The Chartered Institute of Taxation

Application and Professional Skills

VAT and Other Indirect Taxes

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Suggested solution

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Dear Robin, Maureen, and Naomi,

Marandellas House ("the House")

Thank you for your letter of 1 November.

1. Introduction

You asked that I advise on the implications of the reinstatement by the family members of the flats which will require a cash contribution from them of £980,000 ("the main proposal"). Alternatively, the family members will surrender their leases to JW Knight Ltd ("the Company") in return for shares. The Company will then rebuild the House using the family's insurance moneys and its own cash resources. Once rebuilt, the flats will be let by the Company as furnished holiday accommodation when not occupied by family members ("the alternative proposal").

My conclusions and recommendations are based on the information supplied by you. They are provided solely for your benefit. Other than for the purposes of discussing the project with the Company, the contents of this letter should not be disclosed to any third party without my firm's prior written consent.

2 Executive summary

2.1 In relation to the main proposal, my conclusions and recommendations are:

2.1.1 At present the family are facing a shortfall of £980,000. Mitigation of the projected VAT of £830,000 on the works funded by them will go some way to reducing the shortfall.

2.1.2 I do not consider that the works will be zero rated (see 4.1.1)

2.1.3 However, should family members register for VAT, they will recover immediately VAT incurred on the works, subject to a restriction to reflect future non-business use of the reinstated flats. Rather than a single registration, I recommend that the registrations are in Naomi's own name and Robin and Maureen (as a partnership). Based on your estimate of non-business use of 20%, I calculate that VAT registration will reduce the shortfall from £980,000 to £316,000 (see section 3). Any reduction in the non-business element will reduce further the shortfall. While registration will secure immediate recovery of VAT incurred on the works, it necessarily follows that output tax will be chargeable on future lettings. Each side of the family has the option of registering for VAT based on their circumstances.

2.1.4 I consider that the Phase 2 works will be chargeable to VAT at 5%, rather than the standard rate of 20%. If a family member is not minded to register for VAT, the relief will reduce its share of the projected shortfall from £490,000 to £233,750. Alternatively, should a family member register for VAT, the relief will further reduce its shortfall from £490,000 to £104,750. These savings assume family members appoint the Company to undertake the works under a JCT Design & Build contract, with it appointing the main contractor and professional consultants. Not only will the arrangement strengthen the argument in support of the reduced rate on the main contractor's services, but also extend it to those provided by the consultants. While the

reduced rating could be subject to HMRC challenge, I consider this could be defended robustly (see section 4).

2.1.5 Further reductions could be secured through a critical appraisal of building costs, adjustments to the specification of materials, fixtures and fittings, etc and perhaps elements of the Phase 2 works reallocated from the main contractor to sub-contractors at more competitive rates. Subject to commercial considerations and the tax cost, the shortfall might also be met through increased dividends paid by the Company.

2.2 As identified in section 6, expenditure eligible for capital allowances is likely to be material. To maximise future tax relief thereon, family members should seek early specialist advice to identify, document and value eligible expenditure

2.3 Under the main proposal, the Company cannot claim credit for VAT incurred by it; instead, this additional cost will be met by its insurer.

2.4 In section 4.1.1, I consider the potential for recovering all VAT incurred through the option of the Company undertaking the works and, on completion, selling its freehold interest in the House and surrounding grounds to the family members. For technical reasons, I doubt that this is a feasible option.

2.5 While at first sight the alternative proposal is attractive given that the Company may reclaim in full VAT incurred on the works (section 5), significant other costs militate against this:

(a) On the surrender of their leases, Maureen and Robin will each incur an immediate capital gains tax liability of £55,270, with Naomi's liability being £123,540 (section 7.1). While they will receive shares in return, they are illiquid assets. In contrast, under the main proposal, on the reinstatement of the flats, family members may deal with the properties free of encumbrance and allow them to make pension contributions eligible for tax relief.

(b) The Company will be chargeable to Stamp Duty Land Tax of £88,000 on the acquisition of the leases (section 7.2).

(c) The annual tax on enveloped dwellings (currently £7,700 per flat) could be an additional cost to the Company. I refer you to section 7.3.

(d) The directors will be taxed (I estimate £400 per week of occupation) on the benefit in kind accruing from free use by the family members - section 7.4.

