

### BACKGROUND

This paper sets out the VAT implications for Generic Homes Limited (GHL) of a decision to temporarily let newly constructed dwellings before selling them.

### EXECUTIVE SUMMARY

- The main issue arising from a decision to (temporarily) let dwellings before selling them is that the housebuilder (GHL) becomes 'partly exempt' for VAT purposes and this can affect the amount of VAT GHL can recover on its costs;
- HMRC have introduced several measures announced that, if acted upon, could minimize the amount of input VAT to be disallowed by virtue of becoming partly exempt;
- Those measures have included:
  - A 'simple check for de minimis'; and,
  - various options for calculating the amount of any input VAT restriction;
- There is a VAT planning arrangement involving the granting of a zero-rated 'major interest' (sale or 'long' lease (a lease in excess of 21 years) in properties to a connected person in order to secure input tax recovery;
- In certain circumstances, this is a 'disclosable' or 'notifiable' scheme which would mean HMRC must be notified of the arrangements put in place;
- However, HMRC have been asked whether the scheme would be regarded as 'abusive' and, in most cases, they would not. Full details of their response contained in Revenue and Customs Brief 54/08.

Indeed, all of the above issues are explained in detail below.

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### DETAILED ANALYSIS

The key issue arising is that by (temporarily) letting dwellings before selling them, GHLL become 'partly exempt' for VAT purposes and this can affect the amount of VAT GHLL can recover on its costs.

Ordinarily, a housebuilder will sell the properties it constructs. From a VAT perspective, the first grant of a 'major interest' (freehold sale or a long lease of over 21 years (at least 20 years in Scotland)) of a new dwelling is zero rated. This allows the house builder to recover all the input tax they have incurred in connection with the development (subject to the normal rules about blocked input tax on white goods and carpets etc) and to sell the property without adding VAT. These sales qualify for zero-rating for VAT purposes which means that (subject to the blocking order), all (input) VAT incurred on related expenditure is recoverable. This means that the business is 'fully taxable'.

In the current economic climate, many house builders have found that they are unable to sell new dwellings. For most, this leaves them with the choice of leaving them empty until they find a buyer, or renting them out in the short term while they wait for the housing market to recover in order to sell them.

However, letting on a short term basis ('short term' for VAT purposes meaning any leasehold interest of 21 years or less) those properties which cannot be sold is exempt from VAT. Input VAT incurred on expenditure related to exempt income cannot be reclaimed, unless it below certain levels. These levels are known as the partial exemption 'de minimis' limits.

The de minimis limits are:

- (i) £7,500 per annum (which equates to £625 per month and £1,875 per quarter); and,
- (ii) 50% of the total input tax incurred.

### HMRC GUIDANCE

Following the downturn in the property market, HMRC issued 'Revenue & Customs Brief 44/08' and 'Information Sheet 07/08' (both published on 15 September 2008, information sheet reproduced in full below for ease of reference) which provided guidance for house builders renting out new dwellings on short term lets while retaining the intention to sell a major interest in the dwellings when the markets recovered.

As those documents explained, short term lets of this kind can sometimes give rise to adjustments of input tax previously recovered. Adjustments are necessary if the amount of input VAT deemed to relate to the exempt lettings made exceed the above 'de minimis' limits.

In the above documents, HMRC announced the introduction of the concept of a "simple check for de minimis" and it is recommended in all cases that this simple check should be carried out.

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In the event that GHL fails the “simple check for de minimis” then GHL would be required to carry out a ‘proper’ partial exemption calculation which is likely to lead to an adjustment to the VAT previously recovered on VAT returns submitted, as well as a restriction to the VAT to be recovered on current and future VAT returns.

As the monetary de minimis figure is a limit as opposed to an allowance, exceeding this figure - perhaps GHL’s ‘exempt input VAT’ totals £8,000 per annum - would mean that the total VAT repayable (on past input VAT incurred under a ‘clawback adjustment’ (as described in the attached Information Sheet) and future input VAT on construction costs) would be £40,000 in the event that current market conditions prevailed for the next five years.

