TC02751

Appeal number: TC/2012/4534

VAT – property - zero-rating of residential conversion – s 30 and sch 8 VATA 1994 – conversion of pub to two residential units – pub containing manager's flat that was incorporated into both units – whether note 9 to sch 8 denied zero-rating – HMRC v Jacobs considered – Appeal allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

ALEXANDRA COUNTRYSIDE INVESTMENTS LIMITED **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE PETER KEMPSTER
MR PHILIP JOLLY

Sitting in public at Priory Courts, Birmingham on 29 May 2013

Mr Ian Bridge of counsel (instructed by Barringtons) for the Appellant

Mr Bernard Haley (HMRC Appeals Unit) for the Respondents

DECISION

Facts

1. The relevant facts of this case are not in dispute, and are as follows. The Appellant ("the Company") is a property developer, registered for VAT. One of its projects was the conversion of the Cheshire Cheese pub in Nantwich into two semidetached houses. The Company claimed input tax for VAT periods 04/11 and 07/11 of £14,468 in relation to the conversion, on the grounds that the sale of the houses would be zero-rated supplies. The Respondents ("HMRC") denied the input tax on the grounds that the sale of the houses would instead be exempt supplies. Before conversion the pub included a manager's flat. Parts of what was previously the manager's flat have been incorporated into both of the semidetached houses. HMRC's view is that this factor prevents the sale of the houses from being zero-rated supplies.

Relevant Law

2. All statutory references are to the VAT Act 1994.

3. It is common ground that if the sale by the Company of the houses does not qualify for zero-rating as explained below, then the sale will instead be exempt pursuant to s 31 and Group 1 sch 9.

4. Section 30 provides (so far as relevant):

> "**Zero-rating**
>
> (1) Where a taxable person supplies goods or services and the supply is zero-rated, then, whether or not VAT would be chargeable on the supply apart from this section—
>
> (a) no VAT shall be charged on the supply; but
>
> (b) it shall in all other respects be treated as a taxable supply;
>
> and accordingly the rate at which VAT is treated as charged on the supply shall be nil.
>
> (2) A supply of goods or services is zero-rated by virtue of this subsection if the goods or services are of a description for the time being specified in Schedule 8 or the supply is of a description for the time being so specified.
>
> …"

5. Group 5 sch 8 provides (so far as relevant):

> "Item 1
>
> The first grant by a person—
>
> …

(b) converting a non-residential building or a non-residential part of a building into a building designed as a dwelling or number of dwellings …,

of a major interest in, or in any part of, the building, dwelling or its site.

…

NOTES

…

(9) The conversion, …, of a non-residential part of a building which already contains a residential part is not included within items 1(b) or 3 unless the result of that conversion is to create an additional dwelling or dwellings.

…"

6. It is also necessary to quote s 35 (so far as relevant), which provides a mechanism for reclaim of VAT by a non-trader builder – usually called the DIY builder relief:

"**Refund of VAT to persons constructing certain buildings**

(1) Where—

(a) a person carries out works to which this section applies,

(b) his carrying out of the works is lawful and otherwise than in the course or furtherance of any business, and

(c) VAT is chargeable on the supply, acquisition or importation of any goods used by him for the purposes of the works,

the Commissioners shall, on a claim made in that behalf, refund to that person the amount of VAT so chargeable.

(1A) The works to which this section applies are—

…

(c) a residential conversion.

…

(1D) For the purposes of this section works constitute a residential conversion to the extent that they consist in the conversion of a non-residential building, or a non-residential part of a building, into—

(a) a building designed as a dwelling or a number of dwellings;

(b) …

(c) anything which would fall within paragraph (a) or (b) above if different parts of a building were treated as separate buildings.

…

(4) The notes to Group 5 of Schedule 8 shall apply for construing this section as they apply for construing that Group …"

HMRC's case

7. For HMRC Mr Haley submitted as follows.

8. The facts of the current case were very similar to those of the taxpayer in the VAT Tribunal case of *Calam Vale Ltd* [2001] BVC 4056 (case 16869 - LON/99/977). There a pub was converted into two dwellings; the pub included private accommodation which constituted a dwelling; the building was split vertically so as to incorporate into each new dwelling part of the existing dwelling. The VAT Tribunal (Mr de Voil) considered Note 9 to sch 5 and concluded:

