

# **The Chartered Institute of Taxation**

## **Application and Professional Skills**

### **VAT and Other Indirect Taxes**

**November 2021**

**Suggested solution**

## VAT and Other Indirect Taxes

### Report to the Board of Cerebri Cura Trust

8 November 2021

Dear Sirs

#### Report - Construction of Head Office - Tax Implications

##### 1 Scope of report

In accordance with our engagement terms, this report covers our findings and recommendations relating to the acquisition of a new head office and parking facilities.

We have been asked to assess and conclude upon the relative merits of the following proposals:

##### 1) A lease and leaseback arrangement

Cerebri Cura Trust Ltd (“the Trust”) will grant a 150 lease to RG Assurance Plc (“RG”) to the site of the new office and car park. As developer, the Trust will construct a three-storied office building and car park. The base cost in the heads of terms assume a projected cost of £9.2m (excluding VAT), but the final cost is more likely to be £9.5m (excluding VAT) but inclusive of the pre-grant costs of £550,000 to be reimbursed by RG. On completion of the works, the Trust will occupy the facilities under a 30-year lease (“the underlease”) granted by RG at a base annual rent of £604,000, plus a cost related rent, excluding VAT (RG having agreed not to opt to tax the building).

Initially the Trust will sublet the third floor for a projected annual rent of £200,000, using the lower floors for its purposes.

##### 2) Self-funded scheme.

Fixed interest loans secured by the Trust will enable it to construct a smaller two-storied building at a projected cost of £6.75m, excluding VAT. The annual loan repayments over 30 years are currently estimated to be £492,500.

Our report is based upon information supplied by the Trust and has been prepared solely for its benefit. Accordingly, its contents shall not be disclosed to a third party without our prior written consent.

##### 2. Executive summary

Our findings and recommendations are:

##### 2.1 Recommended Option

2.1.1 On the face of it, the annual cost of the lease and leaseback option is cheaper, to the extent of £4,490, discounting the premium receivable of £500,000 – see Appendix 1.

2.1.2 However there are considerable risks associated with this option:

(a) Our calculation takes no account of void periods when the third floor is unoccupied, or on the possible difficulties in finding a tenant. The loss of the rental income on the sublease may have a material effect should there be difficulties in securing a suitable tenant at the outset and in the future.

(b) Whilst you consider that the buildings costs will increase; we consider that revised projected cost may still be understated. The control of building costs is inherently difficult with a project such as this, with intervening external factors invariably resulting in overruns. As illustrated, an overrun will increase the underlease rent. Given the Trust’s relative inexperience in managing building projects, the risk associated with it acting as the developer should not be underestimated.

- (c) The administrative burden and attendant costs assumed by the Trust as the developer should not be discounted. In our experience, it is likely that the Trust – at a minimum – will need to recruit a construction project accountant for the term of the project. Also, it must register and comply with the terms of the Construction Industry Scheme (see section 4.4).
- (d) We calculate the SDLT payable on the head lease to be not less than £47,500; exceptionally, the liability could be as high as £584,500 based on building costs of £9.5m, plus VAT should HMRC conclude that the chargeable consideration on grant of the headlease should take account of the construction costs of £9.5m (see section 4.1). This risk could be removed by the exclusion of the buy-back clause from the final contract.
- (e) Contrary to our conclusion in section 4.3 of the report, HMRC may view the grant of the headlease as a transaction in the nature of a trade subject to corporation tax. Alternatively, when submitting its corporation tax return, the Trust should claim exemption from tax arising on the capital gain on the disposal of the site on the basis that the premium received will be applied in furtherance of the Trust's charitable activities.
- (f) The underlease provides for upward only rent increases over its term. Accordingly, the cost differential identified in Appendix 1 in favour of the lease and leaseback option will be dissipated relatively early in the term.
- (g) Since it will be a very considerable time before the Trust recovers its freehold interest, this may limit future development of the whole site.

2.1.3 Given the above factors, together with:

- (a) at the outset, the marginal difference between the options of the projected annual costs;
- (b) The simplicity of the self-funded option;
- (c) The expressed concerns relating to RG as an investment partner; and
- (d) The environmental issues raised during the planning process,

we recommend the self-funded option, despite the initial annual cost and the limitation on office space.

