

VAT savings on building work

BUILDING SERVICES

By default, your builder clients should charge the standard rate of 20% on their services. However, there are a number of situations when they are entitled to charge the reduced rate of 5%.

It is important that both builders and developers are aware of these situations as many developers cannot claim input tax on their projects because the income they generate is exempt from VAT. Therefore, incorrectly charging 20% instead of 5% will have a big impact on bottom line profits.

Pro advice. Where the 5% rate is applicable, it also applies to the materials your client supplies as part of their work. This is only if the materials are provided along with building services, so as a planning point it will make sense for your client to supply the materials, rather than have the customer source them separately, as they would have to pay 20% VAT.

There are three scenarios where the 5% rate will apply - conversions, work done on previously empty property, and design and build projects. Let's look at each of these in turn.

1. RESIDENTIAL CONVERSIONS

If a developer buys a non-residential building and contracts your client to convert it into dwellings, your client can charge the reduced 5% rate. This type of project is particularly common in big cities, where there is often surplus commercial accommodation but a need for more residential units.

Pro advice. The definition of "dwelling" for these purposes includes houses, flats, bedsits, etc. A full list of conditions for the definition to be met can be found in para. 14 of VAT Notice 708.

One area where your client may run into issues with the rate charged is where they subcontract labour.

Example. Steve has bought the freehold of an office block, which consists of four floors. He intends to retain commercial use on the ground floor but convert the other three floors into luxury apartments. The building work on the ground floor will still be subject to 20% VAT but the reduced rate of 5% will apply to work on the other floors.

Some builders used by Steve insist that they need a certificate from him to confirm the project will create new dwellings. This is not correct and these claims should be refuted. He should also resist claims from builders who say that they need to play safe and charge 20% VAT to avoid a potential query from HMRC - this is not correct because the builder is required to charge the right VAT rate according to the legislation.

Pro advice. If your clients run into these problems, advise them to direct the subcontractor to para. 17.1 of VAT Notice 708 ([direct link available on my website](#)).

A certificate will be needed if the conversion work will lead to the building being used for a "relevant residential purpose". This includes usage as an elderly persons' home, student accommodation, nursing home, etc. Your client should seek a certificate from the developer in these instances.

CHANGE IN NUMBER

Imagine that your client has purchased a detached house and intends to convert it into two semi-detached houses and hopefully sell them at a profit.

The sale of the houses will be exempt from VAT, which means there is no scope to reclaim input tax, even if your client is already VAT registered. However, the good news is that the VAT charged by builders will again be subject to 5% VAT because the project is producing a change in the number of residential units, i.e. from one to two.

Pro advice 1. It is the change in number of units that is key to the reduced rate applying, so converting two semi-detached houses into one detached property will also qualify.

Pro advice 2. Don't fall into the trap many advisors do by treating the sale of the properties following a change in the number of units as zero-rated. It should in fact be exempt, and the only time zero-rating would apply is if the property has been newly constructed on bare land.

APARTMENTS

If a project involves building work on a block of apartments, the number of units is considered on a floor-by-floor basis. So if a block consists of twelve apartments before a project starts, four on each of three different floors, and ends with

the same number but three on the ground floor, four on the first floor and five on the second floor, then the building work will be subject to 5% VAT in relation to the work on the ground and second floors. But the work on the first floor will be subject to 20% VAT because the number of units is unchanged.

2. EMPTY PROPERTIES

If a residential property has been empty for at least two years, i.e. not lived in, then any building work undertaken to alter or renovate it is again subject to 5% VAT.

In this situation your client will need proof of the empty period, e.g. council tax information, electoral register, etc. The evidence must be from a third party source, and it would not be acceptable for the property owner to just sign a statement that the property has not been lived in for at least two years, or asking their accountant or solicitor to write a letter on their behalf.

For any goods supplied that are not building materials, e.g. carpets or fitted bedroom furniture, the cost, plus your cost of installation, must be standard-rated.

3. DESIGN AND BUILD

Professional fees are always subject to 20% VAT, e.g. the services of architects, surveyors and project managers. A potential VAT planning solution is for the professionals to provide their services directly to your client in cases where a 5% project applies to building work.

The client's contract for the developer is then for a design and build service, which attracts a 5% VAT rate on the entire fee, including materials and professional fees.

Example. John has purchased an office block for £1 million and intends to convert it into four flats, which he will then rent out on a long-term basis. The rental income will be exempt from VAT which means he cannot claim input tax on his costs. He will spend £200,000 on building conversion costs provided by Acom Ltd and £60,000 on professional fees linked to the project.

If John engages the professionals, he will pay VAT of £12,000, i.e. at 20%. But if Acom engages the professionals, it will claim input tax of £12,000 on these fees, and then the onward supply to John will be made at 5% VAT as a design and build supply. So the VAT incurred by John on professional fees will be £3,000 rather than £12,000, producing an increase of £9,000 in his profits. This outcome assumes that Acom does not apply a mark-up on the sales invoices from the professionals.

Pro advice. Note that your client could apply a modest mark-up and still leave the developer better off, as long as the mark-up doesn't exceed the VAT savings.

CONNECTED PARTY

As a VAT planning tip, if John sold the apartments when they were completed to a connected party (such as a limited company in which he owns the shares), these sales would be zero-rated. So he could register for VAT and claim input tax on all project costs, including the professional fees.

The design and build option is no longer necessary. The connected entity could then generate the exempt rental income, which would not be a big VAT problem because the major amounts of VAT were incurred by the first entity, which can claim input tax. This strategy would need to consider the impact of other taxes.

SUMMARY

If your client is renovating empty buildings, ensure they obtain third party evidence, e.g. from the council, that the property was empty. If your client procures the services of professionals directly, they can save their customer 15% VAT, and then charge a modest mark-up to leave them both better off.
