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

Answer-to-Question-_1_

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09 November 2022

Dear Robin, Maureen and Naomi

Please see my letter below in regard to my advice and recommendations regarding the works on Marandellas House and the structure for its ownership. This is prepared on the basis that you are using the four flats within this house for a Furnished Holiday Letting 'FHL' business.

This advice has been prepared in line with our agreed Engagement Letter dated 05 July 2022 and has been prepared in line with the current legislation and its understanding as of the date of this letter.

Executive Summary

The values in this summary are for the family members in total unless specified otherwise. Therefore approximately 1/4 applies to Robin, 1/4 to Maureen and 1/2 to Naomi.

- The insurance money would be classed as proceeds for a part disposal of the flats. I recommend that each family member makes a s23(1) TCGA92 claim to not treat this as a part disposal for CGT purposes, saving £97,825.56 for each of Robin and Maureen, and a total of £293,762.24 for Naomi.

- You should consider whether you can alter the proposed redevelopment to be a changed number of dwellings conversion to save £622,500 VAT on purchase with no future downsides, however this likely has more risks than VAT registering.

- If you aren't able to alter the proposal, then voluntary VAT registration would result in £830,000 one time recovery in VAT with the future downside of being required to charge VAT on FHL lets, currently costing the family members an estimated £20,666.67 total per year on VAT due on lets, however allowing VAT recovery on inputs. It would take over 40 years (excluding any input recovery) for the VAT charged to exceed the immediate benefit.

- The second option may be beneficial if cash is needed urgently and a bank loan to cover the shortfall isn't an option, as there is a shortfall from insurance of £980,000 total. We have therefore based the company comparison on the VAT registration position.

- As the properties are FHLs, a large amount of capital allowances can be claimed, although this can't be quantified from the information given. If you go ahead with the proposed redevelopment above, ensure that the FHL conditions are met and these aren't instead exempt short lets of residential property, as this would remove a lot of these capital allowances.

- Although there isn't much in it, I would therefore recommend the self ownership option instead of giving the properties to the company as, after 8 years of running, the costs are similar as funded by the VAT reclaim and structures and buildings allowance. Self ownership provides the future freedom to sell the leases and to gain individual capital allowances of up to £3,195,000 (or more via super deduction) rather than applying this to company income, to which 20% is owned by other parties than the family.

- The combined value of assets is also more if the family retains ownership of the long leases rather than surrendering these.

- The company should consider, if the family members follow the route of VAT registering, opting to tax the property to allow an additional £120,000 VAT recovery by the company. Insurance does cover the amount paid however, so this might not be necessary as it could reduce insurance money paid.

Kind regards

T Adviser

1) Fire Damage

As each flat has been damaged by a fire and insurance money received, this would count as a part disposal of the value of each flat and therefore a capital gains tax ('CGT') sum could be due.

The insurer has provided the family with £4m, therefore £1m for each flat. This £1m compensation is treated as a capital sum derived from the asset.

Given that the CGT value of the interest transferred was £85,000, the gain for each flat is large on the basis that the consideration is £1m.

Robin and Maureen must each pay £97,825.56 in Capital Gains Tax, and Naomi must pay £293,762.24 in Capital Gains Tax based on the part disposal.

However if each family member makes a s23(1) TCGA92 claim, the receipt of each capital sum would not be treated as part disposal of the asset. To do this, the following conditions must be met:
- The receipt must fall within s22(1)(a)-(d) TCGA 92 (and it does being a receipt of insurance),
- The asset must not have been lost or destroyed, (it has only been partially damaged) and
- The capital sum must be applied in whole in restoring the asset. (which it will be)

Therefore I recommend that each family member makes a s23(1) TCGA92 claim, as not only is it very benefical for saving CGT, each family member wouldn't have the money available right now to pay for it, as the entire insurance value is used in restoring the asset. This is supported by the Lease Extract which says that "Insurance claims met by the leaseholders' insurer are to be applied to the reinstatement of the property".

HMRC accept this as the case because the insurance is received for the purposes of restoring the asset, and therefore it is not an avoidance scheme and is an approved method of relief.

2) Reconfiguration - VAT

The reconfiguration will cost £5.7m inclusive of VAT at the standard rate. This is £4,750,000 net and £950,000 VAT. The family members will have to pay £3,735,000 net and £830,000 VAT total.

2.1) Current VAT Aspects

Currently, you are receiving insurance income which is being used to pay for Phase 1 and Phase 2 of works, with some shortfall for the family members.

