

Business tax update (Lecture B1321 – 19.51 minutes)

Direct tax issues for property developers

Accounting and tax treatment

This article considers both accounting and tax matters to be considered by property developers.

The purchase of the property, including all purchase -related costs, is posted to current assets.

As the property is developed, all development costs are posted to current assets as incurred so we have a running cost of the development in current assets. The balance on the current asset is then transferred to P&L account when the property is sold.

Finance costs are frequently written off to the P&L account as incurred, although it is possible to defer these costs by including them in the current asset account. This delays the relief until the asset is sold. With rising corporation tax rates it is worth capitalising the finance costs so that they are matched with the profits on sale.

Property appropriations

Property appropriation occurs where an asset that was initially held as a fixed asset but subsequently becomes stock. If a trader moves a property from fixed assets to current assets, this must be treated as a market value appropriation.

This may be the case where a property developer has a fixed asset premises which he uses in his trade, but later decides to develop that property and sell it on.

For CGT purposes, the trader will be deemed to have disposed of the fixed asset (to himself) at market value so a capital gain will arise. In this instance, the trader can elect not to have a CGT disposal but instead to have the cost of the stock reduced by the chargeable gain. This will reduce the gain to nil but will result in the stock having a lower cost (and therefore a higher trading profit when the stock is eventually sold).

Illustration 1

Mentos Accountants Limited operate from two offices in East Sussex. Due to changing working practices as a result of Covid-19, the practice feels it can operate from just one office going forward.

There is limited demand for office buildings so the practice has decided to develop the property with a coffee shop on the ground floor and flats above. The original office building cost £250,000 in June 2006. Budgeted development costs are £120,000 plus VAT. The intention is to sell the retail unit and flats post development for £600,000.

On 15 March 2022 all staff moved to the main office and the development began. The office was worth £400,000 in March 2022.

What are the tax implications of the decision to redevelop the office for resale?

Mentos Accountants Limited has taken a fixed asset used in their business and has appropriated this to trading stock at £400,000. A gain of £150,000 (400,000 - 250,000) is realised.

The company now has trading stock in current assets at a value of £400,000. Once developed any resultant profit will be taxed at 19% (if sold pre 1 April 2023).

Alternatively Mentos Accountants Limited can make an election under s.161(3) TCGA 1992, in which case:

- The gain of £150,000 is reduced to nil; and
- The cost of the stock in her property development business is reduced by £150,000 and will now be £250,000.

The resultant profit will be £150,000 higher with the election but this simply replaces the gain they were looking at.

Note that no election is possible if a CGT loss is in point i.e. a CGT loss stays as a CGT loss.

It would be advisable for Mentos Accountants Limited to make the election if they expect to sell the developed property before 1 April 2023 as it will defer their 19% tax bill. However, if the sale is expected to occur on or after 1 April 2023 it would be beneficial not to make the election and crystallise £150,000 of profit to be taxed at the lower corporation tax rate of 19%.

Individuals would rarely make the election as income tax rates on development profits are higher than the CGT rates – best pay 20% on the £150k gain.

Appropriating to fixed assets

If the developer company appropriates property from trading stock to fixed assets, there is a market value disposal at the time of appropriation but there is no tax relief available in this case. Corporation tax will be paid on the profit at the rate in force at the time of appropriation. This could be where a developer company intends to let their developed, converted or renovated property.

However, if the developer company chooses to temporarily let the property until the market improves then it can remain in current assets for the time being – do include a letter of representation point to confirm that they still intend to sell.

Dealing with a property crash

What if residential developers experience a slow-down in the next 12 months? They may be minded to temporarily let until the market recovers. Temporarily letting the property will be exempt from a VAT perspective and input tax is at risk (subject to HMRC de-minimus rules).

To protect developers, we should advise them to trade through a limited company. This will give them the greatest flexibility to deal with a downturn in the property market. If the developer needs to temporarily let the new homes, they could simply set up a letting subsidiary. The property would then be sold to the newly formed letting subsidiary.

