

# Importance of strong foundations

**Edd Thompson** sheds light on the VAT treatment of land and buildings.

**A** topic that many students taking the Association of Taxation Technicians paper 6 struggle with is VAT on land and buildings. This is not surprising, nor are these struggles confined to students. Land and buildings is an area in which more or less every tricky part of VAT has the potential to converge neatly – or not so neatly – at the same time. These big hitting VAT issues include, but are not limited to, VAT liability, partial exemption, the capital goods scheme and business or non-business considerations.

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It is impossible to cover all of these complexities in a single short article. Instead, I will focus on the liability of supplies related to land and buildings. This will include a walk through the implications of some classic liability scenarios which regularly crop up in the VAT and property world. The article does not discuss the domestic reverse charge for construction services which came into force from 1 March 2021.

The scenarios in this article are by no means exhaustive but they cover three extremely common situations:

- the construction and supply of a new dwelling;
- the conversion of a non-residential building to a residential building and its subsequent supply; and
- the renovation and supply of a purely commercial building.

## Key points

- Distinguish between works that go into constructing or converting a building and the onward supply of the property.
- Professional fees – such as architects and surveyors – will be standard rated.
- First grant of a major interest in a new dwelling is zero rated.
- Conversion works are usually subject to the reduced rate of VAT.
- Care needed over option to tax elections.



## ‘Works in’ versus ‘onward supply’

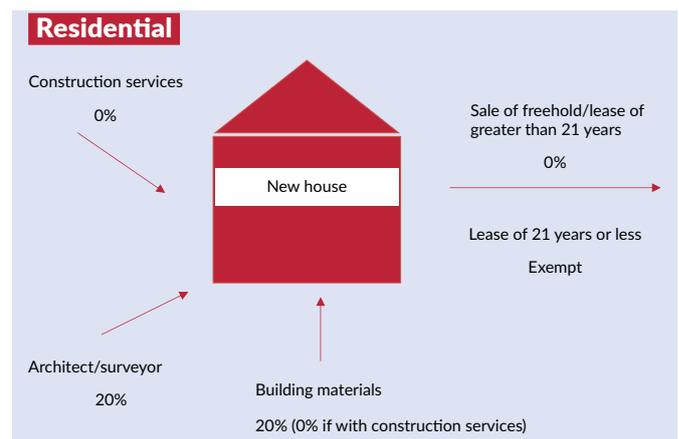
Before diving into the scenarios, one piece of advice I often give to students is to maintain a clear distinction between:

- the works that go into constructing, converting or renovating a building (the ‘works in’); and
- the ‘onward supply’ of the building itself – for example, is it rented, is a long lease granted, or is the freehold sold?

It is easy to confuse and conflate the treatment of these different kinds of supplies and this can lead to mistakes. In the scenarios below it is a distinction that I will keep returning to.

## The new house

The first scenario (see *Residential*) considers a new house which is being built entirely from scratch by a developer. Once built, the property will either be sold, leased on a long lease (say 99 years) or rented out on a short-term basis.



**Works in**

The scenario will normally be classed as the construction of a new dwelling for VAT purposes. If so, most construction services supplied to the developer on their own will qualify for the zero rate of VAT. On the other hand, building materials – goods – which are supplied separately will not attract zero rating at all so these will be standard rated. However, and importantly, if the building materials are supplied by the same contractor who supplies the construction services, both the goods and services will qualify for the zero rate. We have to be careful with ‘building materials’ as the law lists some items that are not included in the definition.

In this scenario, we are also likely to see some architects’ and surveyors’ fees. These services will normally be standard rated. However, we may be able to wrap them into a ‘design and build’ contract which HMRC should accept can be treated as part of a single zero-rated supply of construction services.

**Onward supply**

With the construction work considered, we can think about the liability implications associated with the various onward supply possibilities for the new house.

Both the sale of the freehold or the grant of a long lease, which according to the law is one of more than 21 years or at least 20 in Scotland, would be considered grants of ‘major interests’ in the property for VAT purposes. The first – note *only* the first – grant of a major interest in a new dwelling following its construction is zero rated. This is good news for the developer because while it is not required to charge VAT it can nonetheless recover any related VAT it has incurred. These

could include, for example, VAT on those architects’ fees above and any other VAT on related costs.

