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Residential Property Developer Tax (RPDT)

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Summary

The government has published a consultation document (the **Condoc**) on the design of a new tax, RPDT, to help fund the removal of unsafe cladding and restore confidence in that part of the leaseholder market which has been most impacted following the Grenfell Tower fire tragedy. The idea is to raise at least £2bn over a decade.

Importantly, the scope of RPDT is actually much wider than headlined i.e. it may catch not just large corporate developers building for sale to the leaseholders whose remediation works the tax is intended to fund, but also build to rent businesses (**BTR**) and some purpose built student accommodation (**PBSA**) and retirement accommodation (unless care services are integral). One model proposed could even catch profits from some mixed-use developments. In addition, it will extend to corporate joint ventures (JVs) and other JVs with corporate investors.

The application of the tax to BTR developers is particularly controversial, not least because many of them are likely to have borne the cost of cladding repairs without passing it on to tenants or claiming government assistance. In additon the proposed taxing methodology is likely to lead to unfunded ("dry") tax charges for the BTR model.

The unexpected breadth of the tax is not the only issue giving rise to concern. Others include:

- uncertainty on key concepts (e.g. development);
- the lack of grandfathering provisions for developments already underway which will not complete until after 1 April 2022; and
- the impact on future housing supply, which the government wishes to minimise. Critical here will be the extent to which RPDT makes projects unviable.

Unfortunately, the likely tax rate is not yet known. This could impact on reaction to the proposal. Meanwhile, it is likely that many in the real estate sector will reply to the Condoc or lobby the government. Given the intention is to raise a predetermined minimum amount over a fixed period, the larger the pool of taxpayers in scope, potentially the lower the rate(s), so different segments of the sector are likely to have differing views.

So, lots of questions, lots of contradictions, lots of opinions and unknowns. Industry discussions with HM Treasury are now underway.

RPDT – the basics

The proposals are at an early stage and up for consultation. The basics are:

The tax	With the intention to raise at least £2bn over 10 years, the RPDT will apply from 1 April 2022 to corporate residential property developers to the extent that their annual profits exceed £25m per group from UK residential development activities. The precise rate(s) will be decided once the scope is further defined.
Who is a developer?	Somebody carrying out development activities on their own account (whether in-house or via a third party). In scope activities are not defined in the Condoc but it seems they will be wide-ranging. Non-residents will be caught if UK has CT charging rights.
What is residential property?	A house or flat that is a single residence, together with the grounds intended for the benefit of the dwelling, plus buildings that are suitable for use as dwellings or being adapted, restored to, or marketed for domestic use. Undeveloped land is also caught if a residential building is being constructed on it or would be constructed on it, as is undeveloped land or land undergoing a change in use for which planning permission to construct residential property has been obtained.
How are profits measured?	Two alternative models are suggested (see next slide) but both catch profits that are not fully recognised on a development's completion e.g. potentially deeming there to have been an arm's length sale at market value if the building is not sold. The proposal is that no deductions for funding costs will be allowed.

Is the scope too wide?

RPDT is intended to be a fair contribution by the largest corporate residential property developers.

The Condoc makes clear, however, that the tax is not intended to imply responsibility on the part of payers for historic cladding defects. This, helpfully, takes some of the emotional impact out of the charge. But it does mean that another ground for "fairness" is needed. The government identifies this in the advantages that developers will receive from operating in a market that will benefit from the substantial funding the government is providing to address safety defects and improve the leaseholder market, for example through temporary SDLT reliefs.

It is not obvious, however, how certain business models (in particular BTR and PBSA) will benefit from these advantages. In many cases these models will not benefit from government grants or from SDLT reliefs, and, indeed, many have already remediated without government or leaseholder help. So, if the RPDT in its proposed form applied to them, they could in effect be paying twice. A solution that works with the economic model will be key.

