TSG 06/18

Review of VAT on Property – Summary

1. This paper deals with the current system of applying VAT to property transactions and the various proposals for change arising from a Revenue review of VAT on property.

2. The main changes include removing old properties from the VAT net, confining the VAT on new properties to a maximum of five years, the introduction of a capital goods scheme and changing the system of applying VAT to rents.

3. Under the proposals the VAT charge on sales of new residential property would be unchanged.[1] Residential landlords would no longer to allowed charge VAT on rents and claim a refund of VAT on the purchase of properties. This change is in line with the position in all other EU Member States.

4. The most significant changes relate to commercial properties. Supplies of new properties would remain taxable. Supplies of second hand properties would not be taxable unless the parties opt to tax the supply. Where a supply of a second-hand property is not taxed, there would be a partial claw-back of the VAT credit claimed by the supplier. All properties more than twenty years old would no longer be taxable. Where a supply of a second-hand property is taxed, the VAT charge would be confined to a proportion of the VAT suffered on the purchase price or cost of development. The supply of "building" land would be taxed in the same way as it is currently taxed. The VAT treatment of undeveloped land (e.g. farm land) would not be affected.

5. Commercial rents would be exempt from VAT unless the person opts to apply VAT. The right to opt (and to claim a repayment of VAT on the acquisition and development of the property) would be confined to circumstances where the tenant is using the property for mainly (90%) taxable activities. Since the upfront VAT charge on leases would be removed the restriction requiring mainly taxable use is necessary to compensate and retain all of the present tax take in the area of leasing and letting.

6. Fully taxable traders would be unaffected by the changes, since they are entitled to claim repayment of any VAT suffered. VAT exempt traders would no longer suffer VAT on the capitalised value of a long lease, as the do at present. However, their rental payments would increase since their landlords would not be entitled to claim repayment of VAT on the property let to them. The cost of some second hand property for such persons would reduce, since the sale would not be subject to VAT.

[1] VAT from such transactions accounts for 94% of all VAT accruing to the Exchequer from property transactions.

7. For the State sector rental costs would increase (by about 1.2%). The cost of purchasing second-hand property would however decrease for the State sector, as the VAT charge on such properties would be less than the VAT charge under the current system.

8. Goodbody Economic Consultants were commissioned by Revenue to review the impact of the proposals in terms of yield and impact on the market. Their conclusions are as follows.

- In the case of residential properties the removal of the right to tax rents (and claim credit for VAT suffered) could have a slight dampening effect on the demand for residential property by investors.
- There could be an increase in demand for second hand commercial property as such properties would be exempt from VAT.
- Companies carrying on exempt activities such as banking or insurance, and also public authorities, who are taking new leases and whose landlords would not be allowed to waive would experience higher rents. A fully exempt tenant could incur rental costs that would be about 1.2% higher because of the new rules, and at the extreme, a tenant who is 89% taxable could incur increases up to 25% higher (the latter could include some IFSC firms). However, in practice most businesses tend to be either fully taxable or fully exempt.
- Arising mainly from the exemption of second-hand property, there could be a small reduction in VAT yield in the region of €49m – €105m. This would represent between 2.2% and 4.7% of the yield from VAT on property transactions or between 0.41% and 0.87% of the total VAT yield for 2005.

9. The proposals have been broadly welcomed in the feedback from the stakeholders. However, concerns have been raised that the 90% rule would increase commercial rents for those who are below the threshold and that the removal of the waiver system for residential investors may dampen demand for new houses and apartments. XXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

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11. The TSG may wish to consider the full implications of any change to the VAT system in this area.

12. A more comprehensive discussion of the proposed changes is set out in the attached briefing document.

Review of VAT on Property

1.1 Introduction

The Revenue Commissioners have carried out a comprehensive review of the system for VAT on property and are recommending significant changes to the system for applying VAT to property transactions. The reason for the proposed change is to simplify the rules for VAT on property while ensuring a more equitable treatment for all taxpayers. The new rules would apply to both commercial and residential property and are designed to maintain the status quo in terms of yield. The main changes include removing old properties from the VAT net, confining the VAT on new properties to at most five years and changes to the treatment of leases. In addition the proposal involves the introduction of a capital goods scheme[2] to regulate deductibility to reflect the use over an extended period.

1.2 Background – the Current System

The current rules for VAT on property transactions tax the supply of a property if it has been developed since 1972 and if the supplier has had an entitlement to a deduction for the VAT incurred on acquisition or development of the property. The effect of this is twofold. It applies VAT to new residential property as such properties pass to a consumer; these properties then fall out of the VAT net. In the case of commercial properties however where the use is for a taxable business the trader must charge VAT indefinitely on any sale. This contrasts with the position for properties that are subject to a long lease where the freehold reversion falls out of the VAT net. This leads to difficulties in ascertaining the taxable status of a property particularly in relation to older properties that may have been subject to a number of transactions and where records may not be readily available.

