VAT: immovable property transactions

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Immovable property transactions involve significant tax costs. These include value added tax (VAT), which may impact on cash-flow or constitute an irrecoverable expense increasing the investment cost when the operator is not authorised to recover it or can only partially recover it.

VAT may consequently be a substantial factor in choosing between different ways of carrying out or financing a real estate investment. For immovable property transactions, the common VAT system gives Member States numerous options making it hard at times to grasp the how the rules apply.

That is why the VAT workshop devoted itself to a general survey of several topics relating to those operations. The environment created by the important reform of the rules applying to real estate operations which took place in France in 2010 together with recent case law has been conducive to the choice of this particular subject. It enables us in a non-exhaustive fashion to tackle the following matters:

— A general survey of the latitude allowed to Member States,

— Issues surrounding the categorisation of land,

— Leasing and lease purchase: the Belgian exception,

— The ECJ's contributions as to timeshare property,

— Drawing the line between an astute financing arrangement and an abusive scheme.

The latitude allowed to Member States by EU law

The common VAT system (currently set out in Directive 2006/112/EC of 28 November 2006) gives Member States significant elbow-room with respect to such matters as how property or the rights in question are defined, the treatment of real estate transactions conducted by parties who are not normally taxable for VAT purposes, taxation of self-supplies, traders' rights to opt in to or out of taxation of certain transactions such as transfers of existing buildings or leases of immovable property, or methods of calculating the taxable amount or identifying the correct taxpayer.

Below are some illustrations indicating the issues where there may be significant regulatory divergence between Member States:

— Member States do not all apply the mechanism for taxing self supplies of immovable property in the same way. This applies to buildings erected by a VAT taxpayer (or a third party on its behalf) where there would not be a full right of deduction in respect if the building had been purchased from a third party (Directive, art. 18(a)). In fact taxing self supply and the other elements which, where applicable, may make up the taxable amount may result in a significant increase in the construction cost.

— Real estate transactions carried out by non VAT taxpayers may at the discretion of the State in question be considered to be operations either outside the scope of VAT or mandatorily caught whether the operations relate to a new building or a building land (art. 12).

— The line between a new building and an existing building can be drawn according to different criteria in different jurisdictions, entailing the application of different rules, to wit compulsory taxation of transactions carried out by a taxable person with respect to new buildings, whilst in principle the transfer of an existing building is exempt with

or without the right to opt for taxation under national regulations. Article 12(2) of the Directive authorises Member States to set criteria which may be based on the date of first occupation, the completion date or the date of the first subsequent supply (art. 12(2)).

— Two other important illustrations can be cited with respect firstly to the taxable amount, which can consist of the margin for construction sites and existing buildings (art. 392), and secondly to the rate applicable to operations. States may choose whether or not to apply the reduced tax rate to operations involving provision, construction, renovation or alternation of housing as part of a social policy (Annex III paragraph 10).

Other illustrations will be provided below to show that a case by case examination of each State is needed to ascertain which VAT regime applies to real estate operations.

Issues associated with the characterisation of real property

The VAT system established by the Directive depends in particular on the characterisation of the property the transaction relates to: transfers may be taxable or exempt (with or without an option to tax) depending on whether they involve a building or a plot of land, and where they involve a plot of land, whether it is to be built on or not. Where a building is involved, we must look at its characterisation as new or existing. Besides the fact that the definition of immovable property varies from State to State (see above), doubts are encountered in most jurisdictions as to the dividing line between certain concepts.

For instance, the Directive defines a building as any construction fixed to or in the ground, which according to ECJ case law means objects which cannot easily be dismantled or moved (ECJ, case C-315/00, Maierhofer [2003] ECR I-00563). The transfer of enclosed land, or land with underground lines or conduits, may thus be deemed to relate to a building.

Uncertainties can also arise as to the characterisation of an operation whose purpose is works of alteration to an existing building. Such works may or may not, depending on their magnitude, be deemed to result in the construction of a new building, together with the VAT consequences that characterisation entails.

