[2017] UKUT 0307 (TCC)

Appeal number: UT/2016/0059 & UT/2016/0044

VALUE ADDED TAX – Section 30 Value Added Tax Act 1994 – Group 5 of Schedule 8 to that Act – conversion of property – first grant of major interest – resulting dwelling comprising partly former non-residential part and partly former residential part of pre-conversion building - whether grant is zero-rated supply - no

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS **Appellant**

- and -

LANGUARD NEW HOMES LIMITED **Respondent**

DD & DM MACPHERSON **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS **Respondent**

TRIBUNAL: MRS JUSTICE ROSE, CHAMBER PRESIDENT
JUDGE GREG SINFIELD

Sitting in public at The Rolls Building, Fetter Lane, London EC4A 1NL on 19 and 20 June 2017

Michael Thomas instructed by MHA MacIntyre Hudson LLP for the Respondent Languard New Homes Ltd

D M MacPherson for the Appellant DD & DM MacPherson

Hui Ling McCarthy, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for HMRC

DECISION

1. These appeals concern the availability of zero-rating to the first grant of a major interest in a converted property. The appeals were directed to be heard together since they raise the same legal issue on very similar facts concerning the interpretation of the legislation providing for zero-rating for VAT purposes of the supply of dwellings that have been converted from non-residential space. The difficulty of the point is illustrated by the fact that different panels of the First-tier Tribunal came to different conclusions in the two cases before us as to how these provisions apply to fact patterns that arise frequently in practice. The issue is, broadly, whether the supply of a new dwelling which occupies space which used to be partly residential and partly non-residential qualifies for zero-rating or whether it only qualifies if it occupies space all of which used to be non-residential.

2. The facts were not in dispute. In *Languard*, the Respondent purchased the Haberdashers public house in Battersea, London. Languard obtained planning permission to convert the building into four self-contained maisonettes. Before conversion works started, the public house consisted of three floors: a ground floor, which was entirely commercial (and therefore non-residential), and a first and second floor, both of which were used entirely as accommodation by the public house manager (and so were residential). As a result of the building works, the ground and first floors of the public house were converted vertically into two maisonettes (the "lower maisonettes"). Each of the lower maisonettes contained a part which was previously the commercial ground floor of the public house, and a part which was previously the manager's accommodation. As part of the conversion, Languard added a third floor to the public house. The second and (newly created) third floors of the public house were converted vertically to form another two maisonettes (the "upper maisonettes"). Each of the upper maisonettes contained a part which was previously the manager's accommodation, and a part which was the newly created third floor. Therefore, when looked at as a whole, the building which was originally partly public house and partly manager's accommodation was converted into a building which, with the addition of the third floor, comprised four maisonettes. In 2011 Languard sold its interests in each of the lower maisonettes and the upper maisonettes to third parties. Each of those sales by Languard constitutes the first grant of a major interest in the respective maisonette.

3. In *MacPherson*, the Appellant partnership purchased an old village shop premises in June 2013. The shop before conversion comprised office space and associated storage on the ground floor, as well as living accommodation on both the ground and first floors. On 12 May 2014, the partnership obtained planning permission to convert the property into two semi-detached dwellings. Each of those dwellings includes areas that previously formed part of the living accommodation in the old premises, as well as the commercial areas, that is, the office space and associated storage space.

4. The question that arises in each case is whether the sale of the interests in the dwellings that are made up partly of the former non-residential part of the building and partly of the former residential part is a zero-rated supply or an exempt supply under the Value Added Tax Act 1994 ("VATA"). This is important because if it is a zero-rated supply, Languard and the MacPherson partnership can recover the VAT paid on supplies used in carrying out the conversion. If the supply is not zero rated then it is not a taxable supply even where the supply is made in the course of a business, because it will be an exempt supply under sections 4(2) and 31(1) of and item 1 of Group 1 of Schedule 9 to the VATA. If it is an exempt supply, then there can be no recovery of the input VAT.

The legislation

5. Section 30 VATA provides that a supply of goods or services which are of a description specified in Schedule 8 to VATA shall be treated as a taxable supply but the rate at which VAT is charged is nil. The relevant group of Schedule 8 is Group 5, the relevant parts of which read as follows:

> **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."

