



THE LEADING MAGAZINE FOR LANDLORDS

January/February 2010 • £3.50

Residential Property Investor

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The VAT trap

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

Developers large and small face tax problems if they have been forced to let out a property they had intended to sell, says NANCY CRUICKSHANKS

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

- Materials, hire of plant and machinery
- Architects, surveyors and other similar professionals
- The land itself may also have been subject to VAT.

HMRC permits developers to recover the full VAT they have paid in each of these areas, but only if they sell their new properties and do not rent them out. If developers do opt to rent out their newly built units, they face having to pay back either the full value of the VAT or part of it.

Over the last 18 months, with the turbulent economy, many developers like Jack have considered short-term lets.

If they still intend to sell, they (or their accountants) can pursue a partial VAT disallowance.

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.

Typical implications

Naturally, each developer's situation is different – some will incur very little VAT on their development's costs and others will incur a lot. The mix of where those costs come from also varies. In the last 18 months, we have seen a number of developers fall into one of the following categories and with these implications:

- Those with very little VAT incurred on costs, who still intend to sell and have embarked on a short letting period. In this situation they may end up not having to pay back any VAT.
- Those with a lot of VAT incurred on costs, who still intend to sell but expect to have to let for quite a while. These developers may have to pay back a significant amount of VAT.
- Those with a lot of VAT incurred on costs who have abandoned the idea of selling. It is likely that these developers will have to pay back all of the VAT.
- Developers who have to pay back some VAT face complex calculations to work out how much they owe HMRC.

A word of warning here: these complex calculations have to continue every quarter while the letting activity continues and so can be quite an additional hassle. If you are faced with this situation, you should also note that these calculations need to be applied to your business as a whole. They cannot be calculated on a development by development basis.

Similar problems are also being faced by

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those developers who convert, say, an office building into flats and then need to let the units rather than sell.

In this case, their VAT bill could be higher because the construction costs will also attract VAT, although at the lower rate of 5%.

A glimmer of hope

There is, however, a solution for you to consider. It is one, however, that depends on each developer's individual circumstances, and so if in doubt, do talk to an accountant. For Jack, the solution was to sell his finished units to another new company set up by him.

This new company had to be a 100% subsidiary of his company that had developed the apartments.

By selling the properties to this subsidiary, developers can secure the zero VAT rating

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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.

