

SOUTH KESTEVEN DISTRICT COUNCIL

10th July 2006

Report Title: STOCK TRANSFER - VAT SHELTER ARRANGEMENTS

1. Purpose

1.1 The purpose of this report is to explain the background to the VAT Shelter arrangements and the potential benefits that could be derived by both the Council and the new Housing Association.

2. Recommendations

2.1 The Panel is asked:-

- to note the background to the VAT Shelter arrangements;
- to note the potential savings that could be derived through the VAT Shelter arrangements;
- to note that proposals will be made at a future date for the appointment of specialist advisers in respect of the VAT shelter and allied Corporation Tax issues;

3. Background

3.1 Historically stock transfer housing associations receiving transfers of local authority housing stock have been unable to recover the VAT that is chargeable by the contractors appointed to carry out major repairs and improvements to the transferring properties. In simple terms this is because:-

- the major source of income for a housing association is rents and rents are treated as an 'exempt' supply in terms of VAT;
- VAT borne by the housing association in relation to an 'exempt' supply cannot be reclaimed from the Revenue and Customs.

3.2 The VAT rules in respect of local authorities are different and, in practice, a local authority is able to reclaim from the Revenue and Customs virtually all the VAT it bears including VAT on major works contracts.

3.3 Approximately three years ago a scheme was proposed that would enable stock transfer housing associations to benefit from the transferring local authority's advantageous VAT position. The scheme (the VAT Shelter) was designed by one of the major accounting firms and received the support of ODPM and Customs and Excise.

3.4 In simple terms the VAT Shelter operates as follows:-

- An analysis is prepared to identify all major works and improvements that are proposed and can reasonably be classified as 'enhancements' to the housing stock.
- These 'enhancement' works have typically covered most of the major repair and improvement works that are proposed by the new landlord in the first five or ten years following the transfer.
- The local authority retains an obligation to carry out these enhancement works.
- As the housing association does not have to bear the cost of 'enhancements' to the properties the purchase price payable for the acquisition of the housing stock is increased commensurately.
- The local authority appoints the housing association to carry out the 'enhancement' works and 'pays' the housing association in advance.
- In practice there are no cash transactions between the housing association and the local authority as the increase in the purchase price of the stock is offset exactly by the payment to the housing association for carrying out the works.
- The invoice from the housing association for carrying out the enhancement works includes VAT.
- The housing association must pay over the VAT collected to the Revenue and Customs.
- The local authority must bear this VAT but is able to immediately reclaim it from Revenue and Customs.
- The housing association appoints specialist contractors to carry out the major repairs and improvements programme.
- These specialist contractors charge the housing association the cost of the works carried out plus VAT.
- The housing association is able to reclaim the VAT it bears up to the amount of VAT it has charged the Council.

4. Corporation Tax Issues for the Housing Association

4.1 Fairly soon after the introduction of the scheme the Inland Revenue ruled that there must be consistency in the housing association's accounting in terms of the classification of expenditure for both the VAT Shelter and Corporation Tax purposes. This ruling potentially reduced the effectiveness of the VAT Shelter arrangements as follows:-

- expenditure, as described above, on major works needs to be classified as an 'enhancement' in order to be eligible for inclusion in the VAT shelter arrangements;

- for Corporation Tax purposes major works expenditure which is an improvement rather than a repair is classified as 'capital' and is not a deductible expense for the purposes of Corporation Tax;
- originally the view had been taken that it would be quite proper to classify major works expenditure in a different way for the VAT shelter and for Corporation Tax purposes;
- typically it had been assumed that approximately 90% of major works expenditure in Years 1-5 is eligible for inclusion in the VAT shelter, whereas 'capital' expenditure for Corporation Tax purposes had been assessed at approximately 50% of the major works programme;
- the ruling from the Inland Revenue meant, using the figures in the preceding paragraph, that 90% of the major works programme would be a non-deductible expense for Corporation Tax purposes.

7. Charitable Status

7.1 More recently there has been a general acceptance that a new housing association should adopt Charitable Status as a means to improve their financial position. In summary Charitable Status would exempt the housing association from Corporation Tax and thus provide the dual benefits of enabling savings through the VAT Shelter to be maximised whilst avoiding any liabilities for Corporation Tax.

8. The situation in South Kesteven

8.1 In view of the potential benefits that could be derived from the VAT shelter and the need to avoid possible Corporation tax liabilities the new housing association, South Lincolnshire Homes, has already decided to adopt Charitable status.

8.2 In very approximate terms, if it assumed that approximately 90% of the major works programme could be included within the scope of the VAT Shelter, the potential savings are as follows:

- VAT shelter covering years 1-5 – potential saving £9 million
- VAT shelter covering years 1-10 – potential saving £14 million

8.3 Whilst it will be a matter for negotiation, normally the monies derived from the VAT shelter are shared equally between the Council and the new landlord. Again typically both parties are expected to commit to the principle that the monies will be used for meeting the sustainable communities objectives.

9. Specialist Advice

9.1 In view of the complex technical nature of the VAT Shelter arrangements and the large sums involved, it is recommended that the Council and the Association should jointly obtain specialist advice on both the VAT Shelter and on Corporation Tax planning subject to the achievement of a positive ballot result.