AUDIT • TAX • ADVISORY

Real Estate Matters

Issue 13

MHA's Construction & Real Estate Publication

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Now, for tomorrow

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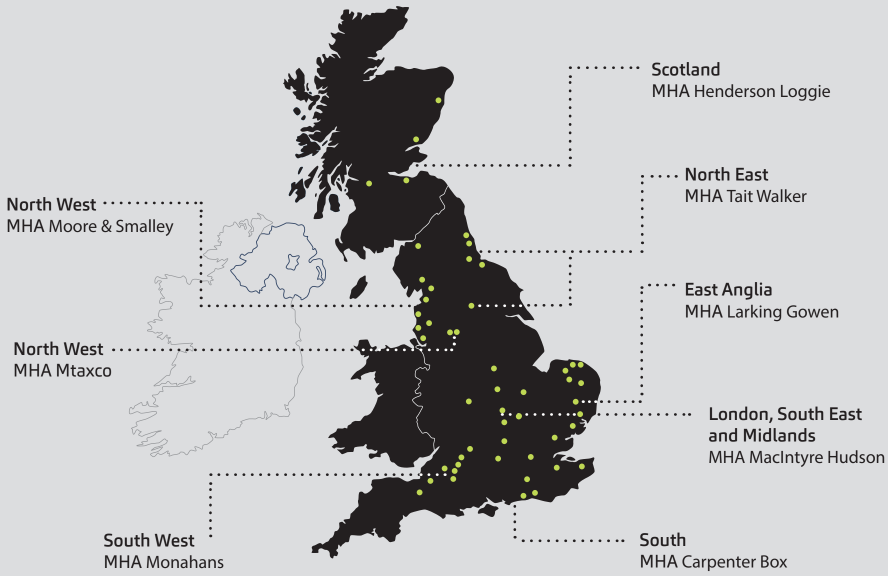
MHA is an association of progressive and respected accountancy and business advisory firms with members across England, Scotland and Wales.

Our member firms provide both national expertise and local insight to their clients.

MHA members assist clients with their needs wherever they are in the UK, as well as globally through our membership of Baker Tilly International, which has a network of trusted advisors covering 145 territories worldwide.

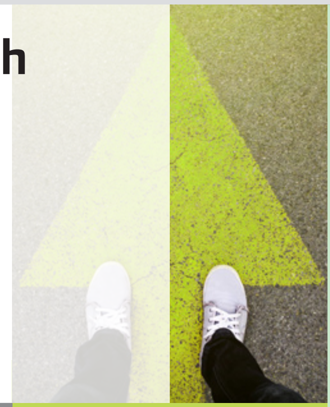


National Reach

National - MHA

50+

Offices nationwide



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10th

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US$3.6bn

Combined member firm revenues

Recent UK Property Tax Changes

HMRC are introducing some very significant changes next year, which might seriously increase the Capital Gains Tax (CGT) that you will pay on the sale of any properties which you still own but might previously have been your main residence.

If you have a property, which was once your main residence and either now let it out or have retained it, possibly as a weekend retreat, these changes will affect you. It is important that you understand the changes, as it is likely to result in you having to pay significantly more CGT when you do eventually sell or transfer these properties.

There are two changes which are coming into effect from 6 April 2020.

Lettings Relief Reform

Lettings relief was introduced back in 1980. It was designed to ensure that people could let out spare rooms within their homes on a casual basis, without jeopardising the hugely valuable protected status, called Principle Private Residence (PPR) Relief, that came with that property being their main home. Without the relief, home-owners risked losing PPR Relief if they rented out spare rooms, giving rise to a capital gains tax liability when it was eventually sold.

In practice however, the relief extended much further than the original policy intended and has come to benefit most of those who let out whole dwellings rather than just spare rooms, and which at some stage had been their main residence.

The original lettings relief effectively deems that the qualifying gain on the sale of a residence does not give rise to a taxable gain, to the extent that is the lowest of:

- The amount of PPR Relief already calculated; or
- £40,000; or
- The amount of the chargeable gain relating to the letting.

Therefore, in a nutshell up to £40,000 of a gain was exempted from tax, if the vendor qualified for the relief.