6. Group 5 contains Notes on the interpretation of the Group. Section 96(9) of VATA provides that Schedule 8 shall be interpreted in accordance with the notes contained in the Schedule. It was common ground that the four maisonettes in the *Languard* appeal and the new homes in the *MacPherson* appeal are dwellings within the meaning of Note (2) to Group 5. The following other notes are relevant for this case. We have omitted irrelevant words and elided the sub-paragraphs together to make the Notes, in so far as they apply in the present case, easier to read.

> "Note (7)
> For the purposes of item 1(b), and for the purposes of these Notes so far as having effect for the purposes of item 1(b), a building or part of a building is "non-residential" if it is neither designed nor adapted for use as a dwelling or number of dwellings.
>
> Note (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.

Note (10)(b)

Where part of a building that is converted is designed as a dwelling or number of dwellings (and part is not) then in the case of (i) a grant relating only to the part so designed [it] shall be treated as relating to a building so designed and (ii) a grant relating only to the part [not] so designed shall not be so treated; and (iii) [in] any other grant relating to, or to any part of, the building, an apportionment shall be made to determine the extent to which it is to be so treated.'

7. It is common ground that transactions falling within Group 5 constitute exceptions to the general principle that VAT is to be levied on all services supplied for consideration and consequently that the provision must be interpreted strictly: see *Customs and Excise Commissioners v Jacobs* [2004] EWCA Civ 930 paragraph 6 citing Case C-169/00 *EC Commission v Finland* [2002] ECR I-2433, para 33.

8. The arguments proceeded before us on the following basis. Mr Thomas appearing for Languard conceded that the upper maisonettes could not be zero rated since they comprised entirely formerly residential space. At some points during the hearing, Mr Thomas appeared to regret having made that concession and Mr MacPherson did not necessarily accept that that concession was well made. However, it was not relevant to Mr Macpherson's appeal because he told us that it was unclear on the facts of his case what parts of the village shop had previously been residential and what parts had been non-residential. Mr Thomas did not apply to revoke the concession and we regard it as having been properly made.

9. All parties rejected the idea that there could be an apportionment to allow some of the supplies used in the conversion to be zero rated and some to be treated as exempt. Ms McCarthy pointed out that where the legislation intends there to be apportionment of some kind, this is made clear, for example in Note 10(b)(iii).

The case law

10. The issue that arises in these appeals has been considered before. In *Calam Vale Ltd* (2000) Decision No 16869, the VAT and Duties Tribunal (Chairman Mr P de Voil and Mr J Bentley) considered the conversion of a public house into two dwellings. The building was split vertically so that both dwellings comprised partly former non-residential rooms in the pub and partly the old bedrooms and bathroom which used to be the pub manager's accommodation. The focus of the tribunal's discussion was the interrelationship between Note (2) (which defines what counts as a dwelling) and Note (7) which defines "non-residential" as being something which is neither designed nor adapted for use as a dwelling. The tribunal held that Note (2) refers to the building after conversion whereas Note (7)

is intended to refer to it before its conversion. Thus the Commissioners had been right, the tribunal held, to contend that because the former manager's living accommodation was designed or adapted for use as a dwelling, part of the building was not non-residential and so the claim for the zero rating failed. The tribunal therefore held that the conversion did not fall within Item 1(b) because:

> " … it is not the simple conversion of a non-residential 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."

11. The tribunal in *Calam Vale* expressed its exasperation at being forced to make what it considered 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". The absurdity was illustrated, the tribunal thought, by the conclusion that "if you take a four-storey office block with a wide frontage and a caretaker's flat occupying the whole of the attic 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 attic untouched, you will get relief". The tribunal therefore reluctantly dismissed the appeal against the HMRC assessment.

12. After *Calam Vale*, Group 5 and its Notes were considered by the Court of Appeal in two decisions. The first was *Customs and Excise Commissioners v Blom-Cooper* [2003] EWCA Civ 493, [2003] STC 669 ('*Blom-Cooper*'). In that case the taxpayer converted a former public house into a single family dwelling. The first and second floors had been used by the former publican as residential accommodation. The appeal raised the issue of the proper interpretation of Note (7) in a different context because the taxpayer had not converted the public house in order to sell it but to live in as her own home. The relevant provision under which she claimed back input tax paid in respect of the conversion was section 35 of VATA. This provides that where a person carries out a residential conversion otherwise than in the course of any business and VAT is chargeable on any goods used by him for the purposes of the works, HMRC shall refund to him the amount of VAT so chargeable. Subsection (1A) of section 35 defines the works to which the section applies as including a 'residential conversion'. According to section 35(1D), building 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 the building into a building designed as a dwelling or a number of dwellings". Section 35(4) provides that the notes to Group 5 in Schedule 8 shall apply for construing section 35 as they apply for construing that Group.