> [10] The Appellant did not argue for the application of Note (9). The Tribunal nevertheless spent some time in debating whether Note (9) could possibly apply. Mr Grodzinski [counsel for HMRC] contends: "Note (9) does not apply to the facts of this case, because (in the light of the vertical nature of the split) each semi-detached house created by the conversion took over what was already a "residential part" of the pub. Thus no "additional dwelling" within the meaning of Note (9) was created out of either conversion". With respect, "either" is something of a weasel of a word; there were not two conversions but one conversion, which resulted in two dwellings growing where only one had grown before. What weighs with us is that Note (9) is apparently intended not to extend Item 1(b) but to cut it down: conversion of a non-residential part of a building is not after all to qualify if the building contained a residential part – unless an additional dwelling or dwellings is created. But the conversion here does not fall within Item 1(b) in the first place: it is not the simple conversion of a nonresidential part of a building but the conversion of that part plus a residential part. If only Item 1(b) had read "converting … into a building or part of a building" the position would have been entirely different. But that is not what it says, and zero-rating has to be construed strictly; there is no question of any Human Rights-style "reading in".
>
> [11] We are accordingly forced by an absurd (and perhaps none too carefully drafted) law into an absurd decision, which flies in the face of common sense, of equity and of the "social purpose" which is supposed to underlie and inform zero-rating. Common sense would suggest that to say, as the Commissioners (apparently correctly) do in their Notice 708:
>
> *"No part of the new dwellings may incorporate <u>any</u> [our underlining] domestic element of the original building"*
>
> goes far beyond anything needed to counteract the types of tax avoidance of which the Commissioners are always, no doubt rightly, terrified. It lacks all proportionality. As we suggested to Mr Grodzinski, if you take a four-storey office block with a wide frontage and a caretaker's flat occupying the whole of the attics and convert that block vertically into four town houses (each incorporating a quarter of the attic) you will get no relief; if you convert it horizontally into four flats, leaving the attics untouched, you will get relief. That seems a strange result. Equity would suggest that there should be apportionment; the Act, whether inadvertently or by design, makes no

> provision for this. "Social purpose" suggests that the conversion of a commercial building and its none too desirable, in effect "tied", flat into two normal dwellings is something to be encouraged; apparently it is not."

9. Thus, even where an additional dwelling has been created, no zero-rating is available if it includes part of an existing dwelling.

10. The other Tribunal cases cited by the Company (*Smith & Others* [2001] BVC 4092 (case 17035) and *Wright* [2011] UKFTT 681 (TC)) were not relevant as they both concerned Note 16 (which defined "construction"), rather than Note 9 (which was concerned with "conversion").

11. The Company relied on the case of *HMRC v Jacobs* [2005] STC 1518 but that case concerned not the interpretation of s 30 but instead the position of a DIY builder making a reclaim under s 35. Section 35(4) introduces the Notes to sch 5 for construction of s 35, but not the rest of sch 8 itself. Thus there was an important distinction between cases involving s 30 and those involving s 35. This had been recognised in the policy stated by HMRC after the *Jacobs* decision, as set out in Business Brief 22/05, which included the following:

> "This Business Brief article sets out HM Revenue & Customs' (HMRC) revised policy on the recovery of VAT by those using the "VAT refunds for DIY builders and converters" scheme in cases where a mixed use building (used for non-residential and residential use) is converted into dwellings in light of the judgement of the Court of Appeal in the case of *Ivor Jacobs* (C3/2004/2457).
>
> **Background**
>
> Mr Jacobs had converted a former residential school for boys into one large dwelling for his own occupation and three flats. His claim for a VAT refund under the provisions of the "VAT refunds for DIY builders and converters" scheme was rejected because none of the four resulting dwellings had been created exclusively from the conversion of the non-residential part of the school.
>
> Mr Jacobs appealed against the above decision to a VAT Tribunal. The Tribunal found that, when looked at as a whole ie a "primary use" test, the school was entirely non-residential and its conversion qualified for the refund scheme.
>
> HMRC appealed the Tribunal's decision to the High Court. The High Court rejected the Tribunal's "primary use" test and held that the school was in part residential and in part non-residential. However the High Court also rejected HMRC's view that any additional dwelling must be created entirely from the non-residential part. It held that the VAT incurred on converting the non-residential part used in creating the four dwellings was recoverable through the scheme. This is because converting the school had created additional dwellings, the school having contained one dwelling before conversion and four afterwards. The VAT incurred on the conversion of the residential part of the school was not recoverable.

