Application and Professional Skills

VAT and Other Indirect Taxes

November 2024

Suggested answer

REPORT TO ANDREW DIXON ("AD")
ON PLANNED DEVELOPMENT OF NEW HOME AT CRAMMTON FARM

1. Introduction

This Report has been prepared for AD to consider the most tax-efficient way of financing and undertaking a project for building a new home ("the Project") on a site at Crammton Farm ("the Site"). The Site is currently owned by DQS Partners ("the Partnership"). Two options have been suggested. Option 1 involves the Partnership contracting with their wholly-owned company, DQS Developments Ltd ("Developments"), to carry out the works, then selling the completed house to AD. Option 2 involves AD purchasing the Site, then undertaking the works personally using a project manager, Developments as building contractor, and Gary Sparkes ("GS") as electrical contractor. Works are due to commence in November 2024 with completion estimated for early summer 2025.

This Report is prepared solely for the use of AD and is based on information provided by AD in his letter of 1 November 2024 and information held in our files. An important point to note is that we have applied the tax law and practice in force at today's date. If there is a delay in implementing our recommendations, a significant fiscal event (such as a Budget), or a change in circumstances, confirmation should be sought as to whether this affects the conclusions and recommendations in this report.

2. Executive Summary

Relevant taxes

1) As regards the proposed financing of the Project, Capital Gains Tax ("CGT") is relevant. Under the two options, relevant taxes are Stamp Duty Land Tax ("SDLT"), Value Added Tax ("VAT"), Income Tax and National Insurance Contributions ("NICs").

Financing the Project

2) In principle, on selling an investment property AD will be chargeable to CGT. This will be at 28% as the properties are residential and AD pays income tax at the higher rate. However, if River Mews is sold, principal private residence relief ("PPRR") will be available except for part of the period when the property was tenanted. We recommend this property is sold, together with Gulliver Avenue (where the chargeable gain is lower than for Park Street). If a swift sale is transacted, this will produce estimated cash of £812,108 (before expenses) i.e., £17,520 more than if a sale of Park Street is sold with River Mews.

Option 1: tax issues

3) From both the practical and tax perspectives, Option 1 is simpler. The sale of the completed house will be a single zero-rated supply for VAT purposes . AD will, however, incur a substantial SDLT cost chargeable at the rate applicable for a second home: a total of £35,606, after giving effect to AD's entitlement to a one-third share in the Partnership's profits.

Option 2: tax issues

4) This Option is more complex from both the tax and practical perspectives. SDLT will be much lower - £600) as it is chargeable only on the Site, but VAT will be an issue. This is because AD will be entering into a number of separate contracts and therefore receiving several supplies for VAT purposes which potentially have different treatments. AD is not registered for VAT and the Project is for private, rather than business, purposes. Certain costs, such as project management and the purchase of non-building materials will incur VAT at 20% which would not generally be recoverable (for more see below). The services of Developments will be charged at the reduced rate of 5%. It is also arguable that a proportion of GS' charges may be reduced rated, though this is uncertain.

5) The safe conclusion, therefore, is that AD will incur a VAT cost. We estimate this at £84,750, though approximately £49,750 of it may be reclaimed from HMRC if AD applies for relief as a person carrying out a residential conversion (“the DIY builder’s scheme”).

Either Option: income tax and NICs

6) The sale of the Site is a sale of trading stock by the Partnership rather than a capital disposal. Consequently, as a partner, AD will be assessed to income tax on his one-third share of the Partnership’s profit from the sale. Assuming his marginal rate is 45%, AD’s will incur income tax and NICs totalling £25,067. This is the same under either Option.

The Options compared

7) Based on the estimates provided and applying the rules for the relevant taxes, the total cost to AD of Option 1 is in the region of £962,676, compared with £960,667 for Option 2 (See Section 8). Accordingly, from a tax perspective, Option 2 offers a slightly better result. In principle, it should also give AD greater control over the Project. However, in reaching his decision, we recommend AD also bears in mind the simplicity of Option 1 compared with the complexity of Option 2. The latter may create practical and commercial difficulties for AD. Examples are: the added risk of contractual disputes; cost and time overruns; insurance; delay and cashflow disadvantages in claiming recoverable VAT under the DIY scheme.