### VAT PLANNING ARRANGEMENT

There is a way in which GHL could protect itself against this potential VAT cost. In conjunction with protecting itself against substantial future VAT costs, this arrangement would also ensure that GHL would not be required to consider ‘partial exemption’ as an issue going forward, reducing a not-inconsiderable administrative burden.

#### *GRANTS OF MAJOR INTERESTS TO CONNECTED PERSONS*

We discussed the planning arrangement in broad outline. Essentially, under this arrangement, GHL as developer would sell the freehold (or long leasehold) interests in the newly constructed properties to another entity - an existing company – Gable Homes (Lettings) Limited or Gable Homes (Investments) Limited or ‘NewCo’, which could be a 100% owned subsidiary of GHL. This would crystallise a zero-rated supply by GHL which would ensure that the input VAT incurred on the build costs is recoverable in full.

NewCo, having incurred no VAT on the purchase of the properties, would then let them on a short term basis (making exempt supplies). In this way, there is no loss of input VAT (by GHL) which is able to derive some income from the properties in the interim, prior to the (hoped for) upturn in the market. Any VAT on costs suffered by NewCo (which is not required and/or able to register for VAT) will be irrecoverable, unless it undertakes other activities which would be taxable. Such VAT is, however, likely to be minimal.

### HMRC VIEW OF STRUCTURE

Following the downturn in the property market, the Commissioners of HMRC were asked whether the granting of a zero-rated major interest in a property to a connected person in order to secure input tax recovery would be regarded as 'abusive'. Their response contained in Revenue and Customs Brief 54/08 dated 29 October 2008, is set out below:

- “1. This brief is for house builders who have built or are building new dwellings with the intention, when they are completed, of selling either the freehold interest or a long lease of over 21 years (at least 20 years in Scotland) in each of the properties.
2. Several such house builders have sought guidance on whether HM Revenue & Customs (HMRC) considers certain transactions involving the supply of new dwellings to be abusive. This brief identifies those situations that HMRC considers not to be abusive.

### BACKGROUND

3. The first grant of a major interest (freehold sale or a long lease of over 21 years (at least 20 years in Scotland)) of a new dwelling is zero rated. This allows the house builder to recover all the input tax they have incurred in connection with the development (subject to the normal rules about blocked input tax) and to sell the dwelling without adding VAT.
4. In the current economic climate, many house builders have found that they are unable to sell new dwellings. For most, this leaves them with the choice of leaving them empty until they find a buyer, or renting them out in the short term while they wait for the housing market to recover in order to sell them.
5. Revenue & Customs Brief 44/08 and Information Sheet 07/08 (both published on 15 September 2008) provide guidance for house builders renting out new dwellings on short term lets while retaining the intention to sell a major interest in the dwellings when the markets recover. As those documents explain, short term lets of this kind can sometimes give rise to adjustments of input tax previously recovered.

### APPROACH MADE

6. HMRC have been asked about the possibility that house builders might, in advance of any short term lets, make the first grant of a major interest in the completed dwellings to a connected person, who would not be a member of a VAT group with the house builder. This zero-rated sale might remove the need for the kind of adjustments explained in Information Sheet 07/08. The suggestion put to HMRC is that the connected person would then rent out the properties until such a time as they could be sold. The rentals would be exempt and not give rise to input tax deduction on ongoing costs including the costs of the eventual sale (for example estate agency and legal costs). However, deduction of the VAT associated with the original construction would have been secured. We have been asked whether we would see this arrangement as abusive from a VAT point of view. This brief does not attempt to address any other tax consequences that might flow from such transactions or any commercial or legal issues.

### IS THIS INTENDED STRUCTURE ABUSIVE?

7. For a scheme to be abusive, it must (as well as having the essential aim of saving VAT) produce a result contrary to the purpose of the VAT legislation. HMRC believe that Parliament intended that the construction of new dwellings should be relieved from VAT. The first grant mechanism introduced by Parliament does achieve this but it relies on the assumption that there will always be a grant of a major interest around the time the dwelling is complete, so ensuring deduction of VAT on all appropriate costs.

