Institution **CIOT - ATT-CTA**
Course **CTA APS VAT and Other Indirect Tax**

Event **NA**

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Count(s)	Word(s)	Char(s)	Char(s) (WS)
Section 1	**3198**	**15528**	**18639**
Total	**3198**	**15528**	**18639**

Answer-to-Question-_1_

Report to the Board of Cerebri Cura Trust

1) Scope of the report

The scope of this report is to provide advice to Cerebri Cura Trust ("CCT") on the following:

1. A recommendation of the means of constructing a new head office
2. Tax implications of a change in business activities
3. Further information required before arriving at a final decision to construct the office

The report is based on information provided by Rory Wiltshire in his letter dated 1 November 2021. Any advice and recommendations set out in this report is for the sole benefit of the Board of CCT and should not be shared with a third party without prior permission granted by Laidlaw Wallace LLP.

2) Executive Summary

We recommend that CCT proceed with Option 1 by leasing and leasing back the property to RG Assurance.

Option 1 would cost approximately **£9,719,810** (Appendix 1) This costs takes into account expected rental costs based on the information provided in Exhibit B. The key advantages to using Option 1 are the reduced financial cost, the reduced administrative burden of constructing the property, as well as the ability to obtain all funding upfront for the building construction without impacting the wider charitable activity.

Option 2 would cost approximately **£17,501,520** (Appendix 2). This cost factors the total construction cost that CCT will pay for, the irrecoverable VAT borne on these construction costs and annual interest costs.

Irrecoverable VAT can be reduced by dedicating one floor entirely to non business use so that the contractors costs can be partially zero rated.
The key advantages to Option 2 is the possibility of selling the property in future, the non-dependence on finding a suitable tenant for the third floor and the reduced pressure from local residents and internal stakeholders for partnering with a overseas financial partner.

We recommend opting for Option 1 due to the **£7,781,710** saving in cost. This cost saving is significant for CCT as this would comprise of over 100% of CCT's total income, and could offset any profit made from a property sale under Option 2 in the future.

CCT's irrecoverable VAT from general charitable activity is expected to increase due to a reduction in blended Business Non business Partial exemption recovery rate.

CCT will be unable to recover costs from the operation of an investment fund and it should adjust its treatment of supplies based on our notes in Appendix 3

3) Option 1 - Lease and Leaseback

The first option is to grant a long term lease to RG Assurance, with the funding provider then leasing back the property back to CCT.

3.1 Financial cost

The total cost of construction for Option 1 is expected to be **£9,719,810**. All calculations can be found on Appendix 1.

3.2 VAT recovery on construction costs

The VAT on developers costs incurred by CCT will be fully recoverable due the disposal of the long term grant constituting as a taxable sale. This is due to the option to tax in place on the Bristol land site.

3.3 Domestic Reverse Charge on the grant to RG Assurance

This will be subject to the domestic reverse charge, as the supply is reportable under the Construction Industry Scheme. This means that CCT will not charge VAT on its recharge of construction service costs to RG Assurance, and will need to register for the Construction Industry Scheme with HMRC. The recharge of costs will not be subject to VAT to RG Assurance, will CCT charging itself VAT on its Box 1 and fully recovering this on Box 4 of the VAT return (as the land has an option to tax on the Bristol site).

3.4 Capital Goods Scheme

If an asset spend is capitalised and the net amount exceeded £250,000, it will be subject to the Capital Goods Scheme. The existing Bristol office may be subject to this depending on the historical consturction spend on the site. If this is the case, a Capital Goods Scheme ("CGS") sale adjustment would be required within the October 2022 VAT return to reflect this disposal of the existing freehold land to RG Assurance. The sale adjustment would be as follows:

Historical VAT incurred on costs x (100% - 33%)/10 years - number of years since existing office has been constructed.

If you are able to provide us with this information, we can provide an estimated sale adjustment figure for you to account for on the October 2022 VAT return.

A normal CGS adjustment will also be required to reflect any change in blended Business/Non Business Partial exemption rate ("blended PE rate") in the 2022/23 year.