13. In *Blom-Cooper*, HMRC disallowed the claim made by the taxpayer for a refund of VAT but the tribunal allowed an appeal to the extent that the works carried out consisted in the conversion to residential use of that part of the building which it had found as a fact to have been non-residential prior to the conversion. An appeal from that decision was dismissed in the High Court and HMRC appealed to the Court of Appeal. As the Court of Appeal stated in *Blom-*

Cooper, section 35 enables a person to take advantage of provisions for the recovery of input tax to claim a refund of the VAT elements of monies paid to his suppliers even though he is not carrying on the works in the course of a business. Chadwick LJ (with whom both Black J and Potter J agreed) said that it was no surprise, therefore, to find that there is a close similarity between Item 1(b) of Group 5 of Schedule 8 dealing with conversions into dwellings and subsection 35(1A)(c) when read with section 35(1D) also dealing with conversions into dwellings. He went on to say at paragraph 11:

> "Works constitute a residential conversion for the purposes of s 35(1A)(c) when, and to the extent that, they consist in the conversion of a non-residential building, or a non-residential part of a building, into a 'building designed as a dwelling or a number of dwellings' … The language of s 35(1D) - so far as it relates to cases within paras (a) and (b) of that section - is indistinguishable from that of item 1(b) in Group 5. …"

14. Chadwick LJ then emphasised that Group 5 is to be construed in accordance with the Notes and that this is carried across to the construction of section 35. Chadwick LJ noted that the building as converted was "a building designed as a dwelling". He recounted the decisions of the tribunal and of Peter Smith J in the High Court. In particular at paragraph 17 of his judgment, Chadwick LJ noted that Peter Smith J had held that in order for the requirements in section 35(1D) to be satisfied, it was enough if the building had comprised a non-residential part which was the subject of conversion works, provided that, after conversion, the building (taken as a whole) was a building designed as a dwelling. Chadwick LJ then stated "Although the judge's conclusion on that point was challenged in the appellants' notice as filed, that challenge was not pursued at the hearing." In paragraph 23 he said that it had been unnecessary to decide whether what has or has not been converted into a dwelling is a non-residential building or a non-residential part of the building. Chadwick LJ went on to note that it was accepted by counsel for the Commissioners before the Court of Appeal that their appeal could not succeed unless Note (9) to Group 5 of Schedule 8 to VATA could be invoked. The issue on the appeal was therefore into what had the non-residential building or non-residential part of the building (in relation to which the works had been carried out) been converted? He held that the only possible answer was that it had been converted into a dwelling. Note (9) however, Chadwick LJ held, restricts the effect which the definition of 'non-residential' in Note (7) would otherwise have. The Notes, taken together, have the effect that where before the conversion, the building already contains a residential part, the conversion of a non-residential part will not be treated as converting a non-residential part of the building for the purposes of Group 5 unless the result of that conversion is to create an additional dwelling or dwellings. Since in that case there had been no additional dwelling created, Note (9) served to restrict the definition of the expression 'conversion of a non-residential part of a building' for the purposes of Group 5. He held that Note (9) put it beyond argument that if the conversion in that case had been carried out by a developer in the course of the business so that Group 5 was directly in point,

the conversion would *not* fall within Item 1(b) because the result of the conversion had not been to create an additional dwelling.

15. The second Court of Appeal decision after *Calam Value* was *HMRC v Jacobs* [2005] EWCA Civ 930 ('*Jacobs*'). That case concerned a claim under section 35 arising from the conversion of a residential school into a family home. Ward LJ (with whom Clarke and Laws LJJ agreed) described the decision in *Blom-Cooper* in the following terms in paragraph 12:

> "In the High Court Peter Smith J rejected the Commissioners' argument that the requirements in s 35(1D) were not satisfied unless the effect of the works is that the non-residential part is, itself, converted into a dwelling. He held that it was enough if the building had comprised a non-residential part which was the subject of conversion works, provided that, after conversion, the building (taken as a whole) was a building designed as a dwelling. The Commissioners did not pursue their appeal against that finding. It was, however, accepted by counsel for the Commissioners that the appeal could not succeed unless note (9) to Group 5 could be invoked."