Conclusions and recommendations

8) For the reasons set out in this Report, we recommend that AD finances the Project by selling the River Mews and Gulliver Avenue properties. AD might also consider selling the Park Street property as financing either Option will involve a shortfall of around £150,000.

9) From a tax perspective, we recommend AD choses Option 2 provided he is comfortable with the practical and commercial risks we have highlighted and the added burden of making a DIY scheme reclaim.

10) Finally, as the Partnership’s accountants have already pointed out, it is important to ensure that all transactions between AD, the Partnership and Developments are made at fair market value. Unless this is done, HMRC may challenge the accounts and substitute values which could have adverse tax consequences. Note that this is applicable for the direct taxes. It may even be an issue for VAT in respect of Option 2 under certain anti-avoidance provisions.

3. Financing the Project

AD is undecided which of his two investment properties should be sold in order to finance the Project. Clearly, cashflow and timing are important here and we recommend these factors are borne in mind when reaching a decision.

In principle, gains on disposals of residential property are subject to CGT at 28% as AD is a higher rate taxpayer. However, properties which have been occupied as a taxpayer’s principal private residence (“PPR”) are eligible for PPR Relief (“PPRR”). Any gains during such period of occupation are exempt from CGT. PPRR extends to the last nine months of ownership (whether occupied by the owner or not), otherwise an apportionment must be made. Applying these rules to AD’s investment properties and based on the estimated values provided, we have calculated the chargeable gains in Table 1.

Table 1

Property	PPR?	Acquisition date	Tenanted from	Acquisition cost	Market value	Gain
				£	£	£
15 River Mews, London	Until November 2023	April 1996	November 2023	180,000	430,000	250,000

73 Park St, Kidderminster	No	July 2004	August 2004	244,000	410,000	166,000
13 Gulliver Avenue, Worthing	No	March 2011	July 2011	268,000	425,000	157,000
TOTALS				**£692,000**	**£1,265,000**	**£573,000**

To date, AD has owned River Mews for a total of 343 months. Tt was tenanted for 12 months however with the relief for the final 9 months of ownership, only 3 months don't qualify for relief.. PPRR would therefore exempt 340/343 of the gain. Assuming a swift sale of properties at current market value, we compare below the estimated sale proceeds net of CGT in Table 2.

Table 2

Property	Total gain	Chargeable gain	CGT rate	CGT due	Market value	Estimated net proceeds
	£	£		£	£	£
15 River Mews, London	250,000	2,187*	28%	612	430,000	429,388
73 Park St, Kidderminster	166,000	166,000	28%	46,480	410,000	363,520
13 Gulliver Avenue, Worthing	157,000	157,000	28%	43,960	425,000	381,040
TOTALS	**£573,000**	**£325,187**		**£91,052**	**£1,265,000**	**£1,173,948**

***** (3/343 x £250,000).

We have ignored sale costs etc., which will reduce the chargeable gain, CGT and net proceeds. Assuming no other disposals in the tax year, AD is entitled to a CGT exemption of £6,000, producing a saving of £1,680 (£6,000 x 28%).

The above estimates demonstrate that AD's best course is to sell River Mews and Gulliver Avenue. The net proceeds would give AD £812,108, after CGT of £42,892 (£612 + £43,960 - £1,680) was deducted. If, however, AD chooses to sell Park Street instead of Gulliver Avenue, net proceeds would be £794,588, after CGT of £45,412 (£612 + £46,480 - £1,680) was deducted. Note that the longer AD holds River Mews, the bigger his taxable gain will be, even if there is no change in property prices, because the non PPR proportion will increase.

We therefore recommend selling River Mews and Gulliver Avenue, which would yield, after CGT, an additional £17,520 towards the Project.

Note that CGT on disposals of residential property is now payable within 60 days of completion.

4. Option 1: tax issues

Under Option 1 AD will be the recipient of a single supply of a completed house. The Partnership will be the supplier. For VAT purposes, this will be zero-rated subject to certain conditions being met. The Partnership must:

1) be a "person converting a non-residential building into a building designed as a dwelling";
2) make a "first grant of a major interest" in the converted building.

