Simplifying the VAT Land Exemption

Response to the Call for Evidence by the Charity Tax Group – 3 August 2021

Introduction and approach to the consultation

1. The Charity Tax Group (CTG) has over 1000 charity members of all sizes representing all types of charitable activity, as well as a professional membership of over 50 firms of charity accountants, lawyers and tax advisers. It was set up in 1982 to make representations to Government on charity taxation and it has since become the leading voice for the sector on this issue. CTG is an active participant in HMRC's Charity Tax Forum and sits as the charity representative on HMRC's Joint VAT Consultative Committee (JVCC).

2. CTG welcomes the opportunity to respond to this consultation. Since CTG is a representative body for the charity sector as a whole, this response does not include any data or discussion of impacts of the proposals on our activities. However, the general theme raises issues for charities, so our response is based on our general knowledge of the position of many charities.

Overview

3. CTG welcomes the proposal that the VAT treatment of land transactions be simplified. Charities find that interactions with landlords can be adversely affected by the complexity of the VAT rules, causing landlords to take exceedingly defensive positions in contracts. Furthermore, since charities have charitable law reasons for moving property from charities to trading companies, they are more often caught up in the complexities of the VAT rules than commercial operators which do not have to follow a similar set of trading rules.

4. Charities often bear a burden of tax as though they were final consumers, and this means that they are more often affected by irrecoverable VAT costs than is common in the commercial sector. Certain reliefs, aimed at reducing this burden, are found to cause interpretative borderline issues, or differences of opinion with landlords and customers/tenants. These give rise not only to administrative pressures but potentially the payment of more tax than is probably intended by the legislation. Charities operate a wide variety of properties, covering dwellings, community residential, pure charitable (such as community centres, schools, and churches), office/administration, and charity retail. Charities are also occasionally involved in cases such as the grant of options to purchase, easements, rights of light, and similar secondary interests. The sector has an interest in all aspects of the land VAT rules and particularly the application of the Relevant Charitable Purpose (RCP) new building rules.

5. Within each heading below the question posed in the call for evidence is referenced for ease of analysis, but the comments can also be read separately from the questions you have posed. We would

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welcome the opportunity to meet the consultation team to run through this feedback in more detail and provide practical examples of the implications of policy changes for charities.

How important is simplification (Q3)?

6. It would be wrong to view simplification as an overriding issue for charities. It is important and would be welcome, of course. But the key issue for charities is to ensure that the tax burden does not increase. Even where complexity arises, and where the transaction values justify this (which is often the case), charities can obtain professional advice and help. This creates an extra cost, but the savings will usually justify the cost in that case. CTG sees no merit in obtaining simplification at the cost of increased taxation. There is, of course, a balance to be struck here, and some simplifications that may lead to higher tax, in some cases, might be acceptable. But our general position is that simplification cannot be a justification for an increase in charities' tax burdens.

Simplifying the boundary between residential use and non-residential use (Q2/3)

7. There are currently two ways in which a property can be treated as exempt for residential purposes, despite the supplier having opted for VAT, which are either that, the building is designed as a dwelling/relevant residential building **and** is intended to be used as such, or that it is intended to be converted into a qualifying residential building by a buyer or downstream buyer (paragraph 6, Schedule 10).

8. Both provisions give rise to complexity of interpretation and potential disadvantage for the seller or buyer. The main problem is that an opted property will give rise to exempt supplies if either of these provisions applies, and this can cause critical losses to the supplier by reference to input tax costs. However, if VAT is charged at the standard rate, this can give rise to a 'sticking tax' charge to the user of the acquired building. These disadvantages would be solved if both scenarios gave rise to a zero rated supply rather than an exempt supply. In that case the criterion that the property must not only be designed as a dwelling/RRP, but be **intended** to be **used** as such, could be changed, allowing a test based on two criteria alone, namely that, at the time of sale, the property would be designed as a dwelling/RRP and have valid planning consent for such use. This would remove the unhelpful requirement for the seller to know the buyer's intentions.

9. The seller would not be resistant to making a zero rated supply, since its VAT recovery would not be compromised. This would also simplify the seller's VAT accounting, as it would not need to consider a Capital Goods Scheme (CGS) or Regulation 108/109 kind of adjustment.

