and by no means exhaustive.

An individual will be connected with

- Their spouse,
- Their relatives or relatives of their spouse,
- Individuals or spouses of individuals with whom they or their spouses are in partnership,
- Any settlor or beneficiary of a trust where the person is a trustee of the trust.

A body of persons (e.g. a company) is connected with;

- A person who has control over the company,
- Another company which acts in pursuit of a common purpose,
- Anyone who may have the means or power to directly or indirectly to determine the activities of 2 companies.

Prohibiting an option to tax or cancelling an existing option is an extremely punitive measure. It means the landlord has to pay back all or some of the VAT that it has recovered on acquiring or developing the property. Given the penalty, it is unfortunate that the application of this measure turns on a definition of a connected person that is at best wide and at worst unworkable.

Capital Goods Scheme (CGS)

The CGS is a totally new part of Irish VAT law. It is about how you recover VAT that is charged to you on acquiring or developing a property.

The CGS will potentially affect any business which buys or builds property.

Basically the purpose of the CGS is to ensure that the VAT a business recovers on buying or building a property reflects the VATable use of the property by the business over its VAT life. Most properties have a VAT life of 20 years.

A business will recover the VAT charged to it on acquiring the property based upon how it uses the property for the first 12 months of ownership. So if the business uses the property 100% for VATable purposes in the first 12 months then it will recover all of the VAT charged to it. However if the business uses the property for 50% VATable purposes in the first 12 months then it can only recover 50% of the VAT charged to it.

The business then has to monitor its VATable use of the property every year and determine whether its VATable use in that year has increased or decreased from the first 12 months of ownership. If the business' VATable use has increased then the business will be entitled to an additional amount of VAT from Revenue. If the business' VATable use has decreased then it will have to pay some of the VAT it initially recovered back to Revenue.

Therefore a business should carry out a review of its VAT recovery on an annual basis, making adjustments if there is a change in the taxable use of the property.

Really where the CGS will be of importance to most businesses is where the business sells or leases a property within its VAT life. This is because if you make an exempt sale or lease of a property on which you have recovered VAT you may have to pay back some of the VAT that you recovered on acquiring or developing the property.

The converse is also true. If you make a taxable sale or lease of a property and you had not recovered all of your VAT on acquiring or developing the property then you may now be entitled to recover an additional amount of VAT from Revenue.

The legislation also obliges capital goods owners to maintain a record in respect of each capital good detailing the taxable use to which the property is put and containing information in respect of any adjustments made.

Transitional Measures

There are a separate set of rules that apply to:

- Freeholds and ownership leases held on 1 July 2008;
- Leases held on 1 July 2008 which were for a period of ten years or more when created.

These rules are called the transitional measures. These transitional measures may affect these properties for the next 20 years.

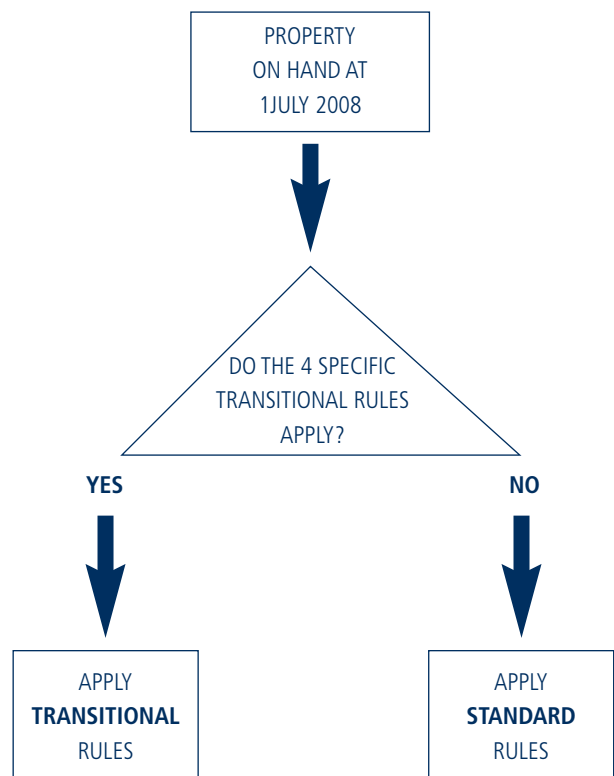
The transitional rules are very complicated.

However at a high level the transitional rules will only apply to certain disposals of properties that are on hand at 1 July 2008. These are:

- Certain sales of transitional properties;
- Certain leases of transitional properties;
- Assignments of transitional leases;
- Surrenders of transitional leases.

If your transaction does not fall within one of these specific categories then you can apply the standard rules. Where you assign or surrender a transitional lease the transitional rules will always apply.

