

South Devon Rural Housing Association Limited

Report on the corporation tax implications of the proposed Brimhay development

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South Devon Rural Housing Association Limited ('SDR')

1. Introduction

I have been asked to advise on the corporation tax implications of the proposed development at Brimhay. More details with regard to this development are outlined in Paragraph 6 below. However, I have considered, in this report, the corporation tax implications for SDR, the extent to which the development should be undertaken in SDR's subsidiary company Rural Homes Limited and the tax implications for that company together with other tax related issues which should be brought to the attention of the Board of SDR.

2. Current structure

SDR is registered as a "charitable Housing Association" under the Industrial and Provident Societies Act and, as stated on the website, is incorporated under charitable rules.

SDR have previously identified the need to create a subsidiary company to undertake any activities that may be taxable and SDR therefore incorporated Rural Homes Limited ('RHL'), in September 2010, as a wholly owned subsidiary to SDR. RHL has remained dormant since incorporation.

3. General tax implications of a charitable Housing Association

In terms of the general tax implications, societies registered under the Industrial and Provident Societies Acts are bodies corporate and are therefore companies for tax purposes and are liable to corporation tax in respect of their profits, which are computed in accordance with normal rules.

However there are a number of tax reliefs and exemptions for charities and charities must apply to HMRC in order to be registered as a charity and benefit from these various tax reliefs and exemptions. They will need to demonstrate that they have been established for charitable purposes only and Charities already registered with the Charities Commission will automatically be able to demonstrate this to HMRC. Other bodies will be eligible for the relief, on application, provided that they meet the definition of a charity.

4. General tax implications - SDR

In the case of SDR it is assumed that they have obtained this charitable tax exemption from HMRC and that HMRC have confirmed that the association is a charity for tax purposes.

The implications of having obtained this exemption from HMRC are that certain profits/income are exempt from taxation; these include:

- i. Rental income
- ii. Capital gains
- iii. Interest/investment income

Trading activities are generally taxable unless certain conditions are met and, in the case of a Housing Association, such trading profits will be exempt provided that:

- a. The trade is a “charitable trade”; and
- b. The profits of the trade are applied for the purposes of the charity only

A “charitable trade” is defined as a trade exercised in the course of carrying out a primary purpose of the charity or the trade itself is mainly carried out by beneficiaries of the charity.

It is therefore very important to be able to identify whether a particular transaction is trading or a capital gain and, if trading, whether it is being undertaken for the primary purpose of the charity.

5. Trading profits and SDR

If SDR was to be able to claim exemption from tax on development profits it would have to be able to demonstrate that the development was for a primary purpose of the Housing Association.

The Articles of Association state that the SDR’s main objects include

- i. Providing housing, accommodation and assistance to help house people and associated facilities and amenities for people in necessitous circumstances or for the relief of aged, disabled or chronically sick people
- ii. Other charitable objects that can be carried out by an Industrial and Provident Society registered as a social landlord.

Therefore if the development activity was to assist people in necessitous circumstances or for the relief of the aged, disabled or chronically sick and the profits were applied for the purposes of SDR then it is possible that the development profits would be exempt from corporation tax.

HMRC do recognise that with any housing development certainty is required as to the tax implications and that it can be difficult to establish if a project comes within these exemptions. Therefore they have introduced a clearance mechanism whereby the details of a project are submitted to HMRC and they will then provide a ruling as to whether the activity is non charitable trading or not.

6. The proposed development

SDR currently owns a site (“Brimhay”) which comprises 18 bungalows built in the 1960s. The proposal is to demolish these bungalows and build social housing flats, supported living accommodation and 11 houses for sale. The development will be funded by a short term loan secured on existing SDR properties.

SDR have already identified that this development should be undertaken by RHL who will then sell the completed houses.

In addition SDR propose to:

- a. Buy land adjacent to Brimhay which is required to provide the land for the houses for sale; and
- b. Sell land which SDR has owned since the 1960s to a company called QSH who will then build flats on the site (with RHL acting as project managers) and then lease them back to SDR for 22 years. The houses will then be made available to the tenants of a charity (‘ROC’) that supports children and adults with learning difficulties. SDR will receive a fee for managing the houses for the ROC tenants.

7. Tax implications of the proposed development

It has previously been suggested that the actual development of houses for sale on the open market will amount to a taxable trading activity and therefore it has already been proposed that this activity is undertaken by RHL. If the potential purchasers of the houses fell within the class of persons identified in the objects of SDR, e.g. the aged or disabled, then it might be possible to argue that the activity was primary purpose trading although I would strongly recommend that clearance from HMRC was sought in advance if this type of activity was ever carried out by SDR. The Brimhay houses for sale are to be sold on the open market and therefore this exemption will not apply in any event and the profits will be taxable.

