

First grant of a major interest in residential property – Input tax and the Capital Goods Scheme

Business Brief 23/06 outlines HMRC's policy regarding input tax incurred on the construction of residential property where the developer sells a long leasehold interest separately from the freehold interest.

The first grant of a major interest (a freehold sale or lease exceeding 21 years) in residential property by its developer is zero-rated under Group 5, Schedule 8, VAT Act 1994. All subsequent grants in the property are VAT exempt. When a residential property is constructed or results from the conversion of a non-residential property, and the developer makes a first grant of a major interest in that property, any input tax incurred is recoverable in full as it is attributed to the taxable first grant. HMRC states that this is the case even where the value of the first grant does not represent full equity in the property, such as in shared ownership schemes run by housing associations.

Application of the capital goods scheme (CGS)

HMRC provides examples of three ways a developer might grant all the leases and the reversionary interest in the freehold of a residential property (typically a block of flats).

(a) *All flats sold followed by the freehold sale* - The sale of each individual flat will be zero-rated as the first grant of a major interest. While the developer will hold a capital item, when the freehold is sold HMRC considers that this will only be exempt to the extent that it relates to those areas of the building that were previously the subject of the zero-rated grants of individual flats. Most of the sale of the freehold will be zero-rated because it relates to common parts of the building, which will not have been subject to any previous supply. HMRC states that any CGS adjustments would be negligible and, accordingly, there is no need for CGS adjustments.

(b) *Freehold sold before any flats are sold* - The sale of the freehold will be a zero-rated grant and, since no leases had been granted, would not be a capital item (by virtue of reg 112(2), VAT (General) Regulations 1995). All input tax incurred on the construction costs will be fully deductible.

The purchaser, as the new freeholder, will normally make exempt grants of leases to buyers of flats. Even where the consideration for such sales accrues to the developer, so that VAT law treats the developer as the person supplying the flat, HMRC states this will not impact on the initial deduction of input tax by the developer. It may, however, have implications for any input tax incurred on selling costs.

(c) *Freehold sold after some flats have been sold* - The flats sold before the supply of the freehold will qualify as zero-rated first grants of a major interest. When the freehold is sold, HMRC considers that this will only be exempt to the extent that it relates to those areas of the building that were previously the subject of the zero-rated grants of individual flats. Most of the supply of the freehold will be zero-rated, relating to the common parts and unsold flats that have not been subject to any previous supply. As per example (a) above, HMRC confirms no CGS adjustments are needed.

If under the agreement for sale, the developer has retained the right to receive the monies from the sale of the remaining unsold flats, the considerations set out in example (b) above apply.

Other residential property

The first grant of a major interest in a relevant residential property (e.g. a care home) is zero-rated. Under reg 116(3), VAT (General) Regulations 1995, in determining any CGS adjustments in subsequent years, the developer disregards any exempt supply arising directly from that grant (including all rents due under that lease). Even though the developer holds a capital item, providing he makes no exempt supplies other than

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those arising from that zero-rated grant, he will retain full deduction of the input tax on the construction of the development.

However, if the developer makes a new grant, such as selling the freehold, this will be a second grant in the building and will be exempt. In this situation, HMRC states that CGS adjustments are likely to be required and CGS calculations must be carried out.