Proposed profit models

Model 1 (a company based): – tax on all profits of companies and corporate groups that undertake more than an insignificant amount of UK residential property development or which support that work. "Insignificant" has not been defined. While straightforward, this could catch commercial profits from mixed-use development if carried out by a single entity. Profits calculated in accordance with corporation tax (CT), with some adjustments (notably exclusion of interest and at least some losses – see below).

Model 2 (an activity based test): – tax on profits from UK residential property development activity or work supporting that activity in another group company.
NB: Here, only profit relating to UK residential property development activities is taxed. It is yet to be determined whether CT or UK GAAP should be the basis for the measure of profits. Again there will be some adjustments (including exclusion of interest and at least some losses).

Some thoughts on what land counts as "residential"

The proposed definition (described above) is similar but noticeably wider than the existing SDLT one, in particular as regards undeveloped land. Such land is within scope if planning permission (PP) has been obtained for a residential building to be constructed on it or if such a building is being constructed or, "would be constructed on it". It is unclear what that phrase means.

So, it seems that the definition could, for example, catch:

- bare land with PP for a residential building;
- land where the landowner has PP and put in essential services, but is not itself going to build dwellings; and
- a building that is partly developed e.g. to be sold at "golden brick" for VAT purposes.

It is not quite clear whether property with residential permitted development rights would fall within this.

Surprisingly, *affordable housing* is potentially within scope (unless held for charitable purposes). Given the growing investment class and new for profit models emerging, getting this right will be key.

Development activities

The Condoc, oddly, does not define development activities. This is generating much discussion. While it does state that a typical development project may encompass a number of phases (from site acquisition and pre-planning, through planning and construction to marketing and sales), indicating a wide scope, it is not quite clear whether the intention is that these activities should be caught on a standalone basis.

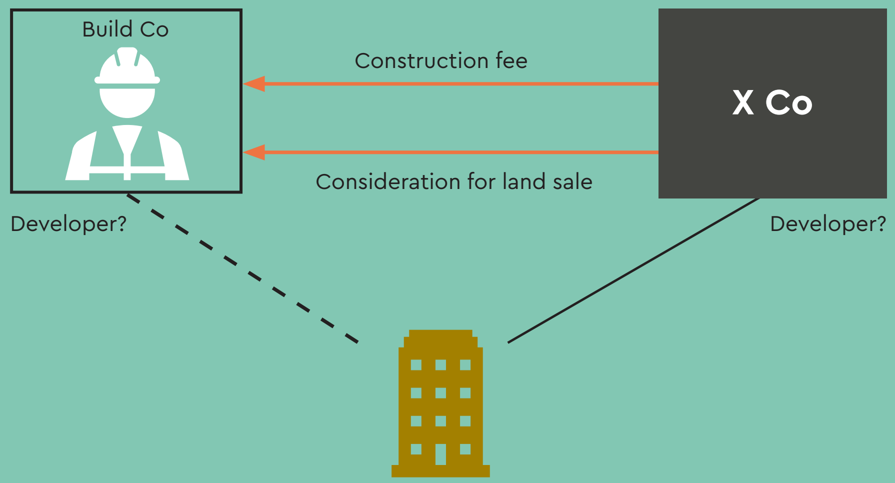
This is an important point: if standalone activities are caught (rather than the inclusion of these activities just being aimed at preventing fragmentation of activities to reduce or avoid the charge), then anybody profiting along the whole line of ownership would appear to be within scope. The Condoc states that a "third-party contractor" in relation to an unconnected developer would not be caught and says that a developer is somebody who undertakes residential property development "on their own behalf". However, there is no further guidance on the meaning of either phrase, though it is clear that more than one person in a chain could be caught.

In some cases the answer should be obvious (e.g. an estate agent should clearly not be a developer). However, in other key cases the position may not be clear. What about planning gain, strategic land etc, even a developer turned contractor?

Case study one: the forwarded funded development

X Co wishes to acquire land from Build Co, on which a block of flats is to be constructed. Build Co obtains planning and builds out the premises to "golden brick". X Co then acquires the land and later pays Build Co to fully construct the flats.