16. Ward LJ went on to say that Peter Smith J had held that Note (9) had no application to the construction of section 35(1D) but that on appeal that decision had been overturned. The decision in *Blom-Cooper* did not however answer the question that fell for consideration in *Jacobs*. That question was whether the additional dwelling or dwellings required by Note (9) must be created solely from the formerly non-residential part alone or could be included in the building as a whole: see paragraph 14 of *Jacobs*. Ward LJ held that the original school had had some parts which were non-residential such as the classrooms and other parts which were residential. In the course of the conversion works the whole building was stripped back, much was razed to the ground and rebuilt. After the conversion the new building contained four dwellings, namely a mansion and three staff flats. Those staff flats were converted from the first floor of the old school which had previously been residential accommodation for the boys and staff. The Commissioners contended that in order for Note (9) to be satisfied, the additional dwelling must be created entirely out of the former non-residential part. The Court of Appeal disagreed. They held in paragraph 39 that:

> "[T]he 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 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."

17. That led the Court of Appeal in *Jacobs* to conclude that 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. In the final paragraph of the judgment, Ward LJ made it clear that Mr Jacobs "has never claimed a refund in respect of the works on the first floor which he does not assert to have been works to a non-residential part of the old school".

18. After *Blom-Cooper* and *Jacobs*, the interpretation of Note (7) was revisited by the First-tier Tribunal in *Alexandra Countryside Investments Ltd* [2013] UKFTT 348 ('*Alexandra Countryside*'). The First-tier Tribunal (Judge Peter Kempster and Mr P Jolly) was considering another pub conversion by a property developer into two semi-detached houses. Before the conversion, the pub included a manager's flat. Part of what was previously the manager's flat had been incorporated into both of the semi-detached houses. HMRC contended that this fact prevented the sales of the houses from being zero rated supplies and that they were instead exempt pursuant to section 31 of and Group 1 in Schedule 9 to VATA. The tribunal in *Alexander Countryside* quoted from the HMRC Business Brief 22/05 issued after the *Jacobs* judgment. There HMRC accepted that *for the purpose of claims under section 35*, 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. But HMRC said that their policy remains that the zero rate will not apply to any dwelling deriving whether in whole or in part from the conversion of the residential part of the building – VAT recovery is restricted to the conversion of the non-residential part.

19. The tribunal in *Alexander Countryside* stated that there was no difficulty with Note (9) in that case because there had been one dwelling before conversion and there were two afterwards. The issue before the tribunal was that HMRC contended that the *Jacobs* interpretation of Note (9) only applied in cases involving section 35 and not in cases involving section 30. The tribunal rejected that limitation and held that Note (9) must have the same meaning for the purposes of section 30 as determined in *Jacobs*. Since the test laid down in *Jacobs* for Note (9) to apply was satisfied in the case before them, they allowed the appeal. The tribunal did not address the prior question which arises here, namely whether Item 1(b) of Group 5 was prevented from applying at all because the two semi-detached houses being sold comprised partly the former non-residential parts of the public house but also partly the former residential parts.

The First-tier Tribunal decisions in these appeals

20. In *MacPherson* the FTT was taken to *Calam Vale*, *Jacobs*, and *Alexander Countryside*. In describing the decision in *Jacobs* the FTT noted that Ward LJ

had stated that the works of conversion constituted a residential conversion for the purposes of section 35 *to the extent only* that they consisted in the conversion of a non-residential part of a building. If and to the extent that the works consist in the conversion of what was not non-residential, then those works were outside the scope of section 35(1D) because they were not works constituting a residential conversion. The FTT disagreed with the conclusion of the FTT in *Alexander Countryside* because they held that there was a material difference between the parameters of a conversion which would qualify for a refund under section 35 and one that would qualify under section 30. The difference is that for section 30 to apply, the conversion must come within Item 1(b). The key passage of the FTT's decision in *MacPherson* is paragraphs 31 to 33.

