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A couple of months ago, I met a property developer who was facing a serious VAT issue – one which is becoming increasingly common.

The issue relates to letting out newly developed residential properties.

In a number of cases, it is creating a sizeable and expensive pitfall for developers, both small and large.

Of course, in the case of large developers – some of whom have become ‘accidental’ landlords on a corporate scale – it also affects their investors. But the issue also affects small operators who have, say, converted former commercial high street premises into flats.

A common pitfall
My contact (let’s call him Jack for the purpose of this piece) runs a limited company and had completed a development of luxury apartments just as the recession took hold.

Prices fell, bank lending plummeted and buyers greatly diminished in number. After a while, and in the absence of any sensible offers, Jack urgently needed to generate some cash to service his loan from his increasingly anxious bank. He therefore considered renting out the units in short-term lets, hoping to bring in a vital income stream until the market picked up again.

By looking to rent out the new apartments, Jack put himself in a very awkward VAT position. He now faced the possibility of having to pay back some (or indeed all) of the VAT he had already recovered from Her Majesty’s Revenue & Customs (HMRC) during the course of the property’s development.

Suddenly there was a strong likelihood of a hefty VAT bill – one that would knock a big dent in the income he sought from letting out the units.

VAT on new property
Developers of new residential property normally expect to fully recover the VAT incurred on a number of costs associated with the development.

These costs typically fall into four categories:

• Legal fees
Some developers, unclear on the length of the recession, have abandoned the intention to sell altogether and switched completely to letting. In doing so, they have faced paying back the full VAT amount on their new build and subsequent sale of its units.

This zero rated sale also protects the VAT already recovered by the developer and prevents any requirement to repay some or all of it back to HMRC. The developer can then use the subsidiary to conduct the short-term letting and also the ultimate sale of the units when the market improves.

As both of these are VAT exempt activities, the subsidiary is not able to register for VAT and is not entitled to recover VAT incurred on any costs post acquisition.

Seek advice
The good news is that it is also a solution that HMRC do not appear to object to either. And, if setting up a subsidiary does not work in relation to your business set-up, your accountant should be able to recommend an alternative solution.

The key is to talk to them or a VAT specialist as soon as you think you need to rent out your newly developed properties. The more time you allow, the more chance you will have of securing the best solution given your current circumstances.

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