

Challenges of selling a commercial property

(Lecture B1085 – 14.04 minutes)

Introduction

VAT and property continues to be a challenge. Let's consider a case study scenario where a firm of solicitors called Legal and Co (a partnership) bought the freehold of a property (office on two floors) for £600,000 plus VAT in 2013 and traded from it for three years. They then relocated to new premises and rented the property out for two years to a firm of accountants. They opted to tax the property when the tenant was found (charging VAT on the rental income) but it is now 2018 and they have decided to sell the freehold. I will consider three different selling situations, all of which have different VAT treatments.

Convert building into residential use

Let us firstly consider the situation where the accountants have ended their rental agreement, so Legal and Co is selling a vacant building.

As an opening question, can you think of two situations when the sale will be made without adding 20% VAT, despite Legal and Co's option to tax election ie the sale will be exempt rather than standard rated?

The first situation is if the buyer intends to convert the building into dwellings or a building that will be used for a 'relevant residential purpose' (RRP). The latter relates to use as eg an elderly persons home, student or nursing accommodation. In other words, a change from commercial to residential use is planned for the building. The buyer will issue form VAT1614D to the seller, which confirms his intention to convert the building into dwellings or for RRP use. The form must be issued before the price of the deal is legally fixed, ie before exchange of contracts (VAT Notice 742A, para 3.4).

Here are the answers to some questions that you might be asking:

If I am the buyer, must I have obtained planning permission to convert the property into dwellings before I can complete form VAT1614D?

The answer is 'no' because it is all about your intention at the time of the deal. The actual statement you will be signing is Condition 2 of the form, which says: "I intend to convert the building or part of the building mentioned above with a view to it being used as a dwelling or dwellings or solely for a relevant residential purpose"

What if my intention as the buyer is to only convert part of the building into dwellings?

The good news is that the seller's option to tax election can be partly overridden to reflect the residential use but VAT will still be charged on the commercial element (Notice 742A, para 3.4.6). There is no specified method of output tax apportionment in the legislation but it must be carried out on a 'fair and reasonable' basis eg a square footage or floor split basis. So if one floor out of two will be used for commercial purposes, a VAT charge on half of the selling price will be reasonable.

If I change my mind after I have bought the building and never convert it to residential use, will I have to repay the VAT I saved?

The answer is 'no' – it is all about the buyer's intention at the time of the supply. If these intentions are genuinely stated, there will be no comeback if the buyer changes his mind in the future about his use of the building.

Charitable use

The second situation when Legal and Co's option to tax election will be overridden is if the buyer is a charity and intends to use the building or part of the building for a 'relevant charitable purpose other than as an office.' In this situation, there is no official HMRC form to complete, so the charity will confirm its intention to the seller in writing.

The phrase 'other than as an office' basically means that the building will not be used by the charity for head office type functions eg dealing with the charity's accounts, administration, IT issues etc. However, if the office use is eg to provide a base for staff operating a telephone helpline service to assist those in need ie a charitable purpose, this is not a problem (VAT Notice 742A, para 3.5).

With regard to the 'part of the building' issue, it is important that the relevant use of the building can be clearly defined for each specific area – see Animal Charity and building use.

Animal charity and building use

Manchester Animals Charity is buying a three floor building and the seller has opted to tax the building so wants to charge 20% VAT on the sale of £300,000. The Charity will use each floor as follows:

- The ground floor will be a shop to sell donated goods to members of the public
- The first floor will be used to treat and look after sick animals
- The second floor will be used as the head office of the charity, dealing with administration issues.

The option to tax election can be overridden by the seller in relation to the first floor ie it will be used for a charitable purpose. So the sale proceeds relevant to this floor will be exempt, with the other two floors being standard rated. The ground floor shop is a 'business' use so does not qualify for exemption and the second floor use is captured by the 'other than as an office' exception for the option to tax override. So it is likely that a floor split basis will apply to the VAT charge ie £300,000 plus VAT of £40,000.

Transfer of a going concern (TOGC)

We have so far considered the potential VAT issues with the building being sold as vacant but what would be the situation if it was sold with a tenant or tenants still in occupation ie the accountants in our case study.

The sale will be outside the scope of VAT as a TOGC as long as the deal meets certain conditions:

- The buyer needs to be VAT registered or liable to be registered at sale time.
- If the seller has opted to tax the property, the buyer must also opt to tax the property before the deal takes place ie form VAT1614A must be completed and submitted to HMRC's Option to Tax Unit in Glasgow.
- The buyer must also confirm to the seller in writing that the option to tax election he has made will not be disappplied. This is an anti-avoidance measure – see VAT Notice 700/9, para 2.4.2.
- The rental arrangement must be carried out on a proper commercial basis ie there is a genuine 'property rental business' in place. I recently dealt with a query where the tenant was only paying a peppercorn rent to the landlord, which did not constitute a business, so there was no scope for a TOGC.

What would be the VAT position if a ten floor building was being sold by a seller who had an option to tax election in place, but only one out of the ten floors had a tenant in place at the time of the sale ie nine floors were sold with vacant possession?

Your initial thought might be that there is scope to treat 1/10 of the selling proceeds as a TOGC but the good news is that all proceeds will qualify as long as the conditions above are met. The HMRC guidance refers to this situation as a 'partially let building' and it makes no difference what the split is between tenanted and vacant. VAT Notice 700/9, para 6.2.

Capital goods scheme and TOGC

There is a twist to the tale for our buyer if a TOGC situation applies, namely that he will take over any remaining capital goods scheme (CGS) adjustments of the seller. Legal and Co bought the property for £600,000 plus VAT five years ago, so this is within the scope of the scheme because the cost is more than £250,000 excluding VAT and the relevant adjustment period for land and property is ten years. So this means that input tax of £120,000 is reviewed by Legal and Co over a ten year period to reflect any change in use between taxable and exempt activities (and non-business activities as well since January 2011). So if Legal and Co bought the property in 2008 or later (which they did ie 2013), then some intervals are still outstanding for the buyer in the event of a TOGC. But as long as the buyer continues to use the building wholly for taxable purposes, the remaining annual adjustments will be 'nil' so no extra VAT is payable.

Option to tax – 20 year rule

This is not relevant to Legal and Co because it only opted to tax the property in 2016 when it sublet the building to the firm of accountants ie to ensure its use of the building was taxable rather than exempt (adding VAT to the rent). However, be aware that if a business made an option to tax election on a property more than 20 years ago, it can reverse the election by submitting form VAT1614J to HMRC. This means that future income from the property will again be exempt from VAT again rather than standard rated. This outcome would be particularly useful to a tenant or buyer who cannot claim input tax eg a bank or a betting shop.

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