8. In HMRC's view, the arrangement set out in paragraph 6 above does not produce a result contrary to the purpose of the legislation, but rather ensures that a transaction of the kind Parliament envisaged will actually take place at the appropriate time. That view rests on the assumption that the purpose of the zero rating provisions associated with new dwellings is to relieve fully from VAT the provision of precisely that – new dwellings. That means that all the costs (save on blocked goods such as washing machines, carpets etc – see Section 13 of Notice 708 Buildings and Construction for more details) associated with producing a new house should either not carry VAT, or carry VAT that is deductible in full.

9. However, whilst we believe it is the policy objective that new dwellings should be zero rated, that does not extend to other goods or services that might be packaged up with the supply of a dwelling. HMRC consider it abusive when a major interest is granted with an essential aim of deducting VAT on costs such as repair, maintenance and refurbishment of dwellings (other than for remedying defects in the original construction) the relief of those kinds of costs not falling within the policy objective as we see it. These types of arrangements are likely to be challenged.

### SUMMARY

10. In short, HMRC agree that the arrangement outlined in paragraph 6 above is one that they would not see as abusive and so would not seek to challenge. However, if the VAT deducted goes beyond the VAT that would normally be deducted in relation to the supply of the new dwelling (for example VAT on costs such as repairs, maintenance or refurbishment, which is not normally deductible) such arrangements are likely to be challenged as abusive.”

Given that the arrangement envisaged would not contain any aspects which, using the criteria set out in the above Brief, HMRC would see as ‘abusive’ then, it would seem clear that GHJ could proceed with establishing a new subsidiary company which would be used to ‘ring fence’ the activity of property letting. This said, in certain circumstances, the above arrangement is seen by HMRC as a VAT ‘avoidance scheme’ which requires disclosure.

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### DISCLOSURE OF AVOIDANCE SCHEMES

#### INTRODUCTION

Since 2004, businesses which use VAT 'avoidance schemes' are required to disclose such schemes to the Commissioners. For some time, HMRC have published the total number of disclosures which have been made in the previous six months.

The legislation relating to avoidance schemes is complex. For completeness and, as a matter of record, I have set out below the various steps involved in determining whether or not GHIL will be required to disclose the use of the above arrangement to HMRC.

The relevant legal provisions make use of the terms "designated scheme", "designated provision", "notifiable scheme", ' and "tax advantage". These are defined below:

Firstly, it is important to note that the arrangement being contemplated by GHIL contains a 'designated provision' which means that it involves a 'property transactions between connected persons'.

A "notifiable scheme" is a scheme which includes, or is associated with, a designated provision and has as its main purpose, or one of its main purposes, the obtaining of a tax advantage.

A "tax advantage" is obtained, inter alia, where a VAT credit is obtained by a taxable person when it would not otherwise have been. The GHIL arrangement would meet this criteria, given the zero-rate relief available under the scheme compared to exemption from VAT without it.

In principle, there is a requirement to notify the Commissioners if the amount of VAT shown on a return for a period as payable by or to him is less than or greater than it would be but for any notifiable scheme to which he is a party.

However, there is an exemption from notification where the following conditions are met—

- (a) the total VAT-exclusive value of supplies (taxable and exempt) in the 12-month period ending immediately before the period in which the notifiable scheme has effect is less than £600,000 (in relation to a designated scheme) or £10,000,000 (in relation to any other notifiable scheme);
- (b) the total VAT-exclusive value of supplies (taxable and exempt) in the prescribed accounting period ending immediately before the period in which the notifiable scheme has effect is less than the appropriate proportion of £600,000 (in relation to a designated scheme) or £10,000,000 (in relation to any other notifiable scheme).

### CONCLUSION

Whilst HMRC retain the power to exclude from exemption and there are penalties for failing to notify use of a notifiable scheme, we conclude that GHL do not have any requirement to disclose the current arrangement as we assume that the above value for 'any other notifiable scheme' will not be exceeded.