3 VAT registration – family members

Under the main proposal, the reinstated flats will be let as standard rated furnished holiday accommodation, thereby enabling Naomi (in her sole name) and Robin and Maureen (as a partnership), at their option, to register now for VAT. While this will increase the number of invoices issued by the contractors, it avoids complications on possible future works, sub-leases to a partnership, income and cost recognition, etc.

As taxable persons, family members may reclaim VAT incurred on the works as they proceed, subject to the disallowance of part of the VAT incurred to reflect future non-business use of the reinstated flats. Non-business use here represents occupation of the flats by yourselves, other family members and friends free of charge; estimated by you to be 20%. As will be apparent from the following calculation, any reduction in non-business use will reduce a family member's shortfall.

Based on 20% non-business use, VAT registration by all family members will reduce the shortfall to £316,000, represented by £980,000 less VAT recoverable of £664,000 i.e., (£830,000 x 80%).

The implications of VAT registration will be:

a) You will be required to account for VAT on letting income. Before proceeding with VAT registration, you should assess the effect of passing on, all or part of the VAT liability to occupiers.

b) An assignment of a flat's lease will be exempt from VAT, as will be the deemed VAT charge on VAT de-registration say, on cessation of the furnished letting business or, with letting income below the VAT registration limit, you decide to exit the VAT system after expiry of the CGS.

c) The CGS provides for the adjustment of VAT initially reclaimed over 10 intervals – the adjustment period. Normally, the intervals are generally 12 months in duration. The adjustment period will commence on first use of the reinstated flats say, September 2025 and then run to the end of the 2035 tax year. Under the operation of the Scheme, there will be a claw-back of VAT initially claimed where, during the adjustment period, a lease is assigned, you decide to de-register or there are changes in the proportion of non-business use during an interval. In relation to the latter, by concession, you may dispense with such adjustments by disallowing at the outset VAT incurred attributable to future non-business use. A decision on this is not required now but be aware that the concession makes no provision for decreases in non-business use.

In conclusion, I recommend that the family members register for VAT despite having to account for VAT on letting income.

4 VAT reliefs

Here I consider the VAT reliefs possibly available on the reinstatement works.

4.1.1 Zero rating

Zero rating is limited to dwellings constructed anew; it does not extend to the reconstruction or alteration of an existing building, whether listed or not. A building ceases to be an existing building when demolished completely to ground level or, in accordance with the planning consent, the part remaining above ground level is a façade. Since the planning consent requires the retention of external and some internal walls, zero rating does not apply.

However, zero rating applies on the first grant of a major interest by the person “substantially reconstructing” a listed building which, on completion of the works, remains a dwelling(s). Subject to the reinstated House meeting the substantially reconstructed test, the Company could, on completion of the works at its expense, transfer its freehold interest in the reinstated House and surrounding grounds at market value to the family. That would represent a zero rated supply, entitling the Company to reclaim in full VAT incurred on the works.

The House will be substantially reconstructed only on completion of the works if it incorporates no more of the damaged building than its external walls. There is no provision in law for the retention of internal features. Unless it is feasible and the planners agree to vary the existing planning consent to allow the removal of internal walls, or exceptionally HMRC allow a degree of latitude given that the planning condition is essentially concerned with preservation of the external walls, the prospects of securing VAT relief on this basis is remote.

4.1.2 Reduced rate

More positively, VAT at the reduced rate of 5% may apply to building services (but not usually to design services supplied by professional consultants) supplied in connection with firstly, a conversion of the House resulting in a change in the number of dwellings therein and secondly, the renovation and alterations of the flats where they have not been lived in during the preceding two years.

You asked if VAT relief would be forthcoming where a flat is reconfigured by adding a bedroom, with a corresponding reduction in the size of an adjacent flat. Regrettably not, since pre and post reinstatement, the number of dwellings within the House (or part of it) remain unchanged. If, however, you were to consider changing the number of flats, please let me know and I will advise further.

Turning to the empty-homes relief, Phase 1 is to commence in February 2023 (and I assume that there is no prospect of deferring the works until 2024). Accordingly, the reduced rate will not apply since the flats will not have been empty for 2 years before the works start (i.e., from December 2021).

