

SHAREHOLDER COMMITTEE

17 SEPTEMBER 2019

COUNCIL AND COMPANY TAXATION

1.0 Purpose of Report

1.1 To inform the Shareholder Committee of the taxation implications for Arkwood Limited, as the Council's wholly owned development company and any associated taxation implications for the Council.

2.0 Background Information

2.1 Members of the Committee requested that the Company provides a briefing on the taxation implications of Arkwood Limited operating as a residential (and commercial) developer.

2.2 This report sets out the Stamp Duty Land Tax, Corporation Tax, VAT and PAYE/NIC implications for the Company (and Council)

3.0 Proposals

3.1 Stamp Duty Land Tax

The Council is a corporate body, and owns 100% of the shares in the company, so the transfer of land interests (these include undeveloped land, partly completed housing units and completed dwellings) from the Council to the Company will be wholly relieved of SDLT through Group Relief. However, the initial purchase of the land from third parties would be subject to SDLT. The qualifying shareholding for Group Relief is a minimum of 75%.

For note, Group Relief would not be available if:

- The company is limited by guarantee rather than by shares, or
- Arrangements are in place at the time of the transaction that could break the group qualifying conditions.

Group Relief would be clawed back, and SDLT would become payable, if arrangements are put in place, within three years of any transaction, to break the group qualifying conditions. This is typically the sale of the company or sale of more than 25% of the share capital.

Where the Council or the company purchases property assets from third parties, or Group Relief is not applicable, the purchaser would be liable to pay SDLT at the appropriate rate.

For non-residential property (and property development land), the company would be liable to SDLT at the prevailing rates.

3.1.1 The respective SDLT implications for the Council and the company are therefore as follows:

Council

Where the Council needs to purchase land then SDLT would be payable, applying the principles outlined above. If the Council already owns the residential development land there would be no transaction leading to an SDLT liability for the Council.

In the event that the vendor of land has opted to tax, so VAT is chargeable, the value on which SDLT is calculated must include the VAT element.

Arkwood Limited

As the company would be constituted as a company limited by shares and wholly owned by the Council, Group Relief would apply, so no SDLT liability would fall on the company in respect of any property purchases from the Council.

If there is any intention for the Council to sell shares in the company, e.g. to make it into a joint venture with another party, then Group Relief could be withdrawn if the Council's shareholding in the company falls below 75%.

In the event that Group Relief is withdrawn, SDLT would be due based on the rates in place at the time the company purchased the properties.

3.2 Corporation Tax

Arkwood Limited is subject to corporation tax on its profits at the rate of 19% for 2019/20 and 17% from 2020.

Profits would be generated from the sale of properties which would be a mix of both affordable and market sales and rental properties. These would be developed by Arkwood Limited before being sold to an end purchaser.

Profits from sales of property will be treated as trading profits. If Arkwood Limited develops the sites itself, construction costs incurred by Arkwood Limited in building the new properties for sale should be deductible when calculating trading profits. Similarly, any associated marketing and legal costs in respect of the sale will also be deductible. Similarly overhead costs such as staff salaries, finance, administration, etc. will be tax deductible.

Losses incurred in respect of the trading business can be set against total current year profits or currently carried forward against future profits from the same trade only. Losses can also be carried back and offset against total taxable profits arising in the preceding 12 month period. From 1 April 2017, losses incurred in respect of trading are to be given more flexible treatment as was discussed in the budget delivered on 16 March 2016. From 1 April 2017, companies are able to use carried forward losses against profits from other income streams.

Where land or property is acquired from the Council for trading purposes, the corporation tax position would be the same as if it were acquired from a third party. This means that provided the property is for sale, the cost will be deductible when calculating taxable trading profits.

Disposals between connected parties must be made on arm's length terms. If this is not the case the actual costs would be substituted for market value. The Council is planning to transfer the properties to Arkwood Limited at full market value and therefore these conditions should be met.

