



BRIEFING PAPER

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VAT and construction

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Summary

One of the more complicated areas of VAT law, as well as one of the more contentious, is the treatment of construction work. The construction of new buildings is charged a zero rate of VAT, provided the supply in question is for a social purpose: in effect, this means that only the construction of new houses, dwellings and buildings with a charitable purpose is zero-rated. Generally VAT is charged at the standard rate - currently 20% - on repair, renovation and maintenance work whatever the status of the building concerned.¹

The case for setting a uniform rate of VAT across all types of construction work has been made quite often, usually on the grounds that this would be an effective tool to encourage urban regeneration, removing an important disincentive for developers to refurbish empty properties.

The UK's discretion in determining the structure of VAT, as with all Member States, is limited by European VAT law. The harmonisation of VAT systems across the EU has been seen as an important part of achieving a Single European Market for many years. In October 1992 the European Council agreed Directive 92/77/EEC which established new rules regarding VAT rates. In brief, Member States are required to apply a standard VAT rate of 15% or more and have the option of applying one or two reduced rates, no lower than 5%, to certain specified goods and services. One item on this list is the "provision, construction, renovation and alteration of housing, as part of a social policy." Member States may continue to charge any lower rates, including zero rates, that were in place on 1 January 1991, though they cannot introduce any new rate under 5%.²

In 2001 the Labour Government introduced some changes to the VAT liability of construction work.³ First, a new reduced rate of 5% was introduced for conversion or renovation work on some types of residential building from 12 May 2001.⁴ Second, the coverage of the existing zero rate on the construction of new buildings was extended to the sale of a renovated house empty for 10 years or more from 1 August 2001.⁵ Despite these reforms, the Labour Government opposed the introduction of a wider VAT relief for construction work arguing that it would be relatively costly and poorly targeted, and successive administrations have shown no interest in extending the scope of the 5% rate.

In January 2018 the European Commission published proposals to overhaul the EU rules on VAT rates – in effect, to reverse the current approach:

In addition to a standard VAT rate of minimum 15%, Member States would now be able to put in place:

1. two separate reduced rates of between 5% and the standard rate chosen by the Member State;
2. one exemption from VAT (or 'zero rate');
3. one reduced rate set at between 0% and the reduced rates.

The current, complex list of goods and services to which reduced rates can be applied would be abolished and replaced by a new list of products (such as weapons, alcoholic beverages, gambling and tobacco) to which the standard rate of 15% or

¹ Detailed guidance on the VAT treatment of construction work is given in, HMRC, [VAT Notice 708: Buildings and construction](#), August 2014, and in HMRC's [VAT Construction Manual](#).

² This legislation is now consolidated in the Principal EC VAT Directive ([EC Directive 2006/112/EC](#)); Annex III sets out this list.

³ [Budget 2001](#), HC 279, March 2001 [para 6.84-5](#)

⁴ The range of eligible conversions and renovations was extended from 1 June 2002.

⁵ Statutory provision to this effect was made by [s97 of the Finance Act 2001](#).

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above would always be applied. To safeguard public revenues, Member States will also have to ensure that the weighted average VAT rate is at least 12%.⁶

There is no firm timetable for these proposals to be agreed, and there is considerable uncertainty as to their relevance for the UK's discretion in setting VAT rates, given the outcome of the EU referendum and the Government's decision in March 2017 to trigger Article 50 – the two-year period for the UK to leave the EU.⁷

To date the Government have not published any specific details as to the UK's post-Brexit relationship with the EU on VAT, beyond stating its ambition for an agreement on "common processes and procedures" to avoid the need for any new VAT-related border controls on goods moving between the UK and the EU.⁸ Previously it had confirmed that, under the draft Withdrawal Agreement concluded in November 2018, the UK would remain compliant with EU law, including VAT law, during the 'transition period' prior to the implementation of the new, yet to be negotiated, UK-EU partnership arrangements.⁹

Although Brexit could provide the UK with full discretion to set VAT rates on individual goods and services, there are several reasons why Ministers may be reluctant to introduce new VAT reliefs in the future. First, VAT reliefs are not means-tested, so there is an argument for targeting them quite narrowly.¹⁰ Second, extending the scope of relief carries with it the risk that individuals might seek to exploit it, or that the boundary between what is eligible for relief and what is not becomes legally contentious. Third, there may be many candidates for VAT relief, and a risk to undermining the tax base if Ministers find that agreeing to one relief makes it hard not to agree to others. Clearly any extension in VAT reliefs would mean that the rate of VAT on everything else would have to rise, to ensure the tax still raised as much money as it does.¹¹

⁶ European Commission press notice, [VAT: More flexibility on VAT rates, less red tape for small businesses, 18 January 2018](#). Full details are on [the Commission's site](#).

⁷ This deadline is now set at 31 October 2019, following agreement between the UK and the EU27 in April 2019 on an extension; for details see, *Brexit timeline: events leading to the UK's exit from the European Union*, [Commons Briefing paper CBP7960](#), 25 September 2019.

⁸ HM Government, *The future relationship between the UK and the EU*, Cm 9593, July 2018 p18

⁹ Letter from the Financial Secretary to the European Scrutiny Committee, ["EU legislative proposals on VAT"](#), 5 December 2018

¹⁰ For details of the cost of the UK's zero and reduced rates of VAT see, HMRC, [Estimated Costs of Tax Reliefs](#), October 2019 pp31-40

¹¹ VAT is estimated to raise £136.6 billion in 2019/20, which represents 16.8% of all receipts (Office for Budget Responsibility, [Tax by tax, spend by spend: VAT](#), ret'd October 2019).