10. Equally, charities (and others) often find that a contract requires that the buyer will not exercise a right to disapply the option to tax under paragraph 6 (converter of property) because of the seller's fear of making an exempt supply and causing input tax disallowance. However, if the zero rate was applied instead, this would remove the seller's concerns. It would greatly simplify application of the rules, since issues around partial exemption and CGS adjustments or change of use adjustments would not become engaged where these situations were involved.

11. Of course, corresponding safeguards in regard to the bona fides of residential use intention may be needed, but these can be achieved by a form of self-supply, similar to that currently applicable on

change of use in Relevant Residential Purpose (RRP) and Relevant Charitable Purpose (RCP) new buildings.

Simplifying the relief for charitable use other than residential (Q3/8)

12. Similarly, landlords of opted property often preclude a charity notifying them of qualifying Relevant Charitable use (RCP) under paragraph 7, schedule 10, for the same reason, namely that it causes partial exemption disallowance problems. Conversely, where landlords overlook this provision, they are open to the risk of a charity tenant exercising that right, which causes bad feeling between the parties, and introduces a complexity in the business dynamic which is not a positive feature. It is to be noted that a charity must, under charity law, seek a financial saving where it is available, so trustees might feel the need to exercise this advantage over a landlord irrespective of any sympathy they might have for the landlord. Trustees may then need to take legal advice on whether they are permitted for forego the advantage, and the need to take such advice is a significant complication and source of cost to charities.

13. This would be removed if the provision allowed for zero rating to replace exemption in this case (for the reasons given above).

14. If that is not available, consideration could be given – subject to further consultation with charities on the practical implications – to removing the aspect of the legislation that allows the charity to use the provision without the landlord's consent. It would aid harmony and trust if the provision required that the charity and landlord would mutually agree the waiver of the option over the land. Although this decreases the potential for savings for charities, it might have a compensating positive effect in allowing landlords not to commit to avoiding the exemption under the terms of the lease, thereby leaving realistic scope for a disapplication under this provision to be entered into between the parties.

15. Since the 'carve-out' from paragraph 7, for 'office use' arose originally from complaints by the real estate industry that its exercise could cause severe input tax costs, the above change could allow the 'office' carve-out to be removed, thus making it possible for office buildings to be included in the relief.

16. In respect of the 'office' criterion, we believe this to be one of the worst aspects of the option to tax rules. HMRC's interpretation of it only including areas used by charities for their own administration is, in fact, contrary to what the legislation says. It allows the landlord to adopt a tougher view of this rule than HMRC's policy suggests, causing significant scope for landlord/tenant dispute. It also introduces an extra term into the rules ('office') which is not a sufficiently precise one. It potentially raises issues concerning the designated planning consent use category to which the building is put. It is a wholly unhelpful criterion.

17. The zero rate approach would remove the need for this restriction, and, failing that, a rule that required the landlord and charity tenant to agree the position would allow this criterion also to be withdrawn, as landlords would then be protected.

18. Finally, we are very concerned at the steady and inexorable erosion of the scope and application of RCP. This has now become very narrow (following *Longridge on the Thames etc*). **We strongly advocate allowing the RCP reliefs to apply where the use is solely for primary purpose activities**. This would align RCP with the direct tax exemption for primary purpose trade, thus significantly improving

simplicity and consistency between the charity tax regimes. Since it is now possible to adapt VAT rules to fit our domestic GB arrangements, this (amongst other rationalisations of conflicting tax/VAT positions) should be treated as an important priority.

Option Anti-avoidance Rules (Q3)

19. Charities frequently become embroiled in discussions with landlords relating to the paragraph 12 et seq. schedule 10 'disapplication' rules. This arises because most charities have a lower recovery rate than 80%, leading to use of the property for 'exempt land' purposes. The definition of a potential 'financier' is fraught with difficulties and is generally far too widely interpretable as being applicable. Charities can also be caught by the possibility of not being able to give an 'article 5(2B) notification' for Transfer of a Going Concern (TOGC) treatment if they purchase a building with the purpose of sub-letting a part into which they expect or intend to move their own operations at a future point in time.

20. 'Financing' can include premium payments and even (arguably) rent free periods in cases where the charity is asked to carry out landlord's works in return for the rent free concession. Whereas HMRC guidance tends to cover such scenarios, they remain a complicated specialist area which increases costs and complications for charities.