<u>3.5 Sub Lease to the charity</u>

Given CCT has an existing option to tax on the Bristol property, when it makes an onward sub lease to another charity, it would ordinarily be subject to VAT. However, the charity may choose to disapply this option to tax, which means CCT's sub lease will be an exempt supply instead with no VAT charged. This would mean any associated costs in relation to that floor will not be VAT recoverable.

Additionally, a non-charity client may pay more than the current £200,000 per annum. The current price seems extremely cheap compared to the rate that CCT will be paying to RG Assurance for its lease. We advise that you agree with the potential tenant whether they intend on disapplying this option.

We would also recommend negotiating a higher price or widening the search to include non-charities so that they cannot disapply this option to tax and there are no adverse VAT consequences for CCT on the lease of this building.

3.6 Corporate Tax

There will be no Corporate tax implications on the grant of the lease as any profits can be gift aided to the charity.

Option 2 - Self construction

Option 2 would involve CCT entirely construction a new office itself on the existing land that it owns. The expected costs for Option 2 is **£17,501,520**. All cost calculations can be found in Appendix 2.

4.1 Zero rated VAT on construction

The key consideration for Option 2 is the ability to zero rate the contractors development fees. Given all VAT charged to a charity is a cost due to the inability to recover all Input tax, this would be a financial saving for CCT.

In order to zero rate all construction services received by CCT, the building must be used for "solely" (or over 95%) use for non-business activity. Non business use is broadly referred to activity where CCT would not receive any consideration for the activity such as delivery of care directly to families. As per HMRC guidance, CCT would not fulfil this criteria as it is used for 48% exclusive use for non-business activity currently.

However, part of the construction services could be zero rated if the building is clearly apportioned so that part of the building (for example Floor 1) is used solely for non-business use and the other floor can be used for the entire charity.

Based on our calculations in Appendix 2, the building will be used for approximately 48% non business use. If Option 2 were opted for, We would strongly advise that plans are made for Floor 1 (approximately 48% of floor space) to be used solely for charitable activities such as fund raising though donations, care and support services provided for free and research and information services.

If Floor 1 will be used solely for charitable purposes such as the means mentioned above, then the contractor is able to zero rate any construction costs as well as building materials used to construct the property, representing a true financial saving for CCT. It would be important for CCT to issue a certificate of intended use to the contractor before the contracts are exchanged so that all construction services in relation to Floor 1 will show as zero rated on the invoices.
Formats for these certificates can be found online on the HMRC website.

The VAT incurred on the other 52% of the building would be recoverable at the existing 33% blended PE recovery rate. Our calculation has assumed that when the invoices are issued, that the blended partial exemption rate will be 22% (Appendix 4) and have factored the irrecoverable VAT as a cost to the project.

4.2 Capital Goods Scheme

The construction of the office will mean the office will be subject to the capital goods scheme as the overall cost will exceed £250,000. The taxable usage of the building should be reviewed every year and if the blended PE recovery rate changes, then the VAT initially recovered will be adjusted each year until 10 years after the property is first occupied (2032).

The VAT on the construction will likely be recovered at 22%. If there are any future changes to the blended PE recovery rate, then this CGS adjustment will be accounted on the October Vat return following that April VAT return. This would be:

£934,000 x (BNB PE recover rate for the year - 22%/10 years)

4.3 Corporate Tax

A fair valuation should be found for the fixtures to make this more atttractive to potential buyers of the property for Corporate Tax purposes, as a high valuation can enable the buyer to claim high capital allowances and reduce the buyer's corporate tax bill.

5. Comparison between Option 1 and Option 2

5.1 Financial Cost

Option 1 is found to be £7,781,710 cheaper in raw costs based on our calculations in Appendix 1 and 2. Please note our calculations are heavily based on estimated figures provided and therefore if there is additional information such as revised annual rent or potential income from the charity shop tenant, please do provide this to us.

