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Fair and reasonable?

The Pre Budget Report announced that the changes to the partial exemption special method regime proposed in the 2006 Budget will come into effect on 1 April 2007.

Under these proposals taxpayers are required to sign a declaration that any proposed special method is 'fair and reasonable' before HM Revenue & Customs ('HMRC') will give approval for its use.

Previously HMRC would have approved a partial exemption special method without such a declaration being signed by a taxpayer. The new declaration procedure means that, if at any time HMRC find a "fair and reasonable" declaration made by the taxpayer to be incorrect, they can serve a notice to override the partial exemption method from its effective date (subject to the three year cap).

This will apply to all methods agreed with HMRC on or after 1 April 2007. This means businesses that have not concluded their negotiations with HMRC regarding the operation of a partial exemption special method before 1 April 2007 will be required to make this declaration (as well as those businesses that begin the process after 1 April 2007).

In respect of what is 'fair and reasonable', in many cases there is likely to be a range of possible methods that will provide a fair and reasonable result. The taxpayer must then consider objectively whether a method is fair and reasonable even where HMRC have previously consented to, or opposed, the use of similar methods.

RSLs seeking to agree new special partial exemption methods will need to consider if they are prepared to make a declaration that their existing special method produces a 'fair and reasonable' result in light of their current business operations. If they do not, however, their method will not be approved.

We would therefore recommend that RSL's ensure that they are in a position to provide evidence to HMRC to demonstrate that they have been through a process to satisfy themselves that it is fair and reasonable. It may therefore be prudent to contact your advisers to ask them to provide an independent opinion which you can retain to show to HMRC.

RSL sector continues to grow

Figures released in February by the Department of Communities and Local Government showed that in the third quarter of 2006 5,527 new homes were completed for RSLs, the highest figure for nearly eight years. In addition, the latest Department of Trade and Industry statistics revealed that public housing and housing association orders rose by 33 per cent in 2006 compared with 2005.

While social housing is still a relatively small part of the total construction sector – about 15% of the new homes market (equivalent to 170,000 new units) – the sector is now worth an estimated £14 billion a year and is expected to continue to grow.

Trading subsidiaries of charities – avoiding the pitfalls

Charities often use trading subsidiaries to shelter surpluses from corporation tax by way of gift aid. This has long been viewed as an acceptable form of tax avoidance. However, recent changes in the Finance Act 2006 could mean that HMRC will take a tougher line if the arrangements are not properly structured, particularly with trading subsidiaries which are not wholly owned by charities. This is especially relevant to RSLs involved in regeneration projects and joint ventures with the private sector.

A charitable RSL should not generally pay corporation tax but, for example, may still be subject to corporation tax on surpluses from commercial property development if the business is carried on by the charity directly. This is the case even though the charity would be applying the profits for charitable purposes to cross-subsidise social housing. The problem is that such trading is not within the charity's primary purpose. Similar issues arise with other types of trading such as the provision of services to third parties on a commercial basis.

The standard approach in these circumstances is to carry on trading within a non-charitable subsidiary, which gift aids profits back to the charity in a tax efficient form. However, there are a number of pitfalls to be avoided.

First, the subsidiary's funding needs to be carefully structured. Loans or equity investments by charities, if they do not fall within one of the categories in Schedule 20 of the Taxes Act, are treated for tax purposes as non-charitable expenditure. Following a change in the Finance Act 2006, non-charitable expenditure automatically results in a corresponding amount of taxable income for the charity. Unfortunately, HMRC no longer give clearance in advance that investments in subsidiaries fall within Schedule 20, so charities should consider taking advice before capitalising or making loans to subsidiaries.

Transactions between the charity and the trading subsidiary should be at arms length and properly documented in inter-company agreements. If the subsidiary's taxable profits were to be increased following an HMRC enquiry into transfer pricing, the company would be out of time to rectify the situation through gift aid.

There are also a number of issues that may arise if a charity transacts at 'under-value' with its subsidiary. HMRC appear to be of the view that deemed income or gains within a charity (for example, under the transfer pricing rules) cannot benefit from the normal charitable exemptions, since only actual receipts may be applied for charitable purposes.

A further change in the Finance Act 2006 has been to introduce sweeping anti-avoidance rules which can result in tax charges for charities which enter into non-arms length transactions with substantial gift aid donors. Fortunately, there is an escape clause for gift aid paid by non-charitable RSLs to other members within a 100% group. The substantial donor rules, though, can still potentially apply to charities which have received gift aid from trading subsidiaries which are not RSLs.

Further problems can arise if the company is not wholly owned by the charity, for example in a joint venture situation. Trading subsidiaries, if not wholly owned by charities, do not benefit from the normal nine month grace period for paying gift aid. Such companies have to calculate the necessary amounts of gift aid and actually pay it to the charity within the relevant accounting period to get a tax deduction.

HMRC could also challenge the tax deductibility of gift aid paid by trading companies which are not wholly owned by charities on the basis that it is a distribution. The gift aid rules were specially amended in Finance Act 2006 to reverse a Special Commissioners decision (**Noved Investment Co v HMRC**). It is now clear that distributions in respect of shares cannot benefit from gift aid. There is a let-out from this rule, though, for wholly owned subsidiaries of charities.

