MISCELLANEOUS POINTS ON VAT AND PROPERTY

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1. The rewritten Schedule 10 VATA 1994 – the option to tax rules

The option to tax rules used to be found in 3 densely-packed paragraphs. They are now to be found in 34 paragraphs! The new Schedule 10 is not merely a rewrite of the old but contains a series of amendments. The main ones are as follows:-

(i) New certification procedures disapply the option where buildings are to be converted into dwellings and where land is supplied to housing associations;

(ii) a revised definition of “occupation”;

(iii) a new way of opting to tax (“a Real Estate Election”);

(iv) changes to the “cooling off period”;

(v) new rules governing revocation after 20 years;

(vi) automatic revocation if no interest has been held in a property for 6 years;

(vii) an option to tax now applies to both the land and buildings on the same site;

(viii) an ability to exclude a new building from an option to tax;

(ix) new appeal rights where Customs refuse to grant a permission under Schedule 10 (only if Customs act unreasonably).

Notable exception

It is worth noting that no change is made to the “beneficiary” rule, now in paragraph 40, to the effect that if the benefit of the consideration for the grant of an interest accrues to a person that person is treated as the person making the grant not the actual grantor. To change this rule appears to have come within the “too difficult” category. In their new notice 742A Customs say that this rule applies in a simple nominee situation but not where the beneficiaries are numerous e.g. where there is a unit trust. To say this avoids numerous complications (e.g. if the paragraph applied to a unit trust would all unit holders have to opt for tax before a valid option would bind the trustees) but it lacks any logical justification.

Statute not the end of the story

One feature of the new Schedule 10 is that despite its length it does not contain all the relevant statutory rules. In a number of cases various conditions must be met before something can or cannot be done (e.g. revocation of an option) but these are as set out in a notice published by Customs. Thus, it is not possible to merely look at the new Schedule 10, despite its length, and be aware of all the relevant rules. Schedule 10 and the new notice 742A must be looked at together.

2. The real estate election ("REE")

a) The new Schedule 10 in para.21 contains a new way to opt to tax, a REE.

Where a REE is made it has effect only with respect to interests in land acquired after the election is made by the person opting or, where that person is a member of a VAT group, by any other member of that group at that time. What it does is to obviate the need to exercise individual options as regards property acquired after the making of the REE. When made it does not amount to the exercise of the option at the time it is made but rather when and if an interest in land is acquired the option is treated as exercised on the day on which the acquisition is made.

b) A number of points are to be noted:

i) While notification of the REE is required (within 30 days – para.21(7)) there is no requirement to notify when and if new interests in land are acquired. If there were there would be no merit in making such an election. Customs have power, however, to obtain such information from a person 'making' a REE.

ii) Because when a REE is made an option is only treated as exercised on the day of acquisition the ability to revoke immediately after exercise, which has now been extended from 3 to 6 months, applies from the day each new interest is acquired. A REE may not be revoked, save by Customs in limited circumstances, but once an acquisition has been made the normal power to revoke, subject to the satisfaction of certain conditions, will apply.

iii) It should be noted that a REE has no effect where a person has made a previous specific election in respect of the land acquired having effect from a time prior to the time of acquisition of the land (see para.21(3)). Where a REE is made the option is treated as exercised on acquisition of an interest in land. There may be circumstances e.g. on a TOGC, where a person wishes to ensure that an election has effect at a certain time – in that case the earliest time at which a grant is made which can include the payment of a deposit. In such a case the REE may not be effective. To ensure that the TOGC rules apply a specific option should be exercised in respect of the property to have effect from a date earlier than acquisition (i.e. prior to contracts being exchanged).

iv) A REE has no effect where a person owns an existing interest in land and then acquires a further interest in the same land after the REE is made. In such a case a specific option will have to be exercised in respect of the land (see para.21(4)).

v) Hitherto a few large taxpayers have made what has become known as a global option to tax – typically an option over the whole of the UK. The ability to make such an option has not been removed by the new rules but it is likely to disappear. This is because:-

1. Para.24 provides that an option exercised by any person is treated as revoked if a person does not have an interest in the property for any period of 6 years beginning after the option has effect. There are no transitional rules so that it may be that many global options will immediately (on 1st June 2008) have ceased to have effect in respect of unacquired land if the election was made more than 6 years ago.

2. Hitherto where a global option has been exercised Customs have by concession allowed the right to revoke to apply to each property when acquired rather than within 3 months (now 6 months) of the time the option had effect. This concession has now been withdrawn so that the 6-month period will apply to the time the global option has effect. It follows from this that the ability to change one's mind is more limited with a global option than where there is a REE.

3. An existing global option and a REE cannot co-exist.

   Para.22(2) provides that once a REE is exercised any option to tax exercised before such time in respect of land and buildings that neither the person exercising the REE nor a member of its VAT group has an interest in is automatically revoked. This does not prevent *future* specific exercises of the option which are wanted to have effect prior to the date of acquisition.

