Taxing times

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Robert Walker examines the unexpected VAT costs of building to rent

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The housing market is seeing an increasing number of investors entering the market to develop residential property for rent rather than sale. Entire developments are being constructed with the intention of letting on assured shorthold tenancies rather than selling.

This change in approach to fulfilling the nation?s housing needs is having unexpected consequences, however, in terms of the VAT cost to developers.

Zero v none

The basic VAT rules for property are as follows. The sale of new residential property is zero-rated for VAT. This means that the developer does not need to charge the purchaser VAT on the sale price, yet because the sale is within the scope of VAT ? albeit being zero-rated ? the developer can still recover the VAT it incurs on the majority of its own costs.

The letting of residential property is, however, exempt from VAT. This means that VAT need not be charged on the rents, but also that letting is outside the scope of VAT so the developer cannot recover any of the VAT it incurs on the development.

This therefore puts traditional housebuilders ? that is, those building to sell ? in a relatively advantageous position. Other than for some minor exceptions in relation to white goods, carpets and so on, the VAT that housebuilders incur on all costs is recoverable. This means that the VAT cost associated with the construction of new housing for sale is minimal.

However, that position drastically changes when a developer is building property to let, as there is potentially a considerable associated VAT cost. It is also likely that the tenant will suffer, given that this cost will inevitably be passed on through the rent.

How the cost builds

The costs of constructing new dwellings are zero-rated for VAT, which means that there should be no cost incurred on the construction itself, except in respect of landscaping and garages. However, other costs that will be incurred by a developer are not so favourably treated, and could become an added cost.

The developer may be charged VAT on the acquisition of the land where the seller has opted to charge it to aid its own VAT recovery position. This can potentially be a significant amount, though the position will vary from site to site. VAT will always be due on other associated costs as well, such as work to fulfil planning gain agreements and professional fees charged, for example, by planning consultants, architects, surveyors or engineers. At a rate of 20%, VAT on all these costs can clearly add up quickly.

Demolition costs can be subject to VAT, too, particularly if it is carried out before obtaining residential planning permission. Similarly, any preparatory civil engineering done before this point will be subject to VAT. Goods on hire such as machinery, scaffolding and mobile site offices will likewise always be subject to the tax.

Finally, all developers, regardless of their intention to sell or let, will be subject to VAT costs on certain fixtures and fittings that they install in new residential property. Items such as integrated appliances, bedroom furniture, carpets, curtains and blinds are specifically blocked from VAT recovery even where the developer sells the completed property to a homeowner.

Contract or separate

Unnecessary VAT costs can be avoided by using so-called design and build contracts, where one contractor is engaged to take the site from its current state ? including the demolition of existing buildings ? to the completion of new residential property. Under such contracts, the majority of costs for the investor or developer will be zero-rated, and thus not subject to VAT.

VAT efficiencies can also be achieved by ensuring different entities in a group are responsible on one hand for the development and on the other for the letting activity. This separation of activities is common throughout the sector, and known to HMRC.

So as there are a number of VAT issues that could have significant impact on the potential returns from the project, traditional housebuilders or other investors moving into the build-to-rent market should take tax advice at an early stage.

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Further information

- This feature is taken from the RICS Property journal (December 2017/January 2018)
- Related categories: New build property ; Residential ; Taxation of real estate ; VAT