

November 2008

## VAT – adding to home builders' woes

The last ten years have been good for the house-building sector. High demand has been sustained by steady economic growth, cheap finance, and favourable demographic trends, while the Government has done its best to create a more benign planning regime. But the collapse of mortgage lending and the continuing downward spiral of house prices seen in recent months means much tougher times for the sector.

A subdued market, particularly in one and two bedroom flats, has left many developers with unsold properties. Falling prices and spiralling finance costs, in conjunction with rising rental yields, have tempted some to rent out unsold properties. While this can make good financial sense, it's important to recognise the VAT implications. Income from short-term residential lettings is VAT exempt – not zero-rated like new house sales - and this means that input VAT relating to rented properties may be clawed back by HMRC.

One option is to make a zero-rated transfer of properties to a related company before lettings begin, but this may have direct tax implications. Moreover, there may not be another company available. So many builders will prefer to leave rented properties where they are.

HMRC have always accepted, on the basis of the long-standing *Briararch* and *Curtis Henderson* decisions, that the developer is entitled to claim back a proportion of this VAT on rented properties where it is clear that it remained its intention to sell. But until recently there has been little clear guidance on how input tax should be split between recoverable and irrecoverable. Information Sheet 07/08, issued in September 2008, goes some way towards addressing this point.

The Information Sheet sets out an alternative basis to the standard partial exemption method to determine the amount of input tax to be attributable to VAT exempt lettings. This involves making a "one-off" adjustment using the following formula to determine the percentage of recoverable input tax:

$$\frac{\text{Final estimated resale value of property/development}}{\text{Final estimated resale value} + \text{estimated income from exempt premiums and lettings}}$$

The calculation can be adopted without prior agreement from HMRC, except where a partial exemption method is already in place, in which case HMRC must grant prior approval.

But while the Information Sheet solves some problems, it raises some new questions. Firstly, the calculation involves the use of estimates of future resale values and rental income. These are going to be difficult to perform objectively and accurately in the present economic climate. No guidance is provided on such practical issues as whether to discount future cash flows or what occupancy percentage to assume in calculating estimated rents from properties advertised for lettings. It is clear that whatever assumptions the house-builder uses in making his estimates, they should be clearly documented and supported by independent, verifiable evidence wherever possible.

Secondly, it involves using judgements about the house-builder's intentions, intentions which may not necessarily be backed up by contemporaneous documentary evidence, and which may therefore have to be inferred from whatever facts are available. It is important to bear in mind that input tax on let properties will only be recoverable if HMRC are persuaded that the developer never abandoned the intention to sell. If they believe this intention was abandoned, even if it is subsequently re-instated, HMRC will demand repayment of all underlying input tax. Care needs to be taken that stated intentions are supported by available facts.

HMRC are already making targeted visits to house-builders to check past compliance.

## Contact Information

For further information please contact one of our Property and Construction Sector specialists below.

Nick Parrett  
Partner and Head of Property & Construction Group  
T: 01689 827 505  
E: [nick.parrett@wilkinskennedy.com](mailto:nick.parrett@wilkinskennedy.com)

Steve Golder  
Senior Property Partner  
T: 020 7403 1877  
E: [steve.golder@wilkinskennedy.com](mailto:steve.golder@wilkinskennedy.com)

Tim Collerton  
Partner  
T: 01494 725 544  
E: [tim.collerton@wilkinskennedy.com](mailto:tim.collerton@wilkinskennedy.com)

Matthew Hall  
Partner and Head of Tax  
T: 01784 435 561  
E: [matthew.hall@wilkinskennedy.com](mailto:matthew.hall@wilkinskennedy.com)

Ian Jefferson  
Partner  
T: 01992 550 847  
E: [ian.jefferson@wilkinskennedy.com](mailto:ian.jefferson@wilkinskennedy.com)

William Payne  
Partner  
T: 020 7403 1877  
E: [william.payne@wilkinskennedy.com](mailto:william.payne@wilkinskennedy.com)

Ian Talbot  
Partner  
T: 01962 852 263  
E: [ian.talbot@wilkinskennedy.com](mailto:ian.talbot@wilkinskennedy.com)

James Selby  
Director of VAT  
T: 020 7403 1877  
E: [james.selby@wilkinskennedy.com](mailto:james.selby@wilkinskennedy.com)

**Visit our website [www.wilkinskennedy.com](http://www.wilkinskennedy.com)**

*This publication has been prepared for information purposes only. No responsibility for loss occasioned to any person acting or refraining from acting as a result of any material in this publication can be accepted by Wilkins Kennedy. Wilkins Kennedy is registered to carry on audit work and regulated for a range of investment business activities by the Institute of Chartered Accountants in England and Wales.*