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Category	**Course title**	**Author**
Tax	Input tax – change of use	Sarah Kay

Content Table

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Input tax – change of use

1. Introduction

Because expenditure is normally incurred in advance of a supply being made, input tax recovery is determined according to the intended use of that expense at the time of supply.

There are three circumstances in which this initial (and provisional) input is adjusted at a later date:

1. Partial exemption
   - Partially exempt businesses provisionally recover input tax before undertaking annual adjustment calculations at year end.
2. Capital Goods Scheme
   - Input tax recovery on certain high value assets is adjusted over the first 10 or 5 years of the assets life.
3. Change in use
   - If, before an asset is first used, there is a change in intention input tax recovery may need to be adjusted.

This module concerns the last circumstance, change in use. Partial exemption and the capital goods scheme were covered in previous e-CPDs. This module assumes a small amount of knowledge from those.

Adjustments needed if there is a change in use are often called ‘Regulation 108 or 109 adjustments after the legislation (Regs 108 & 109, VAT Regulations 1995 (SI 1995/2518).

At the point expenditure is incurred the input tax is treated as taxable, exempt or residual based upon the intention of the business. Regulations 108 or 109 apply if, before the expense is used, the business’s intention changes and it is used for another purpose and this change occurs within six years.

Regulation 108 concerns so-called ‘clawback’ where a business recovers VAT because it has an intention to make taxable supplies, the input tax is ‘clawed back’ by HMRC if there is a change in intention.

Regulation 109 is the mirror of Regulation 108 and concerns ‘payback’ where HMRC pay input which was not recovered because there was no intention to make taxable supplies to businesses which change their intention and do make taxable supplies.

2. Adjustment

2.1 What is a change of use (or intention)?

A Regulation 108 or 109 adjustment is needed if *before* the expense is first used it is used for something other than its intended purpose.

If an expense is used for something else *after* being used for its intended purpose, a Regulation 108/109 adjustment is not needed.

This change of intention is judged according to VAT law at the time the expense was incurred, i.e if the liability of the intended supply changes due to a change in the law an adjustment isn't needed.

2.2 Time limit

Regulation 108 and 109 are only engaged if the change occurs within six years, and after the end of the partial exemption year in which the expense was incurred (changes within a partial exemption year will be corrected as part of the annual adjustment calculation).

The six year period starts on the first day of the VAT return period in which VAT recovery is initially determined.

The four year cap (which applies to errors in VAT returns) does not override this six year time limit.

Example:

- A business completing calendar quarterly returns incurs an expense on 20 July 2019 which it intends to use to make taxable supplies.

- The six year period starts on 1 July 2019 (i.e the first day of the September VAT return period).

2.3 Making the adjustment

'Clawback' adjustments in HMRC's favour:

- Input tax repaid on VAT return for the period in which intention changes.

'Payback' adjustment in business's favour:

- The business must write to HMRC to agree the adjustment.

- HMRC normally allow the adjustment to be included on the next VAT return.

3. Case Law Examples

The following case law examples illustrate practical situations where input tax was subject to clawback or payback due to a change in the business's intention. These notes merely summarise the key points. It is worth reading the case reports as they demonstrate the complexities which can arise in practice.

Really Useful Group [1991] BVC 1310

- The company bought a building which it refurbished, intending to occupy the property for its own business (making taxable supplies as a record producer and music publisher).

- The building proved to be unsuitable for the business's needs so was sold in a VAT exempt sale.

- Because the company never occupied the building, the building costs were used to make an exempt supply (the property sale) therefore VAT recovered on costs was repayable to HMRC (Reg 108).

Tremerton Ltd [2000] BVC3

- The company bought some land intending to build new residential houses for sale (a zero rated supply) and recovered input tax incurred on purchase costs and the cost of obtaining planning permission.
- Due to unexpected financial difficulties the land was sold to another developer (with the benefit of the planning permission) in a VAT exempt sale.
- Because the company used the land to make an exempt supply rather than a taxable supply it was required to repay input tax previously recovered.

Welcome Trust [2009] BVC 2035

- The Trust bought a building which it intended to use to make exempt supplies and for non-business activities so VAT was not claimed. However, three years later the building was leased. As the Trust had opted to tax the building the lease was a taxable supply.
- To the extent that there was a change in the intention to make exempt supplies, a Regulation 108 adjustment (i.e a reclaim from HMRC) could be made.
- Complex case because at the time Regulations 108 and 109 did not include changes from non-business to business purpose.