This would be a zero rated sale from a VAT perspective and input tax recovery in the development company is secured. The sale would be free of SDLT due to the SDLT group exemption for supplies between a parent company and their 75% subsidiary. The subsidiary will be 100% owned but you only need 75% for the SDLT group exemption.

It should be noted that when moving property between 75% group companies, property moves under the no gain/no loss rules. So if it is sitting in current assets in one company but another company wants to occupy (or let) the property then it must be appropriated to fixed assets first and then moved under the no gain/no loss rules. This will result in a profit (or loss) in the transferor company. With the corporation tax rate rising to 25% from 1 April 2023 it will be an advantage to have an uplift as the uplift is currently taxed at 19%.

Installation of pre-formed burial vaults

Summary - A company that installed pre-formed burial vaults at a burial site was making an exempt supply within item 2 Group 8 Schedule 9 VATA 1994.

Hodge and Deery Limited installed pre-formed burial vaults at a 20-acre burial site in East London for RED Landscapes. These pre-formed flexible vaults are used to prepare graves in unstable soil areas. Once installed, the burial plots are ready for use and the land above the plots is landscaped which, in this case, was work undertaken by RED Landscapes.

The company argued that their services were an exempt supply within Item 2 Group 8 Schedule 9 to the VATA1994 which states:

“Burial and cremation

Item No:

- 1. The disposal of the remains of the dead.*
- 2. The making of arrangements for or in connection with the disposal of the remains of the dead.”*

HMRC disagreed arguing that the exemption did not extend to sub-contractors but rather, was confined to:

- those supplies directly involved with the disposal of the remains of a particular dead person;
- supplies directly made by the funeral director with care and custody of the deceased.

HMRC sought to rely on their published guidance in Notice 701/32 referring to:

- para 3.1 (that the digging of a grave would be an exempt service if provided by an undertaker);
- para 5.1 (services are exempt if they comprise “Brick, block or concrete lining of a grave when constructed as a requirement of the cemetery management (or in the case of a churchyard, the church authorities) where for example the soil is unstable.

Both parties understood that if the exemption was available, some input tax may be disallowed. The quantification of the disallowed input tax was not within the scope of the hearing.

Decision

The First Tier Tribunal confirmed that the correct starting point in identifying whether services fall within items 1 and 2 was to identify the result of the service. To be exempt the services must directly lead to the disposal of the remains of the dead or be in connection with the disposal of the remains of the dead.

As the company did not actually dispose of the remains of the dead, the services they provided did not fall within Item 1.

However, as the digging of graves is central to the disposal of the remains of the dead, the services were made in connection with the disposal of the remains of the dead and so fell within Item 2.

As was pointed out by Moses J in *Network Insurance Brokers Limited v HMRC* [1998] EWHC, STC 742, it did not matter that the services were provided in advance, and nor did it matter that the services were not provided in connection with a specific funeral. Further, *CJ Williams v Telford* [2000] BVC 2111 confirmed that the funeral director or undertaker need not provide all the services himself. Here, cold storage services and chapel of rest facilities were provided by CJ Williams to fellow undertakers in the locality without such facilities.

The Tribunal confirmed that HMRC's guidance did not have the force of law and also was not a guide on how to interpret the law. The Tribunal stated that:

- it was difficult to accept that the digging of a grave by another person should be regarded as anything other than an exempt supply as 'Digging of graves is pivotal to the disposal of the remains of the dead by burial';
- it should make no difference that the modern method of dealing with unstable soil requires the advance preparation of multiple graves to deal with that problem. The legislation must be construed in a manner to enable new technology to be adopted to achieve the result expected by the legislation.

The appeal was allowed.

Hodge and Deery Limited v HMRC (TC08484)

Transfer of property business?

Summary - The sale of TV studios to a property developer was not the transfer of a business as a going concern for VAT purposes as the seller and buyer were carrying on different businesses.

The Haymarket Group was formed in 1995 as a publisher of magazines. It is now an owner of brands in a variety of media including exhibitions and online content. It was accepted that until 2015, the Group was also a property owner, using its properties for its own offices, as investments and as rental opportunities.