HMRC are now looking to limit the availability of lettings relief by restricting it to those who 'share occupation' of their house with a tenant for all disposals made on or after 6 April 2020.

What is Shared Occupation?

Shared occupation is considered to apply where the owner is living in the same dwelling as a tenant and continues to occupy that dwelling as their only or main home throughout the period of the letting.

This means that the reformed lettings relief will not be available for those periods where an owner has moved out of the property and no longer shares occupation with the tenant(s).

This will have the effect of significantly increasing the tax payable for anyone who has let out their home for a period, whilst not living there.

Reduction of PPR Final Period Exemption

Currently, if a property has ever been your PPR, in most cases, the last 18 months of ownership of that property is deemed to be your PPR and is therefore exempted from tax.

From 6 April 2020, this final period of exemption will reduce to 9 months, which will inevitably result in a higher CGT for many properties which are sold after that date.

Example

David purchased a property for £400,000 on 5 April 2005. He is considering selling the house for £700,000 on either 5 April or 6 April 2020.

During David's 15-year (180 months) ownership, he:

- Lived in the house as his only residence for the first 10 years (120 months)
- Has let the entire property for the remaining 5 years (60 months) before selling it.

The net gain of the sale is £300,000. PPR is available for the period David occupied the property as his main home – so 120 of 180 months. Therefore £200,000 of the gain is eligible for PPR relief, leaving £100,000 potentially liable to CGT.

If the property is sold on 5 April 2020 (or before)

The final 18 months of ownership is deemed to be exempt, so 18 of 180 months. This relief amounts to £30,000, so reduces the CGT from £100,000 to £70,000.

David will qualify for £40,000 lettings relief; being the lower of:

- The amount of PPR already calculated - £200,000; or
- £40,000; or
- The amount of the chargeable gain relating to the letting period - £70,000.

Assuming David hadn't yet used his annual capital gain exemption and he is a higher rate tax payer during the year, he will pay £5,040 CGT (£18,000 x 28%).

If the property is sold on 6 April 2020 (or after)

The final 9 months (rather than 18 months) of ownership is deemed to be exempt, so 9 of 180 months. This relief amounts to £15,000, so reduces the CGT from £100,000 to £85,000.

As David was not in shared occupancy with his tenants, there is no letting relief available at all, so the net gain chargeable to CGT remains £85,000.

Assuming David hadn't yet used his annual capital gain exemption and he is a higher rate tax payer during the year, he will pay £20,440 CGT (£73,000 x 28%).

Conclusion

The changes to letting relief and the reduction of the PPR final period exemption means David would pay approximately £15,400 more CGT if he sells the property on or after 6 April 2020.

Things to Consider

- Are you letting a property which was once your main residence? If so, it is worth reviewing the likely CGT position to establish any additional tax which might become payable if you sell it after 6 April 2020;
- If you are considering selling or gifting a property within your portfolio, you should consider which properties these changes are likely to effect;
- If you own a property jointly, under the current rules you would each be entitled to the exemptions, so these changes will inevitably have an even greater impact on the overall CGT position;
- Where you are the sole owner of a property, it is worth considering transferring ownership to your spouse, to ensure you both fully utilise your CGT annual allowance.
- It is easy to become an 'accidental' higher rate tax payer, so it is important to take the time to plan future property sales, to minimise your exposure to higher rate tax.

Please note that the calculations provided in this article are for illustrative purposes only and cannot be relied upon to work out any tax that might become payable in your own circumstances.

Professional advice should always be obtained prior to the completion of any transaction.

VAT Domestic Reverse Charge

In order to tackle VAT fraud in the construction industry, HMRC are introducing a domestic reverse charge with effect from 1 October 2019.

This means a person supplying certain construction industry services to a VAT-registered customer will no longer be required to account for VAT (the change will only apply if VAT at 20% or 5% applies to the works carried out, not zero-rated works). Instead, the business customer will account for VAT under the Construction Services Domestic Reverse Charge (CSDRC) or "reverse charge" arrangement. The new rules will cover construction services reported under the CIS and associated materials supplied as part of the contract (but not architects or surveyor services or similar).

