HMRC call for evidence on partial exemption and capital goods scheme – BPF response

Introduction

1. The British Property Federation (BPF) represents the real estate sector – an industry which contributed more than £100bn to the economy in 2018 and supported more than 2 million jobs.

2. We promote the interests of those with a stake in the UK built environment, and our membership comprises a broad range of owners, managers and developers of real estate as well as those who support them. Their investments help drive the UK's economic success; provide essential infrastructure and create great places where people can live, work and relax.

3. Businesses in the property investment and development sector often have to deal with partial exemption and the capital goods scheme and their general experience is that there is room for improvement when it comes to user experience. We therefore welcome the opportunity to comment on HMRC's call for evidence on simplifying Partial Exemption (PE) and the Capital Goods Scheme (CGS).

4. In the sections below, we respond to selected questions from the call for evidence. We would welcome the opportunity to elaborate on the points below in a meeting – please do not hesitate to get in touch if that would be useful.

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Partial exemption

Q1: Does your business use a PESM? If so, what was your experience in getting the PESM approved?

5. Our members regularly use PESMs, typically in order to fair and reasonably recover input VAT incurred in connection with building and maintaining mixed-use properties e.g. those that feature a mixture of commercial and residential use, as will often be the case with newer and large-scale developments.

6. Their experience is often that it is a more time-consuming and involved process than it feels like it should be. It is particularly burdensome that a new PESM needs to be agreed for each company/VAT registration within a corporate group, even though it may be perfectly reasonable for a single PESM to apply to all of them.

7. For instance, a developer may have two development projects on the go at the same time, which for reasons of finance and risk management are carried out through two separately VAT-registered companies. Even though the two developments are broadly comparable in terms of their eventual use and provision of supply, the current PESM rules would require the developer to negotiate two separate PESMs, incurring considerable administrative burden for both the developer and HMRC.

8. It could also be the case that a developer has just completed a development and is about to start another similar one through a separately VAT-registered company. Again, even though it would be reasonable to simply "recycle" the PESM that applied to the recently completed development, the developer and HMRC need to go through the time-consuming process of agreeing a new PESM.

9. It doesn't help that HMRC appears to take an inconsistent approach to the questions it asks and information it requires when agreeing a PESM. This makes it difficult for taxpayers to prepare efficiently for PESM discussions and in this context it would be helpful if HMRC could provide a comprehensive and standardised list of information that a taxpayer needs to supply in order for HMRC to get comfortable with a proposed PESM. We appreciate that HMRC may want further opportunities to scrutinise evidence and arguments put forward by taxpayers, but the goal should be to minimise the number of "rounds" of correspondence.

Q2: How long did the approval process take?

10. It varies, but regularly takes more than a year. One of our large fund manager members recently engaged with HMRC to make certain changes to their PESM – the process took 13 months from initial approach to agreement. However, we have heard from another member of an instance where HMRC have yet to reply to a taxpayer 15 months after the taxpayer initially applied. It is not uncommon for it to take two or three years to agree a PESM.

11. Accelerating this process must be an urgent priority for HMRC and we see there being two elements to this:

11.1. Adequate resource (both in terms of headcount and expertise) within HMRC to agree/disagree PESM applications in a reasonable timescale;

11.2. A deadline (e.g. three months) for HMRC to substantively respond to PESM applications. Such deadlines apply in other areas of the tax code, such as for VAT-grouping applications or seeking reorganisation clearances for Corporation Tax purposes.

Q4: Would allowing businesses to apply PESMs without seeking approval improve the system? Please give reasons for your answer.

12. Taxpayers are unlikely to feel comfortable with this approach. PESMs can determine the VAT treatment of millions of pounds' worth of expenditure and taxpayers – particularly those involved in large-scale development – will want the certainty that HMRC will not at some point in the future challenge the approach they have taken.

13. It is not just property developers and investors that would feel uncomfortable at this lack of certainty – their lenders and insurers will also want to know that the basis on which the taxpayer is recovering VAT on costs is definite and not subject to change in a way that might adversely affect their interests.

14. We think that a more effective simplification of PE for property developers and investors would be the creation of a sectoral framework. However, if the idea set out in paragraphs 2.9 to 2.13 of the call for evidence were adopted, it would be important that taxpayers could still choose to obtain approval for their PESM if they felt it necessary.

Q5: Would there be issues created by removing the requirement to seek approval of a PESM?