1. The VAT treatment of construction work

The construction of new buildings is charged a zero rate of VAT, provided the supply in question is for a social purpose: in effect, this means only the construction of new houses, dwellings and buildings with a charitable purpose is zero-rated. The law which provides for the zero-rating of new construction is contained in schedule 8 to the [VAT Act \(VATA\) 1994](#), which sets out all those supplies charged the zero rate. [Group 5 to this schedule](#) covers new construction, and, within this, item 2 covers the construction of dwellings, and new buildings “intended for use solely for a relevant residential purpose or a relevant charitable purpose.”

When VAT was first introduced in the UK in 1973, all new construction and alteration work was zero-rated, whereas repair work was standard-rated.¹² A number of changes to the scope of the zero rate have been made since then.

First, in his 1984 Budget the then Chancellor Nigel Lawson announced that the scope of VAT would be widened, in part because of the difficulties in administering the borderline between ‘repairs’ and ‘alterations’.¹³ From 1 June 1984 the zero rate for alteration work was largely withdrawn, although alternation work to listed buildings continued to be zero-rated.¹⁴

Second, in June 1988 the European Court of Justice ruled that under EU VAT law, Member States were only allowed to apply zero rates where there was a benefit to the final consumer, and that zero-rating for construction work should apply only for clearly defined social reasons. (The implications of EU VAT law are discussed in the next section of this paper.) The UK was required to extend VAT at the standard rate to a range of goods of services, including all non-residential construction and property development, which it did from 1 April 1989.¹⁵

Third, in July 1994 the Government announced that it would amend this legislation to clarify the scope of zero-rating and reduce the incentives for litigation, as builders faced strong incentives to claim that specific works met the statutory test for new construction.¹⁶ A number of significant changes to the wording of Group 5, Schedule 8 were made, the most important of which resulted in the conversion of non-residential property into a dwelling, collection of dwellings or residential accommodation being zero-rated.¹⁷ Three other important changes were consequent on the provision of a new legal definition of an

¹² under group 8 to [Schedule 4 to the Finance Act 1972](#)

¹³ [HC Deb 13 March 1984 cc302-3](#)

¹⁴ Provision to this effect was made by Schedule 6 to the *Finance Act 1984*. see also, [HC Deb 8 June 2006 c859W](#)

¹⁵ Provision to this effect was made by [ss18-22 of the Finance Act 1989](#).

¹⁶ [HC Deb 21 July 1994 cc426-427W](#)

¹⁷ under the *Value Added Tax (Construction of Buildings) Order* SI 1995/280. The Order was debated in the House ([HC Deb 11 January 1995 cc229-252](#)), and came into effect on 1 March 1995.

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'existing building'. First, in cases where the shell of a building was used in new construction, the work would be considered alteration for VAT purposes if at least two walls of an existing building were retained. Second, granny annexes, sold as part of a dwelling, could no longer be treated as a separate building and be zero-rated. Finally, a newly built annexe to a charity building would be zero-rated if it could function independent of the original building and had an independent means of access.

Fourth, in the 2012 Budget the then Chancellor George Osborne announced a number of changes to the scope of VAT from 1 October 2012, including the withdrawal of zero-rating for alteration work carried out on listed buildings.¹⁸ Following consultation the Government announced that this change in the VAT rules would proceed, but transitional arrangements for alteration work that was already in progress by the time of the Budget would be made more generous.¹⁹ These transitional arrangements ended in September 2015.²⁰ This last amendment to the VAT liability of construction work is discussed in more detail below.

¹⁸ [HC Deb 21 March 2012 c801](#)

¹⁹ Statutory provision was made by s196 & schedule 26 of [Finance Act 2012](#).

²⁰ HMRC, [VAT: approved alterations to listed buildings: VAT Information Sheet 10/12](#), August 2012. See also, HMRC, [VAT Notice 708](#), August 2014 (section 9)

2. The implications of European VAT law

The harmonisation of VAT systems across Member States has been seen as an important part of achieving a Single European Market for many years. The sixth VAT directive (77/388/EEC), adopted on 17 May 1977, marked a turning point in the development of EU VAT law – as Member States agreed on common criteria for the VAT base across the EU (ie, specifying those goods and services which could be exempted from tax).

Initially the sixth directive focused on the VAT base, although it did have implications for the UK's zero rates. Article 28(2) allowed Member States to maintain reduced rates and exemptions that were already in force, provided they were maintained for "clearly defined social reasons and for the benefit of the final consumer." In June 1988 the ECJ found that certain supplies zero-rated in the UK did not satisfy these criteria, including the construction of buildings for industrial and commercial use and in the community and civil engineering sector. The Court ruled that only the construction of social housing could continue to be zero-rated.²¹ As a consequence the *Finance Act 1989* made provision to standardise a range of supplies, including the supply of all new construction, except the construction of new dwellings, relevant residential buildings, and relevant charity buildings used for non-business purposes.²²

Agreement as to harmonising VAT rates was reached in June 1991, and encompassed by directive 92/77/EEC of 19 October 1992. In brief, no Member State can introduce any new zero rates of VAT, though they may continue charging any lower rates, including zero rates, that were in place on 1 January 1991.²³ Member States have the discretion to charge a reduced rate of VAT - between 5% and 15% - on a specified list of goods and services. One of the items of this list is the "provision, construction, renovation and alteration of housing, as part of a social policy."²⁴ As a consequence, Member States may charge a reduced rate of VAT on repair work for *social housing*, though not to historic buildings or churches.