This will include:

- Construction work to permanent or temporary buildings or structures and civil engineering work (e.g. roads or bridges);
- Groundworks and other preparatory works;
- Demolition;
- Construction, alteration and repair;
- Installation of systems for heat, light, power, water and ventilation;
- Painting and decorating.

The impact on the construction industry is potentially significant, not only in terms of cash flow, but construction firms will also have to make changes to their systems to account for the reverse charge and put in processes to monitor the supplies. In addition, the new rules will mean that the customer will be responsible for the correct treatment of VAT and they will also be required to identify if they are the end user of the supply chain, information which could be commercially sensitive. There is no change for supplies to end-users/ consumers, who will continue to be charged VAT in the normal way.

Sub Contractor

Goods and services with no VAT charged (invoice must state 'Reverse Charge applies').

Main Contractor

Declares Reverse Charge Output VAT and claims Reverse Charge input VAT on their VAT return.

Customer/ End User

Goods and services + VAT (there has been no change here).

In advance of 1 October 2019, construction firms need to consider the following:

- The potential impact on cash flow from not charging or receiving VAT payment;
- Changes that need to be made to accounting and invoicing systems to identify and take account of reverse charging and the ongoing monitoring of payments;
- Potential interaction with self billing;
- Customer status, to determine where reverse charges will be required to be made post October 2019;
- Staff training;
- Whether contracts need to be amended, particularly standard contracts.

The government has estimated that between 100,000 and 150,000 companies will be affected by the new rules which have been introduced as part of their mission to clamp down on 'missing trader fraud'. Although the number of criminals carrying out this kind of scam in construction is low, they are believed to be making a significant amount of money and unfortunately the whole of the construction industry will now have to pay the price.

As with all new rules, it's important to plan as early as possible for the changeover, as cash flow for some businesses in particular is likely to be significantly impacted by this change.

Employment Status and Off-Payroll Workers

The IR35 consultation is now closed, so what next?

The latest consultation on the extension of IR35 rules to the private sector was issued on 5 March 2019 and closed on 28 May 2019. The responses will be used to inform the draft Finance Bill legislation, expected to be published in the summer.

It will be interesting to see the Government's reaction to the consultation responses, after the consultation includes details of the additional complexities of rolling out the IR35 changes to the private sector.

Some of the factors that will impact the construction sector are:

Small Business Exemption

It's always been the intention to exclude small businesses from the rules, but there is still no watertight definition of what will constitute a small business. In the public sector, where the rules already apply, the size of the organisation is irrelevant as the rules apply to all. However, in the private sector, the size of the business will be a crucial factor.

A legal no-man's land beckons for small private companies: do they need to implement IR35 rules or not? The current consultation suggests using the definition of small company from the Companies Act 2006, but this only applies to limited companies. If you're a small unincorporated business, for example a sole-trader or a partnership, you probably need to tread very carefully and take appropriate advice before concluding you're safe from IR35.

The consultation proposes defining whether an unincorporated business is small by including a measure of the number of its employees. This is a questionable approach given a company might qualify as small only if it defines members of its workforce as off-payroll, the issue IR35 is trying to address.

Composite or Personal Services

IR35 does not apply to contracts categorised as self-employed. In the public sector, a move to contracts for the supply of composite services has helped manage the impact for the construction sector. However, the suppliers of those composite services will tend to be private sector businesses, who will from April 2020, need to consider how IR35 impacts them and their engagement of workers.

If the burden of operating IR35 leads to increased costs in respect of employers National Insurance Contributions (NIC), which is currently 13.8% and the application of the Apprenticeship Levy, the impact on contracts, margins and costings could be significant.

Supply of Information

The government wants to ensure that all parties in the labour supply chain have sufficient information in order to comply with their obligations, proposing that the determination and the reason for the determination be cascaded to all parties in the supply chain. They therefore consider it necessary to legislate to ensure this happens, whilst at the same time suggesting that a client-led process is used to deal with any challenges to the determination.