However, in principle, the Phase 2 works may qualify. You have cogent reasons for retaining the services of the main contractor for both phases. This may be problematic, however. Where a contractor’s services span the two-year limit, in its public guidance HMRC state that all such works are standard rated. I do not consider the guidance is sustainable for the following reasons:

a) The works to be carried out by the main contractor in Phase 1 are substantially different in character to those in Phase 2, with the former primarily concerned with safeguarding the building from the elements and the latter relating to internal restoration of the House.

b) Invariably the works will be invoiced and paid-for separately which, alongside performance of the services, fix the time of supply.

c) The reduced rate is confined to renovation of the flats, the subject matter of Phase 2. It does not extend to work on the common parts, nor certain fixtures and fittings, loose furniture, etc., as listed in VAT Notice 708, section 13.

If, despite HMRC's stated position, the family wish to retain the main contractor's services for both phases, to pre-empt HMRC taking their stated position, I recommend:

a) in respect of Phase 1, the Company and the family members appoint the main contractor and professional consultants as envisaged. The suppliers should apportion their services between each side of the family and the Company, accompanied by supporting VAT invoices. The reduced rate will not apply, so family members must fund VAT totaling £120,000

b) in relation to Phase 2, the family members appoint the Company to carry out the works under a JCT Design & Build contract, with it appointing the main contractor and professional consultants to fulfill its obligations under the contract.

Contractually, the Company will assume responsibility both for the construction and design services, with the latter subsumed within the construction services to form a single composite supply, subject to VAT at reduced rate.

Consequently, the VAT charge on the Phase 2 works funded by the family will be £177,500 (£3,550,000 @ 5%). Along with VAT of £120,000 payable on the Phase 1 works, the projected VAT charge will be reduced by £532,500 to £297,500, so reducing the projected shortfall to £447,500 (£980,000 - £532,500) in the absence of VAT registration (£223,750 attributable to each side of the family).

Should family members decide to register for VAT, the projected shortfall reduces to £209,500 (£104,750 to each side of the family), represented by £150,000 (£980,000 – £830,000), plus irrecoverable VAT attributable to non-business use of the reinstated flats £59,500 (£297,500 @ 20%).

HMRC may challenge this arrangement as artificial on the basis that, in reality, the main contractor provided standard rated building services covering both phases, with the Company interposed merely to secure the reduced rate. The semblance of artificiality is not the test. Under the abuse of law principle, ultimately HMRC will need to satisfy the Courts that, on a balance of probabilities, the essential aim of the arrangement is to secure a tax advantage contrary to the purpose of VAT law. HMRC's public guidance is no more than its interpretation of the law. If HMRC were correct on this, it seems to me that the arrangement does no more than ensure that the works are relieved from VAT as intended. In the event of a finding of an abuse of law, the arrangement would be redefined such that the Phase 2 works would be subject to VAT at the standard rate, with no penalty payable for proceeding with the arrangement.

For the suggested arrangement to be effective, the parties should ensure:

a) It is implemented carefully, supported by a well-drafted JCT Design and Build contract which spells out the Company's obligations to family members, the remuneration for its services approximates market value, the provision of step-in rights for family members in the event of non-performance by a sub-contractor and finally, separate tax invoices, etc be addressed to each side of the family to reflect the value of the services carried out in respect of their properties.

b) The main contractor and professional consultants are engaged by the Company alone.

c) Sub-contractors provide collateral warranties in favour of the family members.

d) The Company register for the Construction Industry Scheme, as necessary.

In relation to the domestic reverse charge, the Company will be an intermediary supplier. To avoid additional administration, I recommend that it advise the main contractor of this in writing, requesting that the normal VAT accounting regulations be applied.

Finally, services supplied by the main contractor, other sub-contractors and the professional consultants in relation to the common areas should be the subject of separate appointments by the Company, supported by separate invoices and payments.

5 VAT recovery: the Company.

As matters currently stand, the Company owns the freehold of the House but does not (and will not under the main proposal) use it to effect taxable supplies. Accordingly, the Company cannot reclaim VAT incurred on the works, and so will recover this cost from its insurer.

In contrast, under the alternative proposal, in due course the Company will make taxable supplies; accordingly, it will be entitled to deduct in full VAT incurred.

I now consider the other tax aspects of the proposals.

6. Capital allowances.

Since a furnished holiday letting business is a qualifying activity, the annual investment allowance (limited to £200,000) and writing-down allowances available on the acquisition of plant and machinery are tax deductible. Allowances are available on fixtures and fittings (beds, sofas, media equipment, "white goods", etc), but more pertinently, also on integral features such as hot/cold water systems, plumbing, electrical wiring and installations, kitchen units and equipment, solar panels, etc.