> "31. When construing item 1(b), to see whether, in any particular case, a person is converting (or has converted) 'a non-residential building or a non-residential part of a building into a building designed as a dwelling or number of dwellings', one has, in our judgment, to examine the conversion actually carried out. In this case it is clear that the Property (taken as a whole) was not a non-residential building within the definition in the applicable Note (7). This is because it was designed for use as a dwelling by virtue of the living accommodation contained within it. Although we accept that if one divided up the Property one would find that it contained both a residential part and a non-residential part, nevertheless it would not be correct to describe the conversion works in this case as the conversion of the non-residential part of the building – they were works of conversion of the entire Property. For this reason we hold that the Partnership has not converted a non-residential building or non-residential part of a building and we are therefore in agreement with the conclusion of the Tribunal in *Calam Vale* that the conversion does not fall to be zero rated, because it does not come within item 1(b), not being 'the simple conversion of a non-residential part of a building but the conversion of that part plus a residential part' (ibid. [10]).
>
> 32. The position is not the same under section 35. There the words 'to the extent that' in the definition of residential conversion in section 35(1D) – '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 building designed as a dwelling or number of dwellings' – introduce the concept of works qualifying as a residential conversion even if what is converted includes a residential part of a building (as was the position in Jacobs). In such a case an apportionment of the total VAT incurred to find the amount which can be claimed under section 35 is provided for by Note (10) to Group 5, Schedule 8 (as applied by section 35(4) VATA). The amount which can be claimed will be the amount of VAT attributable to the works

carried out in converting the non-residential part of the original building (see: Note (10)(b) and (iii)).

33. This is enough to dispose of this appeal, which must be dismissed. Note (9), the interpretation of which was at the centre of the Jacobs appeal (see: ibid. [27]) is not engaged. That is, it is irrelevant on the facts of the present appeal that 2 dwellings were created in a building in which there had only been one dwelling before the works of conversion, because the threshold condition for zero-rating in item 1(b), Group 5, Schedule 8 VATA is not satisfied. For the same reason Note (10), dealing with apportionment is not engaged on the facts of this appeal."

21. The FTT therefore dismissed the appeal. In the appeal before us, HMRC did not espouse the view that appears to be expressed in the first part of paragraph 31 of the FTT's decision in *MacPherson*, namely that if building work is carried out to the whole building (rather than the works being limited to part of the building leaving the rest of the building untouched) that ruled out the application of zero-rating unless the whole building was formerly non-residential. HMRC accepts that even if the whole building is undergoing a refurbishment, the residential accommodation in the new building that is entirely made up of space that used to be non-residential qualifies for zero-rating even if the old building used to be a mix of residential and non-residential use.

22. In *Languard*, FTT came to the opposite conclusion. They were also referred to *Calam Vale*, *Jacobs* and *Alexander Countryside*. The FTT recognised that the facts of the case before it were very similar to the facts in *Calam Vale* and that the construction adopted by the tribunal in the earlier case had an attractive straightforwardness. However, they expressed their concern that that construction "does not fully take account of the purpose and context of Item 1(b)". They considered that:

> "25 … the social purpose for zero-rating the conversion of non-residential property into dwellings is not respected by this interpretation."

23. They went on, after a review of the authorities, to decide that to achieve the social purpose of creating additional housing, it does not matter from what constituent parts the new dwellings are created provided that additional dwellings are created as a result. Note (9) is required to ensure that relief is available only in those situations where additional housing is created: paragraph 38.

24. They also held that the interpretation of Item 1(b) and Note (7) contended for by HMRC (namely that the whole of the new dwelling had to comprise formerly non-residential space) could not be right because it deprived Note (9) of any purpose:

> "26. … Note 9 requires consideration of the number of dwellings before and after the conversion, and provides that a conversion is

not included in Item 1(b) unless there are additional dwellings after the conversion. Our concern is: If the conversion of a non-residential part of a building is within Item 1(b) only if the new dwelling is formed solely from non-residential parts, then – under the construction asserted by the Respondents – there would always be additional dwellings as a result of the conversion. If the Respondents are correct then we struggle to see what purpose would be served by the test in Note 9. We asked [counsel for HMRC] when Note 9 would be engaged if the construction adopted by the Tribunal in *Calam Vale* is the right approach. [He] was unable to suggest any circumstances in which Note 9 could be engaged, or any purpose or function for Note 9. We agree … that the draftsman of Group 5 must have intended Note 9 to have a purpose and that it would be unsatisfactory to adopt an approach to Item 1(b) which leaves Note 9 without any meaning or function."

25. They concluded:

"40. Looking at Item 1(b) in the light of our conclusions regarding Note 9, we conclude that "converting … a non-residential part of a building into a building designed as a … number of dwellings" should be construed as meaning that the non-residential part of a building has changed its character and now forms part of a building designed as a number of dwellings. It follows that we agree with the Appellant and prefer the careful reasoning of the Court of Appeal in *Jacobs* and of the Tribunal in *Alexandra Countryside*. It seems to us that this is the better interpretation of Item 1(b) as it enables Group 5 to be interpreted as a coherent whole.

