Gabrielle Dillon
Director, Twomey Moran

VAT and Property: Managing the Implications for Landlords in an Economic Crisis

Introduction

An article on VAT and property would not normally arise owing to a public health emergency and global pandemic, but unfortunately it is against this very backdrop that this article is composed. The economic consequences of the pandemic have affected every facet of business life, and the landlord–tenant relationship will not escape the harsh realities of our "new normal". The purpose of this article is to highlight some of the implications that can arise from a VAT perspective when the landlord–tenant relationship breaks down or is under renegotiation and to provide some guidance to help counteract possible pitfalls. Different implications arise depending on when the original lease arrangement was entered into, and it is therefore important to remember the distinction between leases created before 1 July 2008 and those created on or after this date.

Surrender of Leases

The VAT-and-property rules that operated before 1 July 2008 had two categories of lease arrangement. There are leases that were treated as a supply of goods (namely, leases created for a period of more than 10 years and in respect of which VAT arose on the capitalised value of the lease – now referred to as legacy leases) and those that were treated as a supply of services (namely, leases of less than 10 years, which were exempt from VAT unless the landlord waived exemption). For the purposes of this article, only those situations where VAT was chargeable upfront on the capitalised value of the lease or VAT was chargeable on the rent, will be covered.

Leases granted pre 1 July 2008

Owing to the economic toll taken on businesses, a landlord may now be faced with a surrender of a legacy lease either by agreement or otherwise. For VAT purposes a surrender arises where there is a transfer of the tenant's interest (or part interest) to the person who holds the reversionary interest (the landlord) and includes an abandonment of the interest by the tenant, the failure to extend the interest to a period of at least 10 years (where lease was for less than 10 years) (this excludes interests created after 1 July 2008) and the recovery of the interest by the landlord by ejectment or forfeiture before the expiry date.

It is important to remember that any one of these actions gives rise to VAT implications for the landlord. The landlord will be required to self-account for VAT on the surrender (where the tenant had entitlement to input VAT recovery on the acquisition of the lease and the surrender occurs within the 20-year adjustment period). The landlord's entitlement to a simultaneous input credit depends on the proposed future use of the property. Granting a new lease after the surrender of a legacy lease will require careful consideration in VAT terms. A new lease will be exempt from VAT, which means that the VAT on the surrender becomes a VAT cost for the landlord.

This may or may not be an issue if the input VAT amount is not significant. This is where the commerciality of the situation comes into play, with the landlord choosing whether to secure a tenant with no VAT recovery and forgo the input VAT on the surrender or to wait to secure a tenant with input VAT recovery and who would generally have no objection to an option to tax. In the latter case, the option to tax must be evidenced in writing by including a clause in the lease or by notifying the tenant separately. This should be done in a timely manner to avoid a capital goods scheme adjustment, as it is not possible to back-date an option to tax. It is advisable that a VAT clause is also included in the lease to enable the landlord to collect the VAT on the rent and to make it clear from the outset that the landlord has exercised an option to tax.

Something as straightforward as to how the rent is defined is critical – if it is defined as VAT-inclusive, the landlord is required to account for VAT on an inclusive basis, whereas if it is defined as VAT-exclusive, the landlord charges VAT on the rent amount (on foot of a valid VAT invoice).

The definitions used in the lease, together with the appropriate clauses, should be clear and unambiguous to ensure that there are no misunderstandings or misinterpretations at a later stage, which can be costly and/or tricky to resolve. Where a landlord inherits an opted-to-tax lease, any issues surrounding the application of VAT to the lease should be assessed and dealt with before acquisition, by closely examining the replies to the PCVEs (pre-contract VAT enquiries) and the lease clauses. Both parties should be cognisant of the VAT treatment that is being applied.

The tenant is obliged to provide a document under s95(9) of the Value-Added Tax Consolidation Act 2010 (VATCA 2010) to the landlord setting out the number of intervals remaining and the VAT arising. This may not always be adhered to, for instance, where the circumstances of the surrender are acrimonious. Nevertheless, the obligation rests on the landlord to account for the VAT on the surrender. In a situation where the tenant can comply with s95(9), care should be taken to ensure that the VAT amount is calculated correctly, i.e. ensure that the "plus 1" in the formula in s95(8) is included and that the correct adjustment period is applied.