As the properties were habitable in the past two years and no new dwellings are being created, there are no options for VAT relief on the redevelopment. Redevelopment services by the main contractor are standard rated, materials are standard rated and architect services are standard rated. The family members therefore incur the £830,000 VAT in full, and with amounts this large in this scenario it could be worth considering voluntary VAT registration.

FHL properties would also be standard rated supplies, so VAT must be charged at 20% if VAT registered.

2.1.1) Voluntary VAT Registration

If Robin, Maureen and Naomi voluntarily VAT register, they are able to recover the full £830,000 VAT as the supplies made are standard rated regarding the furnished holiday let business, as it is specifically excluded from the exemption.

The negative of this is that VAT must be charged on the gross income from the Furnished Holiday Letting businesses. With the total gross income being £64,000 + £60,000 = £124,000, if the family members wish to keep the price the same, 1/6 of this must be paid to HMRC as VAT, resulting in £20,666.67 gross receipts paid as VAT. This will reduce profits by that amount per year. At this rate, it will take just over 40 years for the reduction in profits to add up to the amount of VAT recovered on the development (excluding VAT input recovery). In addition, the family members are able to recover any VAT on inputs which they incur in the course or furtherance of the FHL, and this would make the position even more beneficial.

This £830,000 covers most of the £980,000 shortfall for the family members and therefore I believe it to be the best option if going down the route of no extra dwellings.

To register for VAT, Robin and Maureen (together) and Naomi (separately) should complete a VAT1 form (or preferably register online) and submit this to HMRC for their FHL business. You must wait for the VAT number to account for VAT to HMRC, however you will need to charge VAT from when you apply.

I recommend to register before the works begin, as this gives you sufficient confidence that VAT can be recovered on the works. If in doubt though, any VAT on inputs incurred 6months before (for goods) or 4years before (for services) VAT registration can be reclaimed,

2.1.2) Partnership or not

In addition, you could consider if taking this route to do it via Partnership, as transferring the properties would result in no SDLT charge as the sum of the lower proportions has no change if Robin owns 25%, Maureen owns 25% and Naomi owns 50%. However this will result in a CGT charge on the individuals, and therefore I believe that VAT registration on the current FHL property business is the optimal position for each person.

However be aware that if HMRC consider the four FHL properties to be ran as one, there may be an aggregation direction and partnership may be mandatory in the future.

The downside of no partnership registration means that any other businesses which Naomi may lead as a sole trader, she will be VAT registered and must charge VAT on her supplies. As she is an MD of Madisons Fine Art Dealers, this will not affect the company position, but if she sells any Fine Art in a private capacity it could do. Please see the margin schemes for art dealers if this is a concern.

2.2) Proposed VAT Aspects

I note that you have considered reconfiguring the flats by adding a bedroom to one of the flats on each floor. You are correct that this could result in a VAT relief. I am uncertain of what exactly is proposed without a floor plan, so I have covered the possibilities below.

Specifically, this could be a qualifying conversion as a changed number of dwellings conversion. For this to be a changed number of dwellings conversion, the following must be met:

After the conversion, the premesis being converted contains a number of single household dwellings that is -
a) Different from the number (if any) that the premesis contained before the conversion, and
b) Greater than or equal to one,

And there is no part of the premesis being converted that is a part that, after the conversion, contains the same number of single household dwellings (whether zero, one, or two or more) as before the conversion.

Looking at each of Robin and Maureen's joint ownings and Naomi's owning separately, there will be two dwellings before and two after, with one with a bedroom added. This would therefore not qualify, as there are no more dwellings being added.

If instead the dwellings are split into two individual dwellings, and the other dwelling on the floor is made smaller by this, the reduced rating can apply.

If the other flat isn't made smaller or contains a different number of dwellings, the reduced rate will only apply to the costs in relation to the flat being converted to two flats. If the whole floor is converted from two to three dwellings and no dwelling before contains the same number of dwellings, reduced rating is obtainable on the whole floor.

Legally, planning permission must be provided for this to be obtainable, however I understand that you are able to vary the consent to meet this.

In addition, the reduced rate will only apply to conversion services and building materials, whereas separate building materials would be 20% VAT and architect fees would have 20% VAT. The solution to this is to go through a single contractor for design and conversion services so that you only incur 5% reduced rated VAT on all costs relating to the two dwellings being converted.

Therefore, if converting the whole floor so that no premesis before the conversion has the same number of dwellings, reduced rated VAT may be due, and this reduces the £830,000 VAT to £207,500 due by the family members.

