VAT on Property - changeover to new rules

The new VAT on Property Guide is now available on the Revenue Website. A printed copy of the guide will be available from mid May. The guide deals with the new rules for applying VAT to property transactions that are effective from 1 July 2008. These rules are briefly summarised below.

1. Supplies of property

The new rules provide that VAT must be charged @13.5% on the supply, in the course of an economic activity, of a developed property while the property is considered "new". The supply can be either the sale of the freehold or the creation or assignment of a very long lease (e.g. a lease for 99 years), which is referred to in the guide as a freehold equivalent interest.

Two rules, the two and five-year rules, determine if a property is "new" –

- The first supply of a completed property within five years of its completion is considered to be the supply of a new property and is subject to VAT.
- The second and subsequent supply of a property is considered to be the supply of a new property and subject to VAT but only if it takes place within two years of occupation.

The supply of an "old" property (i.e. one no longer considered "new") is exempt from VAT.

2. Supply of residential property

VAT is always chargeable on the supply of a residential property by a developer/builder - the two and five-year rules do not apply in such cases.

3. Supply of property in connection with a contract to develop the property

A supply of property in connection with a contract to develop the property is subject to VAT, whether the property is developed or not and even it the person making the supply is not carrying on an economic activity.

4. Joint option to charge VAT on supply of “old” property

Where the supply of property is exempt from VAT, the seller and buyer may opt to charge VAT on the supply. Where they do so, the purchaser accounts for the VAT on the supply.

5. Letting of property

The letting of property is exempt from VAT. A landlord may opt to charge VAT @ 21% on rents from a letting. A landlord who does so is entitled to deduct VAT incurred on the acquisition or development of the property or on the portion of the property to which the option relates.

Unlike the old waiver of exemption rules, the option to tax applies to a specific letting. In other words, the landlord has the right to opt (or not to opt) in relation to each letting. However, the option to tax does not apply to –

- a letting of residential property, or
- a letting between connected parties – the guide includes a full definition of who are connected parties.

A landlord can exercise an option to tax a letting or terminate an existing option to tax a letting at any time. Doing either has implications under the capital goods scheme – see below.

6. Capital goods scheme

6.1 The new rules introduce a Capital Goods Scheme (CGS). The CGS provides for the adjustment of VAT incurred on the acquisition, development or refurbishment costs or a property over the “VAT-life” of a property. The purchaser will be entitled to deduct the VAT when it is charged to the extent that a property is to be used for taxable purposes. The purpose of the CGS is to take account of changes in the use to which the property is put over its “VAT-life” and to ensure fairness and proportionality in the VAT system.

The “VAT-life” of a property is generally twenty years but the “VAT-life” of a refurbishment is ten years. The VAT deducted initially is adjusted annually over the “VAT-life” of the property.

The CGS does not have any impact in respect of properties that are used for the entire "VAT-life" for either fully taxable or fully exempt purposes.

6.2 CGS and supplies of property

The CGS has special rules that deal with the supply of properties during their "VAT-life".

It is important to note that the exempt supply of an "old" property during its "VAT-life" will mean a claw-back of some of the VAT deducted in respect of the acquisition or development costs of the property. This can be avoided by using the joint option to charge VAT on the supply. Similarly if VAT is charged on the supply of a property during its "VAT-life" (either because the property is considered "new" or because of an option to tax the supply of an "old" property), the seller will be entitled to deduct some of the VAT incurred on the acquisition or development costs that the seller was not previously entitled to deduct.

6.3 CGS and landlord's option to tax lettings

The exercising or terminating of a landlord's option to tax a letting during the "VAT-life" of a property has CGS implications. Where the option is exercised during the "VAT-life" of a property that had previously been subject to an exempt letting, the landlord is entitled to deduct some of the VAT incurred on the acquisition or development costs of the property that the landlord was not previously entitled to deduct. Where an option is terminated during the "VAT-life" of a property, there is a claw-back of some of the VAT that the landlord deducted on the acquisition or development costs of the property. Both of these adjustments arise at the time the option is exercised or terminated.

6.4 CGS record

The CGS applies to all new properties (developed) on or after 1 July 2008 or properties refurbished on or after 1 July 2008. For all such properties, a "capital good record" must be set up and maintained. This record should contain all of the information relating to the scheme including how much VAT was deducted on the acquisition or development and details of any adjustments under the scheme, etc.

7. Transitional rules – freeholds and leaseholds

Transitional rules apply to the supply of properties that were taxable under the old rules and which are supplied on or after 1 July 2008. The rules for such properties mirror the new rules above, i.e. the two and five-year rules apply. However, where the seller was not entitled to deduct any of the VAT incurred in relation to the property, the supply is not taxable but the seller and buyer may opt to apply VAT to the supply.