3. Revocation

Rules regarding revocation are now contained in detail in the new Schedule. To an extent these rules represent an enactment of prior Customs' practice.

a) Cooling off period – para.23

The old rule permitted revocation within 3 months in certain cases, this has now been extended to 6 months. It also required consent to be obtained from Customs in all cases as well as certain conditions being satisfied namely

- no tax being chargeable or credit for input tax being claimed as a result of the exercise
- no TOGC

The new rules are slightly different.

i) It is a condition that the taxpayer has not used the land since the option had effect;

ii) again no tax must have become chargeable nor a TOGC made;

iii) as regards input tax, the condition that no credit for input tax must have been obtained as a result of the exercise is now contained in Notice 742A but in respect of this requirement if it is not satisfied revocation is still possible if Customs give their consent.

The ability and need for Customs to give consent in all cases has therefore gone. The ability of Customs to give consent only overrides one requirement.

b) Revocation after 20 years

Revocation after 20 years permitted by changes in 1995 required the consent of Customs in all cases. The position is now that revocation is possible if either the taxpayer obtains prior permission or if certain conditions specified in notice 742A are met. These conditions are either that:

1. The taxpayer or associate has no interest in the property when the options is revoked or;

2. if 4 conditions are satisfied

   - ownership for 20 years and since option had effect
   - capital goods adjustments cannot be made
   - no grants of interest in preceding 10 years at less than open market value or which will give rise to a supply after revocation for a consideration significantly greater than consideration for a supply before revocation (except normal rent review)

– no goods supplied to taxpayer prior to revocation are attributable to supply of property by taxpayer more than 12 months after the options is revoked

4. The disapplication provisions

The new Schedule 10 in paragraphs 12 to 17 contains the redrafted anti-avoidance rule that disapplies the option in specified circumstances. The rule applies when broadly two conditions are satisfied at the time of the grant of an interest -

i) that the property is a capital item of the grantor concerned for the purposes of the capital goods scheme; and

ii) the property will be occupied for exempt purposes by the grantor or certain associates.

The redrafted rules are essentially the same albeit with certain redefinitions.

a) One of the requirements of the disapplication provisions is that occupation of the property by a relevant person must not be "wholly or substantially wholly for eligible purposes (i.e. taxable purposes)". The previous rule was "wholly or mainly" for eligible purposes. In its notice 742A Customs say "substantially wholly" means land occupied at least as to 80% for eligible purposes. This has force of law, and while it accords with prior Customs' practice, such practice did not previously have force of law (and probably was incorrect). Now it does.

b) The question of when a person is in occupation of land has been the subject of recent litigation in the case of *Newnham College* [2008] STC 1225. This case involved a leaseback scheme involving the college library and the specific question that arose was whether the college remained in occupation of the library.

There are two points worth commenting on.

i) One question that arose was as to the meaning of occupation for these purposes. The taxpayer contended, and the House of Lords held, that the term "occupy" had the meaning that the term had been given by the European Court for the purposes of the 6th Directive. In other words, referring to *Sinclair Collis* [2003] STC 898 – it was the right to occupy as if that person were the owner and to exclude any other person from enjoyment of such a right. On the facts the House of Lords held by a majority that there was not such occupation. Customs had argued that a different and broader approach should be adopted so that occupation meant any physical presence on the land for the purpose of making use of it. This was not accepted. While *Newnham College* represents a tax avoidance case that succeeded, it is a doubtful precedent. This is because

Customs deliberately did not argue that the "abuse of rights" doctrine rendered the arrangements ineffective. Customs said that they wanted a decision on the UK legislation alone.

ii) A very live question in the circumstances is whether the abuse of rights doctrine has any application to the option to tax rules, bearing in mind that these rules do not represent community legislation by reference to which the doctrine has been expressed by the European Court to apply. The option to tax rules are rather rules contemplated and permitted by community legislation. In the *WHA* case [2007] STC 1707 it was argued that as reliance was being placed on national legislation, transposing provisions of the 6th Directive, the abuse principle was not applicable. Lord Neuberger said that the principle extended to domestic legislation and rules intended to implement or reflect the terms of the Directive. This hardly covers the option to tax which is something permitted by the Directive but does not implement or reflect its terms. Nevertheless, if the doctrine does not apply to matters permitted but not provided for in the Directive, a rather odd situation arises of certain provisions in the VAT Act being subject to the abuse of rights doctrine and some not. Perhaps this is why Lord Neuberger went on to express the view in *WHA*:-

> "I do not see any reason in principle or logic why the applicability of the abuse principle should be limited to schemes which depend on their efficacy solely on community law, whether transposed into domestic legislation or of direct effect."

The *Newnham College* case was, as I have said, not concerned with the abuse doctrine. Nevertheless, Lord Neuberger said that:

> "... on the face of it the Commissioners would have a strong case for applying that principle in the present case."