> The Court of Appeal unanimously dismissed HMRC's appeal and endorsed the High Court's judgement.
>
> **HM Revenue & Customs' revised policy**
>
> HMRC now accept that, for the purposes of the DIY Refund Scheme, the conversion of a building that contains both a residential part and a non-residential part comes within the scope of the Scheme so long as the conversion results in an additional dwelling being created. It is no longer necessary for the additional dwelling to be created exclusively from the non-residential part. However, VAT recovery is restricted to the conversion of the non-residential part.
>
> **Builders and developers**
>
> HMRC do not consider that the Court of Appeal decision has any impact in similar situations where a building, which is part residential/part non-residential, is being converted into a number of dwellings and the number of dwellings present post-conversion is greater than the number of dwellings present pre-conversion.
>
> Items 1(b) and 3(a) of Group 5 to Schedule 8, VATA 1994 restrict the zero-rating to the dwelling(s) deriving from the conversion of the non-residential part. Our policy remains that the zero rate will not apply to any dwelling(s) deriving (whether in whole or in part) from the conversion of the residential part."

12. For the reasons set out in BB22/05 HMRC consider that in the current appeal zero-rating is denied as the new dwellings derive in part from conversion of the residential part of the existing building.

The Company's case

13. For the Company Mr Bridge submitted as follows.

14. The VAT Tribunal case of *Calam Vale* was not binding on this Tribunal; the comments on Note 9 in that case were *obiter*, the case having been decided by reference to Notes 2 and 7, and the taxpayer not having argued the point; and the case was also wrongly decided as all Note 9 requires is an additional dwelling – as confirmed by the Court of Appeal in *Jacobs*.

15. While it was correct that *Jacobs* concerned a DIY builder claim, the legal principles established by the Court of Appeal were equally applicable to the current appeal. In particular, HMRC had not analysed, either in BB22/05 or in their statement of case in relation to this appeal, why different treatments should be accorded to s 30 claims and s 35 claims.

16. *Jacobs* concerned a former residential school that was converted into four dwellings; the school included an element of residential (a headmaster's flat) that was incorporated into the new dwellings. Ward LJ (at [13]) quoted Chadwick LJ in the case of *HMRC v Blom-Cooper* [2003] STC 669, which concerned the conversion of a pub into a dwelling:

> "26. … the purpose and effect of note (9), in conjunction with note (7) is to give a restricted meaning to the expression "converting [or conversion of] … a non-residential part of a building" for the purposes of Group 5 of Sch 8. The notes, taken together, have the effect that, where (before conversion) the building already contains a residential part, the conversion of a non-residential part will not be treated as "converting [or conversion of] … a non-residential part of a building" for the purposes of Group 5 unless the result of that conversion is to create an additional dwelling or dwellings.
>
> 27. If, on a true analysis, the purpose and effect of note (9), in conjunction with note (7), is to give a restricted meaning to the expression "converting [or conversion of] … a non-residential part of a building" for the purposes of Group 5 of Sch 8, then the same restrictive meaning must be given to that expression for the purposes of s 35(1D). That is what s 35(4) plainly requires. The words of the section are, "[t]he notes to Group 5 … shall apply for construing this section as they apply for construing that Group". The effect of s 35(4) and notes (7) and (9), taken together, is that, where (before conversion) the building already contains a residential part, the conversion of a non-residential part will not be treated as "converting [or conversion of] … a non-residential part of a building" for the purposes of s 35(1D) unless the result of that conversion is to create an additional dwelling or dwellings. …"

17. Ward LJ then stated:

> "[14] [*Blom-Cooper*] does not answer the question which falls for consideration in this appeal, namely whether that additional dwelling or dwellings must be created in the non-residential part alone or in the building as a whole."

18. Ward LJ identified the issue in dispute as follows:

> "[26] Simplifying the facts we have here an original building part of which (the classrooms and associated teaching parts) were 'non-residential' within the meaning given to that word by note (7). It follows that the other part of the building had *ex hypothesi* to be Residential, ie not non-residential. … In the course of the conversion the CLASP building was stripped to its steel structure and as far as the extension was concerned, the external walls, some internal walls and the roof structure was retained but much was razed to the ground and rebuilt. After the conversion the new building contained, as had been designed for it, four dwellings, the mansion itself and the three staff flats.
>
> [27] The appeal centres on how note (9) is to be applied to those facts. …"

19. After commenting (at [30]) that "I do not find the solution at all easy", Ward LJ concluded (at [40]):

> "In my judgment note (9) has to be construed so that the result of the conversion is to create in the building an additional dwelling or

> dwellings. One counts the number of dwellings in the building before conversion and again after conversion. If there are more on the recount, note (9) is satisfied. If that is so then Mr Jacobs is entitled to his refund and the commissioners' appeal must be dismissed."

