TSG 07/21

VAT on Property Transactions

Introduction

1. The Revenue Commissioners, in 2006, carried out a comprehensive review of the current system of applying VAT on property transactions. The review concluded that significant changes are required to the system and made recommendations in that regard. The aim of the proposed changes is to simplify the rules for VAT on property while ensuring a more equitable treatment for all taxpayers. The proposed new rules would apply to both commercial and residential property and are designed if implemented to broadly maintain the status quo in terms of yield. This note provides an update on developments since TSG paper 06/18 of October 2006. A slightly updated[1] copy of the Annex to TSG 06/18, which outlined the review's proposals for change and their prospective impact, is attached for information.

2. Revenue's review concluded that the current system is excessively complex and imposes a significant compliance burden on ordinary transactions. Broadly the same revenue yield and taxation effect could be achieved through a revised simpler system of applying VAT on property transactions. The system needs also to be brought more into line with the EU requirement under the VAT Directive.

3. During the review, through a special sub-committee of the Indirect Taxes TALC, Revenue undertook an open and iterative consultation process with relevant stakeholders so that they would be informed and have input into shaping the proposed changes. Broadly speaking the response to the overall proposals from this group was positive. However, many of the groups raised strong objections to the proposed restriction that requires the use of a property to be mainly taxable before a landlord can opt to tax otherwise exempt rent under a lease (the 90% rule).

Budget 2007 and Further Consultation Process

4. Given the issues that had arisen in the initial consultations the 2007 Budget documentation further referred to the review of VAT on property transactions. It stated that the complexity of this area of taxation needs to be addressed and that it was planned to engage in a wide consultation process with interested parties before making any changes in the 2008 Finance Act. An invitation for submissions was put on both the Department of Finance's and the Revenue Commissioners' websites and also placed in the national daily newspapers. Ten bodies made submissions. In addition to technical consultations with Revenue, officials from Finance and Revenue met with the parties on 25 September 2007.

[1] The Review also raised concerns about the increased usage of the waiver mechanism by residential landlords. It recommended that residential landlords should no longer be allowed to use the waiver mechanism. This recommendation was accepted and enacted for in the 2007 Finance Act, and is therefore not dealt with further in these papers.

Stakeholders Issues – the 90% rule

5. Those who participated in the consultation again welcomed the overall proposals to change the current system of applying VAT to property transactions. However, the proposed 90% rule restricting the option to apply VAT to commercial lettings[2] to situations where the tenant is entitled to at least 90% VAT deductibility was considered to be too broad[3] [see Annex, Para 5.2 (page 8)]. The stakeholders identified problems with the approach, in particular the additional costs that it would entail for landlords in terms of non-deductible VAT, which landlords would in turn pass on to tenants either in the form of additional rents or a premium. As any such payment from the tenant would be liable to income tax in the hands of the landlord, the cost to the tenant would be considerably more than the actual VAT at issue.

6. The original rationale for the 90% rule was to protect any VAT accruing to the Exchequer from the current system of charging VAT on the upfront capitalised value of a long lease. XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX.

Alternative Approach – Connected Persons Rule

7. In the light of the strong concerns expressed, the 90% rule is being examined again to see if an alternative approach could be developed that would provide a solution to some of the concerns raised by the sector, while also protecting the VAT yield to the Exchequer. An alternative approach, to the 90% rule, could be to allow the landlord the option to tax leases where the transaction is a bona fide, arm's length, commercial transaction. The option to tax could not be exercised where the transaction is not arm's length, where the parties are not independent and where the "so-called tenant" is the real beneficial owner of the property. Such an approach would require a robust anti-avoidance provision that would, for example, need to define connectedness[4], control, and commonality of interest. Care would have to be taken to avoid creating opportunities for the insertion of apparently independent landlords into the chain.

