



VAT Treatment of Property Transactions

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The intention of this article is to consider some aspects of the operation of the regime introduced with effect from 1 July 2008. I have not considered every aspect; indeed, I have ignored the vast majority of the transitional rules, which arguably involve the most complicated aspects. My approach is primarily based on my experience to date and matters that occur to me as problematic.

The Bad Old Days

Simplification was the main objective of the change. While it may be easy to be critical of some aspects of the new regime, we need to remind ourselves of the old regime in order to put the changes into context.

Some of the issues with which we had to grapple were as follows:

- › determining VAT history since 1 November 1972;
- › distinctions between long-term and short-term leases;
- › long-term leases treated as supplies of goods;
- › the economic value test;
- › reversionary interest self-supplies;
- › short-term leases exempt, with the possibility of waiving exemption;
- › waivers applying to all short-term leases where exercised;
- › backdating waivers in some cases;
- › special valuation rules applying to the granting, assignment and surrender of long-term leases;
- › section 4A relief applications; and
- › VAT recovery restrictions for landlords.

I think that the main cause of the complexity was the treatment of long-term leases as supplies of goods. This had the effect of creating an artificial world for VAT where reality was ignored and there was a need to apply the concept to all related considerations.

It impacted on VAT recovery entitlement, surrenders, assignments and disposals of reversionary interests.

The “New” Regime

The changes were effective from 1 July 2008 – over three years ago. However, as there have been relatively few property transactions since then, the regime has not been properly tested and is still regarded by most as new.

My view is that the new regime is an improvement, and this is mainly due to the treatment of leases as services. I think that this is a more logical approach and produces a more equitable and intuitive outcome. However, I believe that there are a number of issues that need to be addressed to improve the regime. I have outlined them below and have also made some observations.

Leases

From a technical viewpoint, this heading should probably read “lettings”, as VAT legislation actually refers to the “letting” of immovable goods. For the purposes of this article, I will not consider what exactly the term encompasses and I will take lettings to mean leases.

As mentioned above, in my view the treatment of leases as services is a major improvement. With the exception of freehold-equivalent interests, there is no distinction between leases of different duration. The general rule is that leases are exempt but the landlord can opt to tax (apply VAT) on a lease-by-lease basis.

My main concerns and observations are as follows:

- (1) The option to tax is not available in respect of residential leases.
- (2) The option to tax is not available in respect of leases between “connected parties” unless the lessee has at least 90% VAT recovery entitlement.
- (3) Backdating of the option to tax is not available.

My concern in relation to Point (1) is that it curtails property investment. This was actually precluded in 2007 (waiver of exemption at that time), and I would strongly recommend reconsideration to help the market. I understand that there was a view held by some that its use amounted to a tax-assisted investment and an abuse of the system. In my view the application of VAT to residential leases is a good example of the VAT system operating in its purest form – VAT

applying at consumer level. I can see no principled reason why the option to tax is not allowed.

Points (2) and (3) mainly concern “locked-in” VAT arising where properties are used to some extent for VATable purposes. I appreciate that some abuse could arise where leases are between connected parties, but I suggest that this could be dealt with on a case-by-case basis and abuse could be tackled by using anti-avoidance provisions. The apparent blanket prohibition on backdating is my biggest concern, as it can result in very significant costs arising from a simple oversight. This aspect is very much a backward step, as it was previously possible to backdate waivers of exemption in some circumstances.

Freehold interest disposals

At the risk of oversimplifying the position, the treatment of the disposal of freehold interests (including freehold-equivalent interests) is that new property is subject to VAT and property that is not new is exempt from VAT but an option to tax is available in most cases. I will not consider the meaning of “new” and “freehold-equivalent” interests in this article, as you will all be familiar with the concepts and their application.

In my view the principles involved are well founded, and in my experience the system is generally working well. However, I have some concerns and observations as follows:

My first concern – the need for a **joint** option to tax – is a relatively minor one. In my view the position would be more straightforward if, like is the case for leases, the supplier (vendor) alone could opt to tax. The difference in treatment, from the option to tax applying to leases, confuses the matter. My suggested approach would still allow the purchaser to raise the issue as another commercial matter for consideration.

My second concern – the option to tax must be exercised within 15 days following the month of the disposal – is my greatest concern with the entire new regime. The point is the same as outlined in relation to there being no backdating of lease options to tax, but the impact is likely to be even more significant as the option in the case of a lease can apply from the date on which it is exercised.

My third concern – there is no “transfer of business” relief where the related property is new – has very significant implications and, based on my experience is not generally appreciated. The headline issue is that transfer of business relief applies. However,

while this means the transferor is not accountable for VAT on the transfer, the transferee is obliged to self-account for VAT and the transferor is treated for the purposes of the capital goods scheme as having made a disposal. Where the property is fully used for VATable activities, there are no resultant costs or benefits for the parties. However, where the property is used or partially used for exempt purposes, the outcome is a VAT cost for the transferee and a VAT benefit (revised VAT recovery) for the transferor. In my view, for simplification, there should be no distinction between the treatment of new property and other property in this context. In both cases, the transferee should step into the shoes of the transferor.

Other issues

Two other points occur to me that warrant mention.

The first relates to VAT treatment of lease assignments. I should make it clear that my comments do not concern the assignment of “legacy leases”, to which, as you know, special rules apply. As I mentioned at the beginning, I am not considering transitional measures in this article, and I regard legacy lease issues as coming within that category.

Under the new regime, VAT applies to fees paid by the assignee to the assignor and by the assignor to the assignee. This treatment applies whether or not the lease is subject to an option to tax. Lease surrenders are treated in a different manner; the VAT treatment follows the VAT treatment of the lease.

This somewhat surprising VAT treatment of assignments is in line with a decision of the European Court of Justice (*Cantor Fitzgerald C-108/99*). Accordingly, it would be very difficult for Revenue to treat it otherwise (perhaps, follow the VAT treatment of the lease) even if Revenue were minded to apply different treatment. My advice is

to take care when dealing with assignments. VAT is likely to apply even where the related lease is not subject to VAT.

My second point is a contractual matter relating to leases. In many cases, agents for landlords insert a clause to the effect that the tenant is liable for VAT arising in the event of the tenant exercising a break option in a lease. In my view this is fully understandable if the clause clearly applies only to VAT arising on any related payment that the tenant is obliged to make to the landlord. However, in some cases it can potentially apply to a VAT capital goods scheme adjustment arising for the landlord. Such an adjustment would arise if the landlord subsequently uses the property for non-VATable purposes. The most common example of such use is where the landlord subsequently grants a lease to a new tenant and does not opt to tax because the tenant cannot fully recover VAT.

In my view it is unreasonable for a landlord to expect the original tenant to compensate the landlord for VAT arising in such circumstances. The VAT arises as a result of the landlord’s choice regarding the subsequent use of the property. I suggest that any question of a compensation payment arising in respect of a VAT capital goods scheme adjustment where a new lease is granted should be a matter between the landlord and the new tenant. However, in some cases, I can understand a landlord insisting on receiving such a payment from a tenant where the tenant is seeking to terminate the lease other than by exercising the break option.

Summary

In my view the new regime is an improvement, but a few aspects should be changed. My main concern is the potential for minor technical oversights to result in large VAT costs.

VAT on Property Transactions

- > Detailed commentary on the 2008 VAT on Property rules and how they apply to transactions
- > Analysis of the VAT treatment applying to the sale of a property and lettings
- > Guidance on the application of the transitional VAT on Property rules
- > The impact of EU law on Irish property transactions

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