15. As set out above, the main issue would be the lack of certainty regarding the tax treatment of input tax. In a property context, this is not just an issue for developers/investors, but also for their lenders and insurers.

Q6: Would an increased focus on the use of sectoral frameworks be of benefit, particularly if approvals were removed?

16. Yes, although as noted above we don't think the requirement for PESMs to be approved should be withdrawn (or if it is to be withdrawn, the option for approval should remain). However, we would note that greater use of sectoral frameworks would only be a simplification to the extent that HMRC do not then unduly challenge their use or that of particular features within the framework.

17. We would welcome the opportunity to engage with HMRC on the development of a property sector PE framework, which would most likely use floorspace as a starting point in determining a fair and reasonable attribution of costs.

18. We acknowledge that this approach would not be appropriate in all scenarios and there will be cases where developers and investors wish to agree a bespoke PESM with HMRC. HMRC may also have concerns regarding the range of taxpayers that should be entitled to use a property sector framework and the sort of activity that such a framework should cover. However, we feel that its introduction could simplify the administration of PE for many property sector participants; particularly SMEs.

Q7: Do you have other suggestions to improve or simplify the application of the PE regime?

<u>Making minor changes</u>

19. It is currently not possible to make minor changes to a PESM. If a taxpayer wishes to amend its PESM to reflect small changes affecting its business it must approach HMRC to negotiate an entirely new PESM, which could end up looking very similar to the pre-existing one. This feels like a poor use of resources for both taxpayers and HMRC and the process should be streamlined.

PESM declaration

20. We understand that the PESM declaration was introduced in order to accelerate the process of granting approvals on PESMs. However, it is not clear to us that it has had this effect (as noted above, PESMs take a long time to agree) and would therefore question whether it is still needed. If it is serves no real purpose, then it should be scrapped.

"Making input tax recovery fairer"

21. In April 2003 Customs & Excise (as then was) published a consultation document entitled VAT: Making input tax recovery fairer. The summary of responses to this consultation paper, which was published in March 2005, reported that the Government would not at that time take forward any of the proposals it had proposed. This was a shame, as some of them would have represented a simplification to taxpayers.

22. While the scope of that consultation was broader than just PE, we would recommend that HMRC revisits it and reconsiders introducing some of the changes that were mooted at the time.

VAT Regulations 108 and 109

23. Regulations 108 and 109 (also known as clawback and payback) apply where there's a change of intention or use, before any actual use has actually taken place. These Regulations pre-date the CGS, which focuses on where a change follows actual use and which was developed separately. We believe there is a strong case for considering how Regulations 108/109 and the CGS interact and the extent to which they take account of each other.

24. In addition, we find it inequitable that while Regulations 108 and 109 are broadly the mirror image of each other, a taxpayer that owes money to HMRC must simply adjust their next VAT return and pay it, while a taxpayer that is owed money by HMRC has to make a separate claim for it. In our view, these Regulations should be genuinely reciprocal.

Zero-rated leases

25. It has always been understood that the intention behind the VAT legislation was that taxpayers can recover VAT on capital costs, but not on subsequent "recurring" costs such as maintenance. However, for historic reasons, the legislation doesn't actually support this approach and a strict reading would in fact suggest that the input tax on construction costs is residual rather than fully recoverable.

26. HMRC has long understood the logic and supported the use of the approach set out above. This is alluded to in paragraph 4.3 of Notice 708, which says that "a developer is able to treat as input tax attributable to a taxable supply, the VAT incurred on construction and selling costs".

27. However, in the interests of clarity and providing certainty for both taxpayers and HMRC, we strongly recommend that the legislation is amended to codify the approach. The legislation should also make it clear

that capital costs include things like architects' and surveyors' fees, as well as other costs that relate to the development.

Q8: Do you have other suggestions on how the way in which HMRC interacts with partly exempt businesses could be improved?

28. In our members' experience, HMRC appear to approach PESM negotiations with suspicion regarding taxpayers' motives and this mistrust makes discussions more difficult and time consuming than they need to be. Furthermore, our members have often encountered within HMRC a relatively low level of awareness regarding how taxpayer businesses work and what activities should or should not be considered normal in a particular type of business. The "learning curve" that HMRC need to climb every time PESM discussions take place adds to the length of the process.

29. Improving this situation would require better resourcing (both in terms of headcount and levels of commercial expertise) within HMRC.

Q9: What is your experience of carrying out the de minimis test?