Who is the developer here? Is Build Co only liable in relation to profits on the original sale (with its construction profits out of charge), leaving X Co liable for any further profits from the project? The right answer may differ for different models.



How do the proposals impact the BTR sector?

Currently BTR is very much within scope. It is not clear, however, what the rationale is for the sector as a whole. There is speculation for example about whether BTR is only being included to prevent avoidance of the charge through the use of short lettings, but, that seems like overkill, as there are other potential easier ways of dealing with such avoidance e.g. planning requirements, clawbacks etc.

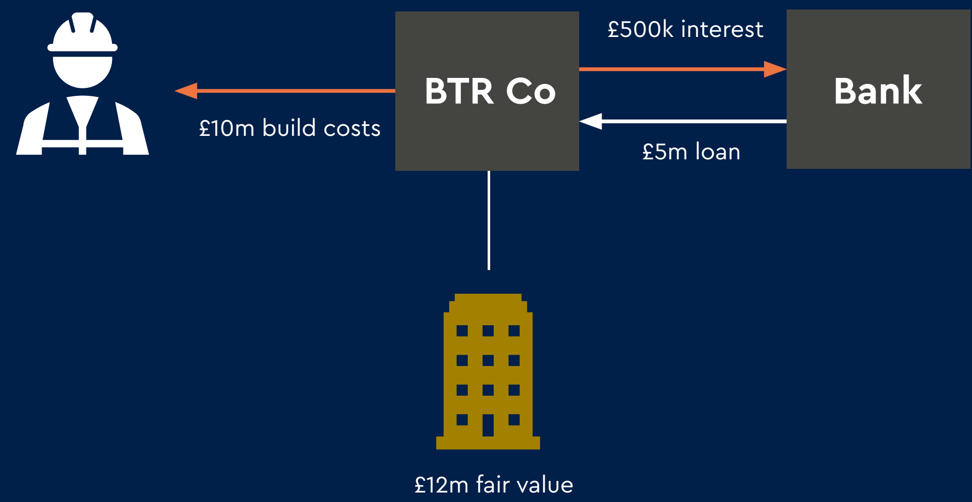
BTR also does not seem to fit neatly into the general structure of the tax, as that follows a sales-based business model. The proposal for BTR, where there are no such sales and so no actual profit at completion of the development, is to base the charge on the fair value of the development upon initial rental, minus the costs of development. There are lots of practical issues with this, not least ascertaining the appropriate valuation and funding of dry tax charges. A real concern is how this proposal might impact on viability and the attraction of the BTR market to the important wall of institutional (including non-UK) capital that is increasingly investing in it.

There is no mention of carve outs, deferral or clawbacks at this stage.

Case study two: the leveraged BTR investor

BTR Co owns a large plot of land and incurs £10m of costs in constructing a block of flats. The development is partly funded by a £5m bank loan and takes 2 years to complete, during which time £500k of interest is paid (in addition to the £10m). At completion of the development the block is valued with a fair value of £12m. BTR Co has a number of other large developments such that its annual profits from other sites, financed on a similar basis, will meet the £25m threshold.

No RPDT will apply to the first £25m of deemed profit. However, BTR Co will have an unfunded RPDT liability on profits of £2m i.e. £12m fair value (subject to any challenge by HMRC) less £10m of costs. No deduction will be allowed for the interest.



What about joint ventures and funds?

Joint Ventures - A JV in the form of a company within the charge to CT will itself be subject to RPDT (as a standalone entity or group). However, surprisingly, each corporate member of the JV will also have to include its share of the JV profits in its own group's RPDT profit calculation. To prevent double taxation (but not complexity) the member will get credit for its share of RPDT paid by the JV.

The position for tax transparent JVs, such as partnerships is simpler. These JVs will not be in scope. However, their corporate investors will have to include their profit share in their own RPDT calculations. We expect that this treatment will apply also to entities that are transparent for income (even if they are opaque for capital gains purposes (eg some Jersey property unit trusts)), but this needs to be confirmed.

