

# VAT Grouping – Establishment, eligibility and registration – Call for Evidence



## Introduction

1. The British Property Federation (BPF) represents the real estate sector – an industry which contributed more than £100bn to the UK economy in 2018 and supported more than 2 million jobs<sup>1</sup>. 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.
2. For a variety of commercial, legal and tax reasons, real estate investment is often carried out through relatively extensive and sometimes complicated holding structures. The ability to VAT group these – or as great a proportion of them as possible, and in different ways – is hugely valuable in terms of simplifying VAT compliance. We therefore welcome the opportunity to comment on the Government's Call for Evidence on VAT grouping.
3. This submission begins with an overview of the legal structures and entities used in property investment and then considers selected questions from the three sections of the Call for Evidence.

## Property investment structures

4. As noted in the introduction, real estate investments are often held through relatively extensive and sometimes complicated holding structures. There are a number of reasons for this, including:
  - 4.1. *Obtaining finance secured on individual assets*: owning individual properties or portfolios of properties in special purpose vehicles (SPVs) allows investors to 'segregate' these properties from other properties owned by the group and facilitates secured lending by banks, some of which specifically offer different terms for grouped entities or may not lend at all because of joint and several liability issues.
  - 4.2. *Risk mitigation*: segregating properties in this way also means that if one investment goes bad, any liabilities incurred are contained within the entity that owns the property and – as long as there are no parent company guarantees – do not affect the wider group.
  - 4.3. *Flexibility*: owning properties through SPVs means that a wholly owned investment can easily be turned into a joint-venture arrangement, as interests in the SPV can be sold to new investors without having to sell the property itself. This means that capital can more easily flow to real estate investments, which generate large numbers of construction and facilities management jobs.
5. Holding structures will be tailored to accommodate different types of investor based in different jurisdictions. That said, there are certain common features that most property investment funds share and a conceptual illustration of how these are structured is set out in Appendix 1.

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<sup>1</sup> <https://www.bpf.org.uk/sites/default/files/resources/16688%20BPF%20Economic%20Footprint%20Report%2014.08.19.pdf>

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## VAT grouping and establishment

6. We have no comments regarding this section of the Call for Evidence.

## Compulsory VAT grouping

*What benefits or disadvantages could a system of compulsory VAT grouping deliver for businesses? Would this vary between different sectors?*

7. We see little merit in introducing compulsory VAT grouping for property investment and development businesses and potentially significant disadvantages. As noted above, property is often owned through bespoke legal structures facilitating a range of commercial, financial and tax outcomes. Imposing mandatory VAT grouping on existing arrangements would be highly disruptive as their intended outcomes could be adversely (and unnecessarily) affected. For instance:

- 7.1. The mismatch between zero rated new build homes, the (typically) standard rated purchase of bare land and the exempt nature of residential property leasing produces a complex position for developers of build to rent residential property and student accommodation. As a result and to put themselves in a similar VAT position to housebuilders building homes for sale (who can recover most or all of the VAT they incur on construction costs), developers often – though not in all cases<sup>2</sup> – grant a first major interest in newly developed residential property to a separate company in their corporate group (though importantly, not in the same VAT group). This would not be possible under compulsory VAT grouping, increasing the cost of building these types of new homes by up to 20%, damaging their viability and ultimately reducing the number of new homes built.
- 7.2. Lenders to property investors almost always prohibit the VAT grouping of different companies in an investment structure to reduce lenders' exposure to liabilities arising in parts of a group that it is not lending to. Compulsory VAT grouping would make this segregation of credit exposure impossible, increase risk to the lender and result in a combination of reduced availability and increased cost of credit for property investment and development. We refer to the more detailed comments made on this point by the Commercial Real Estate Finance Council Europe (CREFCE) in their response to the Call for Evidence.
- 7.3. Developers will often set up an estate management vehicle to hold and maintain the common parts of an estate, with the intention that buyers of each of the properties will own shares in the new company as the estate is sold. This company will initially be wholly owned and ownership diluted as units are sold. Occasionally it may also come under majority control of a single owner during its lifetime as properties are bought and sold. Under compulsory grouping, the joint & several liability issues will create significant administrative difficulties and additional due diligence requirements, which makes no commercial sense as the service charge company exists primarily to maintain an estate and is not generally profit-making
- 7.4. A vehicle may be set up to acquire land and obtain planning permission in advance of inviting joint venture investors for the development phase. The joint & several liability imposed by compulsorily

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<sup>2</sup> For a variety of commercial and financing reasons, it can be preferable for developers to sell the whole development from a First Buyer (development co) to a Second Buyer (letting co) despite the VAT result being less favourable.