### 3. VAT relief – construction and associated professional services.

Under both proposals, VAT chargeable on the construction and related professional services is significant. Since the Trust is a charity, construction services (but not related professional services unless they are subsumed in the construction services supplied by the contractor) will be zero rated (i.e., VAT is chargeable at 0%) to the extent that the offices (or discrete parts) will be used by the Trust for "non-business" purposes.

Given the use of the building will be mainly for business purposes, there is no prospect of zero rating extending to the whole building. That said, the relief will apply if the Trust can identify and certify discrete parts of the building to be used for non-business purposes to the extent of at least 95% on account of:

- 1) The absence of a legal relationship between the Trust and a client pursuant to which the Trust provides goods and services in return for consideration (payment), for example:
  - (a) Research and information supplied free of charge to the public.
  - (b) Through mail and telephone campaigns, the engagement of chuggers, etc the securement of donations and legacies.

The Trust has said that these activities will utilise 315m<sup>2</sup> of the floor area of the new office.

- 2) The activity not constituting an “economic activity”. We consider that the means-tested provision by the Trust of respite care and rehabilitation, along with support and counselling services supplied to families and carers, is such an activity since:
- (a) The annual income derived from the activity is relatively insignificant.
  - (b) It is carried on in furtherance of the Trust’s charitable objectives, rather than for commercial purposes to secure a profit.
  - (c) The service is subsidised to a substantial degree (85%).
  - (d) It is unlikely to distort competition.

Our conclusion in this regard coincides with HMRC’s published guidance to the effect that charities supplying welfare services significantly below cost (i.e., subsidised to the extent of at least 15%) to distressed persons may treat them as non-business.

You have advised that 280m<sup>2</sup> of the new offices will be used in pursuance of this activity.

Given that 595m<sup>2</sup> of the new office’s usable floor area of 1,250m<sup>2</sup> (representing 47.6%) will be used for non-business purposes, it follows:

1) Lease and Leaseback

The first instalment of the rent payable by the Trust under the underlease will comprise zero rated and VAT exempt supplies (RG having not opted to tax). Since the zero-rated supply is taxable (albeit at 0%), in accordance with its partial exemption method, RG may reclaim VAT charged by the Trust as developer to the extent that it is fairly and reasonably attributable to this taxable supply. Given that the zero-rated supply only relates to two thirds of the building, the VAT recoverable by RG is unlikely to exceed £603,235 (£1.9m x 47.6% x 66.7%). If a charity were to take a lease to the upper floor, with all or part of the demised area used by it for non-business purposes with the Trust able to certify such use (certification of the use of the building is covered later), then the proportion of input tax deductible by RG would increase, thereby reducing the variable element of the initial annual rent payable by the Trust under the underlease.

2) Self-funded

XYZ’s construction services relating to a smaller building will produce an immediate VAT saving of £558,824 (£5.87m x 20% x 47.6%) in the form of zero rating. Although the relief does not extend to professional services, if the existing arrangements were varied so that XYZ engaged the professional consultants currently employed by the Trust, with it assuming responsibility for these services in conjunction with the construction services under an overarching design and build contract, the VAT savings would be £642,600 (£6.75 million @ 20% @ 47.6%). Revisions to the contractual arrangements as described here, do not have to be disclosed to HMRC, nor in practice are they considered by HMRC to represent an abuse of law.

To secure zero rating, the Trust must issue RG (XYZ in the case of the alternative proposal) a certificate in the form set out in part 18 of the VAT Notice 708, identifying those parts of the building to be used for non-business purposes by its occupants to the extent of at least 95%, supported by floor plans. Although strictly the relief does not apply until the certificate has been issued, in practice HMRC will, on receipt of a belated certificate, permit XYZ to adjust for VAT previously overcharged on its services (subject to the time limit of 4 years for correcting VAT returns).

To avoid a penalty equal to the VAT relief secured, when issuing the certificate, the Trust must exercise reasonable care (judged by the standards of reasonableness exhibited by a taxpayer with a responsible attitude to its duties as a taxpayer).

The Trust should appreciate that where zero rating is secured and, within 10 years, part of the building ceases to be used for non-business purposes, a proportion of the VAT relief originally claimed will be subject to claw back.

The VAT relief in the form of zero rating is significant. Under the self-fund option, the Trust not only secures an immediate cashflow benefit of up to £642,600 on the zero rated works, but also an immediate right to reclaim £233,442, representing 33% of VAT chargeable on the balance of the

works which are standard rated, thereby reducing its borrowing requirements under this option as recognised in the annual saving set out in Appendix 1.