### STAMP DUTY LAND TAX (SDLT) AND DIRECT TAX ISSUES

It would be necessary to ensure that the transfer of the properties to NewCo would be carried out within an SDLT group so that it would be disregarded for SDLT purposes and no liability would arise in NewCo.

In terms of the direct tax position, whilst advice on the details should be obtained in due course, in broad outline, there should not be any insurmountable difficulties.

The headline direct tax issues to be addressed for most housebuilders are almost certainly to be:

- (i) Would group relief be available on transfer to NewCo of:
  - a. A leasehold interest in the unsold units – perhaps of 25 years, perhaps of 125 years?; or,
  - b. The freehold interests in the above?; and,
- (ii) Would the grant of, in the example above, a 125 year lease have to be made at somewhere near to open market value (of a sale)?

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### HMRC INFORMATION SHEET 7/08, SEPTEMBER 2008

#### 1 INTRODUCTION

Who should read this information sheet?

This information sheet will be of interest to house builders and their advisers.

#### WHAT IS THIS INFORMATION SHEET ABOUT?

This information sheet sets out HM Revenue & Customs (HMRC) policy on the VAT implications when house builders decide to temporarily let their dwellings before selling them. Key points to note are:

- If you temporarily let a dwelling before selling it then you may affect the VAT you can recover on your costs.
- Many house builders who temporarily let a dwelling will not be affected but you need to check this to avoid making VAT mistakes.
- There is an easy way to check if you are affected by applying what we describe here as a “simple check for de minimis”.
- If you fail the “simple check for de minimis” then you may have to:
  - adjust the VAT previously recovered on your submitted VAT returns
  - restrict the VAT to be recovered on your current and future VAT returns
  - both adjust your past VAT recovery and restrict your future VAT recovery
- If you need to adjust VAT previously recovered, then exceptionally and if you prefer, you may be able to do this without contacting HMRC.

#### WHY HAS THIS INFORMATION SHEET BEEN ISSUED?

This information sheet is in response to recent enquiries from the house building sector and takes account of the High Court decision in the joined cases of Curtis Henderson and Briararch [1992] STC 732 which arose in the early 1990's. This Information Sheet uses a number of specialist terms that are summarised in an Annex attached to this Sheet and which are fully explained in Public Notice 706 “Partial Exemption” (Part V8).

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### 2 HOUSE BUILDERS AND PARTIAL EXEMPTION

#### *WHEN IS A HOUSE BUILDER AFFECTED BY PARTIAL EXEMPTION?*

A house builder, like any other business, becomes partly exempt when he incurs VAT on costs (called input tax) that he “uses or intends to use” for making both taxable and exempt supplies. A partly exempt business must apply a partial exemption method (calculation) to determine how much input tax he can recover.

Many house builders are fully taxable businesses that can recover all of their input tax because for VAT purposes, the sale or first grant of a major interest in a dwelling is a taxable supply. However, the letting of a dwelling is an exempt supply and input tax on related costs might not be recoverable.

#### *WHAT HAPPENS WHEN A HOUSE BUILDER BECOME PARTLY EXEMPT?*

Due to the current slowdown in the residential property market some house builders are deferring their intended sales of dwellings and temporarily letting instead, and so becoming partly exempt. A partly exempt house builder might have to:

- adjust the VAT previously recovered on his submitted VAT returns
- restrict the VAT to be recovered on current and future VAT returns
- both adjust VAT previously recovered and restrict current and future VAT recovery

For many house builders the amount of “exempt input tax” related to their temporarily lets is small (known as de minimis) and as a result they can continue to recover all of their input tax; but they must check to avoid VAT mistakes.

