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Answer-to-Question- _1_

Report

To: Andrew Dixon

From: Alex Lee

Date: 3 November 2024

Subject: Tax Advice Regarding Planned Development of New Home

1. Scope

1.1. Background

Faul & Co LLP have been engaged by Andrew Dixon ("Mr Dixon") to provide a report setting out the best approach for undertaking the planned development of a new home ("the Project").

The report will cover:

- The most tax efficient disposal of two properties of Mr Dixon's portfolio in order to part fund the Project;
- Consideration of whether the Project should be structured whereby DQS Partners develops the house and sells to Mr Dixon ("Option 1"), or whether Mr Dixon should purchase the bare land and disused barn ("the Site") from DQS Partners and carry out the development himself ("Option 2").

1.2. Disclaimers

This report has been prepared for the sole benefit of Mr Dixon and cannot be relied upon by any other third party unless express approval is given in writing by Faul & Co LLP.

This report has been prepared based on the information provided to Faul & Co LLP in a letter from Mr Dixon dated 1 November 2024 as well as information held in Mr Dixon's client file. This report is based on current tax legislation and guidance as of 3 November 2024.

Please note that if any information should be subject to change or is incorrect, this should be communicated to Faul & Co LLP as soon as possible as otherwise the advice contained in this report may be incorrect.

2. Executive Summary

2.1. The two properties that should be sold to fund the Project should be 15 River Mews and 11 Gulliver Avenue. 15 River Mews should be sold because Principal Residence Relief is available on the 15 River Mews property, reducing the gain subject to Capital Gains Tax ("CGT") to £5,043 (see section 3.1.).

2.2. 11 Gulliver Avenue should then be the other disposal as it maximises the total net proceeds of £811,308 (see section 3.4.).

2.3. CGT of £43,692 (see Appendix 7.3.) will need to be paid to HMRC for the 24/25 tax year assuming Mr Dixon has no other disposals. The disposal of each property will need to be notified to HMRC within 60 days of completion via an electronic residential return, although it is recommended the payment is included on the 24/25 self-assessment tax return.

2.4. With regards to the Project, it is recommended that Option 2 should be taken - the Site should be acquired by Mr Dixon and work carried out by himself. This is because it will minimise the cost to Mr Dixon and also allows him to have creative control over the conversion works.

2.5. Option 2 minimises the cost because the Stamp Duty Land Tax (SDLT) payable on the purchase of the new house (Option 1) will be £35,607 (see section 4.2.), vs only £600 on the purchase of the Site (see section 5.2.) under Option 2.

2.6. In either scenario, Mr Dixon will need to submit a land transaction return, along with the SDLT payable, to HMRC within 14 days of the completion of the sale.

2.7. No VAT will be incurred on either the purchase of the Site or the completed house. However, under Option 2 it is estimated there will be around £25,000 of VAT incurred by Mr Dixon that will not be recoverable from HMRC (see section 5.1.1.). This still represents a saving compared to Option 1 as the SDLT due exceeds this amount.

2.8. Under Option 2, whilst Mr Dixon will incur VAT of around £84,750 on his costs (see section 5.1.1.), £59,750 will be recoverable under a DIY Housebuilders claim (see section 5.1.2.). Details on how to make the claim are in section 5.1.3.

2.9. Based on the cost to Mr Dixon of Option 2 of £925,600 (see section 6), and net proceeds from the sale of the investment properties of £811,308, there is a shortfall of £114,292 to be covered by Mr Dixon's cash savings.

3. Sale of Investment Properties

The sale of two of the three investment properties in Mr Dixon's portfolio is required in order to fund the Project. There is no preference in which properties are to be sold, as long as the sale is achieved in the most tax efficient way.

The only relevant tax to consider is CGT, as Mr Dixon would be disposing of capital investment properties. SDLT is not payable by the seller, and the sale is exempt from VAT so these indirect taxes do not factor into the decision.

The sale, and CGT arising, of each property is set out as follows:

3.1. 15 River Mews

The gain on 15 River Mews is $£430,000 - £180,000 = £250,000$, assuming the sale is made at the current market value.

If Mr Dixon incurred any enhancement expenditure on the property since acquiring it, such as an extension, then this can also be deducted to reduce the gain.

