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Practical VAT Newsletter

VAT Update

Farm diversification – VAT planning and pitfalls

In order for a farm enterprise to be commercial it is argued that there has to be diversification and some development of land and buildings. Many farmers are preparing for the proposed reduction in the farm subsidies over the next few years by applying for planning permission for alternative land and building use. The production of food is zero-rated for VAT purposes whilst one of the original farm diversifications – the letting of residential buildings – is an exempt supply.

This soon led to problems of partial exemption. Many farms have not been subject to a VAT inspection over the last decade and it is considered that a lot of misunderstandings and misconceptions concerning the partial exemption lie unexposed in the farm accounting records.

Currently "Leader" grants are available for diversification projects to help purchase equipment etc for a diversification project and again the claim for input VAT can be misunderstood.

One of the most complex decisions to have to take is should the landowner enter into an "option to tax" on land and buildings when undertaking building development?

The most common reason for a commercial property being subject to VAT is that the owner/landlord has chosen to charge VAT. This is done by waiving the VAT exemption, more commonly known as "opting to tax".

By charging VAT the landowner can also reclaim substantial input VAT.

There have been a number of changes to the rules governing the option to tax land and buildings. Changes came into force on 1 April and 1 May 2010 (see also Revenue & Customs Brief 08/10 and VAT information sheets 06/09, 02/10 and 08/10).VAT Information sheet 07/10, issued on 1 April 2010, was withdrawn on 8 April 2010 and replaced by a corrected version, numbered VAT Information Sheet 08/10. There are new prints of the following forms:

VAT 1614C	Revoking an option to tax within six months.
VAT 1614E	Notification of a real estate election.
VAT 1614F	New buildings – exclusion from an option to tax.
VAT 1614G	A certificate to display an option to tax on land sold to Housing Associations.

The regulations making the main changes have been published as *The Value Added Tax (Buildings and Land) Order 2010 (SI 2010/485)* and, together with the official Explanatory Memorandum, are posted at www.opsi.gov.uk/legislation and is well worth viewing.

HMRC's VAT information sheet 02/2010 gives details of two important changes to the option to tax. The first

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relates to the anti-avoidance provisions that 'disapply' the option to tax in certain cases where a financier becomes a tenant of a development or a purchased building. It is understood that this has unintended effects, particularly where shopping developments are concerned, where banks that provide finance for the development also, coincidentally, become tenants through their branches. The new rules, effective from 1 April 2010, allow a 10% de minimus test to apply to the area of a given building or shopping development to be occupied by such tenants without triggering the disapplicational rules. The same brief also provides details of a new interpretation to the 'cooling off period', which allows people, who have opted to tax, to apply to waive the option within six months of making the notification. The change relates to the assumed use of the building during that six-month review period.

"To opt or not to opt" is often a concern for the landowner and the ability to revoke an option to tax within six months can assist with the final decision making. The key to all projects is to plan the VAT position from the outset and this is often not the case – indeed the VAT planning is often a low priority consideration which can have an expensive outcome! Have VAT health checks been undertaken?

New VAT Registrations

Many diversification projects undertaken on a farm enterprise are dealt with through a separate legal entity. Some cynics might see such decisions as a form of VAT avoidance, i.e. they would fall foul of the rules of deliberate business splitting. However, many separate businesses are to, for example, allow other members of the farming family to have more involvement or perhaps to have the protection of, say, a limited company. There are new rules on VAT registration.

Notice 700/1 – Should I be registered for VAT? This now emphasises that a trader is liable to account for VAT on his sales from his date of registration, which may be before he receives his VAT number, and that where an application for exception or exemption from registration is refused, the trader will also be required to account for VAT from the date he became liable to be registered. (Exception applies where the trader can show that his taxable supplies, while exceeding the registration threshold in the last twelve months, will fall below the deregistration threshold for the next year; exemption applies where all or most of his supplies are zero-rated.) It is also noted that the special rules for businesses transferred as a going concern apply where the transferor was required to be registered for VAT, even if he was not in fact so registered.

Some of the business splitting and disposal can involve transfer of a going concern.

Transfer of a going concern with sitting tenants

Many farmers might choose to dispose of their commercial development with tenants.

In practice, many commercial properties are sold with sitting tenants. In this case the VAT rules concerned with Transfers of a Going Concern (TOGC) apply. These rules have become more complex over the years but in essence they allow a tenanted building to be transferred VAT-free if certain conditions are met. It is therefore possible, in certain circumstances to transfer tenanted commercial property between VAT registered businesses without charging VAT, as a Transfer of a Going Concern. If the building is opted, one of the main conditions is that the new owner must also have opted and that the option to tax must apply, ie it is not disapplied by the anti-avoidance rules.

Building construction – trying to achieve zero-rating

Land and property is a complex area for VAT purposes and there are many cases of individuals and businesses having found themselves in a position where they have either incurred a substantial VAT bill that was unexpected or that they realise too late that the VAT on a project could have been minimised or reclaimed.

A recent case of Lunn – *CRC v Lunn, Upper Tribunal (Tax and Chancery) 26 November 2009* – sadly showed a win for HMRC on the question of zero-rating not being allowed. What are the facts?

A new building was constructed within the curtilage of an existing building, both of which were owned by the taxpayer. Planning approval for the new building had been obtained subject to the following proviso: 'the development hereby permitted shall only be used for purposes either incidental or ancillary to the residential use of the property...' An issue arose as to whether the supplies of building services should be zero-rated according to VATA 1994, Sch 8 group 6 item 2. Item 2 applies to approved alterations to a protected building. Note 1 then stipulates that a protected building must remain as such and note 2 sets out various conditions, including at (2) (c) that separate use is not forbidden by any covenant or statutory planning.