At present there is no authority determining that the abuse of rights doctrine applies to the option to tax. As a matter of principle, it appears strongly arguable that it does not. It is not a doctrine applicable to UK law generally and therefore there is no basis for saying that it is applicable to a set of rules created under UK law, merely because such rules are contemplated by and permitted by EC Directive. Having said this, and in particular bearing in mind the approach of Lord Neuberger, it is difficult to be optimistic that this is what the UK courts will ultimately hold.

An indication of a possible approach of the Courts is shown by the Tribunal decision of *Redcats*. In that case an attempt was made to artificially treat a supply of taxable goods as involving a zero-rated supply. Zero rating, somewhat like the option to tax, while permitted by Community Law (i.e. it is a permitted derogation from it) is not a provision of such law or a provision which implements it. When faced with the argument that the *Halifax* doctrine could not apply to zero rating, the Tribunal managed to conclude that the abuse of law argument founded on provisions other than zero rating.

So in the context of the option to tax, it may be possible in many cases for a court to say that the abuse is not based on the option to tax rules themselves. Thus if the option to tax rules are manipulated to give an input tax benefit, the argument may be that input tax rules are being abused and hence that the arrangements should be struck down.

5. The Capital Goods Scheme and the Disapplication Provisions

A requirement of the anti-avoidance provisions, in Schedule 10 paragraphs 12 to 17, is that for them to apply the grant giving rise to the supply must be made by someone described as a "developer". The use of this term is entirely confusing because there is no requirement that a person must develop before he is a "developer" for this purpose. For this purpose a person is a developer if he holds the property as a capital item or if the property is expected to become a capital item either for the grantor of the interest or for a transferee. A "capital item" is an item falling within the capital goods scheme and the grant must be made before the end of the period during which adjustments may be made relating to the deduction of input tax as respects that capital item.

In applying the anti-avoidance rules what is relevant to know is whether the property in question is subject to the capital goods scheme and, if so, the period during which it is so subject. The capital goods scheme rules are set out in Regs.113-117 of the General Regulations. In broad terms, property will be a capital item if <u>taxable</u> supplies (either on an acquisition or a building) have been made in respect of it in excess of £250,000 (excluding rent).

Note:-

i) An item is not a taxable item if a person uses it solely for the purposes of selling it. Thus a developer who develops property solely in order to sell, will not hold the property he develops as a capital item. Nevertheless, the anti-avoidance provisions apply on the grant of an interest in land, if the grantor **expected** that the building would become a capital item in respect of a transferee.

ii) The TOGC rules do not apply if on a transfer

   – the item would become a capital item for the purchaser; and

   – that person's supplies would involve exempt use (i.e. use not mainly for taxable purposes) by the purchaser, a connected person or a person providing finance.

Thus, if a developer builds and lets property to a bank, and the bank then lends money to a purchaser to buy the property, the TOGC rules will not apply on the sale. There will, in such circumstances, not only be a VAT charge on the sale but the anti-avoidance provisions will subsequently apply so as to prevent an exercise of the option to tax permitting recovery. Particular difficulty arises if the bank in the above example occupies merely a small part of the building. A person is said to occupy land if he occupies only part of it (para.17(10)). Does this mean that a lease to the bank in the above example of, say, 5% of the total lettable area of the building, precludes the TOGC rules applying at all?

iii) Schemes have been implemented to manipulate the rules applicable where a capital item is sold. These rules apply where the "whole interest" is sold. The rule in Reg.115(3) is that the taxable/exempt nature of that supply determines the calculation of the adjustment in all remaining intervals. This was sought to be exploited in the case of *Centralen Property* [2006] STC 1542 where an exempt lease at a premium was granted followed by a taxable sale of a freehold at a small charge. The taxpayer argued that only on the freehold sale was the whole interest of the taxpayer sold and therefore that such taxable sale governed the mechanics for making adjustments in the subsequent intervals. The European Court held, however, that as the two disposals were closely and inextricably linked both were to be taken account of in making adjustments in proportion to their respective values. The arrangement failed because most of the value arose on the exempt grant of the lease rather than the taxable sale of the freehold.

To counter schemes of this sort more generally, Customs introduced new paras.115(3A) and (3B) in 1997, so that if as a result of a sale, the input tax relieved exceeds the tax charged on the ultimate sale, Customs are given power to secure that the input tax relief is limited to the output tax charged.

6. TOGCs

Morton Hotels v. Customs (20039) is a case which concerned the sale of three hotels which were immediately subject to a sale and leaseback of the properties by the initial purchaser. Customs argued that the TOGC rules did not apply because the assets transferred (i.e. the land) were not used after the sale in the same business. Rather different assets (the leases) were used. The Tribunal rejected Customs' argument. It held that the requirement was that the **assets** had to be used in the same way as before but that there was no requirement that the specific proprietorial interest acquired had to be retained.

This is a welcome decision and removes a possible pitfall existing in a not uncommon situation where a refinancing occurs on a business being acquired. It should be noted in any event that there is real doubt whether the requirement in our domestic legislation that assets must be used in the ".... same kind of business ...." does not go beyond what the European Directive envisages (see *Zita Modes Sarl* [2005] STC 1059).