Ghent Coal (Case 37/95) [1998] BVC 139

- This case demonstrates that a change in intention is different to a case where a purchase is abortive.
- Ghent Coal recovered VAT incurred on the construction of a new coal terminal in the port of Ghent. However, the local authority required the company to exchange the land it was developing for an alternative site.
- Ghent Coal was entitled to retain its right to recover input tax. It could not make its intended taxable supplies for reasons outside of its control and it did not make an exempt supply.

4. Housebuilders

4.1 The Problem

A builder may construct one or more houses which fail to sell as quickly as had been planned. Thus, the builder may decide to let the houses in the short term before finally selling.

The sale of the new house(s) (by the builder) would have been zero-rated, therefore he recovered all of the VAT incurred on their construction. However, the rent of the house(s) is exempt from VAT.

In principle the decision to let the houses triggers a requirement to repay VAT previously recovered.

4.2 Calculating the adjustment

HMRC accepts that when a housebuilder decides to let a house for a short period before selling it he still retains his original intention to make a taxable supply.

Therefore it is not necessary to repay all of the VAT previously recovered, but the VAT cannot be treated as wholly taxable input tax. The exempt 'use' of the input tax must be recognised.

If the housebuilder is already partially exempt the adjustment is calculated using the existing partial exemption method, (either the standard or an agreed special method).

Difficulties arise for housebuilders who do not have an agreed partial exemption method, e.g small housebuilders who only take on one or two developments at a time.

4.3 HMRC's Quick De Minimis Check

The de minimis limits apply to housebuilders just as they apply to other partially exempt businesses. As a simplification, HMRC permit housebuilders in this position to use a 'quick de minimis check'.

This check assumes that the house has an 'economic life' of 10 years. The irrecoverable VAT is calculated using the percentage of time for which the building will be let, e.g if it will be let for 2 years before sale, 20% of the input tax is irrecoverable.

If, using this calculation, the exempt input tax is de minimis no further action is needed. If the de minimis limits have been exceeded more detailed calculations must be done.

A business is de minimis if total exempt input tax is no more than £625 per month on average and no more than 50% of the total amount of input tax incurred.

4.4 Detailed calculations

HMRC's policy is that it will accept any clawback calculation provided it fairly reflects the costs of making taxable supplies.

HMRC's suggestion is that the calculation is undertaken using estimated value of rental and future sales income, i.e the % of input tax which must be repaid is:

$$\frac{\text{Estimated total rental income}}{\text{Estimated rental income + sales price}} \times 100$$

4.5 Examples

<u>Example 1: using HMRC's quick de minimis check</u>

A small builder has one new house unsold. The intention is to take it off the market and rent it for two years at £750 per month. Hopefully market conditions will improve and it can be sold for £250,000.

The total input tax claimed was £10,000 in the year to 31 March 2018 and £12,000 in the year to 31 March 2019.

Using HMRC's quick check, the VAT repayable is 20% (2 years/10 years)

£2,000 is repayable for the year to 31 March 2018 (20% x £10,000) and £2,400 for the year to 31 March 2019 (20% x £12,000).

As the builder is de minimis for both years, no input tax adjustment is needed.

Example 2: detailed calculations

A small builder has two new houses unsold. The intention is to rent them for two years at £1,500 per month each, before selling them for £500,000 each.

Total input tax claimed was £40,000 in the year to 31 March 2018 and £22,000 in the year to 31 March 2019.

Using HMRC's quick check, £8,000 is repayable for the year to 31 March 2018 so the builder is not de minimis. (20% x £40,000 = £8,000 which exceeds £625 per month on average).

The % input VAT repayable using detailed calculations is:

$$\frac{\text{Monthly rent x 24 months x 2 houses}}{\text{Total rental income + sales price of both houses}} \text{ x } 100$$

$$\frac{\text{£1,500 x2 x24}}{(\text{£1,500 x 12 x 2}) + \text{£1,000,000}} \text{ x } 100 = 6.72\%$$

As a result the detail calculation gives £2,686 repayable for the year to 31 March 2018 (6.72% x £40,000) and £1,478 repayable for the year to 31 March 2019 (6.72% x £22,000). The builder is de minimis for both years if the detailed calculations are done.