Care should be taken that the properties continue to be FHLs and not short term exempt lets after the change for the capital allowances position, although this won't impact the VAT position if not VAT registered.

2.3) VAT Summary

The optimal position for VAT only seems to be to consider whether you can alter the reconfiguration proposal to meet the conditions discussed in 2.2, as £207,500 VAT only makes up for 10 years of accounting for VAT on FHL lettings, therefore bearing the cost of this VAT would leave a one time saving of £830,000 - £207,500 = £622,500 in VAT with no future downside of needing to charge VAT.

If you aren't able to meet these conditions as described above, then voluntary VAT registration would be the best position as the family needs cash urgently to pay for the development. This would result in £830,000 one time recovery in VAT with the future downside of being required to charge VAT on FHL lets, currently costing the family members an estimated £20,666.67 total per year on VAT due on lets. This has a benefit of allowing VAT recovery on any costs incurred in the course of the FHL business.

The second option may be more beneficial if cash is needed urgently and a bank loan to cover the shortfall isn't an option, as there is a shortfall from insurance of £980,000 total. Based on the Capital Allowance position (covered further), this seems to be an even better option.

2.3) CIS

You should provide written confirmation to the contractor that you are the end user of the works, as this will mean that they will correctly charge VAT to you. Otherwise, you will be expected to self account for the domestic reverse charge of construction services, and this can cause issues.

2.4) Capital Goods Scheme ('CGS')

In the event that the family members VAT register, given that capital expenditure of £250,000 or more would be made on an item of land which is subject to the standard or reduced rate, the CGS applies.

The use of the property must be considered for the next 10 years (the adjustment period). As all VAT can be recovered at the outset based on the intent to continue as an FHL, if in the 10th year for example it is instead used for exempt purposes instead of taxable purposes, 1/10 (accounting for 1 of 10 years) worth of the VAT recovered must be paid back to HMRC. This is something to be aware of.

Care should therefore be taken to ensure that it remains an FHL and not for short term letting (such as a year/6month lease).

3) Reconfiguration - Other

3.1) Furnished Holiday Lets

Being a FHL has multiple direct tax benefits. It counts as earned income for pension purposes, AIA (Annual Investment Allowance) and WDA (Writing Down Allowance) are available on furniture, and it is treated as a trading asset for capital reliefs, so BADR, Gift Relief and Rollover Relief could apply.

I believe your properties meet the conditions for this as they are furnished, UK based, available for short letting for at least 210 days (despite family member use for 20% of the year, therefore 292 days available) and actually short let for 105 days or more (given £1,000 revenue per week so c£142 per day, and £124,000/4 = £31,000 gross rent from each, so 218 days let pet year assumed).

You must ensure that no one occupies the FHL lets for more than 155 days in a year individually to qualify for the above, as would be the case in a short term let position.

Given the above, I will discuss the impact below.

3.2) Phase 1

Phase 1 comprises re-roofing the property, the replacement of beams to preserve the integrity of the remaining internal and external walls, repairs to the external stonework and the replacement of windows and doors.

These costs would qualify for the Structures and Buildings Allowance (SBA), and each family member can claim 3% relief a year for 33 and a third years on the amounts which they pay. This is a total of £4,500 each for Robin and Maureen pear year, and £9,000 per year for Naomi. This is claimed in the personal income tax calculation as a relief.

The company can also claim this based on what it pays, however I will not calculate this as it is outside the scope of this report.

3.3) Phase 2

Phase 2 comprises the internal works, including reinstating and fitting out the flats and common parts.

Many of the purchases will be fore furniture and similar, for which a revenue deduction can be made when calculating FHL profits in the year, however due to the values it seems maybe some capital items are involved.

It is worth noting that plant and machinery would be subject to capital allowances, with most plant and machinery subject to the 18% WDA for main pool expenditure, so an 18% allowance can be claimed per year until the total is depleted. You are also able to claim the Super Deduction of 130% capital allowance in year 1 (and no further allowance) on these, so you are obtaining a large capital allowance.

Any integral features have a rate of 6%, and this includes
- An eletrical systems (including lighting systems),
- A cold water system,
- A space of water heating system, a powered system of ventilation, air cooling or purification and any floor or ceiling comprised in such a system,
- A lift, escallator or moving walkway,
- External solar shading.

These can instead have AIA up to a limit of £1m per year applied to them to obtain a 100% relief in year one.

These allowances could make up a large tax saving to set off the cost of the development. If the allowances are very large, the charge can be used each year to set profit to £0 and this means that no income tax could be paid on the income from the FHL business.