5.2 Potential for onward sale of the office

Option 2 would allow for CCT to own the building rather than to lease it. Whilst this would give CCT more flexibility to move offices in 30 years time on in between, it would negate the possibility of selling this on to another party in 30 years time. As such the Option 2 calculations have not factored a potential sale in 30 years time and this should be considered.

5.3 Funding liquidity

Unlike option 1, CCT will need to find another means of funding the building construction. If a large scale loan provider is not found, the cash short fall may be taken from CCT's own cash pool which could adversely affect the ability to perform potential charitable activities. In addition, CCT must consider if it has enough cash to cover any short falls in funding as well as borrowing interest costs.

Costs may be required to be paid up front by CCT affecting cash flow, whereas Option 1 will be entirely reimbursed by RG Assurance immediately. In contrast, the use of self funding may be a more palatable option than using a funding partner that is at odds with the overseas investment policies.

5.4 Administration costs

Option 2 seems to be in more of its infancy stage of planning and therefore, more work will need to be done on this proposal if CCT were to proceed with it.

Without the direct aid for another party to help with administration of constructing the building. Therefore, Option 1 would be more attractive in alleviating the time cost of managing the construction project with help of another direct stakeholder

5.5 Leasing of the third floor

By using a two story building, there will be less pressure to find a tenant to lease the third floor out to. In contrast, if CCT were to expand, the third floor would be available to use by the charity without needing to find an additional office.

With opting for a two story building, the cost is evidently lower and therefore there is less financial risk involved with being unable to meet maintenance costs.

5.6 Publicity

Option 1 will trigger adverse publicity for CCT by ignoring the concerns of local residents by constructing a large office. Option 2 would keep the local residents happy and may keep them on as potential donors to the charity.

In addition, Option 1 would be unpopular with internal stakeholders as this is contrary to internal policy. You should seek direct approval from them before proceeeding with Option 1 to ensure all stakeholders are in agreement with the large project.

5.7 Speed of construction

The smaller office of two floors will be quicker to construct than the bigger office, which should lead to less overall business disruption for CCT.

5.8 Additional information required

Please could you let us know the following:

Where CCT will occupy whilst the new office is being built. If this would involve renting a temporary office, then this should be factored into the calculations.

Historical VAT incurred on any capital expenditure on the existing Bristol land. This is in order to calculate the Capital Goods Scheme adjustment for the April 2022 partial exemption year due on the grant of the long lease to RG Assurance.

Any directly associated VAT incurred on costs for the third floor, as this could be irrecoverable if the charity tenant disapplies the option to tax.

5.9 Recommendation

We recommend that CCT proceed with Option 1 primarily due to the approximate **£7,781,710** saving in cost. This cost saving is significant for CCT as this would comprise of over 100% of CCT's total income.

The ability to obtain all funding up front for the building construction significantly reduces financial risk for CCT if they were unable to meet the financing themselves, and would mean that its short term cash liquidity would not be affected

CCT would be able to work with RG Assurance to smoothly construct the building, reducing the admin burden on CCT to manage the project themselves.

CCT should however consider whether they are able to find a tenant to lease the third floor, the potential PR costs from upsetting local residents and the possibility of being able to sell the property in 30 years.

6. VAT recovery on standard activities

6.1 General VAT recovery

Historically, CCT have reclaimed VAT on costs at 33%. However, this is expected to reduce to 22% based on our calculations in Appendix 4. This will lead to a direct cost to the charity in increased irrecoverable VAT on its VAT incurred on overheads. CCT should consider whether it should negotiate a partial exemption special method with HMRC based on floor space to potentially achieve a greater VAT recovery. Please let us know if you would require further advice on this.

6.2 VAT on planning fees

The planning fees incurred from 2017-2021 should not be capitalised and therefore not added to the existing site costs for Capital Goods Scheme purposes. The VAT was correctly recovered assuming that 33% was the blended PE recovery rate from 2017 to 2021. The option to tax will not be able to retrospectively recover this VAT, and this will only affect the sale adjustment on the disposal of the existing Bristol property.

6.3 Investment income

VAT costs on Investment income will be irrecoverable as per recent VAT case law

We trust that you found our advice helpful. Please let us know if you have any questions.