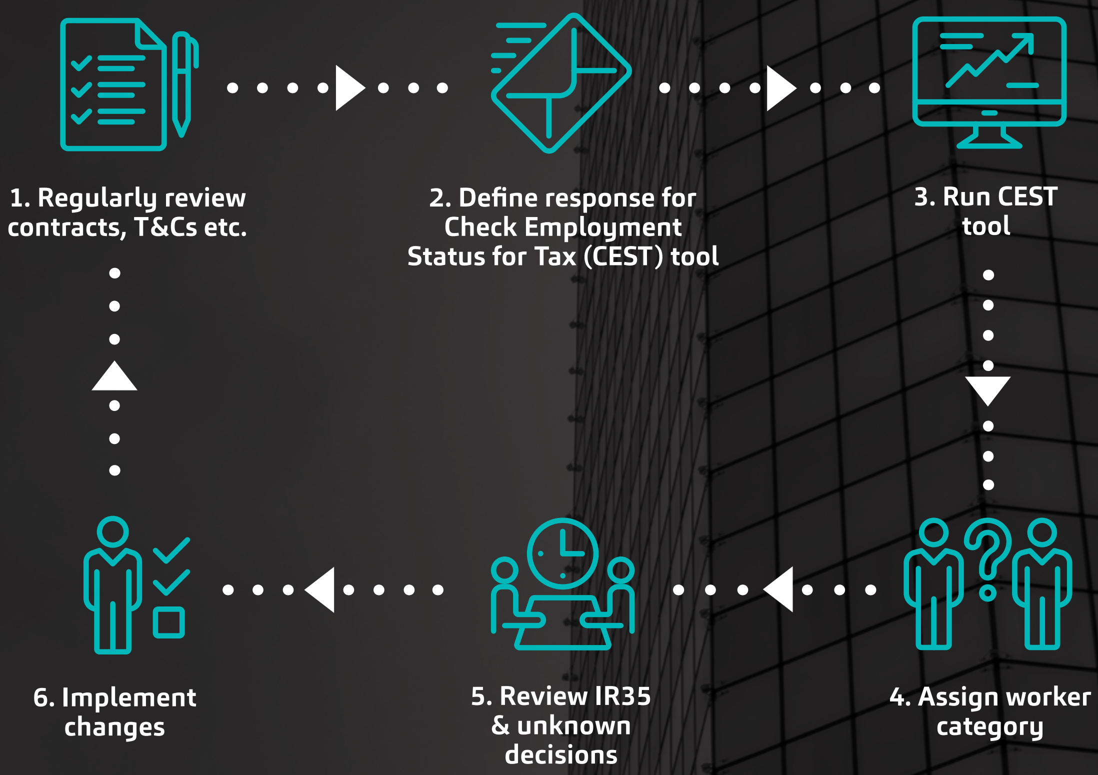
The government suggests that such an approach, where the individual can raise a concern with the client that issued it, will lead to the client taking reasonable care when reaching its final view on the status determination. This remains to be seen!

Timing

The consultation also raises a significant question over timing. It has pledged that the legislation to introduce IR35 changes will be in a draft Summer Finance Bill, but with the consultation having run to 28 May 2019, this leaves a very short window for it to be incorporated into any draft Summer Finance Bill, which would have to be published soon to allow time to pass through parliament.

Introducing the relevant IR35 legislation after the Autumn Budget may be too late to meet the target implementation date of April 2020. In trying to introduce complicated legal changes in a relatively short space of time, the government is likely to run up against its own self-imposed deadline, and a potential repeat of what happened when IR35 was introduced in the Public Sector, with only a matter of weeks of notice.

View our series of video blogs providing our Top Tips for IR35, including what you should consider and do to be ready for the changes.



Minimum Energy Efficiency Standards

The Minimum Energy Efficiency Standards (MEES) came into effect for the granting of new leases and the renewal of existing leases on 1 April 2018.

The regulations make it unlawful for certain residential or commercial properties to be let with an Energy Performance Certificate (EPC) rating lower than an 'E'. With effect from 1 April 2023, the regulations will cover all leases, including leases in place at that date.