In October 1999 the European Council agreed to an amendment to these rules to give Member States the option to apply a reduced VAT rate to certain 'labour-intensive services', as a means to reduce unemployment. Initially this provision was to last just 3 years but subsequently has been put on a permanent basis. The list of labour-intensive services included the "renovation and repairing of private dwellings, excluding materials which form a significant part of the value

²¹ [Case 416/85, 21 June 1988](#). Treasury Minister Peter Lilley set out the implications of the judgement in a statement to the House: [HC Deb 21 June 1988 cc969-70](#). See also, [HC Deb 14 January 1999 cc286-7W](#).

²² specifically section 18 and Schedule 3 to the [Finance Act 1989](#)

²³ Directive 92/77/EEC of 19 October 1992. The directive came into effect on 1 January 1993. It is incorporated in the [Council Directive 2006/112/EEC](#).

²⁴ Item 10 to Annex III of Council Directive 2006/112/EEC

of the supply.”²⁵ At the time a number of countries took the opportunity to have a reduced VAT rate on this supply, though not the UK.²⁶ It is worth underlining that repairs to historic and listed buildings could be covered by this provision, *provided* they were dwellings.²⁷

In June 2003 the Commission published a report on the effectiveness of the scheme for reduced rates on ‘labour-intensive’ services, concluding that “it was not possible to find solid evidence of such reductions ... boosting job creation.”²⁸ The next month it published a review of reduced rates, arguing that the range of reduced rates should be harmonised, and that the automatic right of Member States to maintain their transitional derogations should be withdrawn, to improve the functioning of the internal market.²⁹ As part of this, the Commission argued for a change in the rules as applied to housing and construction:

What changes are proposed in the housing sector?

In order to rationalise this complex and chaotic situation and improve the functioning of the internal market, it is proposed to ... allow reduced rates to be applied to the following operations: the supply, construction, renovation, alteration, repair and maintenance of housing; the rental of housing where a Member State does not opt for exemption. These changes not only substantially rationalise the reduced rates on housing but are a significant extension of Member States' option to apply reduced rates in the housing sector.

Under various specific derogations, several Member States are currently exempt from the requirement to apply the reduced rate solely to housing under social policy and apply it to certain operations in the private housing sector as well. There is no definition of social housing at Community level and it has therefore been defined variously in the legislation of different Member States. At the present time, housing is subject to the reduced rate under various measures in ten Member States. The change will also incorporate two categories currently covered by the Directive authorising Member States to apply a reduced rate of VAT to certain labour-intensive services (renovation and repair of private dwellings, and window cleaning and cleaning in private households) ...

Why isn't the Commission proposing to allow a reduced rate for renovation work on historical monuments?

Currently there is only provision for a reduced rate in relation to housing: nevertheless, one Member State (UK) applies a zero rate to certain types of work on historical buildings. However, the standard rate is applicable in the other Member States. It would therefore be appropriate to put an end to this derogation and make the standard rate the norm. There is in fact no need for a reduced rate of VAT in this area: Member States have much more appropriate means at their disposal to finance work on historical

²⁵ Directive 1999/85/EC. This was consolidated in Articles 106-8 & Annex IV of Directive 2006/112/EC.

²⁶ Belgium, France, Italy, Netherlands, and Portugal (HM Customs & Excise explanatory memorandum, 25 January 2000).

²⁷ HC Deb 8 March 2000 c 769W

²⁸ COM (2003) 309 final, 2 June 2003 p 25

²⁹ COM (2003) 397 final, 23 July 2003. See also, European Commission press notice IP/03/1024, 16 July 2003

buildings (direct subsidies or full cover for work carried out, grants to owners of listed buildings not used as housing, etc.).³⁰

From the UK's perspective the Commission's proposals were controversial as they did not allow for certain zero rates to be maintained, including the zero rate on children's clothing.³¹ Other Member States expressed strong opposition and a final agreement was not reached until February 2006: a minimalist package that allowed for existing reduced and zero rates to continue.³²

In July 2007 the Commission published a study on the impact of reduced VAT rates which argued that the use of "uniform rates is a superior instrument to maintain a high degree of economic efficiency, to minimise otherwise substantial compliance costs and to smooth the functioning of the internal market." However, the authors supported the use of reduced rates in some areas, including social housing, and the practice of countries "applying a uniform VAT to the whole set of social housing activities, including construction, maintenance, repair, restoration, re-construction and demolition. A harmonised VAT rate on a country level ... will provide equal incentives for both construction and restoration of exiting housing, the latter contributing to preservation of urban cultural heritage."³³

In July 2008 the Commission proposed a number of further supplies to add to the reduced rate list, including the supply of all housing – not just housing linked with a social policy, and the "renovation, repair, alteration, maintenance and cleaning of housing and of places of worship and of cultural heritage and historical monuments recognised by the Member State concerned."³⁴ However, after lengthy negotiation in March 2009 European Finance Ministers decided not to adopt this measure and only agreed to two small additions to this list,³⁵ while making the 'labour-intensive services' scheme permanent.³⁶

No further changes have been made to these rules to date.

As noted above, in January 2018 the European Commission published proposals to overhaul the EU rules on VAT rates – in effect, to reverse the current approach.³⁷ This issue is discussed at length in a second Commons Briefing paper: [VAT: European law on VAT rates](#), CBP2683, 17 January 2019.