Leases of ten years or longer in duration are treated as a supply of goods and taxed upfront. The basis for calculating the VAT charge (the capitalised value of the lease) and the anti-avoidance legislation that underpins it are regarded as excessively complex. Short-term leases (less than ten years) are treated as an exempt supply of a service.[3] However, a taxpayer may waive the exemption on such leases and choose to charge VAT on the rents. The landlord is then entitled to deduct the VAT costs on the acquisition or development of the property.

2.1 Need for change

Revenue's review of the current system has led them to a number of conclusions:

- The system is excessively complex and imposes a significant compliance burden on ordinary transactions.

[2] A Capital Goods Scheme is a mechanism provided for in EU law to regulate the VAT credit a person gets on a property.

[3] This means that the landlord is not entitled to deduct the VAT costs on acquiring the property and that there is no VAT charged on the periodic rents to the tenant.

- The system of taxing freehold commercial properties potentially forever achieves little in terms of VAT yield.
- The current valuation system of taxing commercial leases upfront is XXXXX XXXXXXX and causes difficulties for traders and for the administration.
- The same result in terms of Exchequer yield can be achieved by taxing new properties and introducing a capital goods scheme to regulate deductibility claimed by traders.
- The introduction of a capital goods scheme would also enable the removal of certain anomalies in the current system as well as satisfying EU requirements in this regard.
- The current waiver mechanism has been used to enable exempt persons and residential investors to obtain a deduction for otherwise non deductible properties.
- There is concern about the increased usage of the waiver mechanism by residential landlords.

3.1 The Proposed Changes

- The supply of buildings would be taxable only while the building is considered "new".[4]
- The supply of "old" buildings would be exempt from VAT, but an option to tax such supplies would be permitted until such properties are more than twenty years old.
- Where the option to tax is exercised, the VAT charge would not be arrived at on the actual consideration, but would be based on a lower amount.[5] The mechanism in arriving at the VAT charge in these circumstances may require a derogation from the EU. It is being recommended as it adds to the simplicity of the proposed new structure.
- The supply of "building land" would be taxed in the same way as is taxed currently. The VAT treatment of undeveloped land (e.g. farm land) would not be affected.
- Most leases would be exempt from VAT, which represents a major change as the artificial distinction between short-term leases and long leases is removed.[6] There would be an option to tax rents but only if the activities of the tenant are at least 90% taxable. This rule prevents exempt and partially exempt persons and persons whose activities are outside the scope of VAT from using the option to tax rules to defer

[4] This includes the first, second and any subsequent supply of a freehold property within five years of its date of completion. Once "first occupation" of a building occurs the property would remain taxable for a period of two years following this event.

[5] The tax charge would be confined to the amount of tax initially charged on the building reduced over the number of years in which the building has been used, up to a maximum period of 20 years.

[6] Leases than constitute ownership would be taxable in the same way as the supply of a freehold. An example of such a lease would be the acquisition of a residential apartment by way of a 99 or 999-year lease. This is typical within the residential market.

payment of VAT over a number of years. It would also retain the current Exchequer yield from properties used in the exempt sector.

- Residential landlords would not be allowed opt to tax residential rents and thus would not get deductibility for VAT on residential properties.
- A "capital goods scheme" would be introduced. This scheme examines the use to which a property is put on an annual basis (in terms of taxable or exempt use) and calculates an adjustment of the initial VAT deduction where there is change in the use of the property. Ireland is currently the only EU Member State that does not implement a capital goods scheme.
- Transitional measures have been developed to ensure that there would be a smooth transition from the current rules to the new rules so as to minimise any adverse effects on taxpayers. [7]

4.1 Effects of the Introduction of the Proposed Changes

The terms of reference of the Revenue Review required that any proposals made would not impact on Exchequer yield and that any proposals would consider the potential effects on the property market. In order to quantify these effects, Goodbody Economic Consultants were commissioned to perform an economic impact analysis of the proposed changes and the detailed findings of this report are discussed below. The main effects can be broken down as follows:

- effects on Exchequer yield;
- effects on the residential market, and
- effects on the commercial market.

4.2 Effects on Exchequer Yield

The Goodbody report projects that overall, the introduction of the changes would have a small negative effect on VAT yield. For example, if the new rules had been in place in 2005, there would be a decrease of between 2.2% and 4.7%[8] of the yield from VAT on property

[7] The transitional rules would apply to a number of categories of transactions.

- Properties that are over twenty years old would have no VAT liability attached to them.
- The supply of properties less than twenty years old would be subject to the new rules.
- VAT incurred by a tenant (prior to the introduction of the system) on the capitalised value of a long lease (that is less than 20 years old) would be subject to the rules of the capital goods scheme.
- Where a waiver of exemption has been exercised on a short-term letting there would be two options available to the landlord to deal with lettings that do not qualify for the option to tax. They can either cancel using the current rules (within 12 months) or pay back the VAT deducted on a yearly basis under the capital goods scheme.