Financing costs payable by Arkwood Limited to the Council, in respect of the prudential borrowing on-lend to the company by the Council, will be deductible in calculating taxable profits. The transfer pricing rules require connected party transactions to be on an arm's length basis and corporation tax relief may be denied to the extent that the interest payable exceeds market value for similar transactions. It is important that the Council ensures that any loans are made on commercial rates and terms as it must be satisfied that its on-lending does not constitute a breach of State Aid legislation. Even if the on-lending is compliant with the State Aid rules, the transfer pricing rules must also be considered separately and complied with.

Dividends paid from Arkwood Limited back to the Council would be paid out of taxed income and would not suffer further tax in the hands of the Council. Sufficient distributable reserves need to be available to pay a dividend and care should be taken if accounting losses are realised to ensure that there are reserves available.

Group Relief would not be available based on the current group structure because the relevant legislation states that a "company" does not include "a partnership, a local authority or a local authority association". Therefore a holding company structure will, in time, be considered which would mean that ultimately all corporate entities are owned by the Council but via a holding company. Arkwood Limited would then be associated with other companies held by the Council in a group structure and all companies would potentially qualify for Group Relief. Broadly, current year losses in one company can be surrendered to shelter current year taxable profits in another group company and therefore reduce the corporation tax payable for the group as a whole.

For a Group Relief, group to exist in the structure, the ownership condition must be met, where:

- Either one company has to be a 75% subsidiary of the other (i.e. indirect ownership must be at least 75%);
- Both have to be 75% subsidiaries of a third company within the proposed structure.

From 1 April 2017, losses carried forward in one company can also be offset against profits in another group company in a future year and not just in the year that the losses arise. This provides a group with additional flexibility in how profits and losses can be used.

3.3 VAT

3.3.1 **Property Sales**

The sale of residential property, whether freehold or by payment of a premium on a leasehold interest, is free of VAT. New homes are usually zero rated and pre-owned dwellings are exempt. The option to tax, described below, is not effective in relation to residential property so cannot make it standard rated. The sale of undeveloped land, whether intended for development of housing or some other use, is normally exempt from VAT. There are exceptions to this exemption. The most relevant in present circumstances, would be when the vendor has "opted to tax".

The effect of the option to tax is to make what would have been an exempt supply into one that is subject to VAT at the standard rate. A vendor would normally opt to tax in order to obtain or preserve the entitlement to recover VAT it has incurred on the land.

3.3.2 Residential Rentals

The market rental of residential property is exempt from VAT and this cannot be changed by opting to tax. The rental of affordable housing by a local authority is treated as “non-business” but when undertaken by a Company would be exempt from VAT.

Local authority VAT recovery is governed by the VAT Act 1994 s33, so it can recover any VAT incurred for its non-business activities. In practice it can also recover VAT incurred on its exempt activities (through a generous de-minimis regime) as well as its VAT taxable activities.

Other businesses – including the company – are subject to normal VAT rules, so can only recover VAT incurred on VAT taxable activities. Rental of residential property is exempt from VAT, so the company would not be able to recover VAT incurred on its on-going property management costs nor on property maintenance and refurbishment costs.

3.3.3 Application of Tax Principles

The intention is that the Council will sell undeveloped land into the Company, which the Company will then develop and dispose to an end purchaser. It will be necessary to consider the practicalities of this, since the dwellings are likely to be completed in phases, rather than all at once.

3.3.4 Council

The sale of undeveloped land, whether intended for development of housing or some other use, is normally exempt from VAT. The Council has not “opted to tax” any of the pilot sites. If the Council did this on future sites, in which the sale would be standard rated, this would typically be done to preserve the entitlement to recover VAT it has incurred on any costs incurred on the land.

3.3.5 Company

The construction services, understood to be provided by a third party main contractor using a design and build contract, would normally be zero rated. However if there are any direct purchases of goods, these together with directly procured professional services such as architects, engineers and surveyors, would be subject to VAT at the standard rate. The sale of the new dwellings would be zero rated, so the VAT incurred on goods and fees would be recoverable.

VAT incurred on infrastructure works e.g. roads and paths, together with VAT incurred in complying with planning obligations such as section 106 agreements, is treated by HMRC as attributable to the overall development supplies, which are zero rated. This means the VAT incurred would be recoverable.