This means that particular care is needed in structuring joint ventures with the private sector. If a charity invests in a joint venture company and the other shareholder is a non-charity, it may not be possible to return the charity's share of profits in a tax efficient form, since any gift aid paid in lieu of a dividend would not be tax deductible. One solution may be to structure the JV as a Limited Liability Partnership between a wholly owned subsidiary of the charitable RSL and the other party.

RSL uses Yarburgh to secure zero rating

In **Ardenglen Developments Limited v HMRC**, an RSL has won its argument on whether the grant of a major interest lease by its subsidiary company qualified for zero rating on the basis that the building would be used for non-business purposes by a charity.

In order to secure funding from the ERDF Ardenglen Housing Association incorporated a subsidiary company, Ardenglen Developments Ltd ('ADL'), to construct an annexe to another building. The purpose of constructing the annexe was to build additional office accommodation which in turn could be let out to local community groups

ADL granted a 20 year lease in the building to Ardenglen. Ardenglen subsequently agreed to sublet the annexe to a charity which provided care services in the local community.

It was agreed between the parties that the construction work incurred by ADL was standard rated, however, ADL argued that the 20 year lease (being in Scotland a major interest) qualified for zero-rating. This would allow ADL to reclaim all of the VAT it incurred on the construction of the annexe without having to charge VAT on its lease to Ardenglen.

HMRC argued that the lease granted by ADL did not qualify for zero-rating because neither ADL nor Ardenglen would use the building for 'non-business' purposes, i.e. the 20 year lease was not granted to the charity that was actually using the building. Instead, ADL's lease was granted to Ardenglen which was using the building for the 'business purpose' of an onward lease to a charity. This would prevent the grant made by ADL being treated as zero-rated.

However, the Tribunal rejected HMRC's contention and allowed the appeal. Following the judgment of the High Court in the **Yarburgh** and **St Paul's** cases, it held that the annexe had been constructed with the intention of being used by a charity. The transactions between Ardenglen and its subsidiary ADL were incidental to that purpose, being required largely as a result of funding and legal difficulties.

This is the first time that the principles established in Yarburgh and St Paul's have been held to apply to a case involving an RSL.

RSLs with similar structures should now review the VAT treatment of their arrangements in the light of this decision, and where appropriate seek HMRC agreement to retrospective zero rating.

New HMRC Business Brief on residential property

HMRC have released Business Brief 23/06 containing guidance on the treatment of VAT on costs incurred by developers selling a "major interest" (the freehold or a lease of over 21 years – 20 years in Scotland) in domestic dwellings.

In some instances developers may be liable to make repayments of VAT under the VAT Capital Goods Scheme ('CGS') where a major interest has been granted in a relevant residential or a relevant charitable building such as a care home.

Such CGS adjustments will potentially arise where, following the grant of long lease in a CGS item, the freehold is subsequently sold during a CGS adjustment period. This 'second grant of a major interest' would be exempt and CGS adjustments might be required. The result is that a potentially significant proportion of the VAT originally claimed on the building could be clawed back by HMRC.

It is not, however, expected that HMRC will seek to apply CGS adjustments to shared ownership schemes.

RSLs should now review their arrangements to assess the risk of exposure to CGS adjustments.

HMRC lose in challenge to asset leasing scheme

In a decision which could have implications for RSLs and other not-for-profit bodies, a VAT Tribunal has upheld a partly-exempt taxpayer's right to use a VAT deferral arrangement on its acquisition of assets.

The case concerned a structure set up by a leading UK insurance company ("C Ltd"). C Ltd was almost entirely exempt for VAT purposes and decided that it was not VAT-efficient for it to purchase its assets directly. Instead, C Ltd arranged for a subsidiary company to procure its equipment. The subsidiary leased these assets to an unconnected third party, which then leased them back to C Ltd. The arrangements sought to obtain a cash flow benefit derived from the fact that the subsidiary was entitled to recover its input tax on the purchase of the assets and the subsequent irrecoverable VAT charge to C Ltd would be spread over a period of time.

The arrangement is particularly prevalent in the education, Financial Services and Real Estate industries but any not-for-profit business that is unable to recover all the VAT it incurs on an asset purchase may have implemented, or be considering, a lease-and-lease back structure.

Finding for the taxpayer, Weald Leasing Limited, the Tribunal found that, as a matter of law, nothing in the UK or European legislation precludes a taxpayer from leasing an asset to be used for exempt activities so spreading the burden of irrecoverable VAT.

The Tribunal held that restructuring to defer the VAT burden did not fall foul of Halifax, as any advantage obtained did not fall foul of the Sixth Directive. In reaching this conclusion the Tribunal stated that:

"There is however nothing in the Directive which precludes an exempt trader from leasing an asset and thus spreading the irrecoverable VAT, provided that ownership does not pass on payment of the last instalment in which case Article 5.4(b) applies."

This decision is a major development for a number of reasons. It is the first Tribunal case in which HMRC have attempted to deploy a comprehensive 'Halifax' argument since the European Court of Justice issued its judgment in the Halifax case.

Secondly, it considered a VAT mitigation arrangement strikingly similar to those previously widely implemented (particularly in the Education sector) and challenged by HMRC.

This appears to be a significant defeat for HMRC and may result in many of the assessments that have been issued to date being invalid. At present we are unsure whether HMRC will appeal the decision.

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