

The Property Column - Avoiding the VAT traps...

...on Buying and Selling Property

VAT is a European tax. VAT is ruthlessly logical. The trouble is, perfect logic doesn't necessarily mean that the system will be predictable or even comprehensible to anybody except the specialist.

So instead of trying to make sense of the system in all of its detail, let's look at one particular situation, to start off with, which is distressingly frequent in practice and which can scupper a property deal which is on the point of being concluded. Most of those who have been involved in the negotiations for the purchase of a commercial property will have at least a nodding acquaintance with this disaster scenario.

A Disaster Scenario

After many months of negotiations with the vendor and with the bank, you have at long last got to the point of instructing surveyors and lawyers to acquire a new office building for £1 million. The bank are lending 70% of this, that is £700,000, and you have managed to scrape together the £350,000 or so needed for the equity and the costs of purchase. Even in the current climate, the bank's valuer has grudgingly admitted that the property is worth £1 million.

Then, out of the blue, the day before that set for exchange of contracts, your solicitor rings you up to

break the news that the vendor is adding VAT to the purchase price. That is, a total of £1,175,000 will now need to be found in order to complete. With that fine, unworldly attitude towards money that so many solicitors exhibit, your lawyer tells you that you will have to put him in funds to the tune of an extra £175,000 in order to balance the books.

Tearing what remains of your hair after the painful months of negotiation for the purchase, you scream down the phone at your lawyer.

“How can they put VAT on top of the purchase price when they have told us nothing about it before?”

Your lawyer's calm voice comes over the telephone line in reply.

“It appears that the property is subject to an “option to tax”, and the consequence of this is that VAT at the standard rate has to be applied to any sale of the property.”

“But I haven't got an extra £175,000.”

“Then it would appear that we have certain problems.”

Of course, the problem here is purely one of cash flow, assuming that you, the purchaser, are a fully taxable business. In due course of time, if you purchase the property and pay the £1.175 million, HM Revenue & Customs will repay you the £175,000 VAT (no doubt after an in depth inspection) and you will be back in the position you would have been if you had simply had to pay £1 million for the property. But that

doesn't help now, because if you can't pay the full price including VAT the vendor won't be in a position to sign the contract in the first place.

Insult to Injury

To add insult to injury, the Stamp Duty Land Tax is calculated on the basis of the VAT inclusive cost, so effectively you are paying another 4% "tax on tax". Instead of the SDLT being £40,000 it becomes £47,000 because of the VAT being included.

It would of course be easy to draw the facile moral that all this comes about through insufficient planning. If you had known several months ago that VAT was going to be added, or if you had thought of the possibility of its being added, you might have been able to arrange temporary finance to bridge between that awkward moment when the VAT has to be paid and the date some months later when it is refunded by Customs. But, to be realistic, who has VAT as a major consideration when they are entering into this kind of transaction? There is so much else to think about, it's surely a venial sin not to give this irritating little tax first priority?

So is there anything that can be done at this late stage to save the purchase?

Funny you should ask that. There is.

The Escape Route

There is just one situation where a property whose vendor has opted to tax it can be sold to a purchaser

without VAT being added. This is where the sale comprises a “transfer of a business as a going concern”.

For reasons that actually relate to the wish of HM Customs and Excise not to be the ones to lose out when someone goes bust, there is a rule that says that the transfer of a business as a going concern is VAT free, because it is outside the scope of the tax. Because the activity of a landlord letting out commercial property is treated for VAT purposes as a “business”, then the sale from one landlord to a new landlord who will also be letting the property under an option to tax, comes within these provisions, so that VAT not only need not be added, but indeed must not be added.

In our disaster scenario described above, the greatest practical likelihood is that the vendor has the status of a landlord. It would be unusual, and indeed pointless, for a trader who was occupying a property for the purposes of his own trade to opt to tax the property. There would be no need to do so, because any VAT charged to him in respect of the property could be reclaimed under normal principles without opting to tax the property.

