

TAX matters...

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New VAT rules for commercial property

In his budget speech in December, the Minister for Finance confirmed that the proposed new VAT & Property rules will be introduced on 1 July 2008. Detailed provisions on the enactment of the new system will be contained in the Finance Bill which is due to be published on 31 January 2008.

The proposed new rules will represent the most significant change to VAT on property transactions since VAT was introduced in Ireland in 1972.

Anyone who is involved in commercial property transactions needs to be aware of the potential impact which the new rules will have. This not only includes developers, builders, investors, etc. but also solicitors, accountants, tax advisers, estate agents and financial institutions amongst others.



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Purpose of the change & what's staying the same

It has long been agreed that the current system of applying VAT to commercial property transactions is overly complex. In 2005, the Revenue Commissioners began a detailed review of the system and embarked on a project with the ultimate aim of introducing a new system which would:

- Be simple to implement
- Protect the Exchequer in terms of VAT collected
- Not undermine the commercial property market

Revenue invited submissions from all interested parties and consulted with their counterparts in other European countries to examine the rules in those jurisdictions. They published a detailed report on the proposed new system in December 2006 and issued draft legislation in March 2007.

As a result of extensive lobbying by practitioners, the Minister for Finance also announced in July 2007 that transactions currently being negotiated, but which would not be finalised until after the new rules are introduced, could be taxed under the old rules, assuming certain conditions were met.

What's staying the same?

It is important to point out that the new rules should have little impact on the residential market.

Newly constructed houses, apartments, etc. will continue to be subject to VAT at 13.5% and most of these properties will subsequently pass out of the 'VAT net'.

Finance Act 2007 removed the ability to apply for a waiver of exemption in relation to residential properties acquired after that date so even residential properties acquired by investors for letting purposes are likely to pass out of the 'VAT net'.

Sales of undeveloped land (e.g. Greenfield sites) will remain outside the 'VAT net' unless sold in connection with a development agreement (same as current Section 4(5)).

What's changing?

1. Under the current system, once a property was 'developed' after 1972, supplies of that property remained subject to VAT 'ad infinitum' assuming it was not diverted to an exempt use. Under the new system, only supplies of 'new properties' will be subject to VAT. 'New' will mean a first sale within 5 years of completion or any further sale within that 5-year period where the building has not been occupied for 2 years or more. VAT will be chargeable on the consideration at 13.5%. If a property is not 'new', its supply will be exempt from VAT. However, the vendor and the purchaser can opt to tax the supply. It is likely that VAT will then be chargeable on the consideration at 13.5%.
2. Under the current system, there is a major distinction between 'long' and 'short' leases. Broadly speaking, long leases (10 or more

years) are subject to VAT on the capitalised value of the lease and are taxed upfront in the same manner as the outright sale of a property. Short leases (less than ten years) are exempt from VAT. However, a landlord can elect to waive his exemption and then charge VAT on the rents received at 21%. This waiver usually applies to all of the landlord's short lettings (with the exception of residential properties acquired following Finance Act 2007).

Under the new system, there will be no distinction between long and short leases. All leases (other than ownership-type leases such as 999 years) will be exempt from VAT. However, it should be possible to opt to tax the letting and it appears that this will be a matter upon which the landlord will decide.

Under the original proposals, this

option would not have been available where a tenant has less than 90% VAT recovery.

However, it now appears that the option should only be disallowed where the landlord and tenant are 'connected'. This may be a very important feature as many commercial leases are created between 'connected' parties and it will be interesting to see how the term 'connected' is defined under the new rules.

It is likely that a landlord will be able to 'opt to tax' on a property by property basis (unlike the current 'waiver' rules) and the landlord should also be able to cancel an 'option to tax' on a property by property basis.

3. A Capital Goods scheme is being introduced which is a relatively new concept in Irish VAT legislation. This effectively puts a 'VAT life' of 20 years on properties. After 20 years, a property will pass out of the 'VAT net' (assuming it has not been further developed). Therefore, sales of properties which were constructed before 1988 (and not redeveloped) will pass out of the 'VAT net' once the new rules are introduced in 2008.

The Capital Goods scheme

imposes an obligation on persons to monitor the use to which a property is put on a year by year basis. The following example illustrates how this will operate:

ABC Ltd purchases a building for €1,000,000 plus VAT of €135,000. It recovers all of the VAT as it uses the building for the purposes of its 'vatable supplies'. The €135,000 VAT recovered will be known as the 'adjustment amount' and ABC Ltd's entitlement to retain that VAT will depend on how it uses the property for the following 20 years. If, after 5 years, ABC Ltd leased the building to a third party and did not opt to tax the letting, ABC Ltd would be required to make a payment to Revenue of €6,750 each year for the following 15 years as the annual adjustment amount (€135,000/20 years).

If, at any point during the 15 years, ABC Ltd were to use the building for a 'vatable activity' (e.g. for its vatable trade or a lease to a third party with an option to tax in place) then the annual payments to Revenue would stop.

What do you need to do now?