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grouping that entity with would make this vehicle less attractive to potential investors, who may be critical to funding the development and the jobs and broader economic it entails. Expensive due diligence or additional transactions may be required to make this model viable.

- 7.5. It is not unusual for property owners to split the ownership of a building between two companies so that the VAT treatment of the building follows that of its occupation. For instance, an owner may want to the opt to tax one part of the property (e.g. ground floor retail) but leave the other part (e.g. the upper office floors) untaxed if they plan to let the space to an exempt occupier. Compulsory VAT grouping would eliminate this flexibility, forcing the owner to choose (in this example) between lower VAT recoverability on the retail component and a less attractive rental proposition on the office component.
- 7.6. Many organisations, especially housing associations, care home operators and student accommodation owners, will have subsidiaries that procure construction services and professional fees, and then provide a design-and-build service to their parent in line with the policy outlined at section 3.4.1 in Notice 708 Buildings and Construction. This enables them to enjoy the same zero-rated treatment as if they were to procure a design-and-build contract from a third party builder, but allows them to have greater control over the appointment of the professional advisers. With an increased focus on the quality of new build following the Grenfell tragedy, as reinforced in the Government’s recent Social Housing White Paper, there has been a move towards procuring professional services through such a subsidiary. If these subsidiaries were to become part of the VAT group, this parity of VAT treatment would no longer apply.
8. We also foresee significant administrative and VAT technical challenges with transitioning from the current VAT grouping rules to a system of compulsory VAT grouping. These include:
  - 8.1. Partial Exemption Special Methods (PESMs), which would need to be revisited for every company joining a VAT group and a new application made to HMRC.
  - 8.2. Consideration of whether dormant companies would be automatically included within the VAT group and any knock-on impact of that.
  - 8.3. Whether a property-owning company joining a group would trigger the option to tax disapplication rules.
9. There would also need to be clarity regarding the point in time at which companies (particularly – as commonly used in property investment and development – newly created SPVs) become part of a VAT group under compulsory grouping.
10. Finally, it is likely that some businesses would respond to compulsory grouping by looking for ways to “break” groups, such as introducing overseas companies into corporate structures.
11. In summary, we would strongly recommend that compulsory VAT grouping is not introduced. While the existing grouping rules have their complexities (in particular, the anti-avoidance provisions), they are on the whole well understood and we feel do a good job of supporting economic activity by reducing the administrative burden faced by businesses.

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*How would compulsory VAT grouping impact the administrative processes for businesses?*

12. As noted in our response to the previous question, there would be tremendous administrative challenges involved in transitioning from the current grouping rules to a system of compulsory VAT grouping.
13. Compulsory VAT grouping would also concentrate the administrative burden of VAT reporting for taxpayers who currently have multiple VAT groups. Such taxpayers can currently stagger quarterly returns (and the associated workload) so that they are spread evenly throughout the year, but would under compulsory VAT grouping be required to report potentially as often as every month, significantly reducing the time available to carry out and thoroughly internally review VAT reporting and potentially resulting in more errors.

*How would compulsory VAT grouping impact businesses of different sizes, and would the minimised risk of errors be of benefit?*

14. The point we make above regarding compulsory VAT grouping concentrating VAT reporting is more likely to be an issue for taxpayers with multiple VAT groups. This does not necessarily translate into large corporate groups with many employees as it is possible for even relatively small property investment structures to have multiple VAT groups.

*Are there any instances where businesses are not VAT grouped for specific commercial or regulatory reasons? Please provide examples.*

15. Please refer to our response to the first question in this section of the Call for Evidence.

## Eligibility criteria – partnerships

*How do limited partnerships (LPs) and Scottish limited partnerships (SLPs) currently participate in VAT groups?*

16. English limited partnerships (ELPs) generally do not participate in VAT groups, though as the Call for Evidence indicates at paragraph 45, it is fairly common for the general partner (GP) of an ELP to be VAT grouped with other entities, usually with whoever manages the investments of an ELP used for collective investment purposes.
17. We strongly support the outcome that this arrangement delivers and would encourage the Government to introduce legislation that effects this (e.g. by allowing an ELP to join a VAT group where the sole GP is a body corporate and manages the ELP).