³⁰ European Commission memorandum MEMO/03/149, 16 July 2003

³¹ HM Customs & Excise, *Explanatory memorandum on COM(2003) 397 final*, 29 August 2003 paras 16-17

³² Directive 2006/18/EC of 14 February 2006. The directive also allowed Member States to a charge a reduced VAT rate to supplies of district heating.

³³ Copenhagen Economics, *Study on reduced VAT applied to goods and services in the Member States of the European Union*, 21 June 2007 pp 3-4, p80

³⁴ COM(2008) 428 final; European Commission press notice IP/08/1109, 7 July 2008

³⁵ specifically, restaurant services and audio books, CD's, CD-ROMs, etc in addition to printed books (ECOFIN press notice 7048/09, 10 March 2009 pp10-11).

³⁶ Directive 2009/47/EC of 5 May 2009. These services are now part of the list of items set out in Annex III of Directive 2006/112/EC; item 10(a) of this list is now, "renovation and repairing of private dwellings, excluding materials which form a significant part of the value of the supply."

³⁷ European Commission press notice, [VAT: More flexibility on VAT rates, less red tape for small businesses](#), 18 January 2018. Full details are on [the Commission's site](#).

3. Debates on reforming the VAT treatment of construction work

3.1 The case for cutting VAT on repair and renovation

In the late 1990s there was considerable interest in the possibility of cutting VAT on repair and renovation work, to boost urban regeneration.

In July 1998 the Environment, Transport and Regional Affairs Committee published a report on housing, and recommended that the Government should cut the rate of VAT on conversions “to as low a level as the law permits” and “consider redefining conversions so that VAT need not be charged on them.”³⁸

The following year the final report of the Urban Task Force, chaired by Lord Rogers, made the case for setting a single rate of VAT for new construction, conversions and refurbishment:

Recent national statistics suggest that 87% of new housing is created through new build and only 13% through conversions.³⁹ This can at least in part be explained by the fact that people looking to bring existing empty dwellings back into beneficial use soon find themselves up against an odd anomaly. Refurbishment or conversion of existing residential properties carries full VAT at 17.5%. New house building incurs no VAT, nor does conversion of commercial buildings for housing. There is therefore a strong case for harmonising the different rates, preferably by removing VAT on refurbishments or conversions of residential buildings, or introducing zero-rating.

Although this seems a sensible thing to do, constraints imposed by the European Commission may mean that harmonisation is only possible at the intermediate level of 5%. While harmonisation at 5% would increase the costs of developing new dwellings on greenfield sites, it would also affect brownfield development as well. Development schemes on recycled land are already more marginal in commercial terms. The imposition of VAT would therefore increase the costs and, in many cases, increase the need for public subsidy.

Therefore, while VAT harmonisation at 5% would create substantial revenue for the Treasury, a significant amount of that total might be required to increase regeneration funding to tackle the additional costs of development on previously used land. It is essential that the UK presses the European Commission to enable harmonisation to occur without the need to impose VAT on new build housing development. Only if this is impossible should a 5% rate be considered. In those circumstances, there will need to be a significant lead-in time prior to the introduction of the tax on new build costs, so that developers are not hit by additional costs which they have not accounted for in acquiring land for development. There will also need to be careful consideration of

³⁸ Environment, Transport and Regional Affairs Committee, [Housing, HC 495, 22 July 1998](#) para 254. The Government’s response at the time was non-committal (Cm 4080 October 1998 pp11-12).

³⁹ DETR, *English House Condition Survey 1996, 1998*

how VAT would apply to new build — to the cost of materials, labour, sales etc., to avoid any unintended double imposition.

Our recommendation: **Harmonise VAT rates at a zero rate in respect of new building, and conversions and refurbishments. If harmonisation can only be achieved at a 5% rate, then a significant part of the proceeds should be reinvested in urban regeneration. (84)**⁴⁰

At the time the Labour Government opposed a cut in VAT on other types of construction work, on the grounds of cost, and, as Treasury Minister Helen Liddell set out in debate in March 1998, “a reduced rate is not the universal panacea that some people claim it to be”:

The European Commission recently examined the operation of the reduced rates and reported that reduced rates were a very imprecise tool for policy making and should not be used as a substitute for direct subsidies. That is very much in line with the Government’s thinking on the application of reduced rates. In general, we believe that widespread use of reduced VAT rates is likely to result in unnecessary complication of the tax, to the detriment of business and the integrity of the tax ... Obviously, there is a revenue issue. A recent estimate of the cost of reducing VAT to 5 per cent. for all house renovations was £1.1 billion. Even combined with a reduced rate on new construction, there would still be a very substantial loss to the Exchequer, which would have to be made up by increased taxation elsewhere.⁴¹

The Minister was responding to the case for a lower VAT rate on renovation work put by Jonathan Shaw MP. Later that year Mr Shaw introduced a Ten Minute Rule Bill to cut VAT to 5% on the renovation of domestic property empty for at least a year, although it made no further progress.⁴²

3.2 Budget 2001: a 5% VAT rate on conversions

In its Pre-Budget Report published in November 2000 the Labour Government put forward a series of proposals to encourage urban regeneration, in response to the work of the Urban Task Force, mentioned above.⁴³ As part of this package the Government proposed a new 5% VAT rate on construction work to convert residential properties into a different number of dwellings, and the extension of the zero rate on new construction to the sale of renovated houses empty for 10 years or more.⁴⁴ In the March 2001 Budget it was announced that the 5% rate would cover three other types of construction work: the conversion of non-residential property into dwellings; the renovation of dwellings empty for three or more years, and the conversion of residential property into residential communal

⁴⁰ DETR, *Towards an Urban Renaissance*, June 2000 [Dep 99/1269] p255

⁴¹ HC Deb 11 March 1998 cc 727-730

⁴² [HC Deb 8 July 1998 cc1097-1098](#). At this time several EDMs were tabled calling for this reform (for example, EDM 1467 of 1997-98, 25 June 1998; EDM 136 of 1998-99, 16 December 1998; EDM 306 of 2001-02, 24 October 2001).