#### *HOW DOES A HOUSE BUILDER KNOW IF HE CAN TREAT INPUT TAX INCURRED IN PAST YEARS AS DE MINIMIS?*

Like any business, a house builder checks for de minimis by applying his partial exemption method. Large builders may already be partly exempt and familiar with operating a partial exemption method, but smaller ones may not. Exceptionally, HMRC will allow a builder that does not currently operate a partial exemption method, to adopt instead a “simple check for de minimis”. This simple check is based on the expected time period he will let his building as a proportion of the economic life of that building, which for VAT purposes is ten years. His exempt input tax is determined by applying the proportion to his total input tax. Provided his exempt input tax does not exceed £625 per month on average (up to £7,500 per year), and is not more than half of his total input tax, then his exempt input tax is de minimis and he can recover it in full. Do remember that the “de minimis” test applies to the total input tax incurred including for example any input tax on general overheads such as bookkeeping costs.

#### *EXAMPLE: SIMPLE CHECK FOR DE MINIMIS*

A fully taxable house builder recovered £20,000 input tax on a house that he expected to sell for £300,000. After the end of the tax year he decides to defer the sale by letting for two years and so becomes partly exempt. A simple check for de minimis is:

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£20,000 input tax  
x 2 year lease/10 year economic life = £4,000 exempt input tax

The £4,000 of exempt input tax is de minimis because over the tax year it does not exceed £7,500 or 50 per cent of his total input tax. The builder has no need to adjust the VAT previously recovered on his VAT returns. If the input tax was incurred over more than one tax year, the de minimis test should be applied to the input tax incurred in each of the tax years separately.

How does a house builder know if he will be de minimis in future?

If a house builder who was previously fully taxable continues to incur exempt input tax in future then he will need to apply a partial exemption method to determine if he remains de minimis. He can either apply the standard method or he can seek HMRC approval to apply a special method tailored to his circumstances. See Annex for more details.

### 3 ADJUSTING PREVIOUSLY RECOVERED INPUT TAX

#### *INTRODUCTION TO INPUT TAX ADJUSTMENTS*

When a business changes its plans for making a taxable supply, by forming a new intention to make an exempt supply and then a taxable supply sometime later, it may have to reduce the amount of input tax that it had originally recovered. This is known as a clawback adjustment and was the subject of the High Court decision in Curtis Henderson. Remember a business does not make a clawback adjustment if it satisfies the test for de minimis.

#### *CURTIS HENDERSON*

A business claimed input tax on its costs of building a house that it planned to sell. However, it was unable to sell as originally intended and so granted a short-term lease until the house could be sold. The question was whether a clawback adjustment was required for the input tax already recovered, and if so, how the adjustment should be calculated. The High Court agreed with the Tribunal's decision that a clawback adjustment was needed to apportion the input tax to take account of the business's taxable and exempt intentions for the property at the time it was first used. In other words, the business had to adjust its input tax to reflect the fact that it was let before it was finally sold. This meant that the business had to repay some (but certainly not all) of the input tax previously recovered.

#### *MAKING A CLAWBACK ADJUSTMENT*

A house builder makes a clawback adjustment as soon as his actual or intended use of a property differs from his original plans against which input tax was recovered.

For example, a house builder who defers his planned sale of a property by undertaking a period of letting would make a clawback adjustment as soon as his original plans are changed. A clawback adjustment is a one-off event and a house builder would only make a second adjustment if the building was never let. There is no need to amend the adjustment if the actual period of letting proved to be longer or shorter than anticipated.

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### *JUDGING INTENTION*

A clawback adjustment must be based on the house builders' realistic expectation, judged at the time his original plans were set aside. HMRC may ask for evidence to show that the adjustment calculation is reasonable. Evidence might include; the business plan showing the price originally expected; reports of estate agents showing this price to be unobtainable and maybe estimating when a sale will be achievable;

board minutes from the time of the decision to grant short leases, or any other commercial documentation that backs up the estimated use.

### *CALCULATING A CLAWBACK ADJUSTMENT*

The house builder calculates his clawback adjustment by comparing the amount of input tax deducted with the amount of input tax he would have deducted had he held his changed intention all along. His clawback adjustment is simply the difference between the two input tax amounts.