*How do LPs and SLPs tend to be used within the structure of corporate groups and what is the commercial rationale for inserting them into VAT groups?*

18. Because real estate investment and development involves tying up large amounts of capital for extended periods of time in bulky, illiquid assets, investors often choose to mitigate their exposure by partnering with other investors through joint ventures or other co-investment arrangements such as pooled funds.
19. As English limited partnerships (ELPs) are effectively 'transparent' for direct tax purposes, they are often the vehicle of choice for such arrangements; they allow each investor to be taxed according to their own individual attributes. ELPs may also be used where there is only a single investor, as this makes it easy to admit new investors in future if this is deemed to be desirable. Or indeed they may arise where a single

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investor has acquired the interests of previous investment partners but unwinding the ELP would give rise to SDLT complications.

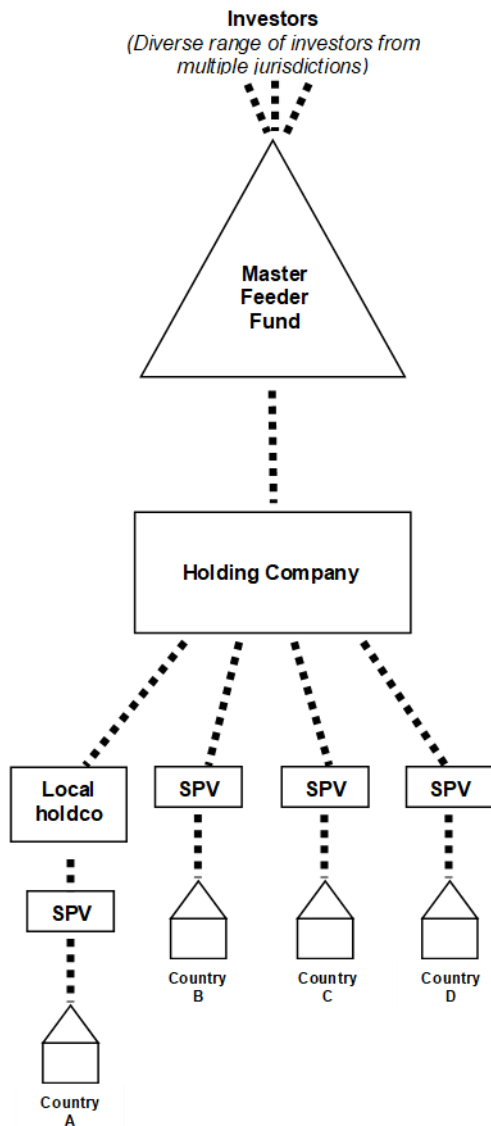
20. However, as they are not 'bodies corporate', ELPs cannot at present be VAT grouped. This means that each ELP must be registered individually and returns prepared and filed, even where an ELP is wholly owned by a single investor. The inability to group ELPs can also cause issues with invoicing; either suppliers must issue several invoices (one for each limited partner) or one limited partner is invoiced and then has to raise VAT invoices to the other limited partners.
21. This all entails a considerable administrative effort on behalf of whoever manages the tax affairs of the ELP (most often, the manager of the fund or investment structure of which the ELP is a part). The ability to VAT group ELPs would render this unnecessary and result in considerable administrative relief for real estate businesses with ELPs in their corporate group. It is hard to estimate a value for the aggregate savings across the real estate industry, but our members reckon that preparing a VAT return involves roughly half a day of work, including management review and sign-off.
22. In addition, being able to VAT group ELPs would reduce the number of invoices required and mean that intra-group recharges could be carried out by way of accounting journal entry rather than by invoice, saving further time and resource within finance teams.

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## Appendix 1 – Illustrative example of property fund structure



### **Investors**

Investors invest via a fund to pool resources and achieve economies of scale, to spread risk and to access professional investment and portfolio management services.

### **Master Feeder Fund**

This vehicle is usually a transparent entity. Investors like to invest in a transparent vehicle to ensure that they are taxed according to their individual tax attributes.

### **Holding Company**

A holding company is required in order to consolidate all of the underlying real estate investments. The administration and financing of the property portfolio may also be carried out by the holding company.

Individual investors may not have the expertise or scale to carry out the administration in respect of their individual investment, so it makes more sense to carry this function out centrally.

It is not uncommon for a local holding company to be used in the same jurisdiction as the investment, as illustrated with the investment in Country A.

### **SPVs and investments**

Individual real estate assets are often directly owned by a special purpose vehicle or holding company. This allows flexibility when selling the asset e.g. the ability to sell a proportion of the asset rather than the whole asset. It also allows for specific borrowing at the level of the asset if required.