30. Our members typically incur input VAT considerably in excess of the *de minimis* and therefore this is of little relevance to them.

Q10: What would the advantages and disadvantages of increasing the de minimis threshold be to business?

31. As noted above, this is not an issue for most of our members, although it feels only fair for the *de minimis* threshold to be updated and for it to increase broadly in line with inflation.

32. While in theory this may result in more businesses having to carry out a calculation to see if they benefit, it will generally be fairly clear to businesses whether they are above or below the *de minimis* threshold.

33. As an alternative approach, the threshold could be made more meaningful for individuals businesses if it were set as a percentage of their turnover. While this would potentially take relatively large businesses out of PE, it would reduce the administrative burden that those businesses currently have to incur in preparing calculations regarding amounts that are – in the scale of their businesses – relatively small amounts.

Q11: Are you aware of the existing simplification, and do you make use of it?

34. As above – not in point for most of our members.

Q12: What would be the advantages and disadvantages of removing the de minimis test?

35. We struggle to see how this would be a good idea. Those businesses who do currently benefit from the *de minimis* exemption would be put in a position of having to carry out considerably more work, for little benefit to the exchequer, and none to the business. As noted above, our understanding is that the time spent checking whether a business meets the *de minimis* threshold is generally negligible.

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Capital goods scheme

Q15: What is your experience of the CGS?

37. Our members can have significant exposure to the CGS, mainly through their property investment activities but potentially also because of capital expenditure on properties they occupy for the purposes of their business.

Q16: How much time and resource do you allocate to carrying out CGS calculations? Does this have an impact on your business?

38. Our members opt to tax almost all their investment properties, use most of them for taxable purposes, and reclaim all the VAT on capital expenditure. There is therefore generally little need for them to maintain detailed CGS-specific records because there are few or no VAT adjustments.

39. As a result, the greatest CGS impact is administrative and in connection with the disposal of tenanted properties under the TOGC rules. This is because, in TOGC scenarios, purchasers inherit a seller's CGS obligations and therefore want detailed records from the seller regarding the values, timing, and VAT recoverability of capital expenditure for up to the last ten years. This is so that they can correctly attend to any future CGS adjustments they might be required to make as a result of any changes in their own taxable use of the CGS asset, albeit in the majority of cases a taxable business is continued and no adjustments will be required.

40. Because, as noted above, there isn't an obvious need to maintain detailed CGS records, sellers can sometimes find these information requests from buyers difficult to comply with because the information is not always readily available and can require extensive work to uncover the relevant details, particularly when they relate to periods more than a few years in the past. As a result, there may be a case for requiring records to be kept in relation to the CGS (and only the CGS) for longer than the normal six years.

41. An alternative way to encourage taxpayers to retain CGS information might be to require the annual submission of a "CGS return" that would record the initial value of CGS items and any adjustments made. However, it is possible that this sort of record-keeping may evolve naturally as a consequence of more digital administration of VAT.

Q17: To what extent does the CGS help to prevent cases of tax avoidance and unfair competition?

42. We are not aware that the CGS helps to prevent tax avoidance. Perhaps it did when it was originally introduced, but this is not self-evidently the case now and even if it were, HMRC now have other means at their disposal to counter such avoidance. However, the CGS is used to provide the scope for other anti-avoidance measures (e.g. for the option to tax).

Q18: What would be the advantages and disadvantages of increasing the threshold for land and property for businesses?

43. Increasing the threshold would remove some property expenditure from the scope of the CGS and therefore reduce the overall record keeping and tax adjustment burden but it could also lead to taxpayers being better or worse off than they otherwise might have been.

44. For example, if a taxpayer's taxable use of a property decreases in the years following its incurring of capital expenditure then, if that capital expenditure is below the new CGS threshold, the taxpayer will not have to repay any VAT to HMRC. Conversely, a taxpayer increasing its taxable use of a property will not be entitled to reclaim any VAT from HMRC if its capital expenditure is below the new threshold.

45. On balance, we would recommend increasing the land and property threshold significantly (e.g. from £250k to £2.5m) in order to take substantial amounts of expenditure out of the scope of CGS, thereby simplifying administration for businesses. From a property investment perspective, a higher CGS threshold would simplify record-keeping on refurbishment expenditure, which would not normally exceed £2.5m. However, businesses incurring capital expenditure above the current threshold but below the new one we propose should be able to "elect into" the CGS.

Q19: Would there be any other issues involved with increasing the land and property threshold?