There are a number of exemptions available, including for properties for which an EPC is not required by law, as well as short term leases (less than 6 months) and long term leases (more than 99 years). However, the new regulations may have consequences for entities that own and rent investment property to third parties.

Under both FRS102 and IFRS (except where using the cost model), entities that own investment properties are required to measure the fair value of the properties each year. This valuation may be calculated by a suitably experienced officer of the entity. However, larger entities, or those that are subject to audit or have external borrowings, may be required to have an external company perform the valuation.

If the entity owns investment property that is not currently, or will not in the future be compliant with the regulations, then the properties may be subject to a downward valuation. This is to reflect the fact that additional expenditure is required to adhere to the new regulations or that the marketability of the property is affected.

A reduction in the value of an entity's investment property not only has an impact on the entity's balance sheet, but also their reported profit for the period. That is because under both FRS102 and IFRS, movements in fair value of investment properties are reflected through the profit and loss account. Therefore, when an entity publishes its results for the year that include a reduction in fair value, there could be additional commercial implications such as a reduction in credit terms or the risk of non-compliance with loan convents.

Compliance with the new regulations may require an entity to incur additional expenditure on properties that do not have an EPC rating of E or above. The treatment of this expenditure will depend on the nature of the improvements, but if it results in an improved EPC rating, the expenditure is likely to be of a capital nature.

If revenue expenditure is required, entities may consider making a provision for such costs. However, both FRS102 and IFRS refer to entities not being permitted to make provisions for legislative changes, because the entity can avoid the future expenditure by changing its method of operation. This means it has no present obligation for that future expenditure and no provision is required – e.g. the entity can sell the property before the regulations apply.

Tenants Fees

First mentioned by Chancellor Philip Hammond in his Autumn Statement of 2016, the Tenant Fees Act 2019 was passed in February this year and came into play on 1 June 2019.

Despite the Conservative party not supporting this ban on tenants' fees, with the argument that tenants will be no better off due to anticipated increases in rents as a result, the new rules have been pushed through by the government to increase transparency in the rental market.

The new rules apply to all Assured Shorthold Tenancies (ASTs), including student lets and properties let on licence, signed after this date.

The Act explicitly states the payments can then be charged in connection with a tenancy and include the following:

- Rent and the cost of utilities;
- A tenancy deposit (restricted to no more than 5 weeks' rent);
- A holding deposit (capped at one weeks' rent);
- A fee for changing the tenancy agreement (if instigated by the tenant only);
- A fee for early termination of the tenancy agreement (if instigated by the tenant only);
- A fee for late payment or lost keys.

Payments for damage are also allowed on the basis these are a breach of the tenancy agreement, but the new rules are designed to ensure landlords cannot present exaggerated bills to tenants.

Any other payments requested by a landlord from a tenant are now treated as 'prohibited' payments, including such fees as administrative fees, credit check fees, and tenancy renewal fees. Provisions requiring the tenant to arrange a professional clean at the end of the tenancy or to hire a gardener have also been outlawed.

The removal of these 'hidden' payments and fees are estimated by the Treasury to save tenants across England £240m a year, or £70 per household.

The government seem to be prepared to act on those landlords that do not apply the new rules with the threat of initial fines of £5,000, increasing to £30,000 or a criminal record.

At headline level, these new rules are expected to be initially welcomed by tenants, and will be seen as another blow for landlords in the private rented sector. However, the work undertaken by the property agent is now expected to be charged as a fee to the landlord and then covered by an increase in the amount of rent. The new Act prohibits rental hikes in an initial period to cover the fees associated with a new tenancy, but not for an increase in the rent for the duration of a tenancy agreement. Agents are expected to reassess the market following the introduction of these rules and may well recommend to landlords to increase their rents to cover some or all of this additional charge.

Similar rules for Wales are expected to come into effect this Autumn and a similar ban on letting fees have been in force in Scotland since 2012.

House Price Growth

The Office for National Statistics have recently released the House Price data for April 2019.

Over the past three years, there has been a general slowdown in UK house price growth, driven mainly by a slowdown in the south and east of England. On an annual basis, house prices are still edging up overall, albeit that the overall annualised increase over the last 12 months is lower than the equivalent rate of increase for the previous year. The average UK house price in April 2019 was £229,000, which is up on the same time last year, but down on August 2018 when the average house price peaked at £232,000.