In our view, these conditions will be met. The Partnership owns the Site (which includes an agricultural building which has always been used as such) and will employ Developments to carry out the works. On completion, the Partnership will sell the freehold of the completed dwelling house to AD.

The VAT implications of the works and materials are, of course, matters for the Partnership and Developments. AD, however, should have no VAT costs other than on e.g., his own legal fees.

As AD plans to keep his London home at Marland Street (and possibly Park Street), the purchase of the converted dwelling will be chargeable to SDLT at the residential rate plus a supplement for a second or additional home. However, as the completed dwelling will be sold to AD by the Partnership (of which he is a member) the chargeable consideration for SDLT purposes will be reduced to the sum of the lower proportions ("SLP"). This is to give effect to AD's one-third profit share. Assuming a sale consideration of £902,000, therefore, the SLP will be £902,000 x 2/3 = £601,333. The SDLT calculation is at Table 3.

Table 3

Chargeable Consideration	SDLT rate	SDLT due
£		£
Up to 250,000	3%	7,500
250,000 – 601,333	8%	28,106
TOTAL		**£35,606**

Under Option 1, therefore, SDLT is a significant cost for AD which he is unable to recover.

5. Option 2: tax issues

Under Option 2, AD will purchase the Site. SDLT will be chargeable on the consideration he pays for the Site. This will be minimal as the Site is currently classed as "non-residential" and the Partnership has not opted to charge VAT. Using the sum of lower proportions the consideration will be £180,000 (£270,000 x 2/3). The nil rate band applies up to £150,000, with the balance charged at 2%. SDLT is therefore £600. The purchase will be VAT exempt although AD is likely to incur VAT on e.g., legal fees.

AD will undertake the development. As he is not VAT-registered and the Project is for private, rather than business, purposes, any VAT he incurs on carrying out the works will potentially be a cost. We have reviewed the various heads of estimated costs (Part 3 of the Appendix to AD's letter) to identify what reliefs, if any, may be available to AD. In our view:

1) The works carried out by Developments will be reduced rated at 5%. This is on the basis they are works carried out in the course of a "qualifying conversion". For these purposes a qualifying conversion is one where a building is being converted such that the works result in a changed number of dwellings. Here, the barn (which has never been a dwelling) is being converted to form one new dwelling. That is a change from none to one and should satisfy the test.
2) In order for a supply of "building materials" to benefit from the 5% rate of VAT, the supply must be made by the person supplying the qualifying conversion. In this context "building materials" is a term limited by statute to goods ordinarily incorporated by a builder in a building of a qualifying description, such as a dwelling. There are exceptions. As AD plans to arrange the purchase of materials from suppliers other than Developments, these supplies will be ineligible for the reduced rate and liable to VAT at 20%.
3) Further details will be needed of exactly what supplies are to be made by GS and how he will treat them for VAT purposes. It is arguable that some of his services will be "services supplied in the course of a qualifying conversion" (e.g., if work is carried out to the fabric of the building or in connection with the means of providing power, heat or security for the building). These services, together with related supplies of building materials, might then qualify for the reduced rate of 5%. Electric heating and security alarms, for example, are specifically classed as building materials. However, other services supplied by GS, together with goods which do not qualify as building materials, will be chargeable at 20% VAT. Where part of a supply qualifies, but part does not, an apportionment must be made and VAT charged on each portion at the appropriate rate.
4) Constantius Consulting Ltd's fee is chargeable at 20% as project management is ineligible for reduced rating.

5) An overarching point, of course, is that determining the liability of supply for VAT purposes is the responsibility of the supplier. Of course, incorrectly charged VAT will not be recoverable under the DIY scheme, and so AD should discuss this carefully with the suppliers.

In our view the safe conclusion is that AD will be charged VAT at 20% on all his costs except purchase of the Site (exempt) and qualifying services supplied by Developments (chargeable at 5%). For ease of reference, we summarise our conclusions in Table 4, being the total cost before potential recoveries/reliefs.