21. In our view, the only benefit to HMRC in these rules is that the effective disallowance of VAT on costs (by reference to the enforced exempt supply) arises prior to the potential revenue stream from taxed rents (which, by definition, is either partly or solely 'sticking tax'). Any relevance to valuation of supplies can be dealt with, instead, by changing the deemed supply valuation rules and applying the principles of *Weald Leasing.* A mere cashflow advantage for HMRC cannot be sufficient justification for a notoriously bad piece of legislation. You are certainly aware that the *Moulsdale* litigation has shown just how dysfunctional the legislation is (a Court of Session Judge describes the provisions as "unnecessarily convoluted"). But, so Byzantine is its application, that it is beyond repair by a process of tinkering and tightening. It therefore ought to be abolished, and this alone would be a significant simplification.

Option to Tax Permission Rules (Q3)

22. We think that the rules that require actual permission are burdensome and cause excessive difficulty by reference to the safeguards they are supposed to achieve.

23. First, the distinction between 'automatic permission' and actual permission is odd and unnecessary. Either permission is required, or it is not.

24. It seems to us that permission should in any case be abolished. Instead, a set of conditions in respect of reclaiming VAT that predates the exercising of an option to tax should be introduced and then applied by the taxpayer without further reference to HMRC. Such rules should be the means of addressing the distortion that sometimes arises (though in our experience, only rarely) without causing delay and uncertainty in exercising a valid option to tax.

Our views on 'Opt in or Opt out' (Q4)

25. The above section on the paragraph 12 rules would automatically be superseded if the rules relating to Opting were changed from 'opt to tax' to 'opt to exempt'.

26. This is a somewhat technocratic area, and there is no specific charity aspect to it. But, clearly, were there an 'opt to exempt' approach, we would still wish the exemptions (or preferably the zero rates – see above) to apply notwithstanding the changed default position to taxability.

27. Otherwise, it is somewhat attractive to change the basis to opting out of VAT. The reason is that perhaps most properties are within the VAT net, so there is less administration, at this stage, to processing an opt out approach. This also inoculates the interest owner against the common error that you mention – failure to realise that it is the interest holder that opts each building, and not that the building is opted per se and for all interest holders. In particular, where a charity, say, is paying VAT on rent, and agrees a minor sublet to a tenant, it is often wrongly assumed that the supply is taxable. Currently, that is not the position, and the making of the option can be overlooked.

28. There are 'cut-over' issues that no doubt could cause problems. However, we can see the possibility that the introduction of the option to exempt could require all currently opted buildings to remain unavailable to exempt until their rights to do so arise under the 20 year revocation date rule (though, see below for more on that). All others could be subject to a potential option to exempt. We would only add that rules would be needed to ensure that an option to exempt was not applied repeatedly and then withdrawn. However, we would not welcome a rule that required the opter for exemption never to be able to charge VAT. The building ought to be allowed to remain exempt under an option to exempt until the opter was about to incur the relevant expenditure that was to make being taxable attractive, and it could then rescind the option to exempt, and this would be applicable for a minimum set period.

29. As to the length of the revocation period, we now turn to this.

Improving the revocation rules (Q3)

30. The option to tax revocation period stands at 20 years (and is subject to overriding rules largely based on the CGS). We feel that this is too long. It would be reasonable to allow a change of mind after ten years, including if the property is in the CGS (since the CGS would generate the relevant exempt input tax cost). If changing to an 'option to exempt' basis, the period between the end of one option to exempt and the start of a new one could be the same ten year period.

31. We also think that the above ten years should not necessarily run from the date of each fresh option, but only from the date of the option to tax made by the first opter in a line of consecutive TOGCs. This would allow a property to be transferred without a VAT charge, under the TOGC rules, without 'stopping the clock' on the revocation period.

32. We request this because charities are often stuck with paying a taxed rent long after the landlord has ceased to benefit from the option to tax on the property. We do not see the above as increasing complication. It will only be on occasions that landlords wish to exercise a revocation type of choice.

TOGC rules relating to property (Q3)

33. The TOGC non-supply rule is an important protection against VAT revenue shortfalls, and it also significantly improves the purchaser's cashflow position relating to a property acquisition. We would not wish to see it removed.