HMRC said the supplies should not be zero-rated, but the VAT tribunal ruled that separate use in note (2) (c) meant distinct use. HMRC appealed saying that separate use meant a use that was separate from the main building. A use that was ancillary could never be separate.

The Upper Tribunal held that the separate use in note (2) (c) meant separate from. Thus the planning restriction meant that the building could not be used separately from the main building. Note (2) (c) was not satisfied and the building supplies should not be zero-rated. HMRC's appeal was allowed.

The question of new building development should always be carefully reviewed and restrictions placed on the development by the planners can influence the VAT treatment. Customs will look closely at the planning restriction and so must the VAT adviser.

Examples of when a zero-rated building is not constructed

Notice 708 Customs and Buildings and Construction says when zero-rated building are *not* constructed. Common examples of work you cannot zero-rate include the construction of:

- A 'granny' annexe which cannot be used, or disposed of, separately from a main house. This is because the conditions of 'a building designed as a dwelling' have not been met in full.
- A detached enclosed swimming pool in the grounds of a new house. This is because the building being constructed is not 'a building designed as a dwelling'.
- A detached building in the grounds of an existing care home which extends the facilities of the home. This is because the building being constructed will not be used for a relevant residential purpose in its own right and it was not constructed at the same time as the rest of the home.

More guidance is given from Notice 708:

You can zero-rate the enlargement of, or extension to, an existing building to the extent that the extension or enlargement contains an additional dwelling provided:

- The new dwelling is wholly within the enlargement or extension; and
- The dwelling is 'designed as a dwelling'

So, for example, a new eligible flat built on top of an existing building can be zero-rated.

If the new dwelling is partly or wholly contained within the existing building, you cannot zero-rate your work under the rules in this section. You may, however, be able to reduced-rate your charge as a 'changed number of dwellings conversion'. Also, the sale or long lease of the new dwelling may be able to be zero-rated as a converted non-residential building.

Purchase of commercial property

Many diversifying farmers might add to their portfolio of commercial property by purchasing more – perhaps the neighbour's commercial property they do not want to run. This can lead to an interesting VAT point.

VAT registered owners of commercial property, for example, may incur and recover VAT on the purchase of a property without planning in advance, but fail to consider issues such as increased Stamp Duty costs and the fact that if the property is sold on or leased without the owner opting to tax, this will be an exempt supply and some of the VAT on the original purchase could be lost. Indeed, where a property has been purchased for £250,000 or more plus VAT, the VAT incurred must be adjusted over a period of 10 years to take account of any change in taxable use.

Golden brick arrangements

The first grant of a major interest (broadly a freehold or a lease for more than 21 years) of a dwelling or building used solely or intended to be used solely for a relevant residential purpose is zero-rated. (*VATA 1994, Sch 8, Group 5, Item 1a*). This rule extends to a partly constructed residential building, provided that it is clearly under construction – that is, it has progressed beyond the foundation stage. Zero-rating also applies on the first grant of a major interest where the developer has converted a non-residential building into a residential one (*Group 5, Item 1b*). A developer can also zero-rate the first grant of a major interest in certain substantially reconstructed listed buildings that, after the reconstruction, are designed to remain as or become residential buildings (*Sch 8, Group 6, Item 1*). Certain restrictions apply, though: for example, a holiday home will not qualify for zero-rating.

Services supplied in the course of conversion of a non-residential building into a residential building are usually standard-rated. However, such services are zero-rated when supplied to a relevant housing association (*Group 5, Item 3*).

It is possible to zero-rate a sale of development land to a housing association, by using a golden brick arrangement: essentially compromising the sale of partly constructed residential building. This enables a developer to recover its input VAT whilst the housing association does not pay any VAT.

Sports Clubs – including shooting syndicates as members clubs

Moving away from property development as a diversification project let's look at another fundamental form of diversification shooting.

The supply of shooting rights are VAT standard rated, however where these are supplied to a non profit making shooting syndicate where the true beneficiaries are individuals taking part in the sport they can be an exempt supply.

Group 10 of *Schedule 9* to the *Value Added Tax Act 1994* exempts: 'The supply by an eligible body to an individual…of services closely linked with and essential to sport or physical education in which the individual is taking part.' An 'eligible body' is essentially a non-profit-making organisation 'which is not subject to commercial influence' (see VAT Notice 701/45/02 Sport).

Prior to this HMRC has held that this provision may be used to exempt affiliation fees paid by sports clubs to sports governing bodies provided they are charged on a per capita basis (on the basis that the club is then paying the fee as proxy for individual members). However, in *Canterbury Hockey Club* the European Court of Justice held that supplies to companies and unincorporated associations are eligible for exemption, providing the true beneficiaries are individuals taking part in sport. Accordingly, subject to the other rules, affiliation fees are VAT-exempt, irrespective of how they are calculated. Furthermore, some other supplies by eligible bodies to sports clubs (for example, letting sports facilities for the use of club members) will also now be exempt. Then the letting of shooting rights will be exempt.

Qualifying supplies must be treated as exempt from 1 September 2010 and may be so treated earlier if the supplier so wishes. Subject to the usual conditions, repayment claims for prior periods may be competent. Further details are given in *Revenue & Customs Brief 15/10 VAT – Changes to the treatment of certain sports-related services*.

The sports club must be genuine. It is considered that many interested parties might try to make an artificial non profit making organisation which is not subject to commercial influence.

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Conclusion

Many farming landowners are diversifying at an alarming rate with a large portfolio of properties being let out. The VAT considerations are often ignored or not given the full attention they deserve. It is hoped that this article provides a flavour of not just the complexity but the opportunity to minimise the VAT penalty. With the increase of VAT to 20% from January 2011 this will become even more critical

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