46. If the new threshold was only effective in respect of capital expenditure from some future date this could introduce complications as a result of the transition between the two thresholds (i.e. for capital expenditure straddling the change); complications that could persist for some time depending on how the transition is implemented. It could also create a two-tier system, as a small timing difference between two identical projects could bring one project into the scope of the CGS and the other outside of it, though this could be mitigated by allowing taxpayers some flexibility regarding the date an asset is brought into use.

47. In addition, as awareness of the CGS is in our experience fairly limited outside of large businesses with dedicated VAT teams, changing one of the two key attributes that people are likely to have knowledge of (I.e. the threshold and the ten year intervals) could well cause some confusion. Furthermore, it could make it more difficult for a buyer to obtain reliable information from a seller in the event of a TOGC.

48. Accordingly, if the threshold were to change, it would be preferable if any new threshold had retrospective effect so that it would not only exclude new below-the-threshold capital expenditure but also automatically remove previous capital expenditure which is currently within the CGS adjustment period but which is below the new threshold. To allow for cases where the retrospective application of the threshold leads to the loss of additional input VAT recovery, affected taxpayers could be given the option of continuing to apply the CGS or making an immediate final adjustment. We recognise that this suggestion would not be revenue-neutral for the Exchequer.

Q20: If the threshold for land and property is increased, do you think we should consider having a different threshold for alterations, extensions, annexes and refurbishments, (i.e. retain the current threshold) or would this increase complexity?

49. No. This would increase complexity, particularly as it is not always clear whether a project is new construction or alteration/refurbishment. As noted above, introducing a substantially higher threshold for land and property would take many alteration/refurbishment projects out of the scope of CGS.

Q21: Are there other ways in which the CGS can be improved?

Pre-registration input VAT

50. As part of a review of the CGS, HMRC should consider the OTS's comments on the challenges that the current pre-registration input VAT recovery rules pose for property developers and the consequent irrecoverability of VAT on genuine business expenses incurred for the purposes of making taxable supplies.

Guidance

51. HMRC's current guidance on the CGS requires substantial improvement. Our members find Notice 706/2 lacking in useful content, and HMRC's manual does not provide much additional supplement. Some aspects of property-related activity get little or no coverage (notably dealing with the grant of a lease for a premium as a part disposal), and some of the material in Notice 706/2 has been wrong or at least misleading since changes made in January 2011.

52. When we have raised this with HMRC in the past we have been told the guidance is under review, but it is not clear when – if ever – updated guidance will be published. We would be happy to support HMRC in this exercise if that would help, but only if there is a genuine commitment and dedicated resource on the part of HMRC.

CGS calculations – reporting

53. For historical reasons, CGS calculations are supposed to be reported on a taxpayer's VAT return a full six months after the end of the relevant period. This is a relic from the pre-computer age and is no longer necessary.

Aggregation

54. We would welcome greater clarity on the circumstance in which expenditure should be aggregated for the purposes of CGS. This was an issue in the case of *Water Property* and it seems to us difficult to reconcile what Notice 706/2 has to say on the matter with what is in the relevant Regulations.

Developers granting zero-rated long leases

55. We would welcome the opportunity to discuss how detailed consideration could be given to the treatment of developers granting zero-rated long leases, typically of apartment blocks or RRP buildings. It may be that there would be benefit in these – or housing in general – being excluded from the CGS altogether.

56. However, there would be issues with subsequent transactions (such as the grant of an overriding lease to a management company), with forced deregistration (because the developer has ceased to make taxable supplies), with white goods (where the input tax is blocked anyway) to name but a few.

57. Regulation 116(3), and Business Brief 23/06, do not wholly deal with the issues, and it is unsatisfactory for developers still to be relying on a 13-year old Business Brief. It's been suggested in the past that if leases are being granted for a premium, the property is already outside the CGS because it's trading stock rather than a capital item, but we understand that HMRC don't accept this, and in any case it wouldn't deal with all cases.

58. We would also welcome the opportunity to discuss the unsatisfactory interaction of Item No. 1(a)(i) and / or 1(a)(ii) Group 5, Schedule 8, VATA 1994, Regulation 116(3) SI 1995/2518, Paragraph 11, Schedule 1, VATA 1994 and Regulation 115(3ZA) SI 1995/2518.