The VAT that arises on a surrender is restricted to the amount calculated by using the formula in s95(8), and the current Revenue Tax and Duty Manual on transitional measures[1] states that "any premium/reverse premium payable by a landlord to a tenant, or a tenant to a landlord in respect of the assignment or surrender of a legacy lease, is considered to be outside the scope of VAT".

Waivers of exemption

Although it is not possible to apply for a waiver of exemption (since 1 July 2008), there are landlords who continue to hold a waiver of exemption. This would arise where, for example, leases of less than 10 years were granted before 1 July 2008 and the landlord continues to grant leases after this date (in relation to properties acquired under the old rules). The waiver of exemption would continue to apply where not voluntarily cancelled. It may be opportune to review the position and consider cancelling the waiver of exemption. This would be appropriate where the output VAT accounted for on rental income equates to or exceeds the input VAT reclaimed during the period of the waiver of exemption. A cancellation amount does not arise in such circumstances. As the landlord is then deemed not to have had an entitlement to input VAT recovery, a subsequent sale would generally be exempt from VAT (provided that development work has not been carried out in the five years before sale).

An automatic cancellation of the waiver of exemption could be unwittingly triggered where the property subject to the waiver is sold and it is the last property subject to the landlord's waiver of exemption.

Before any sale, consideration must be always be given to the existence of a waiver of exemption and the impact that a sale may have. Notwithstanding this, an automatic cancellation may not always have negative consequences. The sale triggers the cancellation, which means that any VAT chargeable on the sale (either by way of a VAT charge or under a joint option to tax) or any capital goods scheme obligation passing can be included in calculating the cancellation amount. This may reduce or even wipe out the cancellation amount.

An area of concern has always been the fact that a change in market conditions is not factored in to the calculation of the cancellation amount. Periods of vacancy or low rent yields during the financial crisis, for example, were not factored in, resulting in significant VAT costs where the property subject to the waiver was acquired at the height of the market. This continues to be the case, and with the uncertainty surrounding the pandemic, it is likely to continue to be an issue. Although the timing of a sale can be managed in the case of a private treaty sale or voluntary sale, this is often not the case in a forced sale scenario.

Leases granted post 1 July 2008

The VAT treatment of a lease granted on or after 1 July 2008 that is surrendered by the tenant is quite different, as such leases are treated as a supply of services (this excludes freehold-equivalent interests). Where the lease is opted to tax, VAT arises on the rental income. In the situation where the lease is surrendered, there is no VAT to be accounted for. However, if there is a payment made in relation to the surrender, then a VAT charge may arise. A premium payable by the tenant to the landlord that represents consideration for the landlord's agreeing to take a surrender of the lease will be liable to VAT – at the standard rate – if the lease was opted to tax. The landlord would be required to issue a VAT invoice in the circumstances. However, if it was an exempt letting, then the premium amount is also exempt from VAT.

1 Revenue's Tax and Duty Manual (VAT – Transitional measures applying to legacy leases).

Refurbishment Work

Works carried out on a property during the course of the lease are certainly an area for consideration where the landlord–tenant relationship comes to an end before the lease term expires. The terms "development" and "refurbishment" are often used interchangeably, and in practice this can give rise to some confusion. Development is defined in s2 VATCA 2010 in relation to any land as "(a) the construction, demolition, extension, alteration or reconstruction of any building on the land or (b) the carrying out of any engineering or other operation in, on, over or under the land to adapt it for materially altered use", and therefore it relates to physical work carried out on a property or a building. Refurbishment is specifically defined in s63(1) VATCA 2010 as "development on a previously completed building", and hence a refurbishment is development work.

This is often confused with "minor development" work (which, in effect, is development work that does not materially alter the use of the property and the cost of the expenditure on which does not exceed 25% of the sales proceeds), and this is relevant in determining whether a sale is liable to VAT. Refurbishment, as defined, is relevant in the context of the capital gods scheme and it has a VAT life (adjustment period) of 10 years. Equally, refurbishment should not be confused with repair work, which is not treated as development work (as defined).

Refurbishment is relevant to the landlord and, more particularly, the tenant where a lease is being surrendered within 10 years of the refurbishment's having been carried out.
A clawback of VAT may be triggered for the tenant (where it had full input VAT recovery on the works), but the tenant can avoid such a clawback if the landlord agrees to take over the capital goods scheme associated with the refurbishment. This may have already been catered for in the lease, or it can be agreed separately between the parties. The proposed future use of the property by the landlord may dictate the decision to take over the capital goods scheme obligations or not. Onerous obligations may restrict a landlord's options vis-à-vis new tenants, as an opted-to-tax letting would normally be the preferred course of action. But a new taxable letting would not be desirable for tenants engaged in exempt or partly exempt activities. This is an area that requires consideration before agreeing to take over the obligations associated with the refurbishment.