- Anyone with an interest in properties should review their portfolio. At the very least, a person should compile a VAT history for each of their properties. It will be more important than ever to keep records in relation to the acquisition and development of properties, as knowing the amounts incurred may be necessary to calculate the annual adjustment figure referred to above, under the Capital Goods scheme. VAT histories of properties are likely to be even more important in due diligence situations and purchasers may look for specific warranties in the absence of complete information.
- Anyone who is involved in commercial property transactions which are currently under negotiation should consider if it is attractive to complete the transaction prior to the

introduction of the new system. For example, a landlord who is about to grant a typical 20 year lease on a commercial property to a fully VAT registered tenant may wish to have the VAT dealt with upfront, thereby removing the need to charge VAT on the monthly or quarterly rents received. Under the new rules, it appears the landlord may be obliged to charge VAT @ 21% for the duration of the lease.

- It may also be attractive to consider delaying a transaction until after the new rules are introduced.

For example, if an owner is considering selling a property which has not been developed in the last 20 years (but is currently in the VAT net), it may be possible to sell that property without charging VAT under the new rules.

This would be very attractive if there were potential purchasers who are not entitled to recover any VAT charged (this might include, charities, government bodies, banks, bookmakers etc.). The same principle would apply if a lease of more than 20 years was proposed for such a property.

- Obviously, those entities who do not have full VAT recovery, and who are looking to acquire property, should consider delaying any transaction until the new rules are introduced, for the same reasons.
- Another reason why a landlord may consider delaying the creation of a long lease is that the capitalised value (and associated VAT amount) of a lease created now may be much greater than the VAT incurred by the landlord in acquiring or developing the property. It appears that the capitalised value of leases created under the current system will form the basis of the capital goods scheme going forward.

However, if such a lease is not created until the new system is introduced, then it appears that the amount used for the purposes of the capital goods scheme

would be based on the VAT incurred on the acquisition and development. This would be particularly attractive if the landlord felt it likely that the property may be diverted to an exempt use at some point.

- Those with short-term lettings who currently have a 'waiver of exemption' in place need to consider how the transitional rules might affect them. Under current proposals, a landlord will have one year from the date of introduction of the new system to cancel his/her waiver of exemption in relation to short-term lettings and pay a once-off adjustment amount to Revenue in accordance with the current rules.
- It should also be possible to continue to charge VAT after the one-year period under a current waiver for the duration of a short lease where there is a formal (written) lease in place. Again, it is likely that it will be possible to cancel the waiver. Subsequent lettings will be subject to the new rules.

- It is worth noting at this point that it was originally planned to restrict the option to charge VAT on rents to cases where a tenant had at least 90% VAT recovery. This restriction appears now to have been replaced by a 'connected parties' rule – it is not clear how this will operate but it is likely that it will seek to prevent special purpose companies (SPCs) from being used to minimise the VAT cost for entities who do not have VAT recovery.
- The position for landlords with 'waivers' currently in place should be clearer after the publication of the Finance Bill - for now it is recommended that landlords review their short lettings to determine how much VAT has been recovered on such properties and how much VAT has been paid over to Revenue from rent income received while

the waiver has been in place – this is particularly important for landlords who have 'waivers' and who have tenants who are exempt from VAT.

This article is intended as a general guide only and should not be regarded as advice in relation to any specific circumstance or transaction. VAT on property transactions is a complex area and the information contained in this article is a broad summary – professional advice should always be taken in relation to VAT on property transactions.

Current & new rules for VAT on property

– a brief summary

Sales of Freeholds

Current system – Generally subject to VAT at 13.5% if property ‘developed’ since 1 November 1972 (assuming certain other conditions are met).

New system – Generally subject to VAT at 13.5% if first supply of ‘new’ building or subsequent supply while building is still ‘new’ (unless occupied for 2 years or more). Sales of other buildings will be exempt from VAT (however, vendor and purchaser can agree to charge VAT on the sale).

Leases

Current system – Major split between long and short leases (less than ten years). Long leases are subject to VAT if property developed since 1 November 1972 (assuming certain other conditions are met).

The lease is capitalised and is subject to VAT at 13.5% upfront. Short leases are exempt from VAT

although the landlord can waive this exemption for commercial lettings and then charge VAT at 21%.

New system – All lettings will be exempt from VAT. However, it may be possible to opt to tax the lettings at 21%.

Waiver of exemption / Option to tax

Current system – Waiver of exemption applies only to short lettings. Generally applies to all of a landlord’s short lettings. VAT arises at 21%. A restriction on extending a waiver of exemption to residential properties was introduced in April 2007.

New system – Option to tax will apply to lettings regardless of length (note: ownership lease such as 999 year lease will be treated as freehold). There will be some restrictions where tenant is ‘connected’ to landlord. ‘Options’ will not apply to residential lettings. ‘Options’ will apply on a property by property basis.

Assignments & Surrenders

Current system – VAT arises at 13.5% where ‘long lease’ is assigned or surrendered (assuming certain other conditions are satisfied). VAT is based on capitalized value of interest being assigned. No VAT arises where short lease is assigned or surrendered (assuming no consideration payable).

New system – No VAT should arise on assignment or surrender of lease of any length. However, landlord may be subject to claw-back of VAT if subsequent letting is not ‘vatable’.

Capital Goods Scheme

Current system – FA 2005 introduced a concept known as a ‘deductibility adjustment’ which was a first step towards a Capital Goods Scheme.

New system – Taxpayers will be obliged to monitor the use to which a property is put each year for 20 years. Based on this usage, additional amounts of VAT may be

payable to or recoverable from Revenue. A shorter ten year period may apply to expenditure on ‘refurbishment’.

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