Kind Regards
Alex Bruce
Laidlaw Wallace LLP

Appendix 1

Assuming the building will be used for next 30 years.

Option 1

Costs:
Annual rent Cost (Note 3)- £785696 x 17.449 = £13,709,610
Less disposal of lease to RG Assurance: (£500,000)
Less Charity sub lease income(£200,000 x 17.449)(Note 1)=: (£3,489,800)

Total estimated cost: £9,719,810

Basic Rent - £604000
Cost related rent (A+B+C+D+E/F)
A - £9,500,000
B - £550,000
C - SDLT payable by RG Assurance - £150,000 x 0%, £350,000 x 1% = £3500
D - £9,500,000 + £550,000 x 20% = £2,100,000. No recovery available for RG Assurance due to exempt letting to the Trust as there is no option to tax applied
E - £9,200,000
F - 150 years less 30 years (120 years)

Total cost related rent amount = £181,696

Note 1) Reimbursement of costs by RG Assurance do not represent true costs as there was no markup applied to them by CCT. Calculate new rent due on Option A
Note 2) All calculations are estimate as the annual rent may be subject to uplift on rent review dates.
Note 3)Discount factor can be used for 30 year loan period. The discount factor assuming a rate of 10% for 30 years is 17.449

Additional information required:

1) CCT's loan rate for Option 2, so that this discount rate factor can be used to calculate the present value of the rent payments due to RG Assurance for comparison purposes
2) Directly associated costs with the third floor, as this will be irrecoverable if a charity tenant occupied the floor and disapplied the option to tax

Option 2

Costs:
Construction costs - £6,750,000
Professional fees - £880,000
Other costs - £550,000
Annual interest (Note 1) - £492,500 x 17.449 = £8,593,633
Irrecoverable VAT - 78% irrecoverable VAT each year x £934,000 Total VAT incurred)

Note 1 - Total VAT incurred: 20% x (6,750,000 x 52% use for standard charitable activity)+(£880,000+555,000) = £728,520
Total costs: £17,501,520

Total cost saving by choosing Option 1: **£7,781,710**

Note 1) Discount factor can be used for 30 year loan period. The discount factor assuming a rate of 10% for 30 years is 17.449

Appendix 2

As per HMRC guidance, the solely test for 95% charitable use can be found on any fair and reasonable basis. We have therefore assessed the non-business use based on physical occupancy and income.

<u>Occupancy basis</u>
Total Non Business activity occupancy (metres squared):
Care and support service (Assumed to be freely provided by the Trust)- 280m
Fundraising - gift aid donation - 300m
Research (No consideration provided)- 15m

Total Non Business activity occupancy: 595m

Total Nonbusiness use of space - 48% use for two storey building

<u>Income basis</u>

Total Non -business activity income (note 1) - £1,910,000
Total income - £5,060,000

Total Non Business activity income percentage - 38%

Note 1) The income recieved from contributions is considered to be non business. This is because it has been heavily subsidised compared to be actual cost of operation (£1,700,000 worth of cost is picked up by the charity and not charged to the individual), and contributions are not mandatory payments (and would therefore be considered akin to a donation)

Using either methodology, the benchmark of 95% non business use is not met.

Appendix 3 - Projected blended PE% rate for 2022/23 onwards

Business income (Note 1) - £3,150,000 (£2,020,000 exempt income)+ £1,130,000 taxable income
Total income - £5,060,000

Business/Total income % = 62%

Taxable Income (Note 2) =£1,130,000
Business income = £3,150,000

Taxable/Business income = 35.8% x 62%

Blended PE recovery rate expected: 22%

Note 1) The income recieved from contributions is considered to be non business.
Note 2) The recharge of catering and accomodation should be considered to be within a single supply of exempt services to the local authorities. Therefore, there should be no apportionment and the annual £1.75 million due each year should be treated as entirely exempt income with no right of recovery on input tax.

Note 3) VAT costs on Investment income will be irrecoverable as per recent VAT case law