As this was once Mr Dixon's primary residence, CGT relief is available in the form of Principal Residence Relief ("PRR"). Essentially, CGT is relieved on the proportion of the gain relating to when it was occupied as Mr Dixon's primary residence.

Assuming a sale date of March 2025, the amount of relief should be around £244,957, resulting in a chargeable gain of £5,043. The calculation of the relief is contained in Appendix 7.1.

3.2. 73 Park Street

The chargeable gain on a disposal at market value of the property at 73 Park Street would be $\pounds 410,000 - \pounds 244,000 = \pounds 166,000$ (assuming no enhancement expenditure). No PRR is available as the property was never used as Mr Dixon's primary residence.

3.3. 11 Gulliver Avenue

The chargeable gain on a disposal at market value would be $\pounds 425,000 - \pounds 268,000 = \pounds 157,000$. As with 73 Park Street, no PRR is available.

3.4. Recommendations

Due to the significant reduction in the gain resulting from the sale of 15 River Mews as a result of PRR, we recommend that this property is one of the two disposed of.

This leaves two options - the sale of 73 Park Street or the sale of 11 Gulliver Avenue. Under both options, the CGT will be calculated at 28% as Mr Dixon is an additional rate taxpayer and these are residential properties.

If 15 River Mews and 73 Park Street is sold, we expect this to result in CGT due of $\pounds 46,212$ (see Appendix 7.2. for the calculation). This would leave net proceeds after the sale of $\pounds 430,000 + \pounds 410,000 - \pounds 46,212 = \pounds 793,788$.

If 15 River Mews and 11 Gulliver Avenue is sold instead, the expected CGT due would be $\pounds 43,692$ (see Appendix 7.3. for the calculation). Under this option, the net proceeds after the sale would be $\pounds 430,000 + \pounds 425,000 - \pounds 43,692 = \pounds 811,308$.

Therefore, we recommend that 15 River Mews and 11 Gulliver Avenue are the two properties Mr Dixon should dispose of in order to finance the Project, as the CGT is

minimised, leaving optimal net proceeds.

These are just rough figures to illustrate the difference. Exact figures, as well as any incidental fees and enhancement expenditure, will be required to compute the actual CGT due.

As these are residential property disposals, HMRC will need to be notified of the gain via an online residential return, which must be submitted within 60 days of the completion of each sale. The CGT can be paid at this point, however for cashflow we suggest it is included on the 24/25 self-assessment tax return instead as usual.

4. Option 1 - Purchase of Completed House from DQS Partners

4.1. VAT

The sale of a dwelling that has been converted from non-residential premises is zero-rated for VAT, so Mr Dixon will not suffer a VAT cost on the purchase of the house.

Whilst it may seem obvious the house will be a dwelling in layman's terms, for VAT purposes it must be 'designed as a dwelling' according to legislative criteria in order to benefit from the 5% rate.

Further analysis will be required to determine if the criteria are met, however on the face of it it seems probable they will be (for example, planning permission will be followed, it is likely to be self-contained, and so on).

4.2. SDLT

Mr Dixon will be required to pay SDLT on the purchase of the completed house.

As the property is being moved out of the partnership to one of the partners, the 'sum of lower proportions' (SLP) rules are required to calculate the chargeable consideration on which SDLT is payable.

The rules state that the consideration is equal to the market value at the date of transfer, multiplied by (100% - SLP %). In simple cases such as this one, the SLP % is the lower of the fractional share in the property owned by Mr Dixon before and after the transfer. Before, it was 33.33%, and after it was 100%. Therefore, the SLP % is 33.33%.

The chargeable consideration is therefore $\pounds 902,000 \times (100\% - 33.33\%) = \pounds 601,363$.

The amount of SDLT payable by Mr Dixon is $\pounds 35,609$ (see Appendix 7.4. for the calculation). A land transaction return, along with the payment of the SDLT, must be submitted to HMRC online no later than 14 days after the date of completion.

4.3. CGT

As the Site is currently held in DQS Partner's balance sheet as trading stock, there will be no appropriation to trading stock and consequently no deemed gain. Therefore, there will be no CGT payable by Mr Dixon or the other partners as a result.