20. In the current appeal there was one dwelling before conversion and two afterwards. Thus the test was satisfied.

21. In terms of a purposive interpretation of the relevant legislation, it was noteworthy that whereas the VAT Tribunal in *Calam Vale* had felt it was obliged to reach "an absurd decision", in *Jacobs* Ward LJ stated (at [41]):

> "I do not find that an unpalatable conclusion. Zero-rating of works of construction and conversion is authorised by art 17 of the Second Directive and art 28(2) of EC Council Directive 77/388 (the Sixth Directive) so long as the statutory measures are taken only 'for clearly defined social reasons and for the benefit of the final consumer'. The Court of Justice has held in *EC Commission v United Kingdom*, as I have set out, that 'facilitating home ownership for the whole population' falls within the purview of 'social reasons', not just the creation of local authority housing. Here three staff flats have been created in addition to the mansion for Mr Jacobs. I do not see that this takes too broad a view of the purpose which s 35 is to meet even bearing in mind the need strictly to construe it."

Consideration and conclusions

22. We have borne in mind the fact (which HMRC consider crucial) that *Jacobs* (like *Blom-Cooper*) concerns s 35 claims, rather than s 30 claims. We first set out the conditions necessary for zero-rating under s 30 of the new houses when sold by the Company. Section 30(2) gives the zero-rating where "the goods or services are of a description for the time being specified in Schedule 8 or the supply is of a description for the time being so specified". One then goes to sch 8 where Group 5 includes as Item 1(b): "The first grant by a person … converting a non-residential building or a non-residential part of a building into a building designed as a dwelling or number of dwellings …, of a major interest in, or in any part of, the building, dwelling or its site." Note 9 then imposes a restriction: "The conversion … of a non-residential part of a building which already contains a residential part is not included within [Item 1(b)] unless the result of that conversion is to create an additional dwelling or dwellings." Mr Haley for HMRC confirmed that the reason for HMRC's refusal of the Company's input tax claim was that they considered the claim was prevented by the restriction imposed by Note 9, as interpreted by *Calam Vale*; that was in conformity with HMRC's policy as clearly stated in BB22/05.

23. Turning to the DIY builder relief in s 35, the conditions are that the VAT must be incurred on works that "consist in the conversion of a non-residential building, or a non-residential part of a building, into (a) a building designed as a dwelling or a number of dwellings, or … (c) anything which would fall within [(a)] if different parts of a building were treated as separate buildings."

24. We pause there to state that we do not see any obvious distinction between the two formulations used in s 30 and s 35. Both require a conversion of a non-residential building or a non-residential part of a building into a building designed as a dwelling or number of dwellings. We have considered whether the closing words of s 35(1D) - "or (c) anything which would fall within [(a)] if different parts of a building were treated as separate buildings" – give s 35 a width that is absent from s 30. However, that extra width, if any, was clearly not relevant to Ward LJ's consideration in *Jacobs* – see (at [34]), emphasis added:

> "(iii) Thirdly the conversion qualifies if it has any one of three results set out in (a), (b) or (c), namely (a), a building designed as a dwelling or a number of dwellings, or (b), a building intended for use solely for a residential purpose or (c), anything which would fall within paragraph (a) or (b) above if different parts of a building were treated as separate buildings. *In this case we are not concerned with (b) and (c).*"

25. Similarly, it was not relevant to the Court of Appeal's consideration in *Blom-Cooper* – see (at [30]), emphasis added:

> "In a case where the works consist in the conversion of a non-residential part of the building, para (c) of s 35(4) will be in point if, but only if, the effect of treating "different parts of [the] building … as separate buildings" is that one or more of those parts (treated as a separate building or buildings) would fall within paras (a) or (b) of s 35(1D). For that condition to be satisfied, the effect of treating a part of the building as a separate building must be that that (hypothetical) separate building would (for example) be "a building designed as a dwelling"; that is to say, that the hypothetical separate building will meet the requirements in note (2) to Group 5 of Sch 8. And, if that condition were satisfied, then it seems to me inevitable that, in a case where the actual building, taken as a whole, had (before conversion of the non-residential part) already contained a residential part, conversion of the non-residential part would result in the creation of an additional dwelling. At the least, I cannot conceive of circumstances in which it would not do so. It would follow that, on the facts, note (9) would not require a restricted meaning to be given to the expression "conversion … of a non-residential part of the building" in a case in which para (c) of s 35(1D) were in point. *But that is not this case*."

26. Accordingly, we conclude that in considering the conclusions of the Court of Appeal in *Jacobs* on the meaning of Note 9, the position under both s 30 and s 35 is, for the purposes of the current appeal, identical. Mr Haley for HMRC confirmed that if – which is not the case – the Company's claim was under s 35 rather than s 30 then HMRC would repay the claim, on the basis of the policy stated in BB22/05.