The house builder calculates the amount of input tax he would have deducted by applying his partial exemption method at the time the costs were incurred. A large house builder is likely to be already operating a partial exemption method, but a small house builder may not. If a house builder was not already operating a partial exemption method then he must apply the standard method unless he obtains HMRC approval to apply a special method instead.

### *ALTERNATIVE BASES OF CALCULATING A CLAWBACK ADJUSTMENT*

A house builder that does not currently operate a partial exemption method, can exceptionally if he prefers, base his clawback adjustment on an alternative calculation (without first adopting a partial exemption method and without prior approval from HMRC) so long as that calculation is fair. HMRC can allow this under their care and management powers.

HMRC will accept any clawback calculation provided it fairly reflects the use of costs in making taxable supplies. A calculation based on the values of supplies is normally fair and straightforward provided it is based on reasonable estimates and valuations:

### *ESTIMATED EVENTUAL SALE VALUE*

Estimated eventual sale value plus estimated short let premiums and rents

Example: house builder preparing a clawback adjustment using values

A house builder expects to sell two houses for £500,000 each. The input tax recovered during the tax year was £50,000. After the end of the tax year the decision is taken to rent them for a period of three years generating estimated rental income of £200,000. The house builder makes no other supplies.

£50,000 input tax incurred x £1,000,000/£1,200,000 = £41,667 recoverable input tax  
£50,000 input tax previously recovered – £41,666 = £8,334 to be repaid to HMRC

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No adjustment should be made for potential bad debts during the letting period. If it is not possible to fairly estimate the values then a different calculation may be needed. Apportionments based on the expected time period of the rental or short-term lease are not recommended except as a quick de minimis check.

### *OTHER POINTS TO NOTE*

The alternative calculations cannot be used if a partial exemption method was already in place. But, if an existing partial exemption method becomes unfair because of the short-term lets, then HMRC may exceptionally allow an alternative method to be agreed and backdated. House builders in this position should contact HMRC.

## 4 RESTRICTING RECOVERY OF CURRENT AND FUTURE VAT

### *INTRODUCTION TO INPUT TAX RESTRICTIONS IN CURRENT AND FUTURE YEARS*

A house builder that expects to continue to incur exempt input tax in his current or future VAT periods would need to adopt a partial exemption method. If he is not already partly exempt (most smaller-sized builders are not), then he must either apply the standard method or seek HMRC approval to apply a special method.

Example: House builder applying the standard method

House let in September 2008. No exempt supplies made before then.

Income received in the VAT period 1 July 2008 to 30 September 2008:

Taxable income from building work unconnected to house let in September 2008 = £16,575

Exempt rental income = £2,925

So the recovery rate under the standard method is 85%

Input tax incurred in the period on the new house = £15,000

So taxable element (recoverable) = £12,750

And exempt element (irrecoverable subject to de minimis) = £2,250

The exempt amount is over £625 per month on average and so is not de minimis, and not claimable, on the 09/08 VAT return. The house builder will have a longer period of 1 July 2008 to 31 March 2009. The figures for this period will go into that adjustment were the recovery rate will be recalculated and conclusions on de minimis reconsidered based on figures for the whole nine months.

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### *ALTERNATIVE TO THE STANDARD METHOD*

A business that feels the standard method is unsuitable may seek HMRC approval to apply a special method instead. The standard method may be unsuitable for house builders, especially during their construction phase, because they may have made few, if any, supplies on which to make the apportionment calculation. For example, they may have no taxable supplies at all until the dwelling is finally sold. In this case a special method would be needed. A house builder should contact his local business centre if he is unsure whether to adopt the standard method or to apply for a special method instead.

### **5 ADJUSTING VAT RECOVERED ON PREVIOUS RETURNS AND RESTRICTING THE VAT TO BE RECOVERED ON CURRENT AND FUTURE RETURNS**

Some house builders will need to make a clawback adjustment for VAT previously reclaimed and use a partial exemption method for current and future VAT.