Not all national legislation sets criteria making it possible to distinguish works which are restricted to mere renovation of a building from works resulting in construction of a new building, and EU case law is not particularly abundant in this regard (the case of Jespers, C-233/05 [2006] ECR I-00072, concerning replacement of a façade, may be cited).

In this connection, France appears to be one of the only Member States to have laid down objective criteria in legislation. The merit of those criteria obviously lies in the fact that they have considerably reduced litigation on this issue, which was previously voluminous.

A further question arises as to how to characterise the transfer of a plot of land on which there is a building intended for demolition. The ECJ has recently handed down a decision on that issue, noting that in principle transfers relate to plots of land if the land in question is vacant, but deciding that built on land is to be likened to vacant land where the edifice is in a state of ruin and the vendor is responsible for its demolition (case C-461/08, Don Bosco [2009] ECR I-11079).

Similarly, some Member States are of the view that transfer of built on land must be treated as relating to vacant land where the building in question cannot be used in any manner whatsoever, or in other words when it is in a state of ruin.

Hence, for such characterisation issues, it is highly advisable to assemble and preserve all material evidence showing the condition of the property at the time of the transaction, so as to be in a position to justify its VAT treatment at a later stage.

Leasing and lease purchase: the Belgian exception

EU law provides for exemption of leasing and letting except for hotel operations, holiday camps, campsites, the letting of car-parking spaces and the hire of safes (art. 135(1) and (2)).

However, the VAT Directive gives Member States the right to enable taxable persons to opt to tax rental payments, subject to conditions they set. A large majority of Member States grant the rental taxation option, especially where the premises concerned are for business use.

That is not the case in Belgium. Real property leases in that country are exempt in principle, thus naturally entailing that the lessor is unable to recover the tax on acquisition or construction of a building. To get around that rule however several methods are available. Thus provided that the premises are made available with certain services included among those listed in the national regulations, the leasing of business centres can be subject to VAT.

Similarly, national regulations provide a specific taxing mechanism for shopping malls. The tax on the cost of acquisition or construction of a mall can in practice be recovered for up to 90% by virtue of the distinction that can be made between the concrete “shell” being provided to businesses occupying the premises, which remains exempt, as against provision of common areas which may be seen to constitute provision of services to the occupants, and therefore attracts VAT. “Hybrid” parts remain such as the foundations, in respect of which the lessor can recover VAT on a pro rata scale. Those tax authority rules apart, operators may also have recourse to a converse reading of the definition of leasing given by the ECJ in which leasing is the right to occupy a building as owner for an agreed period in consideration of payment (see in particular the judgments in cases C-346/95 Blasi, [1998] ECR I-00481, C-326/99, Goed Woenen [2001] ECR I-06831 and C-284/03 Temco Europe [2004] ECR I-11237). Operators need only ensure that the agreement does not contain all of those features in order for the provision of property not to attract exemption.

CJUE findings on the system applicable to time-share

Timesharing was developed from the end of the 60s and involves transactions in real property rights over a building. However, today’s schemes also involve all kinds of services ancillary to timeshare ownership. As regards the application of VAT, the analytical problem lies in settling on the place of supply, and the place for determining which VAT regime applies, the tax treatment of the remuneration received by the intermediary who manages the scheme, and, where relevant, the supply of other services to owners.

In practice, there are principally two places of supply that may be envisaged: the place where the building is located or the service provider’s place of establishment. In principle the place of taxation of a supply of services by a taxable person to a non taxable person is the place where the service provider is established (that principle was not affected by the entry into force, on 1 January 2010, of Directive 2008/8 of 12 February 2008 on the place of supply of services). However, the rule has certain exceptions regarding in particular the provision of services pertaining to a building which are taxable where the building is situated.

When the service relates to management of the rights to use a building, the link to the place where the building is located would seem naturally enough to be the most appropriate, but the existence of various remuneration components (contributions, scheme membership fees, and other services) led some Member States (in practice, Member States in which the service provider was established) to take the view that the link with a building was not close enough to engage the rule of taxation in the place where the building is located. The ECJ has in that connection decided that a service relating to a building is a service with a sufficiently close link with the building, because the building constitutes a central and essential item in the supply of the service (case C-165/05, Heger [2006] ECR I-07749).