"41. Applying our interpretation of Item 1(b) to the facts found, the non-residential part of the public house has been converted into, i.e. changed its character into, a building designed as four dwellings (the lower maisonettes and the upper maisonettes)."

Discussion

26. The parties approached the interpretation of these provisions from different starting points. Ms McCarthy for HMRC said that the provisions make clear that it is not enough that the subject matter of the supply is now a dwelling; otherwise there would be no need to refer to non-residential buildings and non-residential parts of buildings at all. The question is whether a new dwelling which comprises partly a former dwelling and partly a non-residential part is covered. HMRC stress the fact that the definition of what is a non-residential part of a building in Note (7) is constrained because it is drafted as a negative condition. Note 7 as it applies in these cases reads:

> "For the purposes of item 1(b) a part of a building is non-residential if it is neither designed, nor adapted, for use as a dwelling"

27. Note (7) means, HRMC submit, that it is not the case that a part of a building is non-residential if it contains *some* commercial space but rather than it will only be a non-residential part if it contains *only* commercial space. If that is right, then it must follow that in order for a conversion to fall within Item 1(b), the major interest granted in the dwelling must be of a building designed as a dwelling that has been converted entirely from formerly non-residential space and not from a mixture of residential and non-residential space.

28. Mr Thomas and Mr MacPherson both emphasised the opening words of Item 1(b). They both are, they submit, clearly persons converting a non-residential part of a building into dwellings. They argue that as long as a non-residential part is converted into a dwelling, it does not matter that the dwelling also comprises some space that was formerly residential – they are still properly described as a person converting a non-residential part of a building into a dwelling. They also rely on the natural meaning of the word 'convert'. In so far as the dwelling includes former residential space, there has been no 'conversion' of that space into a dwelling because it was previously a dwelling. The word 'conversion' means to change the nature of the part from being one thing (non-residential) into a different thing (a dwelling). No such change takes place where the use has not changed. That is why Languard conceded both before the First-tier Tribunal and before us that the upper maisonettes did not qualify as a conversion. Even if the new dwelling contains some formerly residential space, the only conversion that has taken place is a conversion of the formerly non-residential part into a dwelling.

29. With some hesitation we have concluded that HMRC's interpretation of the statutory provisions is the correct one. We do not see that one can avoid the difficulty of deciding what has happened here by focusing on the person rather than on the conversion as Mr Thomas and Mr MacPherson urged us to do. The question whether they are both persons who have converted a non-residential part of a building into a building designed as a dwelling still has to be answered by considering the definition of 'non-residential' in Note (7). Further, we do not accept that the difficulty with construing the provision can be resolved by restricting the word 'conversion' so that it refers only to one kind of transformation; that of a non-residential use into a residential use. It is common to speak of a house being converted into flats or a row of small terraced houses being converted into a larger more luxurious dwelling. The formerly residential part of the building which takes up some of the space now comprising the new dwelling has been converted from its former state into something new, in these cases from a former publican's or former shop keeper's on-site accommodation into flats for the general property market. That space has been converted into something different even though it was residential before and is residential now.

30. The difficulty with Mr Thomas' argument is that the former non-residential part of the Haberdashers public house has not been converted into a dwelling because it has been converted into part of a dwelling – the ground floor of the two lower maisonettes. That lower floor is not a dwelling or a number of dwellings. The boundary of the non-residential part of the former building is the outer limit of all that part that was non-residential, including office space, storage, cellar and so forth. Similarly, where the former building contains a number of different flats they all form a single residential part, not a number of residential parts. We respectfully agree with the Court of Appeal in *Jacobs* that the non-residential part of the building cannot include any space that was residential because "[a] non-residential part and part which already contains a dwelling are mutually exclusive concepts." We do not accept, as Mr Thomas submitted, that HMRC's interpretation involves adding conditions to the application of zero-rating for which there is no basis. It involves only construing the words in Note (7) in order to arrive at the meaning of Item 1(b).

