Cardinus Advisory Notice # 6 – Including VAT in your building sum insured – the case increases

The Case

In Advisory Notice # 4 we provided guidance on this topic. We make no apology for repeating information and data, because we believe this to be such an important issue for our clients.

Since our last Notice we believe that the case for routinely including VAT has hardened. We base this view on a combination of factors:

- We have encountered instances where we have been asked to assist clients with valuations following claims related underinsurance problems. These would have been unlikely to have occurred had VAT been included.
- In any 12 month period we undertake thousands of Buildings Value at Risk surveys. The majority of our clients instruct us to include VAT.

Introduction

With VAT remaining at an all-time high, the potential for substantial underinsurance and reduction of claims, if you were to get your building sum insured wrong, should not be understated.

The position can be a complex one, but we have attempted in this document to provide some simple guidance, which we hope will enable the vast majority of clients, with property interests, to not only understand but address the VAT question without too much difficulty.

Background

Value Added Tax (VAT) is a tax on the consumption of goods and services. The UK adopted VAT when it joined the European Community in 1973. The tax is administered by HM Revenue & Customs.

It has been our experience, to date, that very few properties are insured at their full rebuilding value. We have found there to be a wide variation between current sum insured and the measured valuation figures and whilst a few properties were overvalued the vast majority were found to be undervalued. Overall and across thousands of properties, buildings were, on average, found to be undervalued by 20%.

As we reported in our Cardinus Advisory Notice #2 - Insurance Rebuilding Valuations and Underinsurance.

What are the issues? The experience of insurers is, perhaps not unsurprisingly, very similar. According to Norwich Union (now Aviva), as many as 50% of claims for damage to buildings are being settled below the cost of reinstatement. VAT can be a major part of such underinsurance.

VAT notice 708: Buildings and construction (February 2008) gives an interpretation of the law in connection with construction works from the point of view of HM Revenue & Customs. VAT tribunals and court decisions since the date of this publication will affect the application of the law in certain circumstances. The notice is available on HM Revenue & Customs' website www.hmrc.gov.uk/index.htm.

In determining the application of VAT, let us consider the following questions:

1. **What is the occupation/proposed occupation of the property?**
2. **What is the VAT status of the client/insured?**
3. **What is the insurer's position?**

1. What is the occupation/proposed occupation of the property?

The construction of a new building and work to an existing building is normally standard-rated. There are, however, various exceptions to this. Briefly, they are:

Construction Service	Rate of VAT
Construction of new qualifying dwellings and communal residential buildings, and certain new buildings used by charities	0%
Conversion for a housing association of a non-residential building into a qualifying dwelling or communal residential building	0%
Other conversions of premises to a different residential use	5%
Renovation or alteration of empty residential premises	5%
Approved alterations to listed dwellings and communal residential buildings, and certain listed buildings used by charities	0%
Alterations to suit the condition of people with disabilities	0%
Installation of energy saving materials; and grant funded heating system measures and qualifying security goods	5%
Development of residential caravan parks	0%

Q. When is a zero-rated building constructed?

The following table will help you decide if a zero-rated building is being constructed:

It is built from scratch, and, before work starts, any pre-existing building is demolished completely to ground level (cellars, basements and the 'slab' at ground level may be retained)	Either 'designed as a dwelling or number of dwellings', or intended for use solely for a 'relevant residential purpose', or intended for use solely for a 'relevant charitable purpose'
The new building makes use of no more than a single facade (or a double facade on a corner site) of a pre-existing building, the pre-existing building is demolished completely (other than the retained facade) before work on the new building is started and the facade is retained as an explicit condition or requirement of statutory planning consent	
A new building is constructed against an existing building so that they share a party wall but there is no internal access between them	
An existing building is enlarged or extended and the enlargement or extension creates an additional dwelling or dwellings	Designed as a 'dwelling or number of dwellings'
An annexe to an existing building is built	Intended the annexe, or a part of it, be used solely for a 'relevant charitable purpose'
A garage is built, or a building is converted into a garage	Constructed or converted at the same time as, and intended to be occupied with, a building 'designed as a dwelling or number of dwellings'
A building is built that is one of a number of buildings constructed at the same time on the same site	Intended to be used together with those other buildings as a unit solely for a 'relevant residential purpose'

Further information in regard to examples and additional criteria for the above tables can be found in **VAT notice 708: Buildings and construction (February 2008)** at www. hmrc.gov.uk.

One common misconception concerns the belief that the application of zero rated VAT to building claims relates to the re-building of residential blocks of flats in the event of damage. This is not the case. The vast majority of insurance claims are not 'total' losses and therefore VAT will be payable on most costs, in most cases, and should be added to the Building Sum Insured.

2. In addition to the occupation/proposed occupation of the property there is the question of the VAT status of those who are party to an insurance contract.

Sometimes this is a simple case of a single organisation insuring one property. In the case of an organisation registered for VAT, insurers would not expect to have to pay VAT on any claim and therefore VAT should be excluded from the building sum insured. Conversely, VAT should be added to the building sum insured if the client is not VAT registered.

In the case of multiple parties to the insurance contract with differing VAT statuses that may also change regularly, the cautious approach may be for the policyholder to add VAT to the whole building sum insured, accepting that insurers will make payments to VAT registered claimants, net of VAT.

3. In preparing this advisory notice we sought guidance from the claims manager of a leading UK insurer. Extracts of their own guidance notes are included below:

VAT is a highly complex area, but the basic points in setting sums insured are:

- Businesses registered for VAT can recover the VAT they have paid
- Private individuals or other VAT exempt business or persons cannot recover VAT they have paid out on goods and services purchased
- Partially exempt businesses or persons fall into a half way category and can partially recover VAT
- When property owners consider their sums insured they would normally take into account
- All building works relating to non-domestic properties are standard rated for VAT, whether new builds or repairs, maintenance, refurbishments, extensions etc.
- Domestic new builds are zero rated for VAT. (As are some other new builds like churches, monasteries, buildings for charitable use etc.)
- Part domestic/part commercial new builds are VAT taxable on the commercial portion
- Services involved in the building of zero rated new builds e.g. domestic properties, such as legal and architects fees) do incur VAT

In setting sums insured the simple guidelines are that:

- Only those property owners NOT registered for VAT (as exempt or partially exempt) need to include VAT in their sums insured
- Property owners who are VAT registered can recover VAT so they do not necessarily need to include it in their sums insured

Where to get help?

More detailed guidance on VAT can also be obtained from **www.hmrc.gov.uk/index.htm** *the HM Revenue & Customs' website. Help and advice for the production of an insurance rebuilding valuation may be sought from* **www.cardinus.com** *through our UK-wide team of Competent People.*