⁴³ Further details of the Government’s strategy were given in the Urban White Paper published at this time (*Our towns and cities: the future delivering an urban renaissance* Cm 4911 November 2000)

⁴⁴ *Pre-Budget Report*, Cm 4917 November 2000 para 6.80

homes.⁴⁵ A regulatory impact assessment set out the rationale for this change:

After the Pre-Budget Report (PBR) the main options for Budget 2001 were:

(a) not to go beyond what was announced in the PBR: the reduced rate for converting houses into a different number of dwellings; and the adjusted zero rate for the sale of renovated houses that have been empty for more than 10 years;

(b) to leave the adjusted zero rate for houses empty for 10 years but introduce a reduced rate for the renovation of houses that have been empty for over 3 years in addition to the reduced rate for conversions into dwellings, residential communal homes, and houses in multiple occupation (HMOs);

(c) to adjust the zero rate to allow sales of houses that have been left empty for 5 years to qualify and introduce a reduced rate for renovation services to houses that have been empty for over 3 years in addition to the reduced rate for conversions into dwellings, residential communal homes, and HMOs.

Our EC obligations allow us a zero rate for the sale of completely new dwellings. By analogy, we also zero rate the sale of renovated houses empty since 1 April 1973, on the grounds that the renovated home is in effect the first time sale of a dwelling since it would be in such a poor state of repair that no-one would live in it before renovation. This argument holds true for properties empty for ten years and so the proposed adjustment is considered to be acceptable under EC law. A reduction to fewer than ten years is more open to question under EC law.

Option (c) was therefore rejected. Option (b) was selected as the one that creates or brings back into use the greatest number of extra homes, yet is within EC VAT law.⁴⁶

The benefits of each of these measures were summarised as follows:

The reduced rate for conversion services should have an impact on property developers who will be encouraged to take on more conversions. Many of the additional dwellings created as an effect of the reduced rate for conversion services will provide new homes for relatively small households. 71% of households formed between 1996 and 2021 will be single person households. The measure will help with the creation of smaller dwellings which will be relatively affordable compared with other homes in the same area. Our best estimate is that the net unit gains are expected to be about 1,000 extra dwelling units in 2002/3.

The reduced rate for conversions to residential communal homes, and HMOs does not create individual units, but helps with the provision of accommodation for vulnerable groups and the mobility of the young professional workforce. The reduced rate for services of renovating houses that have been empty for more than 3 years will help to prevent the deterioration of long term empties and regenerate areas where empty houses have attracted litter, vandalism, crime and anti-social behaviour. Our best estimate is that it should help to bring back into use up to 2,400 empty homes each year.

⁴⁵ *Budget 2001*, HC 279, March 2001 para 6.84-6

⁴⁶ HM Customs & Excise, *Regulatory impact assessment: VAT on housing*, 7 March 2001 para 3

The adjustment to the zero rate should bring back into use up to 250 long term empty homes each year.

Taken together this package should create up to 3,700 individual homes each year through better use of the UK's existing housing stock. All these measures should have a positive (but not significant) impact on employment in the construction sector.⁴⁷

Provision to this effect was included in the *Finance Act 2001* (specifically [section 97](#) of the Act)⁴⁸ and in secondary legislation ([SI 2001/2305](#)).

In the 2002 Budget a number of changes were announced in the scope of the 5% rate on conversion and renovation of residential building, to take effect from 1 June 2002:

The reduced VAT rates for residential conversions and renovations introduced in Budget 2001 were targeted at services where a price cut would have the most effect on the regeneration and renewal of the UK's housing stock. The Government has carefully considered representations made since the 2001 Budget, particularly by those representing charities, and has been convinced of the merits of making further targeted changes.

The scope of the reduced 5% VAT rate will be extended to the costs of:

- converting a non-residential property into a care home (or other qualifying building used solely for a 'relevant residential' purpose);
- converting a non-residential property into a multiple occupancy dwelling, such as bedsit accommodation;
- converting a building used for a 'relevant residential' purpose into a multiple occupancy dwelling;
- renovating or altering a care home (or other qualifying building used solely for a 'relevant residential' purpose) that has not been lived in for 3 years or more;
- renovating or altering a multiple occupancy dwelling that has not been lived in for 3 years or more; and
- constructing, renovating or converting a building into a garage as part of the renovation of a property that qualifies for the reduced rate.⁴⁹

In the Pre-Budget Report in October 2007, the Government announced that the 3 year test for alteration or renovation work qualifying for the 5% rate would be cut to 2 years – with effect from 1 January 2008.⁵⁰ Statutory provision for this change was made by secondary legislation ([SI 2007/3448](#)), and the Government's explanatory memorandum to the Order set out the purpose of this change:

As part of the Government's policy to increase the availability of housing stock by bringing sub-standard housing back into use, a 5% reduced rate of VAT had been applied to the renovation of

⁴⁷ *op.cit.* para 4

⁴⁸ This measure was the subject of a short debate at the Committee stage of the *Finance Bill*: SC Deb (A), 8 May 2001, cc183-186.

⁴⁹ HM Customs & Excise Budget Note CE40, 17 April 2002. Provision to this effect was made by Order ([SI 2002/1100](#)).