As Phase 2 costs for the family is £3,195,000, the majority of this would allow revenue deduction, the super deduction or the AIA as it is a FHL business, and this would be a large amount of relief for the family.

You can only claim these capital allowances for items in residential property if either:
- You run a FHL business, or;
- The item is in the common parts of the residential building.

Therefore I recommend that you further ensure that, if you go ahead with the proposed redevelopment, ensure that the FHL conditions are met and these aren't instead exempt short lets of residential property, as this would remove a lot of these capital allowances.

4) Alternative Structure

Under this structure, the family members would surrender the leaseholds to the company in exchange for shares, and the family members would also assign the insurance money to the Company.

4.1) Disposal of Leases

When the family members surrender the leaseholds to JW Knight Ltd, a disposal is made by each family member and an acquisition made by JW Knight Ltd. As the disposal is not at arms length, the acquisition is deemed to have taken place at market value. As these leases are long leases with more than 50 years left to run, the gain is calculated in the usual way. This therefore ignores the shares which Naomi, Maureen and Robin receive and instead the lease is deemed to be sold for market value, of £125,000 for each leasehold of the flats.

Robin and Maureen would each pay £2,770, and Naomi pays £6,770 CGT for surrendering the lease (a total of £12,310).

Gift relief will not apply as Robin and Maureen are each receiving shares for the surrender of the lease, and therefore the leases are not gifted or sold for less than value to help the buyer. If the leases were surrendered without receiving anything in return, the total CGT due would be £0 and the gain rolled over into the base cost of the company, however as 500,000 ordinary £1 shares are received in return, applying BADR seems to be the best bet and paying the £12,310 CGT seems most optimal.

4.2) Insurance Money

As the insurance money is treated as proceeds in respect of the fire damage, if each family member makes the s23(1) TCGA92 claim as per section 1, no other taxes such as personal income tax are due.

The transfer of the money to the company could be regarded as a capital contribution as consideration for shares. Shares are exempt for VAT purposes, so no extra tax is charged. However it may also be considered as a gift anyway, so no other tax is due.

4.3) Stamp Duty

Stamp Duty is usually due on the acquisition of shares. As stamp duty is based on the value of consideration, a gift of shares is exempt. However, the leaseholds of the flats are being exchanged for the shares, therefore consideration is given. Where non-cash items are given, it will be the market value of the item. The market value of the leasehold for each is £125,000, and for the each property 0.5% Stamp Duty is due. Therefore Robin owes £625, Maureen £625 and Naomi £1,250.

4.4) Other

The company must pay SDLT on the acquisition of the lease, but this is outside of the scope of this report.

The family use for four weeks would not exempt it from being a FHL, as it will still meet the conditions above.

4.5) Commercial Aspects

I have calculated in the appendix the commercial aspects in the company position and the position beforehand.

The leaseholds will be worth £650,000 before conversion and were in 'desperate need of modernisation'. We can therefore assume the rents will increase after the refurb, however we will keep them fixed for now.

The increase in equity in the company for Robin and Maureen results in 5% more ownership of the company. Based on the values of the company, this extra 5% ownership gives Robin and Maureen (combined) and Naomi (separate) each £948,000 net assets, £28,000 increased profit share and subsequently a net dividend increase of £12,500, so £25,000 increase total per year for the family. It must also be calculated that the family will also get their ownership percentage of the property profits too, so £28,933 (after Corporation Tax) should be added to each, a total of £57,866 for the family increasing th values to £25,000 + £74,400 = £82,866 per year.

The family will therefore receive £82,844 per year from the increase in shareholdings and assuming the leases are in the company, whereas holding the leases themselves would result in £103,333 profit on the letting per year (assuming VAT registration option). Therefore using the company would result in a £20,489 reduction in net earnings per year.

Surrendering the leaseholds would cost £12,310 total in CGT and obtaining shares £2,500 in Stamp Duty, so it would cost the family a total of £14,810 to use the company option.

Via the self ownership option, the family would obtain £830,000 in VAT recovery, £18,000 of SBA per year, input VAT recovery 100% to themselves so would have more impact on increasing profit, and substantial Capital Allowances from the construction which again, would apply to their positions only and not the company profits, where 20% of it would be by other parties.

The increased cost of the self ownership option is £980,000 total, so removing the £830,000 leaves £150,000, which is covered by the SBA in 8 and a bit years, and the cost of the company option £14,810.