31. Mr Thomas and Mr MacPherson argued that such a result is inconsistent with a purposive reading of the provision. This was a factor that weighed greatly with the tribunal in *Languard*. They argue that the purpose of the provisions is to encourage the conversion of non-residential buildings or parts of buildings into new homes. This was recognised as a legitimate purpose in the judgment of the European Court of Justice in Case 416/85 *EC Commission v United Kingdom* [1988] ECR 3127, [1988] STC 456. In that case the Commission had challenged the zero-rating conferred at that time by the United Kingdom on a wide range of goods and services supplied to both consumers and business customers, including the major grants now covered by Group 5. The Commission argued that this should be limited to housing constructed by local authorities. The Court disagreed, holding that the measures adopted by the UK were adopted "in order to implement its social policy in housing matters, that is to say facilitate home ownership for the whole population". That aim fell within the purview of 'social reasons' which could justify the grant of zero-rating. It could therefore be applied to housing constructed by local authorities and by the private sector but could not extend to the construction of industrial and commercial buildings.

32. In our judgment the tribunal in *Languard* placed too much reliance on this social policy as a tool of construction. The furtherance of that policy explains why the UK has introduced section 30 and Group 5 to apply zero-rating to the creation of new housing stock. It explains why the provisions cover not only the construction of new housing but also residential conversions by the inclusion of Item 1(b) and by the inclusion of section 35 in the overall VAT scheme. But that purpose does not assist in deciding how to construe the provisions which aim to establish precisely where the UK has decided to draw the line in its encouragement of that purpose. That can only be determined by construing the words using normal canons of interpretation without particular regard to the underlying purpose. If HMRC's construction meant that there were almost no circumstances in which Item 1(b) could operate then the underlying purpose might be relevant. But HRMC's interpretation cannot be regarded as frustrating that purpose merely because another interpretation would be more generous.

33. The other reason why HMRC's submissions were rejected by the tribunal in *Languard* was that it left Note (9) devoid of content. If a dwelling only qualified for zero-rating if it was made entirely out of former non-residential space, then there would always be more dwellings at the end of the conversion than there were at the beginning. But that is not right, given how the Court of Appeal in *Jacobs* has held that Note (9) should be interpreted. It sometimes happens that a building comprising some commercial space on the ground floor and a large number of small flats on the floors above is converted into a building comprising a large flat on the ground floor and then a smaller number of larger flats on the upper floors; the small flats having been knocked together to create more spacious dwellings. In that situation *Jacobs* holds that even though the ground floor flat is within Item 1(b) because it is entirely made up of the former non-residential part of the building, it is excluded from zero-rating by the application of Note (9). One must count up all the dwellings in the converted part of the building (including dwellings made up of former residential space), not just the dwellings made up of the former non-residential part. But it is still the purely non-residential part that must be converted into a building designed as a dwelling (or where the grant of the major interest relates only to a part of the building that comprises a dwelling, into a part which is deemed to be a building by Note 10(i)).

34. Mr Thomas on behalf of Languard submitted that *Blom-Cooper* was binding authority on us that Note (7) does not restrict the meaning of "non-residential part of a building" to a part that is exclusively non-residential. We have not found decision of the Court of Appeal in *Blom-Cooper* easy to understand. However, we do not regard it as authority clearly rejecting the interpretation for which HMRC contend in this appeal and none of the other judges subsequently considering these provisions has so regarded it either. Certainly Peter Smith J in the High Court in *Blom-Cooper* held that it is not necessary to show that the whole of the dwelling comprises space which was formerly a non-residential part of the building which was converted. However, the point was not pursued on appeal so the Court of Appeal did not deal with it and they overturned the decision of Peter Smith J on other grounds, namely that Note (9) did apply and was not satisfied by the conversion in that case.

35. The point at issue here was not addressed by the Court of Appeal in *Jacobs* as their focus was on the question whether the additional dwelling required by Note (9) had to be created out of the non-residential part of the building or would still satisfy Note (9) if it were created out of former residential parts. The issue in these appeals did not arise because it was not asserted that the works to the first floor of the school which had entirely comprised residential accommodation for the boys and staff had been works to a non-residential part of the school: see paragraph 44. It did not matter in *Jacobs* that the mansion resulting from the conversion incorporated both the non-residential ground floor of the old school and part of the former residential accommodation on the first floor because Mr Jacobs only claimed a rebate in respect of work on the ground floor, all of which had been non-residential. It was possible for him to apportion the input tax incurred in the creation of the mansion between the input tax incurred to convert the ground floor non-residential areas of the old school and the input tax incurred

to convert the residential accommodation on the first floor because section 35(1D) provides for works to constitute a residential conversion "to the extent that" they consist in the conversion of a non-residential part of the building into a dwelling. Thus there would have been no point in the Commissioners contending in *Jacobs* that the input tax for the conversion of the mansion should be excluded because the mansion included residential parts of the former school. That would not have precluded Mr Jacobs from claiming back input tax for the conversion of part of the school into the mansion, to the extent that the mansion comprised formerly non-residential parts of the school. That was all that Mr Jacobs was claiming.