[8] Total VAT yield in 2005 was over €12,089m. During 2005 property sales worth some €40bn took place. Total VAT yield from these is estimated as €2,247m. This is made up of €2,105m from the purchase of new residential property by owner occupiers and investors, €59m from the purchase of new commercial property by exempt persons and €83m from the purchase of second-hand commercial

transactions, or between 0.41% and 0.87% of total VAT yield. The amount of the projected loss if the changes had been in place is between €49m and €105m. The bulk of the loss (€43m-€94m) arises from the sales of second hand commercial properties, which become exempt from VAT. The balance of the loss (€6m-€15m) arises from the removal of an anomaly where partial deductibility claimed led to the sale of a property being fully taxable. The primary beneficiaries in this regard will be the exempt sectors, including the banks and other financial institutions which are the main commercial sector exempt from VAT at present.

4.3 Effects on the Residential Market

There would be no impact for residential property apart from the impact arising from changes to the rules for buy to let properties. Currently residential landlords are allowed opt to tax residential rents and thereby get deductibility on the purchase of residential properties. This option would not be allowed with the proposed changes. Goodbody predicts that this change would have a slight negative impact on demand for residential properties and a slight positive effect on yield from this sector. Evidence available suggests that most investors choose to keep their properties out of the VAT system and there would be no impact in such cases.

4.4 Effects on the Commercial Market

Most commercial property transactions would be unaffected by the proposed changes as the bulk of these transactions are between fully taxable persons where the VAT charged is fully deductible.[9] In the case of commercial property the effects can be broken down between the effect on rents and the effect on the market.

Effect on Commercial Rents

There would be no impact on rents for the mainly taxable user (90% taxable use). In such cases the landlord would be entitled to opt to tax the rent and any VAT charged would be fully deductible.

The exempt user would no longer suffer the upfront VAT charge based on a valuation of the lease. However since the use of the property would not taxable (landlord would not be entitled to opt to tax the rent), the landlord's input VAT would be non deductible. The Goodbody Report predicts that this VAT would be passed on to the tenant in the form of higher rent.[10] On a typical twenty-five year commercial lease Goodbody estimates that a fully

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property by exempt persons. The actual amount of the projected loss if the changes had been in place is between €49m - €105m.

[9] 88% of all sales of properties and 78-92% of all commercial leases.

[10] Under the new rules all leases would be exempt in line with the Sixth Directive. There would be an option to tax rents but only in cases where the lessee is at least 90% taxable. A landlord would not be allowed to opt to tax the rents if the activities of the tenant are below this threshold.

exempt tenant would incur rental costs that would be 1.2% higher because of the new rules. At the extreme, a tenant who is 89% taxable would incur a rental cost that would be 25.7% higher because of the new rules (could include some IFSC firms). In practice most businesses tend to be either fully taxable or fully exempt.

Effects on Commercial Property Market

The reduction or elimination of the VAT charge on second hand properties may mean that there would be an increase in the demand for second hand commercial property. By removing the VAT charge where partially exempt persons sell such properties, the supply of second hand properties from such bodies may also increase.[11]

5.1 Advantages of the proposed changes

The proposed changes should bring about a number of advantages.

- It would answer the demands from stakeholders for a simpler and more equitable system.
- The Exchequer yield would be substantially unaffected.
- The cost of administering the tax by Revenue would reduce.
- The tax status of a property would be much more readily identified.
- The substantial upfront liability on the supply of a long lease would no longer arise, together with all the associated avoidance activity and need for complex anti-avoidance legislation.
- The simplifications would ease the compliance burden and would reduce the need for specialist VAT advisors for normal commercial property transactions.
- The introduction of a Capital Goods Scheme would bring Ireland's VAT system more into line with the Sixth Directive and would enable the removal of certain anomalies in the system.

5.2 Likely Reaction to the Proposals

From the outset of the review, Revenue undertook to engage in an open consultation process so that all the relevant stakeholders would be informed and have input into shaping the proposed changes. A special sub-committee of the Indirect Taxes TALC was set up at the beginning of the review. Broadly speaking the response to the proposals from this group has been positive.

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[11] This is because partially exempt persons would, in some circumstances, be entitled to a VAT credit when they sell a property, for the non-deductible portion of VAT initially charged to them. This mechanism would contribute to the loss of yield discussed above in section 4.2. As mentioned above, this ensures that VAT would not be trapped in such circumstances. They would then be obliged to charge VAT to the purchaser on the sale of the property.

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7.1 Better Regulation

As mentioned above, these proposals have been developed within the Regulating Better framework. The *necessity* of the changes has been identified though the submission and consultation process with the stakeholders. The proposals also adhere to the *effectiveness* criterion in that the changes proposed attempt to reduce the compliance burden and to minimise the effect on economic activity within the construction and property sectors. The consultation process, which is an integral part of this review, ensures full *transparency* in the proposals with the relevant stakeholders having the opportunity throughout to voice any concerns or recommendations they have. The proposals conform to the *consistency* criterion in that they are consistent with the provisions of the EU Sixth VAT Directive and the VAT Act itself

8.1 Conclusion

This paper has outlined the perceived need for the introduction of the proposed changes to the system for VAT on property transactions as well as the likely implications of introducing these proposals. If introduced, the changes should provide for a simpler and more equitable set of rules for such transactions.

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