Table 4

Item	Cost	VAT liability	VAT due	Total cost
	£		£	£
Site purchase (from Partnership)	270,000	Exempt	-	270,000
Conversion works by Developments	275,000	5%	13,750	288,750
Building materials	180,000	20%	36,000	216,000
Goods and services (GS)	125,000	20%*	25,000*	150,000
Project management	50,000	20%	10,000	60,000
TOTALS	**£900,000**		**£84,750**	**£984,750**

***** An apportionment may apply to reduce certain items to 5% but we will require further details before advising.

6. The DIY builder's scheme

In our view AD will be entitled to make a claim to HMRC for repayment of VAT incurred on any qualifying services and builder's materials. Form VAT431C must be submitted to HMRC together with associated evidence not later than three months from the date on which the dwelling is completed. Three important points should be made here:

1) Completion is the date on which the local authority certifies the dwelling as complete or, if earlier, the date on which it is first occupied.
2) HMRC require hard copy invoices as well as evidence that planning permission has been complied with.
3) There may be some delay in processing claims and in receiving payment, especially if HMRC raise queries. AD may have to finance the VAT cost until late 2025.

Referring to Table 4 above, we calculate AD will be entitled to a VAT refund of £49,750 on Developments' supplies and on building materials he buys personally. He may also be able to reclaim some of the input VAT charged to him by GS where it can be shown to relate to supplies of building materials, but more detail is needed on this point, as noted above.

He will not be able to reclaim the VAT on the project management fees charged to him by Constantius Consulting Ltd.

This means that the costs of construction, after VAT has been refunded, will come to £665,000, subject to the VAT treatment of GS's supplies. The land cost of £270,000 will increase the total cost of Option 2 to £935,000.

7. Income Tax and NICs

The barn will be treated as sale of trading stock by the Partnership, rather than as a capital disposal. Consequently, the partners will be assessed to Income Tax on the profit.

Under Option 1, AD will pay the Partnership £902,000. After deducting the base cost of the Site of £110,000 plus the total amount payable to Developments of £632,000, the Partnership will be left with a profit of £160,000. Under Option 2, the Partnership's profit will be the same, namely the proceeds of sale of the Site less its base cost (£270,000 - £110,000 = £160,000). Under either Option, each of the

three partners is entitled to a pre-tax profit share of £160,000 x 1/3 = £53,333. AD's personal tax liability on this profit share is shown in Table 5.

Table 5

Item	Income Amount	Tax Due
	£	£
Income Tax @ 45%	53,333	24,000
NICs @ 2%	53,333	1,067
TOTAL		**£25,067**

As AD will be aware, under either Option, the profit made by Developments from the Project will also affect his Income Tax position, depending on how Development's profits are distributed.

8. The Options compared

Based on the estimates provided to us, the cost to AD of Option 2 is marginally lower compared with Option. Summary calculations are in Table 6.

Table 6

Option 1 item	Cost	Option 2 item	Cost
	£		£
House purchase	902,000	Site purchase	270,000
SDLT	35,606	SDLT	600
		Gross cost of works (less DIY VAT reclaim)	665,000
Income Tax/NICs	25,067	Income Tax/NICs	25,067
TOTALS	**£962,673**		**£960,667**

AD's legal fees etc (on which VAT is not recoverable) may be higher under Option 2.

Apart from cost, we consider Option 2 has certain advantages. These include AD having greater control over the Project and the opportunity to use the expertise of GS for supply and installation of the hi-tech equipment. AD may be able to achieve greater savings and adherence to deadlines as he will also employ the services of Constantius Consulting Ltd to manage the Project. Possible disadvantages of Option 2, however, are that it involves greater complexity. The use of multiple contractors may increase the risk of disputes or insolvency. AD will have to take out insurance of the Site (including public liability) for the duration of the works and obtain satisfactory warranties and performance guarantees. It will be important to ensure contractors are applying the correct VAT liability. The need to rely on the DIY scheme for a VAT reclaim involves compliance issues and a potential adverse cashflow situation.

By contrast, Option 1 is much simpler. AD will purchase a completed home from his long-standing associates and relatively free from tax complications, especially relating to VAT. Disadvantages are that the Partnership/Developments will have day-to-day control over the Project. Any cost overruns will increase the price of the house and AD's substantial SDLT liability.

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