Deeds of Variation

If the parties are willing to continue with the landlord–tenant relationship, there may be other VAT issues to consider where there is a request to vary the terms of the lease – some variations could trigger VAT implications (if, for example, it triggers a surrender of the original lease), and others may be benign from a VAT point of view. The requests for variation that may arise in the current circumstances are rent variations, extension of lease periods and changes to the space let (for example, seeking an increase in space to enable social distancing or a decrease in space due to the business down-sizing).

A deed of variation providing for changes in the quantum of rent will not give rise to VAT implications.
In a legacy lease scenario, the rent will have been capitalised based on one of the three valuation methods at the time that the lease was granted (subject to the economic-value test), with VAT being accounted for upfront. An increase in the rent does not result in a VAT cost, as the supply of goods occurred at the time the lease was created. A change to the rent amount in an opted-to-tax letting, equally, does not result in a VAT issue – the amount of VAT to be remitted to Revenue is based on the taxable amount, i.e. the rent, so the VAT liability arising for the landlord is linked to the rent amount.

A deed of variation that extends the term of the lease may give rise to VAT implications depending on the circumstances.
Extending a lease where the option to tax was exercised simply means that the option to tax

applies for a longer period (where, of course, the option to tax has not been terminated). An extension to a legacy lease will be treated as a new lease with effect from the date of expiry of the original lease. This will be an exempt letting and, where it is extended outside the 20-year adjustment period, a capital goods scheme adjustment would not be required. However, it would be worthwhile considering opting to tax the new lease to protect input VAT recovery on related costs or on future works/repairs.

Increasing or decreasing the area being let via a deed of variation will certainly have VAT implications.

An increase in area would be considered to be a new letting of the additional area and would be exempt from VAT. Opting to tax the new lease may be the prudent course of action. However, a decrease in the area would be a partial surrender of the original lease and, where it is a legacy lease, the implications noted earlier in this article are relevant. The calculation of the VAT arising would be a little more complex in that an apportionment exercise would have to be carried out to determine the amount of VAT attributable to the surrender and the remaining interest.

A deed of variation could include one or more of these alterations, and each alteration should be examined in its own right from a VAT point of view.

Post-Letting Expenses

It is also worth remembering that VAT recovery is available in respect of post-letting expenses related to legacy leases. The types of expense that gives rise to recovery are specified in s93(3) VATCA 2010. Recoverable costs in the current circumstances would be costs relating to the collection of rent, costs relating to the review of rent or the exercise of a break clause. As with all input VAT that is recoverable, there is a four-year window in which the VAT can be reclaimed. Fewer restrictions apply in the case of opted-to-tax leases as, once the property is put to a taxable use, input VAT recovery arises in relation to all costs associated with the letting (subject to normal VAT principles).

Emergency Accommodation

A key principle of VAT recovery is, of course, the link with making taxable supplies, and this is carried through to the capital goods scheme. This becomes even more apparent in the application of the "big swing" rules under s64(4) VATCA 2010, which come into play where there is a change in use of more than 50 percentage points. Depending on the direction of the diversion, this can result in a negative or positive adjustment. In normal circumstances, the diversion of a property from taxable use to use as emergency accommodation (which is an exempt activity) would result in at least a capital goods scheme adjustment if not a big swing adjustment, depending on the circumstances. This could result in a significant VAT cost for the landlord. A recent Revenue eBrief (No. 77/2020) on emergency accommodation, however, provided some concessionary relief from the big swing rule and the capital goods scheme rules. The big swing provisions were disapplied in relation to the diversion to emergency accommodation to combat Covid-19. Concessionary treatment in relation to the normal capital goods scheme rules also applies; rather than the rules' being disapplied entirely, the deductible use is based not on actual use in an interval but on prior deductible use, i.e. on the use that applied in the interval before diversion to emergency accommodation.

Conclusion

The full extent of the fall-out from the current public health crisis may not be known for some time, but it is highly likely that it will be keenly felt in the property sector, in terms of both sales and lettings. Careful consideration is required of the VAT implications that arise in the context of changes to the landlord–tenant relationship.

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