27. Section 30, like s 35, requires consideration of the restriction imposed by Note 9 to sch 5 – in the case of s 30 because the supply must fall within Group 5 of sch 8 and so the Notes to that Group are obviously relevant, and in the case of s 35 because the Notes are specifically imported by s 35(4).

28. In *Jacobs* Ward LJ stated concerning Note 9:

> "[32] There is also, in my judgment, no difficulty in concluding as a matter of language that the conversion ('that conversion'), the result of which must be to create an additional dwelling or dwellings, is the conversion of the non-residential part of the building which already contains a residential part. But that is not to say that an additional dwelling has to be created from the non-residential part, as Mr Mantle [counsel for HMRC] contends. The language informs one of the result that has to be achieved but it throws no light on how or where that result is to be achieved. A literal interpretation does not answer what to my mind is the crucial question: must the additional dwelling or dwellings be created (either entirely or in part) in the non-residential part of the building or in the building as a whole. So the crucial question not answered by the language of note (9) is where must that additional dwelling or dwellings be created.
>
> …
>
> [39] … The result of the conversion of the non-residential part of the building which already contains a residential part must be to create an additional dwelling or dwellings and the vital question is: additional to what? It must be additional to what is there already. One cannot have a dwelling additional to the non-residential part which is being converted because it would not be a non-residential part if it already contained a dwelling. A non-residential part and a part which already contains a dwelling are mutually exclusive concepts. The dwelling has to exist outside the area contained within the non-residential part. It must therefore be a dwelling to be found in the building as a whole."

29. Ward LJ's conclusion (at [40] - already quoted above but repeated here, with emphasis added) was :

> "In my judgment note (9) has to be construed so that the result of the conversion is to create *in the building* an additional dwelling or dwellings. One counts the number of dwellings *in the building* before conversion and again after conversion. If there are more on the recount, note (9) is satisfied."

30. We see no reason why Ward LJ's analysis should be different when considering Note 9 in the context of s 30 than when he performed it in the context of s 35. In the current case there are more dwellings in the whole building on the recount.

31. We quizzed Mr Haley on HMRC's analysis of the distinction drawn in BB22/05 between on the one hand claimants under the DIY refund scheme (ie s 35 claims) and builders and developers on the other (ie s 30 claims). He – quite properly – reiterated that HMRC's policy was to draw such a distinction as s 35 claims were covered by *Jacobs* while s 30 claims were covered by *Calam Vale*, and that policy was clearly stated in BB22/05 and had been consistently applied to the Company's claim.

32. We conclude that Ward LJ's analysis of Note 9 gives the clear answer to the current case. The fact that an additional dwelling has been created means that Note 9

does not prevent the conversion coming within Item 1(b). Accordingly the sale of the houses will be zero-rated, and the input tax is recoverable.

33. We appreciate that this conclusion is contrary to the decision in *Calam Vale* (which drives HMRC's current policy on this issue) but:

(a) that case, as a decision of the VAT Tribunal, is not strictly binding on this Tribunal;

(b) the VAT Tribunal's views on Note 9 were *obiter* and on a point expressly not argued by the appellant;

(c) the VAT Tribunal was clearly, and vocally, unhappy at the "absurd" view it felt it was forced to take;

(d) in our opinion, the VAT Tribunal would have reached a different view if it had had the benefit of Ward LJ's analysis of Note 9 (as we have); and

(e) *Calam Vale* was not cited to the Court of Appeal (nor, so far as we can see, to the VAT Tribunal or the High Court) in *Jacobs* and so their Lordships did not have an opportunity to comment on the earlier decision.

34. *Other matter* - We wish to comment briefly on the HMRC formal review (issued under s 83F) dated 9 March 2012, which was prepared by an HMRC Higher Officer. Apart from the preamble and the standard onward appeal rights, the letter consists of two sentences:

> "I refer to your later [*sic*] dated 23th [*sic*] February 2012 relating to the VAT reclaim for Period 04/11, in which you request an independent review. The Officer who has made the decision concluded after receiving policy guidance and having reviewed the case, I have upheld the Officer's initial decision."

Ignoring the two typos and the fact that it refers to only one of the two VAT periods in dispute, this review in effect says nothing other than "we are right and you are wrong". We feel that taxpayer confidence in the statutory system of HMRC internal reviews – most of which, in our experience, are conscientiously and carefully drafted – requires better performance that in the current case. At the hearing Mr Haley for HMRC stated that the brevity of the letter had already been noted internally and HMRC apologised for the letter.

Decision

35. The appeal is ALLOWED.

36. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to

"Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

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PETER KEMPSTER
TRIBUNAL JUDGE

RELEASE DATE: 14 JUNE 2013