36. Mr Thomas also referred to the decision of the VAT tribunal at first instance in *Jacobs*. There the tribunal considered the natural description of the building taken as a whole in order to establish whether it was a residential or non-residential building. In that case they held that the converted building had been a school and was therefore primarily non-residential even though it contained some ancillary residential space namely the boys' dormitories and the headmaster's flat. Here, Mr Thomas argues, the conversion looked at in the round was of a non-residential building, namely a public house. If that was right, then all four maisonettes in the new property would be zero-rated. We do not accept that the statutory provisions allow one to consider the nature of the former building as a whole and characterise it on the basis of the primary overall function of the building in its unconverted state. The provisions contain too many references to parts of buildings for this impressionistic approach to be the correct interpretation.

37. We have said that we reach the conclusion that HMRC's interpretation is correct with some hesitation. This is because, like the tribunal in *Calam Vale*, we are concerned that the interpretation we favour leads to potentially curious results whereby a developer can achieve zero-rating on most of the building or none of the building depending on how he chooses to divide up the old space. Thus where, as is common, a building has commercial use on the ground floor and residential use on the upper floors, a developer can achieve zero-rating on any dwellings created using only the ground floor space but will not obtain zero-rating on any of the dwellings if he creates vertical dwellings each comprising a ground floor and upper, former residential, floors. In his written submissions, Mr Thomas raised the issue of fiscal neutrality and the requirement that similar transactions must be treated in the same way: see for example Case C-309/06 *Marks & Spencer plc v Revenue and Customs Commissioners* [2008] ECR-I 2283, [2008] STC 1408 paragraphs 33 – 36.

38. During the hearing we posited the situation where a ground floor of a building before conversion comprised a large commercial gym and a small residential caretaker's flat. If it is split into three identical flats, two may be zero-rated if they occupy space formerly entirely within the gym, but the third which incorporates part gym and part caretaker's flat will not benefit because it is not wholly made of a former non-residential part of the building. We pressed Ms McCarthy whether the Commissioners considered that a situation where supplies of the three identical flats attracted different VAT treatment raised concerns about fiscal neutrality. She responded that the Commissioners would not regard the three flats

as 'identical' for this purpose since one of them included the old caretaker's flat. She pointed out, fairly, that if it were sufficient for the flats to look identical from the potential purchasers' perspective for them to be treated the same for VAT purposes, then that would mean that if there were four identical flats made from the ground floor, one of which was solely comprised of the former caretaker's flat, that should also attract zero-rating. But we have rejected the idea that a new dwelling made up entirely of former residential space can qualify just because it is in a building which also including non-residential space. Mr Thomas also accepted that the provisions did not extend that far and, although Mr MacPherson did not accept this, we consider that the concession that the upper maisonettes in the *Languard* case are not zero-rated was correctly made. If a new dwelling is made up of space that was entirely residential before, it cannot be zero-rated simply because it forms part of a building which previously contained some non-residential space. As Ms McCarthy pointed out, such an interpretation would not only greatly expand the scope of zero-rating but would also lead to problems if parts of the building were owned or developed by different people and converted or sold off at different times.

39. Ms McCarthy accepted that if HMRC's interpretation is upheld, the limited circumstances in which zero-rating is available may influence the decisions taken by developers as to how to reorganise the space in a building that they plan to convert. However, she submitted that if this was a factor, it was likely to be one factor among many arising from the location of the building and the state of the local housing market for different kinds of dwellings. It was unlikely to be a determining factor causing a developer to make an otherwise sub-optimal choice of design, particularly since the VAT saved was now only 5% rather than 20% because of the operation of Schedule 7A to VATA which came into effect for supplies made after 31 October 2001.

40. We therefore allow the appeal in *Languard* and dismiss the appeal in *MacPherson*. None of the dwellings in the converted Haberdashers public house in *Languard* or the former shop in *MacPherson* has been created by converting part of a building that was not previously designed for use as a dwelling because it has been created from an amalgamation of the non-residential part and the residential part. The fact that the new dwelling contains some space that used to be non-residential is not enough, in our judgment, for it to qualify for zero-rating.

The Hon Mrs Justice Rose DBE
Chamber President

Judge Greg Sinfield
Judge of the Upper Tribunal

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