Capital allowances are likely to be of greater value to the family members than to the Company (currently 19% of its profits are chargeable to tax, whereas the family members are paying tax at 40% on net letting income). The value of plant and machinery eligible for capital allowances could be significant; so, to ensure that the maximum relief is secured, I recommend that one of my colleagues meets with the project manager and contractor to identify and document expenditure eligible for capital allowances, with their value quantified on completion of the works.

7. The alternative proposal.

Under this proposal, the Company would claim the capital allowances, and it would avoid the members having to meet the shortfall. However, the following matters fall to be considered:

a) Capital gains tax ("CGT") on surrender of the leases.

b) Stamp duty land tax ("SDLT") on acquisition of the leases.

c) Annual tax on enveloped dwellings ("ATED").

d) Income tax on free use of accommodation.

7.1 *Capital gains tax*

The surrender by the family members of their leases is a disposal chargeable to CGT. Since they and the Company are connected persons, the consideration on disposal is deemed to be the market value. The advice of a specialist valuer should be sought on this.

Since £4m will pass to the Company, a flat's value of £650,000 immediately prior to the fire may not be an unreasonable approximation of market value. I very much doubt that HMRC will accept a valuation of £125,000. Adopting a value of £650,000, the chargeable gain will be £565,000 (discounting allowable costs associated with the disposal and enhancement expenditure incurred since acquisition in the absence of relevant information). Since the properties were let by family members as furnished holiday accommodation prior to the fire, each may claim business asset disposal relief ("BADR"). Allowing for this relief and the annual CGT exemption, I calculate Robin and Maureen's CGT liability would be:

	£
Deemed disposal proceeds	650,000
Cost on acquisition	(85,000)
Gain	565,000
Annual exempt amount	(12,300)
Chargeable gain	£552,700
Tax due (£552,700 @ 10%)	£55,270

As far as Naomi's is concerned, her gain would be £1.13m to reflect her interest in two flats. Taking account of the annual allowance, her chargeable gain would be £1,117,700. Since BADR is restricted to £1m; the liability would be £123,540 i.e., £100,000, plus £117,700 @ 20%

7.2 Stamp Duty ("SD") and Stamp duty land tax ("SDLT")

The issue of new shares would not constitute an agreement to transfer securities and, accordingly, is not chargeable to SD.

The surrender to the company of the unexpired leases (I have assumed that to be 107 years) would be chargeable to SDLT, with the consideration deemed be market value. Again, for illustrative purposes, I have adopted a valuation of £650,000.

SDLT is chargeable according to whether the land is "residential" or "mixed-use". Residential property represents "a building that is used or suitable for use as a dwelling (my emphasis) or is … in the process of being constructed … for such use".

Provided the flats are transferred to the Company before preparatory works commence, in their current condition they clearly are not "suitable for use" as dwellings, so they fall to be classified as non-residential property. That being so, the SDLT charge would be £88,000:

Bands	Rate of tax (%)	Tax due (£)
Up to £150,000	0	0
£150,001 – 250,000	2	2,000
£400,000	5	20,000
Tax due on each property		£22,000

7.3 ATED

Since the value of the reinstated flats will exceed £1m but less than £2m, the Company will be subject to an annual charge of £7,700 per property. While it will be relieved from the charge while the flats are used as furnished holiday accommodation, that will not be so when occupied by the family. Such non-qualifying family days would not be restricted to actual occupation but would extend to void periods prior to and following occupation. On this account, the administration associated with quantifying the relief can be significant and disproportionate.

7.4 Provision of holiday accommodation – income tax and NIC

Accommodation provided by the Company to a director and his/her family or household is a benefit in kind subject to income tax and Class 1A NICs, quantified by reference to the cash equivalent.

Since the accommodation is holiday accommodation which the Company will exploit commercially, the cash equivalent is the open market rent and service charge, less the contribution made by the director. Given that the weekly rent on these properties during peak periods is £1,000, in the absence of a contribution by occupants, the directors will face an income tax liability of £400 per week, with the Company required to account for Class 1A NICs.

My conclusions and recommendations are summarised at the beginning of this letter. I shall be pleased to elaborate on any matter arising from the contents of this letter.

Yours sincerely,

Nasim Ahmed
Partner