4.4. Personal Taxes

The proceeds on the disposal of the house to Mr Dixon would be trading profits on the partnership, and as such result in income tax and national insurance contributions (NICs) charges for the partners.

For Mr Dixon, his share of the profits will be subject to the additional rate of 45%, with Class 4 NICs due at 2%. Further details on costs will be required to ascertain Mr Dixon's taxable profit and his personal taxes due, although it is assumed they will be in the region, if not higher, than those in section 5.4. under Option 2 (approximately £25,000).

5. Option 2 - Construction of House by Mr Dixon

5.1. VAT

Although acting in a private capacity, Mr Dixon is entitled to VAT relief on the conversion works under the 'DIY Housebuilders Scheme'.

The purpose of this scheme is to put Mr Dixon in the same position from a VAT perspective as if he had bought the new house from a development business, such as DQS Partners under Option 1.

Mr Dixon will still be charged and pay VAT at the relevant rates by his suppliers. VAT on qualifying expenditure will then be refunded to Mr Dixon following the submission of a successful claim to HMRC.

5.1.1. Rates of VAT Incurred

The purchase of the Site from DQS Partners will be exempt from VAT. This is because the partnership has not opted to tax the Site. Even if they did decide to opt before the sale (for example if they intended to recover the VAT on selling fees), it will not have an effect as Mr Dixon is a DIY housebuilder. No certificate is required to be produced but it is recommended evidence of intended use is retained by the partnership.

Building materials purchased by Mr Dixon in isolation will be subject to VAT at 20%. Therefore, VAT of $\text{£}180,000 \times 20\% = \text{£}36,000$ will be incurred.

Services supplied by DQS Developments will largely be subject to VAT at the reduced rate of 5%. This is because they are services in connection to the conversion of non-residential premises into dwellings. 'Building materials' when supplied with these services will also be subject to the 5% rate of VAT.

However, there are some exceptions to the 5% rate. Goods supplied with conversion services, which are not 'building materials', will be standard rated, along with the service.

Building materials are defined to be those ordinarily incorporated in the dwelling (must be both incorporated and ordinarily incorporated). However, there are specific exclusions, those being most gas/electrical appliances, furniture (except kitchen furniture) and carpets.

Based on the information provided, the sound system, roller blind and electric gates will not be considered 'building materials' for VAT purposes. A detailed breakdown of Gary Sparkes' fee will be needed to determine the amount of VAT that will be subject to 20% and the amount subject to 5% (as the security alarm system will qualify for the 5%). To be prudent, we will assume the whole amount is subject to 20% VAT - $\text{£}125,000$ plus $\text{£}25,000$.

Any goods supplied by DQS Partners in isolation will not benefit from the reduced rate and will be standard-rated, although based on the information provided they are not expected to provide materials or equipment.

Based on this analysis, the likely amount of VAT to be incurred on DQS Partners' fees

will be $£275,000 \times 5\% = £13,750$.

Project management services are also specifically excluded from the reduced rating. Therefore, Constantius Consulting will charge £50,000 plus £10,000 of VAT.

In total, there will be a maximum of £84,750 of VAT incurred.

5.1.2. Qualifying Expenditure

The VAT eligible for the refund scheme is the same VAT that a house developer would be able to deduct. Broadly, this will be all VAT incurred on the conversion works, with the exception of supply and/or installation of non-building materials.

Hence, the VAT Mr Dixon can expect to recover would be £59,750.

5.1.3. Making the Claim

A VAT431C form must be filled in by Mr Dixon and submitted to HMRC no later than 3 months after the completion of the house. It must also be supported by the invoices that Mr Dixon is claiming the VAT on, as well as a certificate of completion.

The forms are now to be submitted electronically via HMRC's website.

It is important that the VAT charged to Mr Dixon is calculated at the correct rate, otherwise HMRC will deny the claim. If an invoice is received with incorrect VAT, it would be advisable to withhold payment until it is reissued with the correct amount of VAT.

Finally, the conversion works must be for private, non-business use in order for the claim to be successful. This will be met as Mr Dixon intends to use the house as his primary residence.

5.2. SDLT

Under option 2, Mr Dixon will still have to pay SDLT on the purchase of the Site from DQS Partners. However, this will be much lower than under option 1. This is because the chargeable consideration is less, and also because it is subject to the non-residential rates.