59. This impacts Property Owners (PropCos) which construct residential assets and make the first grant of a major interest (specifically a long lease) in those assets to Operators (OpCos), which in turn certify that the assets will be used solely for a relevant residential purpose (RRP), and also Property Owners (PropCos)

which construct assets designed as a dwelling or number of dwellings and make the first grant of a major interest (specifically a long lease) in those assets to an Operator (OpCo) or Occupier.

60. An issue arises as follows:

60.1. PropCo incurs VAT on the acquisition of the land and or services related to the construction of the asset (some services may be zero rated where dwellings are being constructed).

60.2. PropCo is entitled to be registered for VAT, and recover the related VAT as input tax by virtue of the fact that it intends to make a taxable supply (i.e. the zero rated first grant of a major interest in a dwelling / RRP by a person constructing).

60.3. PropCo makes a zero rated supply, and continues to charge rent as a property rental business. All subsequent supplies arising under the grant (i.e. subsequent rental payments received) are exempt from VAT.

60.4. PropCo has no intention of making any further taxable supplies but is entitled to ignore the subsequent exempt income for the purposes of the capital goods scheme (CGS).

60.5. However, because PropCo has no intention of making any further taxable supplies it is required to deregister for VAT. Any VAT that has been recovered will immediately fall to become repayable under the CGS.

61. Potential Solutions are as follows:

61.1. HMRC have stated informally that they will not seek to deregister businesses with this fact pattern if they no longer intend to make taxable supplies. However, HMRC's informal assurances are not based on the legislation and are not reflected in their internal guidance and cannot therefore be relied upon.

61.2. Ideally the legislation should be changed to remove the risk of deregistration for PropCo in this specific scenario.

61.3. Alternatively, and perhaps more realistically, HMRC's internal guidance should be updated to make it clear that this is an area that HMRC will not seek to enforce.

Disposal test

62. We understand the disposal test was originally introduced to tackle the planning used in *Centralan*, but the ECJ found the planning to be ineffective, and the relevant UK regulations were later amended to address the point. It is not clear to us what purpose the disposal test now serves other than to create a risk for taxpayers, who must consider a (in our view harsh) provision that applies "save as the Commissioners may otherwise allow".

63. We are not aware of any instances where HMRC has not allowed it, but the test seems an unnecessary complication. If HMRC sees a continuing need for it, we would welcome legislation to confirm the circumstances in which HMRC would not use this power (currently set out in Notice 706/2).

First use

64. We would welcome greater clarity regarding what constitutes the point of “first use” and the interaction between the CGS and adjustments potentially falling to be made under the principles in *Briararch* and *Curtis Henderson*.

Q22: Do you have experience of computers being included in the CGS?

65. No.

Q23: Would removing computers from the CGS be a simplification for business?

66. Yes. We understand HMRC’s argument that this would be of limited benefit if there are few computers in the CGS, but that is not a good enough reason not to remove them. The benefit here is slightly simpler legislation.

67. We note that the OTS also suggested removing boats and aircraft from the CGS and are intrigued as to why HMRC has not considered this in the current call for evidence.

Q24: What do you think of the current interval length?

68. Given the context in which the question is raised, we assume that it refers primarily to the adjustment period for capital items (ten years for most items of capital expenditure) rather than the length of a given interval (usually a year).

69. Both the adjustment period and the interval length have the benefit of being widely known, even among those with little in-house VAT expertise. This might be a strong reason for not making any changes.

70. However, if one considers that the CGS adjustment period should roughly coincide with the useful life of an asset, then a ten year period is arguably too short for most property assets. While the useful life of property will vary greatly (many buildings in the UK are still in use centuries after their construction), it is not unreasonable to assume that most developers have recouped their construction costs after 15 or 20 years of ownership and that the adjustment period should therefore be increased from its current level.

71. There is an opposing argument that intervals covering an adjustment periods of up to ten years are too long because they rely upon record keeping beyond the usual six-year limit as well as making it more likely to lead to businesses inadvertently failing to properly make adjustments. This needs to be weighed up against the fact that shortening the adjustment period would mean that a change of use can have a disproportionate effect on input tax.

72. On balance, we would recommend increasing the adjustment period for property assets to 20 years.

Q25: Would a change in the number of intervals help businesses with their administration of VAT? Why?

73. Yes, reducing the number of intervals would – in theory at least – result in a reduced administrative burden. However, as with changing the CGS threshold, there are potentially tricky transitional issues to consider.

Q26: Do you have other suggestions to improve and simplify the application of the PE and CGS regime?

Please see our responses to Q7 and Q21 above.