Haymarket Group Properties Limited was a member of a VAT group whose representative member was Haymarket Media Group Limited.

The company owned land and property at Teddington Studios, which it had opted to tax. Prior to its sale, the site was occupied by the Haymarket Group as its business premises, as well as a number of tenants to whom leases had been granted or assigned by the company.

Haymarket Group Properties Limited planned to sell the site but in order to increase its value prior to sale, in 2013 the company applied for planning permission to be able to construct 213 flats and six houses.

With planning consent in place, the company then sold the site to Pinenorth Properties Limited for £85 million, treating the disposal as the transfer of a going concern and so outside the scope of VAT. It was neither the supply of goods nor a supply of services.

The buyer went on to complete the development.

HMRC later concluded that the sale of land and property at Teddington Studios was a supply of an asset, and not the supply of a business as a transfer of a going concern. There was no dispute that if the transaction in question did not fall within the transfer of a going concern provision, then the VAT payable by the purchaser was £17 million, and that this would be fully reclaimable. The real tax that was at stake was the additional Stamp Duty Land Tax of £680,000.

Haymarket Group Properties Limited appealed arguing that it was carrying on a business before the sale of the Teddington site, which consisted of two elements: property development and property lettings. As a result, the transfer of a going concern treatment was available in respect of the sale.

Decision

To be eligible for the transfer of going concern VAT treatment, the buyer must use the transferred assets to continue the same kind of business as the seller.

The First Tier Tribunal found that Haymarket Group Properties Limited was not carrying on a property development business prior to the transfer. Although the company held the Teddington site as an investment, generating passive rental income, it had never intended to develop the site prior to sale. It was always the company's intention to sell the site to a developer, with the planning permission in place. The property was marketed as a development opportunity, not a development business. The £870,000 spent to obtain planning permission prior to sale was to enhance the value of the site as an investment. This was not development.

The First Tier Tribunal moved on to consider whether a property lettings business was being transferred. The Tribunal concluded that it was not as under the terms of the sale, the Teddington site was to be transferred to Pinenorth Properties Limited with vacant possession.

The appeal was dismissed.

Haymarket Media Group Limited v HMRC (TC08495)

Items used for business purposes

Summary - Input VAT claimed relating to two luxury cars, a private number plate and pilates clothing was disallowed as these items were not used for business purposes.

Maddison and Ben Firth registered for VAT from 8 December 2017 as Church Farm whose trading activity was "subcontracting glam/camping, weddings and events".

The October 2020 VAT return was submitted and included a claim for Input VAT totalling £28,374 for two cars, a personalised number plate (BS70 BEN) for a motorbike used for promoting the business and clothing purchased for use whilst Maddison Firth trained as a pilates instructor.

HMRC refused the input tax claim on the basis that the items claimed were not allowable business expenses.

On investigation, HMRC established that the cars were insured for 'Social, Domestic and Pleasure' only, implying there must be some private use. The couple claimed that the vehicles were only used for travel to and from business meetings or on the farm, as shown on the business' agricultural insurance for all of the farm's vehicles.

Decision

The First Tier Tribunal stated that the test of whether a car is available for private use is a test of the intention of the business when the car was bought and in particular whether a car has the potential for private use rather than if such use is likely. The Tribunal found that there was insufficient evidence to prove a business-only intention at the time of purchase. In addition to the 'Social, Domestic and Pleasure' only insurance, the Tribunal noted the impracticality of using an Audi TT for private hire.

The input tax relating to the number plate was disallowed as it did not refer to the business or its name in any way. Further, there was no evidence to prove that the business was known as "Ben's business or Ben's farm or Ben's anything", which might bring it within the ambit of the decision in BJ Kershaw Transport Ltd and within the classification of promoting Church Farm.

Finally, the Tribunal stated that normally a person is responsible for their own clothing at work. Although the pilates clothing was also worn while working on the farm, the clothes were neither protective nor did they represent a uniform. No input VAT could be recovered.

The appeal was dismissed

Maddison and Ben Firth T/A Church Farm v HMRC (TC08496)