There are special rules that apply to certain leasehold interests, which are assigned or surrendered on or after 1 July 2008. These are leases for a period of 10 years or more, but not freehold equivalents. Under the old rules the VAT charged on the creation of these leases was based on the capitalised value of the lease. Where an assignment or surrender of such a leasehold interest occurs on or after 1 July 2008, it is subject to VAT, unless the person making the assignment or surrender was not entitled to deduct any of the VAT incurred in relation to the lease but in this latter case the parties may opt to apply VAT to the assignment or surrender. The taxable amount is calculated by reference to VAT charged on the creation or previous assignment of the lease and the number of years remaining in the "VAT-life" of the lease.

The CGS rules for dealing with changes in the use of a property during the "VAT-life" of the property do not apply to freehold or leasehold properties that are subject to the transitional arrangements. This means that no adjustment is required if the taxable use of a transitional property (or a transitional leasehold interest in property) changes from one year to the next[1]. However, where the sale of a transitional freehold occurs or the assignment or surrender of a transitional leasehold interest occurs, the CGS rules as outlined above apply. (Claw-back of some VAT if supply exempt, VAT credit if taxable and not entitled to full deductibility.)

8. Transitional rules - waiver of exemption

There are also rules to deal with transitional properties that were rented prior to 1 July 2008 where the landlord has a waiver of exemption in place. The existing waiver of exemption may continue in place for the majority of these properties on or after 1 July 2008. The waiver of exemption may also be cancelled under the old rules. There are

[1] The exception to this rule is if an exempt letting of a transitional property occurs after 1 July 2008.

special cancellation rules that apply in respect of waivers of exemption in the case of lettings between connected parties.

9. What to do now – checklist & further information

The Guide to VAT on Property sets out in detail the rules that apply to the various types of property transactions. Concern has been expressed that tax practitioners, accountants and solicitors need to review all of their clients' property portfolios before 1 July 2008 to ensure compliance with the new VAT on property rules.

In the vast majority of cases no action is needed in respect of existing properties. The key transactions that need to be reviewed are lettings between connected persons where the waiver of exemption has been exercised. In all other cases, action is only required where the transitional property is being disposed of or let. Care has to be taken in respect of the transactions that are currently being negotiated. If the transaction is completed before 1 July 2008 the old rules apply; if the transaction is completed on or after 1 July 2008 the new rules apply. The transitional rules generally apply to properties that were subject to the old rules prior to 1 July 2008 and are subsequently disposed of on or after 1 July 2008. The checklist below is to facilitate agents in the changeover to the new rules.

VAT on Property – Checklist for Agents

What have you to do for 1 July 2008?

1. For clients who own and occupy properties for the purpose of their business – generally nothing

2. For clients who have a leasehold interest that was taxed as a supply of goods under the old rules – generally nothing.

3. For clients who are landlords and charge VAT on their rents (as they have waived their exemption in respect of the letting of property) – check whether any of the lettings are to connected persons (See 5 below)

4. Where the lettings are to unconnected tenants or in the circumstances mentioned in 5 below, the old rules continue to apply to these lettings.

5. Where the lettings are to connected tenants -
   (a) If the tenant is entitled to deduct at least 90% of the VAT charged on the rents, (4) above applies;

   (b) If the tenant is **not** entitled to deduct at least 90% of the VAT charged then the waiver of exemption is cancelled under the old cancellation rules with effect from 1 July 2008. In such circumstances, in the July/August 2008 VAT return, the landlord must account for the claw-back of the excess of the VAT claimed in respect of property over the aggregate of the VAT paid on the rents to 30 June 2008;

   (c) **But** if the VAT payable on the rent over a twelve year period is greater than or equal to the VAT claimed on the initial acquisition or development of the property then (4) above applies;

   (d) **And** if the VAT on the rents does not meet the conditions set out at (c) the landlord can benefit from (4) if the VAT on the rent for the rest of the twelve-year period is increased to meet the condition at (c).

6. If a client is in the process of selling or entering into a lease agreement before 1 July 2008 the old rules will apply if the sale or lease is entered into before 1 July 2008. If negotiations are under way and the supply takes place on or after 1 July the new rules apply.

7. If a client has a property on hands at 1 July 2008 and the property is sold on or after 1 July 2008, it is subject to the new rules (2/5 year rule, etc).

8. If a client surrenders or assigns a leasehold interest on or after 1 July 2008 that was taxed as supply of goods under the old rules and the client was entitled to deduct any of the VAT then the assignment or surrender is subject to VAT on an amount based on a CGS calculation.