The Court has where timeshare management is concerned provided the following clarifications in two recently decided matters.

In the matter of RCI Europe (case C-37/08 [2009] ECR I-07533), the timeshare scheme was based on a business model in which members deposited their usage rights in a timeshare accommodation “pool”, and were able to obtain the benefit of other members’ usage rights, in consideration of an enrolment fee and subscriptions. When the Court was asked about the place of assessment of the provision of services by the manager of the timeshare scheme, it found that it was the location of the building in respect of which the member concerned held usage rights.

In the matter of MacDonald Resorts Limited (case C-270/09 [2010] ECR I-00000), the scheme involved a mechanism for subscribers to acquire points. The mechanism entitled them to then convert the points acquired into a temporary right of usage of a property, or into other services such as hotel services. The Court was asked not merely about the characterisation of the services rendered by the managing company and their place of supply but also about the time at which that characterisation had to operate.

The Court held in that instance that the actual service for which “points rights” are purchased was that of making various offers available to be obtained through the said points. The Court held that the chargeable event occurred at the time of the conversion of points, which was when the operation was to be characterised. The place of supply was where the buildings in question were located, whether the points had been used for the enjoyment of temporary residential rights or for hotel services. Further, the Court specified that the service might be covered by the exemption for leasing of immovable property (Dir. Art. 135(1)(l) when it related to a temporary right of enjoyment.

Nonetheless from those cases may be seen the diversity of business models that timeshare scheme managers may develop: other difficulties may appear in the future.

Where to draw the line between a prudent finance scheme and a fraudulent arrangement

For those investors not entitled to full deduction, minimising the cost of residual tax is one of the factors in choosing financing for the investment. Naturally, that is so for public bodies, associations, banks, insurance companies, or medical sector operators whose activities do not generally carry the right of deduction.

Arrangements calculated to assist in minimising residual VAT include lease-purchasing and externalising the investment through a land development structure which leases the property. Care must be taken to ensure that the arrangement envisaged is not objectionable as abusive practice. In relation to arrangements designed to limit residual VAT for those without the right of deduction, the Court of Justice recently had occasion to make some useful clarifications with respect to abuse of rights.

The case law defines abuse of rights on the basis of two criteria:

— The transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and the national

legislation transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of the common VAT system,

— It is apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain such a tax advantage.

Those criteria emerge from the Halifax case in particular, where the ECJ held to be abusive an arrangement by which a group, whose banking activity entitled it to VAT recovery of less than 5%, had obtained recovery of almost the whole of the tax on the construction cost of banking “call centre” premises, by virtue of the fact that the investment was made by a structure with a meaningful right of deduction, and through a system of reinvoicing the construction works carried out by that structure at lower prices (case C-255/02 [2006] ECR I-01609).

Likewise, in the context of a real estate arrangement the ECJ handed down some useful clarifications with respect to lease-purchase (ECJ case C-103/09 Weald Leasing [2010] ECR I-00000).

Within an insurance group entitled to recover around 1% of VAT, real estate investments were placed in a group subsidiary which made them available to a company outside the group which then sublet them to various companies in the group. The two lessors exercised their full entitlement to deductions arising from taxation of the rents.

As the Court of Justice viewed it, the tax advantage resulting from an undertaking which was not a VAT taxpayer financing its real estate investments through lease-purchase rather than direct purchase was not contrary to the Directive’s purpose. Where a trader is not authorised to recover the tax on its investments, lease-purchase financing has the benefit of evening out over the term of the contract the residual VAT burden, which is payable as and when rents are paid. The Court therefore held that the terms of a contract can give a transaction an abusive character, especially where rents have not been determined in market conditions.

The Court held that where an arrangement is found to be abusive transactions should be redefined so as to re-establish the VAT position as it would have been in the absence of factors having an abusive character In other words, and without prejudice to the penalties to be applied in each jurisdiction by reason of the existence of an abusive arrangement, when tax authorities review an arrangement it should not lead to a party being assessed for a greater amount of tax than it would have borne without such an arrangement.

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