In the past year, average house prices across the UK have risen by just 1.4%, half of that was in April. In England house prices increased by 1.1% over the year to April 2019, with the average price now £245,000. Scotland saw house prices increase by 1.6% over the latest 12 months to stand at £151,000. Wales was the top performer, with prices increasing by 3.9% to an average of £164,000; this was driven by a combination of strong growth in March and April and the fact that prices were actually falling 12 months earlier, which was probably linked to the move from Stamp Duty Land Tax to Land Transaction Tax in Wales in April 2018.

In the Regions

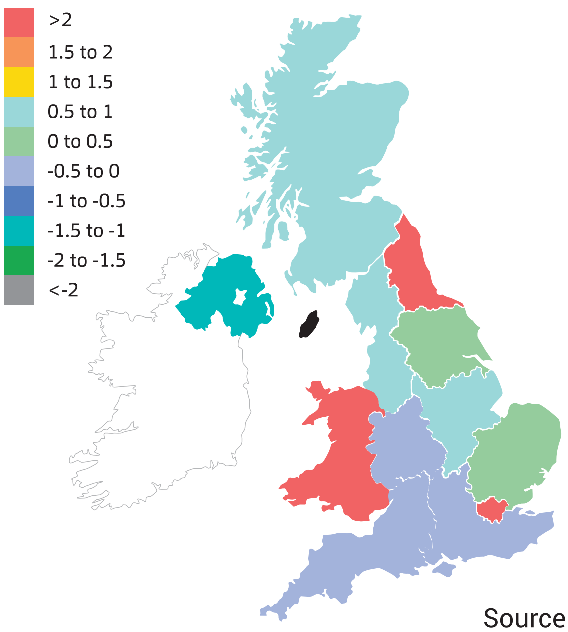
On a regional basis, London continues to be the region with the highest average house price at £472,000, but London actually showed a reduction in prices, with a fall of 1.2% in the past year, albeit that there was an increase in the month of April as the graphic shows. London is followed by the South East and the East of England, which stand at £319,000 (-0.8% for the year) and £289,000 (+0.2% for the year) respectively.

Northern Ireland and Wales had the strongest annual growth at 6.7% and 3.6% respectively. The biggest annual increase in England was East Midlands at 2.9%, but the North East had a 5% increase for April alone (2% annually, so we will see if this was a blip next time). The average price being paid by a first time buyer increased in the year to April by 1%.

Property Type

In regards to property type, all property types except flats and maisonettes showed growth in the year; detached houses had the strongest growth at 2.7%. Flats and maisonettes showed the weakest performance, with a reduction of prices of 1.6% overall for the past year. As mentioned last time, there has been some coverage in the press about the effect of the tax changes for buy to let owners starting to reduce prices in this area of the market, as investors are beginning to see how the changes affect them individually.

Monthly House Price Changes Across the UK and Ireland - April 2019



Source: ONS

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- Accounting and Financial Reporting: assistance with bookkeeping, preparation of management accounts and statutory reporting, including advice and support with the continuing amendments to new UK GAAP relating specifically to the property sector.
- External Audit: audits specifically tailored to provide various levels of assurance with work targeted to mitigate risks affecting the property sector.
- Internal Audit, Control Reviews and Finance Function Effectiveness Reviews: cost effective assurance assignments tailored for the real estate sector, together with advice on how to optimise the effectiveness of the finance function.
- Fund raising for property transactions.
- Advice and support for landlords and businesses who will need to prepare to meet their commitments relating to the HMRC initiative: Making Tax Digital.
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T: 0207 429 4147