A basic methodology is as follows:



This table should help you decide if the transitional rules apply and the

Transaction	Conditions for the Transitional Measures to Apply	VAT Treatment
Sale	<ul style="list-style-type: none"> • It must be a “completed” property • The vendor must not have been entitled to recover VAT on acquisition or development of the property; • The property must not have been significantly developed after 1 July 2008. 	<p>Exempt with the option to tax.</p> <p>If the option to tax is not exercised then the vendor may have to repay some of the VAT it recovered on the property.</p>
Letting	<ul style="list-style-type: none"> • The landlord must have been entitled to recover VAT on acquiring or developing the property. 	<p>Exempt with the option to tax.</p> <p>If the option to tax is not exercised there are special provisions to calculate any claw back of VAT that could arise.</p>
Assignment of an occupational lease	<ul style="list-style-type: none"> • The assignor must have been entitled to recover VAT on acquiring the lease or developing the property <p>And</p> <ul style="list-style-type: none"> • It must be less than 20 years since the assignor acquired the lease. 	<p>Subject to VAT.</p> <p>The amount of VAT that has to be charged is set out in a Formula in the legislation.</p> <p>If the two conditions are not met then the assignment will be exempt from VAT with the option to tax.</p>
Surrender of an occupational lease	<ul style="list-style-type: none"> • The tenant must have been entitled to recover VAT on acquiring the lease or developing the property <p>And</p> <ul style="list-style-type: none"> • It must be less than 20 years since the tenant acquired the lease. 	<p>Subject to VAT.</p> <p>The amount of VAT that has to be charged is set out in a Formula in the legislation.</p> <p>If the two conditions are not met then the surrender will be exempt from VAT with the option to tax.</p>

Waiver of Exemption

Under the “old” VAT on property rules leases of less than 10 years were exempt.

A landlord could, however, waive his right to the exemption and charge VAT at 21% on these leases. The waiver would then automatically extend to all the landlord’s commercial property let under short leases. If a landlord wished to cancel a waiver of exemption an adjustment of VAT would be calculated and the landlord would pay Revenue any shortfall between the VAT charged on the short term rents and the VAT recovered by the landlord.

Under the new rules *no* new waiver can be put in place on or after 1 July 2008.

However old waivers will remain in force and can extend to certain lettings made after 1 July 2008 if:

- The property was acquired before 1 July 2008, And
- The property was not developed after 1 July 2008.

If you have a waiver in place on 1 July 2008 and the above two conditions are met then you will have to charge VAT on the rent. You do not have a choice. This rule will apply to any occupational lease of a commercial property where the property meets the above conditions. The rule that a waiver will only apply to leases of less than 10 years is no longer applicable.

You should also be aware that there is an anti avoidance provision that cancels an existing waiver that applies to a letting between “connected parties” or a letting where a person connected to the landlord occupies the property. The cancellation will only apply to the lettings between connected parties and will not impact on other lettings covered by the waiver. In other words the waiver itself is not cancelled.

If your waiver is cancelled in respect of a connected letting you have to repay the difference between the VAT recovered on the property and the VAT paid over on the rent of the property.

If the connected tenant has an entitlement to VAT recovery of at least 90% this provision will not apply and the waiver may continue post 1 July 2008. If you are connected to the occupant there is no VAT recovery threshold (however we believe this is currently under discussion and a threshold might apply).

It’s not all bad news. The waiver of exemption will not be cancelled where the VAT accounted for on the rents meets the minimum requirements as laid out in the legislation. These are

- The waiver and the letting should have been in existence on 18 February 2008.
- A minimum amount of VAT on the rent should be paid. The amount of VAT is given by a formula.
- The VAT must be paid in equal installments in each VAT period.

Residential Properties

There are some specific rules that apply to sales of residential properties by "developers". Basically it is Revenue's intention that sales of residential properties by developers or persons connected with developers will always be subject to VAT. The exemptions for old buildings, second hand buildings, etc. will not apply to sales of residential properties by developers.

There is also a VAT relief for developers who let a residential property before selling it. Although the residential letting will be exempt without the option to tax, the developer will not have to pay back all of the VAT recovered on acquiring or developing the property. Rather it will only have to pay back 1/20th of this VAT for each year that the property is let. A subsequent sale of the property will then be subject to VAT.

Conclusion

VAT on property has always been a difficult area. This isn't going to change any time soon. We are often asked whether the new system is

simpler than the old. The answer is probably yes. However if the question was rephrased and we were asked is the new system simple then the answer would most definitely be no.

Indeed, perhaps throughout this process people have been focused on the wrong issue. The key concern has been to make the VAT on property rules simple. Perhaps it should have been to make the rules fair.

In our view the real difficulty with the old system was not that it was too complex, it was that it was often unfair. It gave rise to unfair VAT costs arising on property transactions. The real challenge for the new rules is to be fairer than the old.

It is debatable whether this has been achieved. The connected party provisions for leases have the potential to be every bit as unfair as anything under the old system. Unfortunately the pitfalls in VAT on property law are very definitely still there.

However, opportunities also remain for businesses. As discussed by the European Courts in Halifax (Case C-255/02), a taxpayer has the freedom to opt for the least taxed route when conducting their business. There is no legal obligation to run a business in such a way as to maximise tax revenue for the State. ■

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