The default position for the supply of land and property is exemption (VATA 1994 Sch 9 Group 1 Item 1). Although no VAT is charged to the customer, the disadvantage of the default exemption is that input VAT on related costs cannot be recovered.

However, there are various exceptions to exemption. These exceptions can be valuable for businesses which are desirous of recovering their input VAT.

Developer grants lease in new property: zero-rating example
The ideal VAT position for any supplier is zero-rating. The supplier is permitted to recover VAT on related costs and is not required to charge VAT to its customers. Its profits are maximised, and its market is not limited to particular business customers that can fully recover any VAT charged to them.

However, only certain supplies of certain properties qualify for zero-rating (VATA 1994 Sch 8 Groups 5 and 6).

A key requirement for zero-rating is that the supply of the house is the first grant of a major interest. Although this often means the freehold sale of a new building, our developer is granting a lease. To qualify as a major interest, the lease must be a long lease which in the UK (except for Scotland, which has slightly different rules) is interpreted as meaning a lease exceeding 21 years.

Once it is clear that the lease will qualify as the first grant of a major interest in the property, the developer needs to determine whether the property itself also qualifies. There are a number of difficulties here.

Much of the focus for zero-rating is on the use to which the property is designed. There are three relevant categories, as follows:

- designed as one or more dwellings;
- designed solely for relevant residential purposes; and
- designed solely for relevant charitable purposes.

There are a number of technical definitions for each of these terms, which the property must meet if the developer is to zero-rate its long lease. In general terms, a relevant residential purpose refers to certain types of home (e.g. student accommodation, hospice, care home, monastery, etc), whereas a relevant charitable purpose refers to non-business or community use by a charity (e.g. a place of worship, a village hall, school buildings, etc).

At this stage in the VAT analysis, we must beware of a pitfall. Not all the above categories will be relevant in determining whether a property qualifies for zero-rating. A difference arises depending on whether the developer constructed the new building from ground level, or whether it was the result of a conversion.

Had it been a qualifying conversion, only the first two categories would have been relevant; and even then, the new building would have to have been converted from a non-residential building.

However, if the developer had constructed a completely new building from ground level, all three categories are relevant.

Let us say, for the purposes of this example, that the developer had constructed the new property from ground level and confirms that the house will not be used for relevant residential or relevant charitable purposes, but will be inhabited by several families. Can we now assert that the developer is granting a qualifying lease in a qualifying building? This would be premature, as it would ignore the four criteria in the legislation (VATA 1994 Sch 8 Group 5 Note 2), all of which must be satisfied before the building qualifies as a dwelling. These are:

- the dwelling consists of self-contained living accommodation;
- there is no provision for direct internal access from the dwelling to any other dwelling or part of a dwelling;
- the separate use or disposal of the dwelling is not prohibited by the term of any covenant, statutory planning consent or similar provision; and
- statutory planning consent has been granted in respect of the dwelling, and its construction or conversion has been carried out in accordance with that consent.
These criteria might seem innocuous at first glance. However, there are several common pitfalls.

For instance, there is an increasing tendency amongst developers to construct apartments which are not self-contained (e.g. with a shared kitchen or shared bathroom). Such a property would not satisfy the first criterion and supplies of such properties could not qualify for zero-rating.

Another pitfall arises where planning consent contains restrictions. If these restrictions amount to a prohibition either on the separate use or on the separate disposal of the property, then that property would fail the third criterion. The supply of such a property could not qualify for zero-rating.

Many developers are able to meet all the above requirements to zero-rate their supplies. However, if a developer does not qualify for zero-rating on the above criteria, a planning point worth considering is whether the building is protected (e.g. a listed building). If it is, there is a possibility of zero-rating the first grant of a major interest (e.g. a listed building). If it is, there is a possibility of zero-rating the first grant of a major interest in the protected building. The key will lie in whether or not the protected building has been ‘substantially reconstructed’. This term is not very precise, but the protected building is likely to qualify if it was gutted before reconstruction, so that only the shell of the external walls remained.

**Company sells freehold of new office block: standard-rating example**

Although zero-rating is an ideal VAT position for a supplier, standard-rating can still be more valuable than exemption. Consider the following example calculations, comparing a company’s sale of an office block under the exemption with the same sale under the standard rate:

**Calculation 1: exempt supply**

Sale proceeds: £1.1m gross (no VAT)

Purchases: £1m net, £200k VAT, £1.2m gross

Result: £100k loss

*Note: the VAT on purchases cannot be recovered, as the related sale is exempt. The result is therefore the sale proceeds (£1.1m), less the gross purchases (£1.2m), and the project is not viable.*

**Calculation 2: standard-rated supply**

Sale proceeds: £1.1m net, £220k VAT, £1.32m gross

Purchases: £1m net, £200k VAT, £1.2m gross

Result: £100k profit

*Note: the VAT on purchases is recoverable, as the related sale is taxable. The result is therefore the net sale proceeds (£1.1m), less the net purchases (£1m), and the project is viable.*

In the above calculations, the project will be viable if the company’s sale of its commercial property is standard-rated, but will be loss-making if the company’s sale is exempt. Determining the correct rate of VAT on disposal could prove decisive at the planning stage of the company’s project.