In short, the VAT cost under the self-funded option is £473,958. In contrast, under the lease and leaseback option, on an equivalent basis, the VAT cost would be £664,064 (£1.9m x 52.4% x 66.7%).

[Examiner's note: as will be apparent to students, the suggested solution envisages that significant VAT savings could accrue if the Trust is able to avail itself of zero rating on the building works. In common with previous APS papers, candidates might have come to different conclusions (as indeed was the case here), with the majority concluding that zero rating was not in point, and then going to consider the basis under which VAT incurred might be recovered, qualifying VAT so deductible as input tax, the possibility of applying for a partial exemption special method, a brief examination of the operation of the capital goods scheme, etc. To the extent that these answers were well-reasoned and relevant, credit was given by the examiner].

#### 4 Other matters particular to the lease and leaseback.

##### 4.1. *SDLT*

While SDLT payable on the grant of the headlease is principally a matter for RG, under the lease and leaseback option, the liability falls to be met by the Trust as part of the initial annual rent payable under the underlease.

Normally SDLT is chargeable on the consideration (inclusive of VAT) attributable to the land (£600,000, the Trust having opted to tax the site), together with the costs expended prior to completion of the headlease on 3 January 2022 (£660,000, inclusive of VAT). That being so, the SDLT charge will be £52,500. If, as we recommend in the following section, the Trust revokes its option to tax, the consideration attributable to the land will reduce to £500,000, thereby reducing the overall SDLT charge to £47,500 – see Appendix 3.

Given RG's entitlement under the HOTs to require the Trust to buy back the land should its performance as the developer be deemed unsatisfactory, in the light of previous precedents, HMRC may point to this term as evidence that the economic reality of the arrangements was for RG to acquire a completed building. Accordingly, the chargeable consideration for SDLT purposes should include not only the agreed premium, but also the sums invoiced under the development agreement, namely £9.5 million, plus VAT. Under this scenario, the SDLT liability will be £584,500 (Appendix 3) which represents a significant risk to the Trust. Accordingly, we recommend that the buy-back clause be removed from the final agreement if the Trust decides to proceed with this option.

The Trust will not be liable to SDLT on the rent payable on the grant of the underlease on account of the general exemption available to charities on the purchase of a chargeable interest in land.

##### 4.2 *Option to tax.*

We consider that the Trust's decision to opt to tax the building site may have been misplaced given that the input tax on the pre-grant costs is deductible under an alternative mechanism.

Until the heads of terms were agreed with RG, such input tax was non-attributable input tax. Were the Trust to proceed with the lease and leaseback, we consider that this input tax is deductible in full as wholly attributable to the Trust's taxable supplies as a developer and/or the costs that RG has agreed to reimburse. The change of use rules permit the Trust:

1) to include in the 2021/22 annual adjustment, additional input tax deductible in that year; and

2) with HMRC's written agreement, to adjust a current tax return in respect of earlier input tax underclaimed since the inception of the project (the four-year cap relating to late claims for input tax only runs from the start of the accounting period in which the change of intention is manifested).

For this reason and to mitigate SDLT chargeable on the grant of the headlease, we recommend that the option be revoked before the grant of the headlease. The prior permission of HMRC is not required since tax has not been charged on account of the option, nor has related input tax been claimed and less than 6 months have elapsed since the effective date of the option. The revocation should be notified on form VAT1614C.

There is no rationale for the option to tax under the self-fund proposal which reinforces our recommendation.

#### 4.3 *Corporation Tax*

We consider that the grant of headlease does not represent a venture in the nature of a trade. Since “trade” is not defined, we must have regard to the following badges of trade developed by the Courts:

- 1) Is there an intention to make a profit?
- 2) Are there systematic and repeated similar transactions?
- 3) Was the asset repaired, modified, or improved to make it more easily saleable or saleable at a greater profit?
- 4) Is the asset of a type or amount that it can only be turned to advantage by a sale, rather than held to yield income or a setting in which a trade is carried on?
- 5) Is the transaction like an existing trade?
- 6) How is the transaction financed?
- 7) The length of ownership.
- 8) The reason for the acquisition and resale.
- 9) Was the asset sold in a way that was typical of trading organisations?

The presence or absence of a particular badge is unlikely, by itself, to provide a conclusive answer to whether there is a trade. The weight to be attached to each badge will depend on the precise circumstances.

We consider that the grant of the headlease will not represent a venture in the nature of a trade for the following reasons: the carving out of a lease such as we have here is not typical of a land dealer, the building site is not trading stock and there is no evidence of the Trust previously dealing in land.