For both corporate and non-corporate JVs, an investor in it, will only be liable to tax where it has a relatively significant economic interest. The Condoc does not suggest what this threshold could be: 10%, 25%, 40%, 50+%? This will be important. Managers will need clarity, not least so they can understand the scope of their reporting obligations.

The government is considering the important question of what the test should be for deciding whether a person is participating in a JV.

Funds - The Condoc does not discuss funds at all, which is a strange omission, given the size of investment by funds in the BTR, PBSA and retirement markets. One way or another, unless clarification that they are exempt is given or lobbying can get them out, the inference is that the government considers that these should be treated in the same way as other companies/JVs and that this could include those structures that are exempt from CT on profits, such as REITs and PAIFs.

Pensions Funds - UK pension funds are generally structured as trusts and should not be "corporates" for the purposes of the regime (even if they have a corporate trustee), albeit they would effectively bear the cost if they invest indirectly via a corporate within the regime. But, what about non-UK pension funds? Some of these may be corporates or invest via a corporate. Some may have sovereign immunity. Others will not.

Other points of interest

Non-UK resident corporates within the scope of corporation tax will be subject to RPDT.

The government is considering whether to use tax or accounting concepts for the **definition of group**. However, the Condoc notes that, either way, further rules may be needed to take into account profits attributable to the economic entity that arise in companies that fall outside the core definition of group.

A **new Gateway 2 planning levy** has also been announced. It will be applied when developers seek permission to develop certain high-rise buildings in England. This is not part of the consultation on the RPDT, but the Condoc says there will be interaction between the two. Being handled by different government departments, it will be important that the two charges dovetail.

Will there be **anti-avoidance** provisions? As anticipated, the proposals contain provisions to stop avoidance, where the main or one of the main purposes is to avoid the RPDT. This would include activities being fragmented or recharacterised so that all or part of development profit falls out of the charge. In addition, it is proposed that there will be anti-forestalling rules to prevent circumvention of the charge by arrangements to accelerate profits to before 1 April 2022.

What about **losses and group relief**? The government is seeking views on losses. Not all activity will be profitable. It is key that losses arising after the tax has been introduced can be carried forward. It is proposed however that this would not apply to earlier losses, which, given the lack of grandfathering, may be a difficult pill for some to swallow. It would not appear to be possible to reduce profits by group relief of losses from out of scope activities.

What about **"lumpy" profit streams**? Businesses may not complete developments at an even rate, such that for most years they have profits well below the £25m allowance but in others significantly above. Unused allowance cannot be carried forward, so a business with three year profits of, say, £5m, £5m and £40m will have £15m of its profits taxed (in year 3) whereas one with profits of £20m per year will be untaxed.

What will happen at the **end of the initial 10-year period?** Notably here, the £2bn is well below the anticipated costs of cladding remediation and the Condoc reserves the right for the tax to be extended if insufficient amounts are raised. It will be interesting to see if and how this relatively novel approach is built into the legislation or if it is left for a future parliament to extend or repeal RPDT.

This could end up being highly controversial further down the line: how easy will it be for the government to abandon RPDT once it is in place, both from an economic and political perspective? If it ends up being just another tax on the sector it will be even more important to ensure that operationally it works and that viability of projects and the much needed supply of housing in its wider form is not impeded.

TRAVERS SMITH

Key contacts

Cathryn Vanderspar
Head of Real Estate Tax
Cathryn.Vanderspar
@traverssmith.com
+44 (0)20 7295 3337

Jonathan Woodall
Senior Counsel, Tax
Jonathan.Woodall
@traverssmith.com
+44 (0)20 7295 3234

Ian Zeider
Knowledge Counsel, Tax
Ian.Zeider
@traverssmith.com
+44 (0)20 7295 3849

Madeline Gowlett
Partner, Tax
Madeline.Gowlett
@traverssmith.com
+44 (0)20 7295 3411