

Is the treatment of VAT on RCAs proving to be taxing?

A White Paper by EK Reinstatement Cost Assessments

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In recent years, one of the most talked about aspects of reinstatement cost assessments (otherwise known as insurance valuations) has been the subject of VAT. Should VAT be included in the surveyor's calculations, and why is it a contentious issue?

In this white paper, I look at the applicability of VAT in a residential block of flats scenario, from the point of view of a block manager aiming to do the right thing by their client.

EK Reinstatement Cost Assessments' view is that VAT should be included, and this paper explains why.

Remind me why I am arranging RCAs in the first place.

An RCA is commissioned to make sure the rebuild cost of a building is correct. If it's too high, your client/ the leaseholders will be paying too high an insurance premium (overinsurance). If it's too low, then they run the risk of the insurer paying out a claim pro-rata rather than in full (underinsurance).

So getting the sums right is vital, hence the importance of using a professional reinstatement cost assessor — usually a chartered building surveyor — to calculate the building's declared value (DV).

Why is VAT relevant to the declared value?

A building's DV represents its reinstatement cost, should the worse happen (i.e. a total loss, where the building is razed to the ground but the debris remains on site). The reinstatement cost needs to include demolition and site clearance; the bricks and mortar to return the building to its previous state; professional fees; planning/local authority fees; and VAT. Given the standard rate of VAT is 20%, you can see just how large an influence VAT can have on the overall declared value.

It is this DV figure that should be inclusive or exclusive of VAT on the 'works' cost, depending on your chosen approach, and your conscientious chartered surveyor will make it clear whether or not VAT has been included in their calculations.

Aren't there clear-cut regulations from the HMRC as to when VAT is applicable or not? Why do I need to 'choose' an approach?

There are some clear-cut regulations in fact. Broadly speaking, if there is a total loss, rebuild costs for residential properties are zero-rated for VAT. In other words, VAT is not applicable on the bricks and mortar if a building requires total reconstruction. The same applies to new build properties — zero-rated for VAT. Because reinstatement costs are calculated on the basis of a total loss, many RCA practitioners apply the zero-rating to their calculations.

In reality, a total loss is highly unlikely, whereas a partial loss is almost expected for a residential block of flats! Repairs to any part of a residential block of flats in a partial loss claim scenario attracts VAT at 20%.

So there is no VAT applicable on the bricks and mortar in a total loss scenario but VAT is applicable for a lesser claim.

Ah, but what about VAT when it comes to the non bricks and mortar elements of a claim?

Good point. Even in a total loss situation such as a devastating fire, residential buildings attract VAT for debris removal and demolition (although if the demolition was ‘closely connected to the reconstruction of the new building by the main contractor, there is an argument for zero rated VAT).

If your building has a DV of £10 million, perhaps as much as £3 million (30%) of it may comprise professional fees (surveyors, structural engineers, architects), planning and building control fees, CIL (Community Infrastructure Levy) and VAT. Aside from the local authority and government levies, VAT would be applicable on all other fees in a total loss or partial loss scenario.

Similarly towards the end of a total loss reinstatement, unless every single finishing detail is included in the schedule of works, you could end up in an argument with HMRC over whether the final fit-out is an embellishment to the original reinstatement plans. It is common to have landscaping struck-out of a zero-rated VAT claim for instance, similarly for signage, car park markings, cycle racks, etc. Anything deemed ‘not part of the main building reinstatement’, even an equivalent item to that originally insured, may be subject to VAT at 20%.

OK, so it's clear that just applying VAT at 20% at the end of an RCA calculation isn't the way to go!

Correct. A declared value is an aggregate sum composed of lots of different costs — some have VAT applied to them as we have ascertained, and some of which will never incur VAT (usually money paid to the government or local authority). It's not an easy calculation.

A more complicated building will incur more professional consultants and therefore more of the DV will be ‘VAT-able’. A simpler building will incur lower professional fees, and so a greater proportion of the overall DV will be ‘works costs’.

Understood. So I can see there are there some rules when applying VAT and expertise is required to apply them correctly. As VAT is applied differently depending on the extent of the loss, what actually constitutes a total loss as opposed to a partial one?

That's an interesting one. HMRC states that a building can qualify for zero-rated VAT if:

“...the new building makes use of no more than a single façade (or a double façade on a corner site) of a pre-existing building, the pre-existing building is demolished completely (other than the retained façade) before work on the new building is started and the façade is retained as a condition or requirement of statutory planning consent or similar permission.”

HMRC Buildings and construction (VAT Notice 708), first published 2014, revised 2019.

So to achieve a zero-rated VAT scenario, not only does the building have to have been virtually razed to the ground by the disaster, the local authority's planning department have to deem it conditional that the one or two façades remaining have to be retained as a condition of the redevelopment proposal.

In other words, it's no good having a terraced building burn to the ground with only one façade standing and then automatically thinking you've got a qualifying building for zero-rated VAT. The planners have actually got to stipulate that any remaining façades must be retained. Otherwise, you're back in non-qualifying territory and VAT will apply.

If a claim qualifies as a total loss and HMRC agrees its rebuild is subject to zero-rated VAT, doesn't the insurer still have to pay the contractor inclusive of VAT?