The chargeable consideration is $\pounds 270,000 \times (100 - 33.33)\% = \pounds 180,009$, applying the SLP rules as per section 4.2. The SDLT on this is $\pounds 600$ (see Appendix 7.5. for the calculation).

5.3. CGT

As with Option 1, the Site is held as trading stock in DQS Partners' balance sheet and so there will be no gain on the disposal.

5.4. Income Tax and NICs

The sale of the Site by DQS Partners will result in taxable profits. The anticipated profit on the sale is $\pounds 160,000$ (being current market value of $\pounds 270,000$ less purchase price of $\pounds 110,000$). Mr Dixon's share is $\frac{1}{3}$ of this, $\pounds 53,333$.

Assuming Mr Dixon's other activities result in him being an additional rate taxpayer in 24/25, then the income tax due on this is $45\% \times \pounds 53,333 = \pounds 24,000$.

Class 4 NICs will also be due. Again, assuming Mr Dixon's other activities result in

profits over £50,270 for the 24/25 year, then the additional Class 4 NICs due would be $2\% \times £53,333 = £1,066$.

6. Recommendations on Option 1 or Option 2

Based on the above analysis, it is recommended from a tax perspective that Option 2 is pursued - Mr Dixon purchases the Site as it is and converts into a house himself.

This is because there is a significant SDLT difference between the two options - £35,607 due under Option 1 vs only £600 due under Option 2. This is still a saving even when considering the additional £25,000 VAT cost to Mr Dixon under Option 2.

To illustrate the difference, the cost to Mr Dixon under the two options is as below. We have ignored the income tax and NICs as we cannot estimate them under Option 1, however they are likely to be in the same region if not higher than the amounts under Option 2.

Option 1:	£		Option 2:	£
Purchase Price	902,000		Purchase Price	900,000
VAT	-			25,000
SDLT	35,607			600
Total	937,607			925,600

The difference is therefore £12,007 which is not marginal.

There are additional administrative burdens with carrying out the works himself, however the monetary saving more than outweighs this and Mr Dixon has expressed he would like creative control over the Project anyway.

However, care should be given as to the practical consequences of using the non-preferred electrician. Will this damage the relationship between Mr Dixon and the other partners?

Additionally, there will be a sizeable cashflow disadvantage under Option 1 between paying the VAT on costs and having it refunded by HMRC - around £59,750. This could be mitigated if Mr Dixon had sufficient cash savings to not need this money in the interim, or potentially a short-term loan could be taken out.

7. Appendices

7.1. PRR Calculation

Period	Explanation	Period (months) to include in relief	Period (months) to exclude in relief
Nov 1996 - Nov 2023	Actual occupation	331	
Nov 2023 - June 2024	Letting		7
June 2024 - March 2025	Last 9 months are deemed occupation	9	
Total		340	7

PRR = gain x occupation period / total period

$$= 250,000 \times 340 / (340 + 7) = \text{£}244,957$$

7.2. CGT Calculation on Disposal of 15 River Mews and 73 Park Street

Gain on 15 River Mews	5,043		
Gain on 73 Park Street	166,000		
Net gains	171,043		
Less annual exemption amount (AEA)	(6,000)		
Chargeable gain	165,043		
CGT at 28%	46,212		

7.3. CGT Calculation on Disposal of 15 River Mews and 11 Gulliver Avenue

Gain on 15 River Mews	5,043		
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Gain on 11 Gulliver Avenue	157,000		
Net gains	162,043		
Less AEA	(6,000)		
Chargeable gain	156,043		
CGT at 28%	43,692		

7.4. SDLT Calculation on Purchase of Completed House

Start of Band	End of Band	Chargeable consideration within band	SDLT % *	SDLT due
0	250,000	250,000	3	7,500
250,001	925,000	351,363	8	28,109
Total		601,363		35,609

* The residential rates of SDLT apply, and as this would be a purchase of an additional residential property, Mr Dixon is subject to the higher rates (3% uplift).

7.5. SDLT Calculation on Purchase of the Site

Start of Band	End of Band	Chargeable Consideration within Band	SDLT %	SDLT due
0	150,000	150,000	0	0
150,001	250,000	30,009	2	600
Total		180,009		600