The acquisition of the land adjacent to Brimhay by SDR for the development is of concern. The sole purpose of the acquisition of this land is to obtain planning permission on the land and then sell the land with the completed houses to third parties. As such there is a strong argument that this in itself could cause an issue for SDR if this land was acquired in SDR; this is for two reasons:

- I. Under first principles the question arises as to whether this is a trading transaction or a capital gain. If the land had been held for a number of years as an investment then there is the argument that this is a capital gain and therefore exempt from tax in SDR. However the fact that it was acquired for the purposes of the development taints this analysis.
- II. There is anti-avoidance legislation (Section 752 Income Tax Act 2007) which applies if “land is acquired with the sole of main object of realising a gain on the disposal of

the land". If this situation arises then the gain is not a capital gain but is subject to income tax which would give rise to a tax liability if undertaken in SDR.

I understand that SDR are shortly to complete on the acquisition of this land and I would therefore strongly recommend that SDR sells the land to RHL as soon as possible so as to minimise any risk that the value of the land has increased whilst in the ownership of SDR. Alternatively, if there is time, it would be worth asking SDR's solicitors if it would be possible to assign the contract and complete the transaction in the name of RHL.

The sale of the housing by SDR to QSH will be a capital gain, as the land has been held since the 1960s and forms part of the fixed assets in the accounts of SDR. As such the gain will be exempt from tax because SDR is a charity under HMRC rules provided that the proceeds are applied for charitable purposes.

SDR will be in receipt of a management fee in connection with the services they are providing to the housing for the ROC tenants. However, I consider that this income will relate to a trade that is exercised in the course of carrying out a primary purpose of SDR and will therefore be exempt from tax.

8. Tax implications for Rural Housing Limited

RHL will pay corporation tax on its trading profits. These profits are computed under normal accounting principles and are then adjusted for any items which are either not allowable for corporation tax purposes (e.g. entertaining) or for which the tax treatment is different to the accounting treatment (e.g. depreciation on fixed assets where certain assets for taxation purposes will be eligible for capital allowances).

Any company can obtain corporation tax relief on its donations to charities and therefore RHL can pass some or all of its trading profits to SDR using these rules. Therefore if all the tax adjusted profits in RHL are gift aided to SDR then there will be no corporation tax liability in RHL.

The general rules for this relief are that a company can only deduct the donation in the accounting period in which the donation is actually made and the donation cannot be carried back to a previous accounting period. However, where the company is wholly owned by a charity then a donation can be deducted against profits in the previous accounting period provided that:

- i. The donation is made in the nine month period after the end of the accounting period; and
- ii. A claim is made within two years after the end of the accounting period

The actual claim is made as part of the company's corporation tax return and therefore no further action need be taken.

There are a number of conditions that need to be satisfied for the donation to be treated in this way and in particular the payment must not be conditional on its being repaid to the

company at a later date. In addition the payment must not be associated with benefits that the company has received from the charity.

Therefore in practice the usual procedure is that the accounts for the trading subsidiary are prepared without any donations. The accounts are finalised and the provisional corporation tax computations are prepared and the tax adjusted profit identified. The donation is then made to the charity and, provided that payment is made within 9 months of the year end, the deduction can be claimed in the corporation tax computation reducing the taxable profits to nil.

9. Other issues

There are a couple of other issues that I would like to draw to your attention which all revolve around the financing of the development.

The first is to make sure that the financing does not breach any Housing Associations regulations.

Secondly the loans to RHL must be seen to be made for the benefit of SDR (as a charity) and be commercially sound. SDR therefore must ensure that the investments are secure, carry a commercial rate of return and provide for recovery of the amounts invested. The decision to make any such loans needs to be properly minuted and accompanied by cash flow forecasts and projections. If this decision making process is not properly followed then there is a risk that the SDR will lose its charitable status.

In addition it is important that the donations to SDR are not linked with the funding and fall foul of the benefit rules mentioned above. The emphasis here is that any funding from SDR should be sufficiently distinguishable from the receipt of the donation and, as mentioned above, be on commercial terms.

10. Conclusion

To summarise the main points that should be drawn to the attention of the Board of SDR are:

- i. The Brimhay development should be undertaken in RHL;
- ii. The additional land required to facilitate the development should be transferred to RHL as soon as possible
- iii. The funding of the development should be carefully considered and the legal aspects of the loan (e.g. security, interest rates etc.) reviewed and documented
- iv. The taxable profits in RHL can be gifted to SDR to reduce RHL's corporation tax liability.