#### *EXAMPLE*

A house builder who constructs six new dwellings over a period of three years incurs the following input tax:

VAT period	Year to March 2007	Year to March 2008	Period 06/08	Period 09/08	Total
Input tax	£150,000	£70,000	£5,000	£25,000	£250,000

In August of 2008 he lets the properties for two years, retaining the intention to then sell the properties.

#### *SIMPLE CHECK FOR DE MINIMIS*

By the number of years against a set period of ten years the exempt use would be 20 per cent. This would produce a de minimis result in only the period 06/08 so full calculations are needed.

The house builder estimates that the dwellings will sell for £300,000 each in two years time. The rental income in the interim will be £1,500 per month per house. So expected sales values gives a taxable use of:

$$£1,800,000 / (£1,800,000 + £216,000) \times 100 = 89.29\%$$

So an exempt proportion of 10.71%.

Applying this to the input tax amounts

Year to March 2007 – £150,000 x 10.71% gives an adjustment due of £16,065. This must be entered into the VAT account for period 09/08 when the intention changed. Although this year is not technically a longer period (as no exempt input tax was incurred before or during the year) HMRC are content for this year to be considered as a whole to save the cost of splitting it into periods and analysing each separately.

Year to March 2008 – £70,000 x 10.71% gives an exempt input tax amount of £7,497. This is under £7,500 and so de minimis. No adjustment is needed for this year.

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Period 06/08 – this period was de minimis by the simple check and will clearly be so again. No adjustment is needed for this period.

Period 09/08 – the input tax incurred in this period is residual in the period as there has been exempt use in the period. As the only supplies made in the period are exempt rentals the standard method would allow no input tax deduction. This result is plainly unfair as we know that the final taxable use will be almost 90 per cent. A special method will be needed to allow a fair deduction of input tax.

### 6 QUESTIONS AND ANSWERS

#### *HOW IS A CLAWBACK ADJUSTMENT ACCOUNTED FOR?*

The house builder simply includes the amount of the clawback adjustment on his VAT return for the period in which the change of intention occurs. The house builder has no need to seek HMRC approval for his clawback calculation (unless he wishes to do so), but he should keep evidence to show that the adjustment was reasonable.

#### *CAN A HOUSE BUILDER BASE HIS CLAWBACK ADJUSTMENT ON “YEARS”?*

HMRC strongly discourage house builders from basing their clawback adjustments on the anticipated number of years that a dwelling will be let. This is because an adjustment based on years begs the question as to the “useful life” of a dwelling that whilst constructed to last was also constructed with the intention of an immediate sale. As a result there is seldom objective evidence as to what “useful life” to adopt creating the risk of uncertainty and dispute. Accordingly, partial exemption policy is to apply a ten-year “economic life” for buildings when preparing time-based clawback adjustments. This time period is applied consistently for VAT adjustment purposes, including building related items subject to the Capital Goods Scheme, and in respect of the deemed supply of non-business property as per “Lennartz charges”. A calculation based on anticipated years of letting from an economic life of ten years is helpful as a simple indicator of whether a house builder is de minimis because it saves the need for estimation/valuation of rental income and is easy to apply.

#### *HOW SHOULD A HOUSE BUILDER DETERMINE THE “VALUES” FOR HIS CLAWBACK ADJUSTMENT?*

A house builder should base his clawback adjustment on an estimate of his future receipts from the proposed let and anticipated sale of his dwelling. There is no set way to form this estimate although it should be a reasonable one based on realistic assumptions. In some cases house builders may have received professional estimates of future values in which case these figures could be used, alternatively, the house builder may have prepared cash flow statements and funding plans based on a best judgement view of future income. HMRC will not challenge the clawback adjustment provided the approach taken to estimating values is reasonable.