That said, we consider that the grant of the headlease represents a part disposal of the site giving rise to a chargeable gain of £413,050 - see appendix 2. The gain will be exempt from corporation tax since – on the face of it - the premium will be applied for charitable purposes but, for the avoidance of doubt, we suggest that the exemption be claimed on the Trust’s tax return.

Finally, we note that capital allowances may be claimed by RG alone. This is a sensible concession, given that the Trust’s activities are substantially exempt from tax. However, in the absence of further information, it may be desirable to seek RG’s assurances that the underlease rent reflects the tax relief accruing from such allowances.

#### 4.4 *Construction Industry Scheme*

Since the Trust is acting as a contractor outside the exemption applicable to charities, we consider that it is required to register under the terms of the Construction Industry Scheme.. Once registered, the Trust must verify the tax status of XYZ before paying it; as necessary, deducting tax from such payments and accounting for it to HMRC’s Accounts Office and making monthly returns. Failure to comply with the regulations is subject to penalties.

#### 4.5 *Reverse charge, construction services*

The reverse charge mechanism does not extend to the Trust since it will be an intermediary supplier which shares a “relevant interest” in the site with RG, the end user. A relevant interest includes an agreement for lease. The Trust should advise XYZ on the position, requesting that the Trust be invoiced under the normal accounting rules.

**Cerebri Cura Trust**

**Appendix 1**

**Annual cost comparison:**

1) Lease and Leaseback:		£
Basic rent		604,000
Cost Related Rent:		
(A) Expected building costs invoiced by Trust as developer, net of VAT	8,950,000	
(B) Pre-grant costs reimbursed by RG	550,000	
(C) SDLT chargeable on grant of headlease	47,500	
(D) Irrecoverable VAT incurred by RG on the invoiced costs of £9.5m, inclusive of the pre-grant costs of £550,000 (£1,900,000 – 603,235), representing VAT otherwise chargeable on zero rated works as detailed in the body of the report	1,296,765	
	<u>10,844,265</u>	
(E) Base cost	<u>(9,200,000)</u>	
	<u>£1,644,265</u>	
Cost related rent amortised over 30 years		<u>54,809</u>
		658,809
Rental income on sublease of upper floor		<u>(200,000)</u>
Initial annual rent payable		<b><u>£458,809</u></b>
2) Self-Funded:		
Initial estimated loan repayments		492,500
Effect of zero rating:		
Building services (£5.87m x 20% x 47.6%)	558,824	
Professional services (£880,000 x 20% x 47.6%)	83,776	
	<u>642,600</u>	
Input tax deductible on build costs (£1,350,000 – 642,600) x 33%	233,442	
Reduction in borrowing requirement	<u>£876,042</u>	
Reduction in borrowing requirement amortised over 30 years		<u>(29,201)</u>
<b>Revised Annual Cost</b>		<b><u>£463,299</u></b>
Difference in Annual Cost		<b><u>£4,490</u></b>



**Cerebri Cura Trust****Appendix 2****Capital gain - grant of headlease**

	£
Premium	500,000
Less associated costs	<u>(5,000)<sup>2</sup></u>
	495,000
Cost: £25,000 x (500,000/500,000 + 1 <sup>1</sup> )	<u>(25,000)</u>
Unindexed gain	470,000
Indexation allowance £25,000 x 2.278	<u>(56,950)</u>
	<u><b>£413,050</b></u>

## Notes:

1) Since the term of lease is 150 years, the value of the Trust's freehold interest subject to the lease assessed at £1.

2) Costs are estimated.

**Cerebri Cura Trust****Appendix 3****Projected SDLT charge on grant of headlease**

	<b>£</b>
Premium	500,000
Value of building works undertaken prior to grant, inclusive of VAT	660,000
Chargeable consideration	<u>£1,160,000</u>

## SDLT chargeable:

£0-150,000 @ 0%	0
£100,000 @ 2%	2,000
£910,000 @ 5%	<u>45,500</u>
	<b><u>£47,500</u></b>

SDLT chargeable should HMRC determine the chargeable consideration to be £11,900,000, represented by the premium of £500,000 and the invoiced building works of £9.5m, plus VAT:

£0-150,000 @ 0%	0
£100,000 @ 2%	2,000
£11,650,000 5%	<u>582,500</u>
	<b><u>£584,500</u></b>