mha-uk.co.uk

@mha_uk

MHA National Accounting Association

Contact Your Local MHA Office

MHA Carpenter Box
carpenterbox.com

Worthing (Head office)
Amelia House
Crescent Road
Worthing, BN11 1QR

T: 01903 234 094

Additional Offices: Brighton & Gatwick

MHA Henderson Loggie
hlca.co.uk

Dundee (Head office)
The Vision Building
20 Greenmarket
Dundee, DD1 4QB

T: 01382 200 055

Additional Offices: Aberdeen, Edinburgh & Glasgow

MHA Larking Gowen
larking-gowen.co.uk

Norwich (Head office)
King Street House
15 Upper King Street
Norwich, NR3 1RB

T: 01603 624 181

Additional Offices: Colchester, Cromer, Dereham, Diss, Fakenham, Holt & Ipswich

MHA MacIntyre Hudson
macintyrehudson.co.uk

London
New Bridge Street House
30-34 New Bridge Street
London, EC4V 6BJ

T: 020 7429 4100

Additional Offices: Bedford, Birmingham, Canterbury, Chelmsford, High Wycombe, Leicester, Maidstone, Milton Keynes, Northampton, Peterborough & Reading

MHA Monahans
monahans.co.uk

Swindon (Head office)
38-42 Newport Street
Swindon
Wilts, SN1 3DR

T: 01793 818 300

Additional Offices: Bath, Chippenham, Frome, Glastonbury, Melksham, Taunton & Trowbridge

MHA Moore & Smalley
mooreandsmalley.co.uk

Preston (Head Office)
Richard House
9 Winckley Square
Preston
Lancashire
PR1 3HP

T: 01772 821 021

Additional Offices: Blackpool, East Midlands, Kendal, Kirkby Lonsdale, Lancaster, Liverpool, Manchester & Southport

MHA Mtaxco
mtaxco.com

Manchester (Head Office)
Peter House
Oxford Street
Manchester, M1 5AN

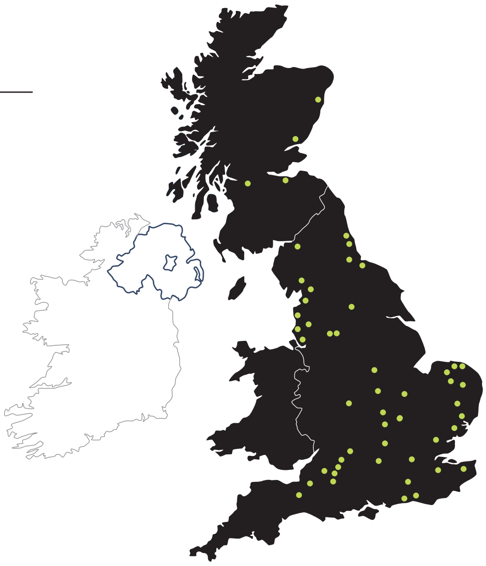
T: + 44 (0) 7760 166 802

MHA Tait Walker
taitwalker.co.uk

Newcastle (Head office)
Bulman House
Regent Centre
Gosforth
Newcastle Upon Tyne, NE3 3LS

T: 0191 285 0321

Additional Offices: Durham, Leeds, Northumberland & Teesside



To find out more about the services MHA can offer, please contact

T: 0207 429 4147

mha-uk.co.uk

Contact us

MHA Carpenter Box
T: 01903 234 094
Brighton, Gatwick & Worthing

MHA Larking Gowen
T: 01603 624 181
Colchester, Cromer, Dereham, Diss, Fakenham, Holt, Ipswich & Norwich

MHA Monahans
T: 01793 818 300
Bath, Chippenham, Frome, Glastonbury, Melksham, Swindon, Taunton & Trowbridge

MHA Mtaxco
T: +44 (0) 7760 166 802
Manchester

MHA Henderson Loggie
T: 01382 200 055
Aberdeen, Dundee, Edinburgh & Glasgow

MHA MacIntyre Hudson
T: 020 7429 4100
Bedford, Birmingham, Canterbury, Chelmsford, High Wycombe, Leicester, London, Maidstone, Milton Keynes, Northampton, Peterborough & Reading

MHA Moore & Smalley
T: 01772 821 021
Blackpool, East Midlands, Kendal, Kirkby Lonsdale, Lancaster, Liverpool, Manchester, Preston & Southport

MHA Tait Walker
T: 0191 285 0321
Carlisle, Durham, Leeds, Newcastle, Northumberland & Tees Valley

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