⁵⁰ *2007 Pre-Budget Report and Comprehensive Spending Review*, Cm 7227, October 2007 [para 6.14](#)

residential properties that have not been lived in for 3 years or more. The main beneficiaries of this reduced rate are property developers, landlords and home owners buying such property for their own use, who are unable to reclaim VAT on works to existing housing. As a result of this reduced rate, the amount of irrecoverable VAT (and the cost of regenerating housing) is reduced.

The 3 year condition was thought to strike a balance between the point at which a property can be considered to be in need of major renovation and the point at which property speculators might prefer to keep properties empty and postpone renovation until they were eligible for a reduced rate.

When this reduced rate was introduced, it was estimated that 6,000 properties would benefit at a revenue cost of £5m per annum. A reduction from 3 years to 2 years would allow an additional 2000 properties to benefit from the reduced rate where they are unoccupied because they are sub-standard rather than because of short term factors such as lengthy selling/buying procedures, probate settlement etc.⁵¹

Prior to this in July 2007, the Government introduced one other small change to the VAT treatment of construction. A disabled person may benefit from zero-rating on alternation work done on their house to install a chair lift, ramp or some other modification designed to help them with their disability.⁵² However, in the past elderly people who are not disabled had not been able to claim this relief. In Budget 2007 the Government announced that the 5% VAT rate would be extended to the supply and installation of certain mobility aids installed in private homes for individuals aged 60 or over.⁵³

3.3 Subsequent debate on setting a uniform VAT rate

Following the changes made by the Labour Government to the VAT treatment of construction, there was some debate as to the case for setting a single VAT rate across different categories of construction work. In October 2005 86 Members signed an EDM tabled by Gordon Marsden supporting this measure,⁵⁴ and 133 Members signed a second, similar EDM tabled by Bob Russell in December 2008.⁵⁵

However, the Labour Government consistently opposed cutting VAT in this way. In answer to a PQ in February 2007 the then Paymaster General, Dawn Primarolo, said, "VAT reduced rates have been applied only in respect of goods and services where we consider that a reduction in the rate of VAT is consistent with our EU VAT agreements,

⁵¹ HMRC, *Explanatory memorandum to SI 2007/3448*, December 2007 para 7

⁵² Certain goods and services for disabled persons are eligible for zero-rating (under group 12, Schedule 8 to *VATA 1994*). Generally speaking these supplies have to be specifically designed or adapted for a disabled person's use.

⁵³ *Budget 2007*, HC342, March 2007 [para 5.131](#). Provision to this effect was made by Order: [SI 2007/1601](#), with effect from 1 July 2007. Guidance is given in [HM Revenue & Customs Brief 47/07](#), 26 June 2007.

⁵⁴ EDM 879 of 2005-06, 26 October 2005

⁵⁵ EDM 7 of 2008-09, 3 December 2008

and provides the best-targeted and most efficient support for our social objectives, when considered against alternative policy instruments.”⁵⁶ Some insight into the reasons for the Government’s position was given in the Treasury’s review of housing supply, commissioned from Kate Barker, published alongside the 2004 Budget. In her report Ms Barker suggested that harmonising VAT in this area would be ineffective and regressive:

Some suggestions to the Review have recommended that new build and repairs, maintenance and improvement (RMI) be made more equal through a ‘levelling down’ of the VAT on RMI to a lower rate of 5 per cent rather than a ‘levelling up’ of VAT on new build. Equalising the rates as far as possible under EU law would encourage individuals to improve and maintain their existing homes – and would go some way to helping the Government meet its decent homes target.

While increased RMI work might be broadly helpful in promoting better care of the existing stock, a significant proportion of investment in housing in the UK is individuals upgrading their homes beyond that required to keep them in a decent and habitable condition. Reducing the cost of RMI across the board would act as an incentive to all home improvement, and consequently subsidise a great deal of work that would have happened anyway, generating a (possibly substantial) deadweight loss. Evidence suggests also that it is the relatively affluent who spend most on RMI, and thus an across-the-board RMI VAT cut would be broadly regressive.⁵⁷

At this time it was estimated that “the effect of harmonising VAT on the repair, maintenance and improvement of dwellings currently at 17.5% and on the construction of new dwellings currently zero rated, at 5% would be broadly revenue neutral,” whereas replacing the zero rate on new housing with a 5% rate “might raise up to £1.9 billion.”⁵⁸

Following the agreement by European Finance Ministers in March 2009 to make the ‘labour intensive services’ scheme permanent, the Government was asked whether it would consider making use of the provision:

Asked by Lord Hylton: To ask Her Majesty's Government whether they will reduce the rate of value added tax on repairs to buildings and charge a similar rate of value added tax on new constructions.

The Financial Services Secretary to the Treasury (Lord Myners): VAT is a broad-based tax upon consumption, which operates within a framework of rules, which are agreed by unanimity within the European Union. This framework does not permit reduced rates of VAT to be charged for the repair or construction of all types of buildings.

At the March 2009 Ecofin EU Finance Ministers agreed that all Member States should be allowed the choice to introduce a reduced VAT rate for the, “renovation and repairing of private

⁵⁶ HC Deb 19 February 2007 c483W. see also, HC Deb 27 June 2006 cc377-8W & HL Deb 29 October 2008 c170WA.

⁵⁷ [Housing Supply: Delivering Stability: Securing our Future Housing Needs - Final Report: Recommendations](#), March 2004 p83

⁵⁸ HC Deb 15 January 2001 c128W; HC Deb 14 November 2005 c883W

dwellings, excluding materials which account for a significant part of the value of the service supplied".