#### *WHAT HAPPENS IF A HOUSE BUILDER CHANGES HIS INTENTION FROM MAKING A SHORT LET FOLLOWED BY A SALE TO SIMPLY MAKING A SALE?*

The reverse situation to clawback, known as “payback” can arise where the change of intention is from, exempt use to taxable use or from exempt and taxable use to just taxable use. This could happen if a house builder intends to make a temporary let before selling, but in fact does not make any let before the sale. This is known as a payback adjustment. If a business feels that such a change of intention has arisen then it should contact its local business centre.

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### *WHAT HAPPENS TO COSTS THAT RELATE DIRECTLY TO THE LETTING OR SALE OF THE NEW DWELLING?*

Input tax on costs that relate wholly to taxable or exempt supplies must be directly attributed to those supplies. For example, input tax on costs related to letting such as letting agents' fees will not be recoverable, subject to de minimis rules, whereas input tax on costs related to the final sale such as conveyancing fees will be recoverable in full.

### *WHAT HAPPENS IF BUILDINGS FALL UNDER THE CAPITAL GOODS SCHEME?*

Dwellings will not normally fall within the Capital Goods Scheme (CGS). The CGS applies to any building used otherwise than purely for sale where the VAT bearing cost of constructing it is at least £250,000. As each building is considered separately a new development creating several houses will not normally create any CGS items despite VAT bearing costs for the project exceeding £250,000. House builders whose dwellings might become capital items should contact a Partial Exemption specialist in HMRC in order to agree a suitable methodology to cover CGS adjustments.

### *WHERE CAN I FIND MORE INFORMATION ON "MAJOR INTERESTS"?*

More information can be obtained in Public Notice 708 "Buildings & Construction" (Part V8).

## **7 WHO CAN I CONTACT FOR FURTHER INFORMATION?**

If you have a query for which you have been unable to find the answer within this VAT Information Sheet please contact our National Advice Service on Tel 0845 010 9000 (Tel 0044 2920 501 261 for International Enquiries).

The National Advice Service is available from 8.00 am to 8.00 pm, Monday to Friday (GMT), and will be able to answer both general queries and deal with enquiries relating to the Special Scheme.

If you have hearing difficulties, please ring the Textphone service on Tel 0845 000 0200.

Alternatively, international enquirers may email us.

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### ANNEX: BACKGROUND TO PARTIAL EXEMPTION

#### *VAT RECOVERY*

A business can recover the VAT it incurs on its costs (known as input tax) so long as the costs are “used” or “intended to be used” to make taxable supplies. A business cannot normally recover the input tax it incurs on costs that relate to its exempt supplies. A business that incurs input tax related to both taxable and exempt supplies is known as partly exempt and must apply a partial exemption method to apportion its input tax to determine how much it can recover against its taxable supplies.

#### *AGREEING A PARTIAL EXEMPTION METHOD*

A business becomes partly exempt from the first day of the VAT period in which it incurs input tax related to its exempt supplies (called exempt input tax). On first becoming partly exempt a business has two options as to its choice of partial exemption method. The easiest option is to apply the standard method that is laid down in law and which apportions input tax according to the value of taxable and exempt supplies made by the business during the tax year. If the standard method is unfair or unsuitable (for example if there are no taxable or exempt supplies during the year) then the business may have to correct for this using the standard method override, or alternatively by seeking HMRC approval to apply a special method. A special method can be any calculation, but it cannot be applied unless it is first approved by HMRC and that approval cannot be given unless the business first declares that the special method is fair in writing.

#### *APPLYING A PARTIAL EXEMPTION METHOD*

Once partly exempt a business must apply its partial exemption method in each VAT period (usually a quarter) and then again at the end of the tax year (called a longer period) to smooth out any fluctuations from one VAT period to the next. The longer period normally runs for the year ending March, April or May, although it can be for less than a year when the business first becomes partly exempt.

#### *DE MINIMIS RULES*

If the amount of exempt input tax is small, then the business is known as de minimis and is allowed to recover its input tax as if all its costs had been “used” to make taxable supplies. A business is de minimis provided its exempt input tax does not exceed £625 per month on average; and half of its total input tax.

# Housebuilders



## VAT Briefing Paper August 2011

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