The first sale of the freehold, or lease in excess of 21 years of a newly constructed dwelling is zero rated, so no output tax would be due. It is assumed for now that for the pilot sites all completed dwellings are sold.

If residential units are retained, the subsequent rental of the dwellings, whether at market rents or affordable rents, would be exempt from VAT. In addition, any freehold sales or grants of long leases in flats or shared ownership dwellings would also be exempt.

If the company's only activity is the exempt rental of property, then it would not be entitled to register for VAT, nor would it be able to recover any VAT it incurs on its costs.

If the company has other activities that are subject to VAT it may register for VAT. Alternatively even without those activities it could be registered in a VAT group with other companies under common control of the Council. In these circumstances, even though it would be VAT registered, the exempt property rental income would mean its ability to recover VAT would be severely restricted.

At present it is the intention of Arkwood Limited to sell completed dwellings but if for example there is a downturn in the property market which impacts on its ability to sell it may wish to retain for rent. The rental of residential property is always exempt from VAT, which would lead to Arkwood Limited needing to restrict its input tax claims. In this instance, as long as the intention remains to sell and with letting being a short term expediency, then HMRC accepts that any VAT incurred in construction (typically professional fees) is attributable to both the intended sale and the current rental stream. This would usually result in the majority of the VAT being recoverable.

If the intention changes so that dwellings are to be retained for investment, the rental income would be exempt and this would adversely impact Arkwood Limited's ability to recover its input tax. Further advice will be sought by the Company as it should be possible to mitigate the adverse effects by careful planning.

3.4 Employment Taxes

3.4.1 **Payroll Taxes and National Insurance**

A new PAYE scheme has been set up with HMRC for Arkwood Limited in order to deal with employees including directors. Arkwood Limited operates PAYE/NIC as normal on all remuneration paid to employees and directors.

If employees of NSDC are to be transferred to Arkwood Limited (this is currently not the anticipated method of staffing the Company), NSDC needs to consider the Transfer of Undertakings (Protection of Employment) Regulations 2006 (TUPE). The legislation is complex in this area and legal advice will be sought in this situation from NSDC Legal Services.

It should also be noted that pension obligations require attention with auto enrolment considerations for any employees of Arkwood Limited. Arkwood Limited employees will not be offered the benefit of the LGPS.

3.5 Construction Industry Scheme (CIS)

In most cases Arkwood Limited will be acquiring land and will enter into a construction contract with design and build contractors. CIS would only apply for working with sub-contractors who do not qualify under certain conditions to be paid gross for the works provided to Arkwood Limited. The drafting below is provided for completeness but contractors used would be deemed large enough for this to not apply.

If Arkwood Limited have construction operations which have an annual expenditure of £1million or more for a period of three years ending at the end date of the latest period of account, Arkwood Limited would need to be registered as a deemed contractor for CIS purposes.

If Arkwood Limited makes the payments direct to design and build contractors, it would need to ensure that it carries out the necessary verifications with HMRC, together with making any tax deductions and completing monthly CIS contractor monthly returns.

If Arkwood Limited continues to be involved in similar future developments it would need to remain registered for CIS purposes.

4.0 Equalities Implications

4.1 There are no equalities implications.

5.0 Financial Implications

5.1 None as the report is for information only.

6.0 Community Plan – Alignment to Objectives

6.1 The Company is referenced in the Community Plan under the objective of accelerating the supply of new homes by delivering 300 new homes by 2026/27.

7.0 Comments of Director

7.1 The taxation implications are complex and this paper provides the Committee with an overview of the various strands of UK tax legislation and how it applies to Arkwood Limited, and as a consequence to the Council. The directors of the Company will continue to take advice from professional tax advisers during its evolution and will include appropriate sections on taxation when it presents future financial reports to the Committee.

8.0 RECOMMENDATION:

That Members of the Shareholders Committee to note the report.

Reason for Recommendation

To inform the Committee of the taxation implications of operating a wholly owned development company.

Background Papers - Nil

For further information please contact Nick Wilson on ext 5317.

Nick Wilson
Business Manager – Financial Services