However, equalising the VAT rate for all domestic new build work would require us to permanently give up the current zero rates and the Government have no plans to do so. The Government continue to keep the impact of VAT on all building work under review.⁵⁹

In its first Budget in June 2010 the Coalition Government announced that the standard rate of VAT would be increased from 17.5% to 20% from 4 January 2011.⁶⁰ No further changes were proposed for other VAT rates, including the coverage of zero rates. When the legislation to increase the standard rate was debated, two Members took the opportunity to point out that this would increase the discrepancy in the VAT treatment of renovation and new build:

Andrew George: On the renovation of buildings, the primary purpose is to distinguish between the treatment in VAT law of new build and of renovation. I am seeking to probe that subject in order to elicit a response from the Exchequer Secretary. Surely we as a society should be trying to encourage renovation of existing buildings rather than always taking up greenfield sites for development. In particular, we should not discourage improvements to dwellings in the lower council tax bands ...

Simon Hughes: This issue is a long-standing subject of debate ... May I suggest that it would be helpful to hear from Ministers later whether they have considered revenue-neutral ways of taxing renovation as opposed to new build? Are there not very good environmental reasons, very good energy-saving and green reasons, and very good land use and planning reasons, for continuing to use existing sites rather than building on new greenfield sites?⁶¹

In response Treasury Minister David Gauke said the following:

I should like to take the opportunity to respond to the comments made by the hon. Member for Bermondsey and Old Southwark (Simon Hughes) and my hon. Friend the Member for St Ives (Andrew George) about the tension between renovation and new build and the incentives for them. I know that the Liberal Democrats have campaigned consistently on that matter for several years. As a Government we will continue to keep it under review. They make their case well.⁶²

Some updated estimates of the costs to harmonising the rates of VAT on the different types of construction work were given in a written answer in July 2011; an extract is given below:

The Commercial Secretary to the Treasury (Lord Sassoon):

The cost of reducing VAT from 20 per cent to 5 per cent on repair, maintenance and improvement of residential property, in the absence of behavioural change, is tentatively estimated to be in the region of £2.2 billion.

⁵⁹ HC Deb 15 December 2009 c221W

⁶⁰ For more details see, [VAT: the new 20% standard rate, Commons Briefing paper CBP5620](#), 3 September 2013

⁶¹ HC Deb 13 July 2010 c880-1

⁶² HC Deb 13 July 2010 c889

The revenue from VAT at 20 per cent on the conversion of non-residential into residential property, in the absence of behavioural change, is estimated to be about £300 million, compared to an estimate of about £75 million at the current 5 per cent rate.

The revenue from making the construction of new dwellings liable to VAT at 5 per cent rate, in the absence of behavioural change, is estimated to be about £1.5 billion.⁶³

Subsequently the Federation of Small Businesses made the case for VAT to be cut on both construction work and tourism,⁶⁴ and in September 2011 the then the Shadow Chancellor, Ed Balls, argued that VAT be set at 5% on repairs and maintenance for a year “to help homeowners and the many small businesses that are so dependent on the state of the housing market.”⁶⁵

In October 2011 Bill Esterson MP put the case for reducing the differential in the VAT rate applied to new build and renovation in a debate in Westminster Hall. In response to the debate Treasury Minister Chloe Smith noted that “wide relief already exists for the renovation and conversion of empty properties” and that introducing a 5% rate on all renovation and refurbishment work would cost about £2.2bn a year: “if we made such a cut, the revenue shortfall would have to be met from additional taxation elsewhere, which would lead to job losses that would offset any job gains in the building sector. Alternatively, we would need to meet the cost through additional borrowing, which would risk increasing interest rates.”⁶⁶ The Minister also disagreed with the Member’s claim that cutting the differential would reduce the incentives for households to employ rogue traders: “There are many other factors—this is key—beside cost that cause a customer to use the informal economy, and a trader to operate in it. It is unlikely that a reduction in the rate of VAT, which is only one factor, would have an impact on rogue trading and purchasing.”⁶⁷

⁶³ HL Deb 18 July 2011 ccWA254-5

⁶⁴ FSB News Release PR 2011/49, *Targeted VAT cuts needed to restore growth, says FSB*, 18 July 2011

⁶⁵ Labour Party press notice, *Ed Balls’ Speech to Labour Party Conference*, 26 September 2011

⁶⁶ HC Deb 18 October 2011 cc249-50WH - see also, HC Deb 17 October 2011 c713W

⁶⁷ HC Deb 18 October 2011 c250WH - see also, HC Deb 21 October 2011 c1201W

4. Budget 2012: VAT on approved alteration work

In the Budget the Coalition Government announced proposals to extend the scope of VAT to deal with a series of “loopholes and anomalies”, including the removal of the zero rate to approved alteration work carried out on listed buildings. Taken together it was estimated these changes to VAT liability would raise £270m by 2013/14, of which the change to approved alteration work would contribute £85m.⁶⁸ At the time HMRC published further details of the change to be made to the law, and its anticipated impact. To mitigate the impact on listed churches, the Government proposed expanding the Listed Places of Worship Scheme, a grant scheme introduced in 2001 which effectively cut the VAT rate on repairs to churches to 5%:

The repair and maintenance of a protected building is standard-rated, but the approved alteration of a protected building is zero-rated. Some alterations restore or enhance the unique character of a building or prolong its active life, but most work covered by the relief is extension work which is unnecessary for heritage purposes. Alteration work on other types of building is standard-rated so owners of listed buildings receive a tax advantage over owners of other types of building ...