So, assuming that our vendor is a landlord, we have one half of the qualifying criteria met. One moment though. You, as the purchaser, were going to occupy the building yourself for the purposes of your trade. You are not purchasing it in order to let it out to tenants. So we need to think again.

Fortunately, the rules apply just as much if the landlord and tenant are closely connected. So all you have to do is make sure that the purchasing entity is different from the trading entity. It can, indeed, even be a company in the same group which you have formed for the purpose, so long as there is no group VAT registration in place.

Contrived it may be, but this situation brings our purchase within the transfer of going concern rules and this last minute, apparently fatal, problem has been sidestepped.

The Sub-Letting Trap

The last minute VAT charge isn't the only way you can come a cropper in property transactions, though. Whilst least frequent, the sub-letting trap can also prove exceedingly unpleasant.

Let's say you've purchased or constructed a property for use in your business. All of the VAT on the purchase or construction has been reclaimed, on the reasonable basis that you are going to be trading from the property, and your trade is a vatable one.

Later, perhaps some time later, it appears for whatever reason that you don't need the whole property for the business, so you decide to sub-let part of it. This is great, until a VAT inspector comes along perhaps a year or so later, and tells you that you are faced with a claw-back of some of the VAT you originally claimed. Why? Because the rent you have been charging the tenants is VAT exempt, and for properties which cost more than £250,000, getting an

exempt income within the first ten years of your ownership turns a proportion of the original VAT you have incurred into “exempt input tax”. This isn’t reclaimable and can therefore retrospectively be clawed back. Note the crazy but quite consistent logic here.

The remedy? If the VAT man has actually caught you with your trousers down after the event in this way, there really isn’t much you can do except pay up. But if you had thought about it at the time, the answer would have been to “opt to tax” the rents charged to the tenant. In this way you turn your exempt income into taxable income and there is no question of any input tax claw-back.

Opting to Tax by Default

There have been instances, strangely, of people accidentally opting to tax property. Through ignorance of the rules, they apply VAT on top of the rents of a property even though no formal option has actually been made and submitted to the VAT man.

With their delightfully “heads I win tails you lose” attitude, the tax authorities have been known to claim (successfully) that this is a de facto option to tax, which means that any sale of the property forever after will need to bear VAT. This, of course, is very bad news indeed if a prospective purchaser of the property is VAT exempt. It makes the property 17.5% more expensive for him, or, more likely, effectively comes out of your profit margin on sale.

If you're in the situation where VAT has simply been added to the rents charged on your property since time immemorial, one approach you could take, in an attempt to forestall this possible future problem, would be to apply to HM Revenue & Customs formally to ask whether an option to tax has been submitted. If they can find no option to tax, it might be worth trying simply leaving off charging VAT on the rents in future, and trusting to Time the Great Healer. After all, the law is that an option to tax is not effective unless it is properly notified to Customs. All you would be doing, arguably, would be correcting an anomaly in the charging of VAT when it should not have been charged. Nobody should, by rights, be enriched in the course of this process, and that includes HM Revenue & Customs themselves.

The Tax Juggernaut

More so than any other tax, in our view, VAT is like a great complex machine. You may not know how to operate it, but if you press that button and twiddle that knob you will set the machinery in motion, with possibly disastrous results. Better to read the manual before switching it on, or better still, find someone who knows how to work it!

Alan Pink FCA ATII is a specialist tax consultant for APT. Based at their Tunbridge Wells office, Alan advises on a wide range of tax issues and regularly writes for the professional press. Alan has experience in both major international plcs and small local businesses and is recognised for his proactive approach to taxation and solving tax problems. Please send an email to info@aptpartner.com if you would like to contact Alan.

The information contained in this article is for general guidance on matters of interest only. The application and impact of laws can vary widely based on the specific facts involved. As such, it should not be used as a substitute for consultation with professional accounting, tax, legal or other competent advisers. Before making any decision or taking any action, you should consult an APT professional. You can contact an APT consultant on (01892) 539000.