The story is slightly different if the developer instead rents out the new house on a short-term basis. Short-term rents are not a grant of a ‘major interest’. As a consequence, they will not qualify for zero rating and instead fall back on the less favourable treatment of exemption. While there is no VAT (or VAT at 0%) associated with exempt or zero-rated supplies, VAT on costs related to the exempt supplies cannot generally be recovered. This means that the VAT incurred on those architects’ fees, as well as any other costs attracting VAT, will be irrecoverable.

**The converted warehouse**

For the second scenario (see *Non-residential to residential*), consider an old commercial warehouse – a non-residential



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building – which is to be converted into flats – a residential property – by another developer. The warehouse is not being knocked down and the conversion is taking place within the existing structure. After it is complete, the flats (like the new house) may be sold, leased or rented on a short-term basis.

### Works in

This should be what is known as a ‘qualifying conversion’ for VAT purposes. In the context of qualifying conversion works, it is the reduced rate of VAT rather than zero rate that becomes relevant. The conversion services supplied on their own should qualify for the reduced rate – currently 5%. Building materials – goods – which are supplied separately will not attract the reduced rate. However, building materials supplied by the same person who is supplying the conversion services will be reduced rated. Architects’ and surveyors’ fees will be standard rated as before.

“The effect of the option is to turn the exempt supplies of the building into supplies that are taxable at the standard rate.”

A key thing to note here is that conversion works themselves will almost never be zero rated, with a limited exception for services supplied to housing associations.

### Onward supply

While the conversion works will not normally qualify for zero rating, the first grant of a major interest in the new flats after the conversion should. Therefore, either a long lease (more than 21 years) or the sale of the freehold immediately following the conversion will be zero rated.

However, if the new flats are rented out on a short-term basis the income generated will not qualify for zero rating. Instead, as for the house in the first scenario, the liability of the short-term lets will be exempt. Again, these exempt rents are likely to lead to an irrecoverable VAT cost, this time on the costs of conversion.

A key point to highlight in this scenario is the distinction between the treatment of the conversion works and the first grant of a major interest in the newly converted flats. Although the bulk of the conversion works will be reduced rated (‘works in’), the first grant of a major interest after the conversion will be zero rated (‘onward supply’).

### The renovated office

The final scenario considers the renovation of an existing office block or, indeed, other commercial premises by its owner. After the renovation, the office block may be sold, leased or rented out but it will remain commercial premises.

#### Planning point

Note that works converting a non-residential property to a residential one will rarely be zero rated unless they are for services supplied to housing associations.

### Works in

Typically, there will be no VAT relief available for renovation works on commercial property. In the absence of VAT relief, VAT will need to be accounted for at the standard rate.

### Onward supply

In many ways the onward supply of the commercial property is straightforward from a VAT perspective: whether the newly renovated commercial property is rented, leased or sold, the supply is likely to be exempt from VAT.

However, there are a couple of important caveats. The first concerns the age of the building. If the building was completed less than three years ago it is a ‘new commercial property’. The sale of the freehold in new commercial property is always standard rated. However, caution should be exercised here because this compulsory standard rating of new commercial property applies only to the sale of the freehold. The grant of a leasehold interest will remain exempt from VAT. This applies irrespective of the length of the lease. Do not get confused by thinking about major interests here – these are not relevant for these supplies of commercial property.

The second caveat relates to the option to tax. It is possible to apply an option to tax over the property. The effect of the option is to turn the exempt supplies of the building into supplies that are taxable at the standard rate. The option to tax will normally apply to all future supplies so VAT would need to be charged on rental income or the consideration for the grant of a lease or sale of the freehold. The advantage of applying an option is that it should entitle the owner to recover VAT on costs related to the building – for example, those standard-rated renovation costs above – but consideration will need to be given as to whether the tenant or purchaser will be able to recover VAT it would now be charged.

### Final thoughts

There is a lot to think about when looking at the liability of supplies related to land and property and it is easy to feel overwhelmed. However, by approaching scenarios logically and thinking about this distinction between the ‘works in’ and the ‘onward supply’ we can quickly start to tackle questions of liability. The scenarios in this article appear again and again albeit perhaps in slightly different guises or with minor variations. So, build the foundations of land and property strong, and the rest will follow. ●

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