At this point, it is worth noting that the price paid by the purchaser will be higher (in absolute terms) when the disposal is standard-rated. However, the comparison is a fair one: tenants of commercial properties tend to be VAT-registered businesses which can recover the VAT charged to them. Such purchasers’ profits would be unaffected by the additional VAT charged by the vendor company. Having said that, vendors should be aware that charging VAT on the sale of a property will not appeal to those sections of the market which are unable to recover the VAT charged (e.g. exempt businesses such as banks, insurers, financial advisers, or unregistered small businesses).

In this example, the company had purchased a new office block two years ago, but now intends to sell it. Will the sale be standard-rated or exempt? The key point here is that all supplies of ‘new’ commercial properties are subject to VAT at the standard rate. ‘New’ includes properties which are three years old from the date of their completion.

The company therefore needs to consider when the property was completed. Being only two years old, the commercial property still qualifies as ‘new’. This is good news for the company, whose VAT on expenditure will be recoverable as its re-sale will be a taxable supply.

A pitfall to note is that the three year rule applies not only to traditional commercial properties, such as office blocks, but to all new properties which do not fall within the three categories set out in the zero-rating example above (see HMRC Notice 742, Section 3.2). For example, if all the apartments in a new residential block share facilities, the sale of those apartments would be standard-rated; and as the purchasers would be private individuals, there would be no prospect of recovering the VAT charged.

A planning point to bear in mind is that the grant of a lease (rather than the sale of a freehold) in the new apartment block would be exempt, no matter how long the term.

**Business sells freehold of old office block: standard-rating example**

The first standard-rating example above might seem rather limited, since it only applies to commercial buildings that are less than three years old. For example, the business which purchased the two year old office block in that example would be unable to recover all the VAT charged to it if it sold the office block two years later: the office block would be more than three years old, and the sale would fall under the default exemption.

However, the business can avoid this issue if it opts to tax in accordance with VATA 1994 Sch 10. In effect, the purchaser decides that all its future...
supplies of the office block will be subject to VAT at the standard rate, rather than being exempt. As we saw in the two example calculations, this can be very valuable to a business.

The purchaser's decision to opt to tax must be notified to HMRC within 30 days for it to take effect and an acknowledgement letter will be received from HMRC. The option to tax normally remains valid until revoked. As a revocation can only be made after 20 years, it is advisable that the acknowledgement from HMRC be kept on file for future reference and should not be destroyed.

Again, there are pitfalls to take into account. In particular, the option to tax does not convert all exempt supplies of property into taxable supplies.

The business should check whether there are any residential penthouses or other dwellings in the building. The option to tax has no effect on the supplies of such properties, which remain within the default exemption. As a result, the business might be required to make partial exemption calculations and capital goods scheme adjustments in its VAT returns.

A similar issue arises if the business is supplying the property (or any part of it) to a charity, which certifies its intention to use it solely for a relevant charitable purpose (other than as an office). The option to tax is disapplied and ceases to have effect in respect of the supply to the charity. The supply to the charity would be within the default exemption, with similar consequences for the business.

**Transfer of going concern: outside the scope example**

Perhaps the next best VAT position after zero-rating is for a transaction to fall outside the scope. No VAT is chargeable on a transaction which falls outside the scope of VAT, and input VAT is deductible as per the underlying business.

Consider a company which rents a public house to an operator and lets to tenants several residential apartments above the public house. The company has notified its option to tax to HMRC and charges VAT at the standard rate to the operator. Its option to tax has no effect on the lets to tenants in the residential apartments.

When that company decides to sell the whole building to another company, the vendor will be required to charge VAT on the supply of the public house and its supply of the apartments will be exempt. SDLT will be applied to the VAT-inclusive price of the public house.

However, the vendor's supply of its tenanted properties to a new company might qualify as a transfer of a business as a going concern (TOGC). This would make the transaction fall outside the scope of VAT, resulting in cashflow advantages and an absolute saving of the SDLT applied to the VAT element of the sale.

Importantly, this is not a choice, but applies automatically if the conditions are all fulfilled. Below is a ‘headline’ summary of HMRC’s criteria for TOGCs:

- the business test;
- the going concern test;
- the purchaser’s VAT registration rules;
- the continuity test: ‘same kind of business’;
- the continuity test: ‘no significant break in trading’;
- the condition of no consecutive transfers of business; and
- the special rules for transferring part of a business.

There are special anti-avoidance rules for transfers involving real estate, which are likely to apply in this case as the new company will be making exempt supplies (i.e. residential lets). If the vendor receives confirmation from the purchaser that it has opted to tax the properties and that this option to tax will not be disapplied (the rules for which are complex), the property can be transferred as part of the TOGC and will fall outside the scope of VAT; otherwise, the property will be transferred outside the TOGC and VAT (along with additional SDLT) will be chargeable at the standard rate on the sale of the public house.

**Conclusion**

It is not easy to write a ‘basic’ VAT article where property transactions are concerned. There are a great number of exceptions to the default exemption. Whilst these can be very valuable to businesses in certain circumstances, it is important to understand exactly how to structure a transaction to secure the best VAT outcome for the parties involved.