Yes. VAT is normally something that has to be claimed back from HMRC retrospectively. You will probably find that the insurers have to (initially) pay the contractor its VAT inclusive invoices through interim payments as the building is being rebuilt and claim back the VAT at a later date.

It seems clear that VAT should always be included on those DV elements where VAT is always applied, even in a total loss. But I can see why there is confusion about applying VAT to just about everything else. What does the RICS recommend?

Interestingly, the RICS sits on the fence on this subject. It states that VAT inclusion or exclusion should be led by the client ("Reinstatement Cost Assessments, guidance note, 3rd edition", February 2018). Following their advice would mean asking each of your clients for their view. Is that practical?

The Chartered Institute of Loss Adjusters, on the other hand, says that VAT should be included as the default setting ("VAT on property claims" — CILA Property Special Interest Group paper, June 2017).

Many insurance brokers and insurance underwriters encourage the inclusion of VAT, arguing that most losses are partial (i.e. not total) so the VAT charged on the reinstatement costs (repairs, fees etc) should be reflected in the insurance premium. Insurers will contend that larger claims requiring major repairs can be more expensive to deal with than a total loss scenario. This is a strong argument although you will appreciate that insurers and brokers benefit from higher declared values as the premiums are calculated from them.

A situation may arise where severe damage to a property (a partial loss) leads to reinstatement costs that may exceed the declared value or even the inflated sum insured. So whilst a complete rebuild does not attract VAT on the 'works', repair costs in respect of a partial loss do.

Do you want to risk your insurer capping a pay-out at the level of the sum insured and an investigation ensues as to why the DV was too low? Knowing that the financial shortfall resulting from a capped claim would fall to your client or the leaseholders, ensuring VAT is included in the DV in the first place is highly recommended!

If there is no firm consensus in the insurance and surveying sectors, what do YOU recommend?

The declared value figure from your reinstatement cost assessor ought to, in our opinion, include VAT on all elements that could be subject to VAT (everything except local authority and government fees essentially). That way you are fully protected, whatever the scenario.

Ok, I've read all of this and I agree VAT should be included. But my RMC client still fancies their chances with fate and wants me to insure their block of flats for the lowest possible DV, and by that I mean not including the VAT. What should I do?

First of all, make sure their building is 100% residential. You will need to think again if it's mixed-use (e.g. retail on the ground floor) as the non-residential elements will need VAT including in the DV calculations.

Secondly, get the RMC's decision in writing. This may prove to be very important. Ask for their permission to check that decision accords with the insurer's wishes. Many insurers expect VAT to be included.

Thirdly, ask your reinstatement cost assessor to provide a note in their report that the client wished VAT to be excluded from the cost calculations for the works.

I only manage blocks of flats but out of interest, does the treatment of VAT vary for different property type or even different property owners?

I've focussed on residential blocks of flats in this paper and yes, there are other VAT considerations when your client owns a commercial or mixed-use building.

In a commercial scenario where the insured building is owned a company that is VAT registered, it is not necessary to include VAT within the declared value on the cost of the works. If a claim occurred, VAT on the reinstatement costs would be reclaimed from HMRC as a VAT registered business would do ordinarily. If the owner of the commercial building is not VAT registered, then it is recommended to add VAT to the declared value.

For a mixed-use scenario such as flats sitting above ground floor shops/restaurants, a total loss scenario should mean zero-rating for VAT on the rebuild of the flats but the retail and restaurants are standard rated. As above, commercial owners of property are usually VAT registered but not always — see pension funds, or freeholds owned in an individual's name. Charities have special rules for VAT too.

Don't necessarily take it for granted that all residential dwellings were created equally in the eyes of HMRC. The nature of your leaseholders and how they own their flats (e.g. through companies or by individual title) may have an effect on how they are treated for zero-rating purposes with VAT.

How to apply VAT in a reinstatement cost assessment scenario is a minefield, and I'm glad of the expert help.

There are good reasons why most insurance brokers and underwriters would prefer if your clients include VAT in their RCA calculations on everything that VAT could be applied to in the event of a claim, so by far the safest (and dare I say fairest) route is to include the VAT. That said, if you check with your insurer and they are satisfied that VAT does not need to be included on the works costs, then get that in writing and ask your reinstatement cost assessor to exclude it. A warning though: As soon as your client changes insurer at renewal, the new underwriter may insist on the inclusion of VAT.

And finally...

Managing agents make sure that their clients' declared values are correct because in the event of a claim, you would like your insurer and their loss adjuster to focus 100% on the claim itself, instead of investigating suspected underinsurance. Your client won't thank you if there are delays to their property's reinstatement — or worse still, if only a proportion of the claim value is paid out.

The reality is that the overwhelming majority of residential building reinstatements do not qualify for zero-rated VAT, because they are not total losses. They will be single flat fires in large blocks, structural claims relating to subsidence, escapes of water, vandalism, weather related events including flooding and storms, and impact damage from trees and vehicles. These form the majority of claims in a residential setting, and in general these are almost always partial losses and will attract VAT.

We say, it's just not worth the risk, so do include the VAT. As a property manager you should always be including for the VAT on works within the DV. If your clients still disagree, send them a link to this white paper.