34. However, we note the significant uncertainty that arises around the classification of property as an asset of 'the same kind of business' as the one carried out by the transferor. In our view, HMRC's emphasis on the assets being used almost identically to the transferor's use is a pointless over-complication. We think that any subsequent and unbroken business use should be regarded as allowing TOGC treatment. For example, if a building is transferred from a rental landlord to a charity, where the charity seeks to use it in hand, such as for storage of goods which are to be sold in charity shops, then we think this should be allowed to be treated as a TOGC.

35. We also think that the TOGC rules should incorporate a reverse charge element to cover cases where the purchaser does not fulfil the conditions set by the parties, in respect of TOGC. This would remove the complexity of needing to have dispute resolution provisions as between seller and buyer.

36. The TOGC rules will otherwise need to be adapted to whatever chosen approach arises for the option to tax or to exempt.

Mandatory Taxation of short leases etc. (Q5/6)

37. We do not have detailed representations to make on this idea, but we again ask that such rules would not override our points concerning charity reliefs discussed above.

38. Otherwise, it is clear that the lack of flexibility or choice inherent in this approach is a disadvantage to charities as it would increase costs and could drive distorted behaviours in which charities make choices as to length of leases merely for the purpose of avoiding a VAT cost. These are significant downsides, so we do not support this idea.

39. However, we would see merit in the view that any right that falls short of a lease (even where a licence to occupy is deemed in law to amount to a lease) should be treated as falling short of the test of being a right of occupation or to obtain financial return on land, and thus should be taxable. We realise that this could give rise to increased costs for charities in marginal examples, but we think that the greater certainty achieved by setting a lease as the minimum standard of grant for the possibility of making an exempt supply is worth the minor financial downside that might arise.

40. We would also reinforce the point above, that any lease, even over 'office facilities' (including a lease that has a high element of 'hot desking') should be allowed to fall within the ambit of the charity reliefs discussed above.

Where Charities need to use their subsidiaries

41. Charities are different from other bodies in that they often must use a wholly owned subsidiary company, and therefore have no choice but to grapple with the complications that can arise from this. We think that any new set of rules should include specific additional rules for charities to enable them

to retain flexibility. The best approach to this point is for HMRC to settle on the design of the over-arching position (as detailed above) and then to revert to us to consider any specific arrangements that these may suggest as being needed for charity groups.

Regulation 109 and 116(2) (Q3)

42. This point strays a little further than land and property, but often applies to such transactions, so we mention it here. Both regulations require the taxpayer to obtain HMRC's clearance for an adjustment (either as to increased input tax recovery following a change of intended use or a special approach to the CGS annual calculation). We think that these ought to be allowed without the requirement to obtain HMRC's permission. There is evidence that HMRC officers are not particularly aware of either rule. Perhaps a permission requirement could be replaced by a notification requirement which thus allows the taxpayer to make the adjustment but alerts HMRC to something that HMRC might wish to check.

Registered Land (Q10/11)

43. This issue does not have a specific charity aspect, but we have been asked to mention it in any case. We cannot see any merit in the idea, for the following reasons.

44. If registered land would always be exempt, then that exempts 85% of English/Welsh land, where the remaining 15% would mainly be poorer quality agricultural land. And as the law requires land that is sold to be registered, this percentage reduces over time. Also, the very act of selling unregistered land will lead by law to it becoming registered. The sale of the land could then be taxable (not registered) but the holding from then on exempt (having had to be registered).

45. If it was to work the other way around (only unregistered land being exempted), then almost all land, and an increasing proportion, would be taxed compulsorily, and the same issue would arise in reverse as above, namely, once it is sold it would become taxable, having been bought as exempt.

46. It is Government policy to encourage everyone to register their land ownership. There should not be a tax status complication cutting across that clear policy. In any case, there is no logic in whether land is registered affecting the taxation of a supply. There is no material difference between registered and unregistered land. It creates a clear fiscal neutrality issue.

47. Experience also suggests that the use of land registration to define a building and its demise is hit and miss. Title numbers often cut across different demises, and a single building will often have multiple title numbers. It would even be possible to find that a single estate/building curtilage comprises a mix of registered and unregistered land. Although the proposal is to make the registered status of the land determinative of the liability, rather than opting by reference only to title numbers, experience suggests that the latter could create significant confusion.

48. Land registration is not about tax, and the two should not be linked.

CTG
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