Removing the zero rate removes a perverse incentive to change listed buildings rather than repair them and ensures that all alteration works receive the same tax treatment. The change makes the VAT rules simpler for businesses to understand and for HMRC to administer and reduces the scope for error and non-compliance ...

There are an estimated 350,000 listed dwellings in the UK. It is estimated that around 10,000 individuals and households may be affected each year by the measure, with the additional costs from the VAT change varying according to the extent of work undertaken ... There are an estimated 35,000 to 50,000 listed buildings owned by businesses or charities used for a residential or charitable purpose. It is estimated that around 1,000 businesses and charities may be affected each year ...

Listed places of worship will ... be affected by the change, although our evidence suggests that places of worship form only a small minority of the total number of listed properties in the UK. These will be predominantly used by Christian denominations. In order to mitigate the impacts on these groups the DCMS is expanding the existing Listed Places of Worship Grant Scheme which refunds the VAT on repairs and maintenance work, so that this includes approved alterations to listed buildings.⁶⁹

It was proposed to make these changes from 1 October 2012 – though approved alterations which have already been contracted for or under way would be entitled to transitional relief. Full details were given in a

⁶⁸ [Budget 2012](#), HC 1853 March 2012 para 2.179, p50 (Table 2.1 – items 27 & 28). For more details on the other changes made to VAT law see, [VAT: Budget 2012 changes to loopholes and anomalies](#), Commons Briefing paper CBP6298, 3 September 2013.

⁶⁹ HMRC, [VAT: approved alterations to listed buildings – tax information & impact note](#), March 2012

consultation document HMRC published at this time, which asked for views of businesses and individuals affected by the changes, so as to identify any unintended consequences or unidentified impacts.⁷⁰ The deadline for responses was 18 May 2012.

The proposal to remove this VAT relief proved highly contentious, though most comment focused on the potential impact for listed churches – rather than other categories of listed building. As the *Financial Times* reported, in announcing the change the Chancellor “was aiming at work on private homes with historic value – such as millionaires installing swimming pools – but 45 per cent of the buildings with a grade 1 listing are churches.”⁷¹

Following the end of the consultation exercise, the Government announced that in addition to extending the scope of the Listed Places of Worship Grant Scheme, it would substantially increase its budget to ensure that listed churches would not be adversely affected by this change.⁷² This appears to have met many of the concerns about removing this relief, and in its formal response to the consultation, HMRC confirmed that this measure would go ahead:

HMRC are of the view that there remains a strong case for removing a relief that is illogical and poorly targeted. The VAT system is not the most effective vehicle for achieving targeted policy objectives, such as bringing listed buildings back into use. Removing the zero rate for approved alterations work reflects the Government’s view that support for the heritage, and public money for such objectives, is better channelled through expenditure rather than poorly targeted tax reliefs, especially when public finances are tight ...

Some alterations to listed buildings will continue to benefit from other VAT reliefs which apply equally to non listed buildings and which are not being removed, for example the reduced rate for the renovation and alteration of empty residential premises or the conversion of premises to a different residential use, and the zero rate for certain alterations to buildings to provide facilities for the disabled ...

Applying a reduced rate of VAT at the same level to both repairs and maintenance and alterations of listed buildings would be difficult to justify without also cutting the VAT on comparable work to other buildings which are not listed. A cut in VAT on home repairs, maintenance and improvements would have significant exchequer costs. These costs would have to be met either from increasing other taxation or from increased borrowing.⁷³

In its response to the consultation, the Government also announced that the transitional arrangements for alteration projects that were in

⁷⁰ HMRC, [VAT: Addressing borderline anomalies](#), March 2012 pp 23-28

⁷¹ “Ditty by dean’s wife joins chorus of disapproval over VAT charge”, *Financial Times*, 17 April 2012.

⁷² HC Deb 17 May 2012 c731. The particular position of churches is discussed in, [VAT on churches. Commons Briefing paper CBP1051](#), 7 January 2019.

⁷³ HMRC, [VAT: Addressing borderline anomalies – summary of responses](#), 28 June 2012 paras 2.6.24-5, 2.6.7

hand at the time of the Budget would be made more generous, a change costing an extra £5m in 2012/13 and 2013/14.⁷⁴

In response to the wider consultation, the Government also made some changes to the proposed amendments to the VAT treatment of holiday caravans, and to hot takeaway food – the two other elements of this reform package that proved most contentious.⁷⁵ To make all of these changes to VAT law, the Government put down a new schedule to the *Finance Bill*, which was debated and approved at the Bill's report stage of 3 July 2012. On this occasion Treasury Minister David Gauke argued that this change showed "that the Government are willing to listen to practical concerns and to amend the proposal accordingly, without undermining the rationale for the measures." Speaking for the Opposition Catherine McKinnell MP argued that there should not be any changes to "VAT exemptions until [the Government] have ... worked out exactly what the impact of any change would be on jobs, living standards and business," though the Government refused to undertake any further formal research on the issue.⁷⁶

⁷⁴ [VAT: Addressing borderline anomalies – summary of responses](#), para 2.6.14-5

⁷⁵ HMT, [Letter from the Exchequer Secretary to the Treasury, David Gauke MP to the Chairman of the Treasury Select Committee](#), Dep2012-0858, 28 May 2012

⁷⁶ HC Deb 3 July 2012 c784, c785. The new schedule was approved by 311 votes to 230 (HC Deb c830). It now forms [Schedule 26 of the Finance Act 2012](#).

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