Advantages of the Connected Persons Rule

8. The use of a "connected persons rule" in place of the 90% rule would allow landlords to opt to tax the rents to unconnected tenants (and obtain deductibility for VAT incurred on acquisition or development of a property), with the result that a partially deductible tenant would get the same element of deductibility for the VAT on its rents as for the VAT on any of its other costs. The connected parties rule takes account of this but allows the market to

[2] Lettings are exempt under the proposed new system

[3] The restriction meant that where a tenant is engaged in exempt activities such as financial services the option to tax the rents would not be allowed. This means that VAT costs to the landlord on acquisition and development of the property would not be deductible.

[4] Connectivity will be determined by a number of objective tests. Similar provisions have been included in the Taxes Consolidation Act 1997.

operate without being adversely affected by the VAT system while providing a robust system to prevent blatant avoidance schemes.

9. The connected persons rule would result in greater simplicity, both from the point of view of landlords and from the point of view of the property market generally. It would avoid a two-tier market in the commercial sphere (property with deductibility and property without deductibility) and would mean that landlords/investors would have certainty as to the VAT treatment when investing in property. This certainty would last for the entire period of ownership and would not be dependant on the tenant's use of the property.

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Implications for Other Elements of Proposed New System

11. Arising from the move to a connected persons rule the precise operation as to how VAT is charged on the supply of second-hand[5] property is also being looked at, especially as to the taxable consideration in such circumstances. Instead of confining the VAT charged on the sale of a second-hand property to a proportion of the VAT charged on the acquisition or development of the property as had been proposed, consideration is being given to applying VAT to the full consideration on the disposal. However, in order to ensure the system is proportionate for the purchaser of such a property, and to minimise any opportunities for artificial avoidance schemes, a new Capital Goods Scheme (CGS) adjustment period (20 years) would need to begin each time a property a sold.[6] To allow more owners of second-hand properties to dispose of such properties without opting to tax the supply of such a property and without suffering a claw-back of VAT previously deducted, consideration is also being given to reducing the period for which the CGS scheme would apply to a property to ten years (instead of 20 years as presently proposed).

12 The views of the Group are invited.

October 2007

[5] As outlined in the Annex, the supply of second hand property is exempt from VAT in line with the EU VAT Directive. However, an option to tax will be allowed to avoid trapped VAT in such circumstances.

[6] The original proposal was that the purchaser would take whatever period remained in the 20 years, i.e. if sold after 12 years purchaser would have an eight year period.

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[7] 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.[8] 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:

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

[8] 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 is excessively complex and imposes a significant compliance burden on ordinary transactions.
- 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 highly artificial 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 to obtain a deduction for otherwise non deductible properties.

3.1 The Proposed Changes

- The supply of buildings would be taxable only while the building is considered "new".[9]
- 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.[10] 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.[11] 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 payment of VAT over a number of years. It would also retain the current Exchequer yield from properties used in the exempt sector.

[9] 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.

[10] 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.

[11] 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.

- 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. [12]

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; and
- effects on the residential and commercial markets.

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%[13] of the yield from VAT on property 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.

[12] 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.

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

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 and Commercial Markets

There would be no impact for residential property arising from the changes. 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.[14] 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.[15] On a typical twenty-five year commercial lease Goodbody estimates that a fully 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.[16]

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[14] 88% of all sales of properties and 78-92% of all commercial leases.

[15] 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.

[16] 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.

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.

However, almost all of the groups on the TALC subcommittee have raised strong objections to the restriction that requires the use of a property to be mainly taxable before a landlord can opt to tax otherwise exempt rent under a lease (the 90% rule). There are a number of reasons for these objections -

- they claim it is an inequity as it would result in trapped VAT;
- the system would be complex in terms of its administration for landlords;
- it would result in increased rental costs for certain sectors;
- the idea that one taxpayer's obligations would be based on the taxability of another is seen as undesirable.

The reason for the 90% rule is that the exempt tenant would no longer suffer an upfront VAT charge on the lease and this VAT would be lost to the Exchequer. In order to compensate for this the landlord's input VAT would become non deductible. If the landlord were allowed opt to tax rents to exempt tenants then this would spread the payment of the landlord's input VAT over the period of the lease. XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX. XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

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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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