I would therefore recommend the self ownership option as after 8 years of running, the costs are similar, and self ownership provides the future freedom to sell the leases and to gain individual capital allowances of up to £3,195,000 (or more via super deduction) rather than applying this to company income, to which 20% is owned by other parties than the family.

In addition, the increase in company assets is worth £948,000 for Robin and Maureen (combined) and £948,000 for Naomi (individually). This is £1,896,000 total.

The value of the properties would be a minimum of £650,000 * 4 = £2,600,000 (but likely more after refurbishment as they were in need of updating), so the net assets increase is more by keeping the properties.

5) Company

The company is already registered for VAT. As it makes an exempt lease to the leaseholders, the costs in relation to the rebuilding are in relation to this exempt activity and VAT cannot be recovered. The company therefore incurs £120,000 irrecoverable VAT, covered by the Insurer as it is in relation to the common areas.

If the company opted to tax the building, it would charge VAT on the lease to the family members, however once VAT registered they can recover this anyway, and this £120,000 VAT can be recovered as the company will make taxable supplies. Insurance does cover the amount paid however, so this might not be necessary as it could reduce insurance money paid.

6)

<u>Appendix</u>

BADR Requires:

When an individual sells a qualifying asset (such as a Furnished Holiday Let in a FHL business), if for 2 yrs up the date you sell the business;

- You're a sole trader or business partner;
- You've owned the business for at least 2 years;
- Over 80% of your activity is trading,

Then BADR is eligible and 10% is applied as the CGT rate up to a lifetime maximum of £1m.

1) Capital Gains Tax - Fire Damage

Allowable Cost

A/(A+B)*Cost

£1,000,000 / (£1,000,000 + £125,000) * £85,000 = £75,555.56

Base cost of the asset retained

£85,000 - £75,555.56 = £9,444.44

Proceeds	£1,000,000		
Base Cost	£9,444.44		
Gain	£990,555.56		

Gain for Robin and Maureen

Gain	£990,555.56		
AEA	(£12,300)		
Net	£978,255.56		
10% BADR	£97,825.56	£978,255.56 @10%	

For Naomi

Gain	£1,981,111.12	£990,555.56 * 2	
AEA	(£12,300)		
Net	£1,968,811.12		
10% BADR	£100,000	£1m @ 10%	
20% Rest	£193,762.24	£968,811.12 @ 20%	
	£293,762.24		

2.1.1)

£830,000/£20,666.67 = 40.161 Years

2.2)

£207,500/20,666.67

3.2)
£600,000 * 3% = £18,000 per year, so
Robin and Maureen £4,500 each, Naomi £9,000 per year.

4.1) Surrender of Long Leases

Proceeds	£125,000		
Cost	(£ 85,000)		
Gain	£ 40,000		

So Robin and Maureen each make a gain of £40,000, and Naomi £80,000.

Assuming AEA not yet used,

Robin and Maureen each pay

Gain	£40,000		
AEA	(£12,300)		
Net	£27,700		

10% BADR	£2,770	£27,700 @ 10%	

Naomi pays £80,000 - £12,300 = £67,700 @ 10% = £6,770

Gain	£80,000		
AEA	(£12,300)		
Net	£67,700		
10% BADR	£6,770	£67,700 @ 10%	

4.3) Stamp Duty
£125,000 * 0.5% = £625

4.5)

Company Ownership

Shareholder	Before %	After	
Robin	35%	31.6%	5% Extra (combined with Maureen)
Naomi	35%	40%	5% Extra
Raymond	15%	10%	
Simon	8%	5.3%	
Mary	7%	4.6%	
Maureen	0%	8.3%	

Shares

Shareholder	Number Before	Number After	
Robin	350,000	475,000	
Naomi	350,000	600,000	
Raymond	150,000	150,000	
Simon	80,000	80,000	
Mary	70,000	70,000	
Maureen		125,000	
Total	£1,000,000	£1,500,000	

Increased Ownership/Dividends

	Value	Robin and Maureen Inc of 5%	Naomi Inc of 5%
Company net assets	£18,960,000	£948,000	£948,000
Company Profit	£560,000	£28,000	£28,000

Company Dividends Paid	£250,000	£12,500	£12,500

Marandellas House Share

	Mandellas House	Robin and Maureen (40%)	Naomi (40%)
Total Profit	£124,000		
CT (25% for future years)	(£31,000)		
VAT (1/6)	(£20,667)		
Net	£72,333	£28,933	£28,933

Personal owning

	Mandellas House		
Total Profit	£124,000		
VAT (1/6)	(£20,667)		
Net	£103,333		