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Real Estate Matters

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Construction & Real Estate Newsletter

Issue 23

Now, for tomorrow

Introduction

Welcome to the latest issue of Real Estate Matters from MHA.

With rising interest rates impacting mortgage holders, inflation leading to higher costs and energy prices spiraling, household and business finances are under enormous pressure and experts predict the UK is heading for a recession by the end of this year.

While there are undoubtedly challenges ahead, the wheels of industry will continue to turn and the construction and real estate sectors have proven themselves to be resilient and adaptable in difficult market conditions in the past.

Facing an increasingly uncertain marketplace, businesses in all sectors need focus on building resilience in their business model, and take steps now to reduce risk, mitigate the effects of inflation and manage cash flow.

Cash flow and working capital across all projects need to be carefully mapped out and contractors need to keep an eye on payment terms as well as the frequency of payments to manage cash flow and protect against potential business failures.

Larger contractors will also need to pay close attention to their supply chain monitoring mechanisms, to assure themselves of the financial stability and performance of their supply chain. Where sub-contractors run into difficulty, it is not uncommon for larger contractors to provide support to help manage the delivery and protect their project. Above all, it is important to keep communication channels open across the supply chain to manage expectations.

In this edition of Real Estate Matters, we take a look at several issues which businesses in the construction and real estate sectors should be aware of, such as the VAT trap for unsold dwellings, finance and funding in the current climate, registration of overseas entities as well as Making Tax Digital and a whole host of other topics.

If you would like further information on any of the issues covered, please get in touch.

Best wishes,

The MHA Construction & Real Estate team

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The emergency budget – a missed opportunity

Brendan Sharkey
Head of MHA Construction & Real Estate

With a new prime minister and a "medium term fiscal plan" due to be delivered 17 November 2022, hopefully the political and financial turmoil we've seen over the past few weeks will stabilise and it will be possible to gauge the impact of the announcements and U-turn's since the so called mini-budget and how they affect the Construction and Real Estate sector.

While the permanent cut to Stamp Duty Land Tax (SDLT), announced is still going ahead and was welcomed by buyers, it has largely been dwarfed by the impact of interest rates affecting mortgage affordability and confidence in the market. While any help to reduce the cost of moving is positive, higher monthly mortgage payments is likely to lead to a downward pressure on house prices, which will be mitigated only by the acute shortage of housing stock.

However, high energy costs may encourage older homeowners with large family homes and children that have long-since flown the nest, to consider selling and forced sales, from homeowners unable to cover higher mortgage payments over the next 18 months could increase the availability of suitable housing on the market, which has often been the biggest barrier to downsizing.

Taking a more measured, long-term approach, I feel there are more effective ways to free up under, or unoccupied housing stock, using the tax system to tax property to redress the balance. A huge amount of housing stock is tied up by 'second homes'.

Not holiday lets or rented accommodation, but houses that remain empty for large parts of the year with owners less likely to be paying for local goods and services on a day-to-day, or regular basis. These so called second homes often weaken the local economy and price out younger generations from owning their own home.

Other than Capital Gains Tax on sale (which is often avoided with good tax planning), these homes attract no specific tax, so it is remarkable that you can own as many houses as you like, and have potentially a bullet proof investment and no tax to pay unless you, yourself, dispose of it. When there is a clear shortage of housing, the tax system should reflect this!

Another concern is the value of sterling and the likelihood of further unsustainable inward investment from foreign investors, who will see ripe pickings, particularly in London – one has to recognise the impact of homes being swallowed up by these types of investors who leave these properties empty and tax them accordingly.

What I would also like to see, if the Government wants to stimulate the first-time buyer market, having inflated interest rates by their recent actions, is the re-introduction of tax relief on mortgage interest for first time buyers to help them get on the property ladder. This relief, running alongside the reduction in SDLT for first-time buyers could be an attractive incentive to both the buyer and developer.

The VAT trap unsold dwellings!

Carolyn Van Hecke
VAT & Indirect Taxes

Builders and developers should be aware of a potential VAT trap (and opportunity) when temporarily letting unsold dwellings!

Background

During the recession in 2008 to 2009, many housebuilders were unable to sell their completed dwellings and were forced to let some properties temporarily to generate cashflow until the property market recovered. It is possible that this could happen again in the current economic uncertainty. We expect that HMRC will be paying close attention to the sector with a view to raising VAT assessments for overclaimed input tax. Letting new residential properties creates a potential VAT problem which is explained below.

Zero-rating

Sales of new dwellings built from scratch are zero-rated provided the sale is of either the freehold or a long lease exceeding 21 years (or 20 years in Scotland). Zero-rating also applies to supplies by builders or developers of buildings converted from non-residential to residential use, for example a barn conversion. Where the intention is to make a zero-rated taxable sale, input tax on building materials, professional fees and equipment hire etc may be recovered in full. Construction services supplied by a builder and materials supplied by the builder which are incorporated into the dwellings by him, (or her) will be zero-rated.

Exempt

Rental income from dwellings is VAT exempt apart from holiday accommodation (including holiday lets and short-term serviced accommodation). Under the partial exemption rules, an input tax block applies on the construction costs, if the property is let out other than as holiday lets.

Whilst there is a clear intention to make zero-rated taxable supplies, input tax is reclaimable, subject to holding the correct evidence to support the claim.

So, what does it mean when a builder or developer is forced to change their plans and let out some or all of the new homes on a temporary basis?

Payback and claw back rules

The input tax treatment depends on the first supply that is relevant to an expense.

- If a business claims input tax as there is an intention to make a taxable supply, but then the intention changes and an actual exempt sale is made, input tax claimed in the previous six years must be repaid to HMRC in the VAT period when the change in intention takes place.
- If a business does not claim input tax because the intention is to make an exempt supply, but then the intention changes and an actual taxable sale is made, input tax unclaimed in the previous six years can be claimed in the VAT period when the change in intention takes place.

2008 guidance

In 2008, HMRC addressed the VAT position and published guidance to housebuilders on the implications of letting unsold residential properties for VAT purposes. This guidance has not been updated and remains in place today.

The guidance explained that in many cases builders could temporarily rent out new dwellings without any loss of input tax. It essentially relaxes the normal partial exemption principles and often provides a better result than applying partial exemption calculations. HMRC will exceptionally allow builders who do not currently operate a partial exemption method, to instead adopt a "simple check for de minimis". This simple check is based on the expected time period a builder will let their building as a proportion of the economic life of that building, which HMRC have said is ten years. The exempt input tax is calculated by applying the proportion to the total input tax. Provided exempt input tax is less than £7,500 per annum and less than half of the total input tax, the exempt input tax is de minimis and can be recovered in full.

If the simple check cannot be applied, HMRC prefer calculations based on values and expected values of the various transactions.

Further opportunity

If the amounts of VAT involved are significant and breach the partial exemption de minimis threshold, a taxable supply can still be achieved (and irrecoverable VAT avoided) by transferring the completed houses to a connected person that is not a member of the same VAT group as the housebuilder. This would mean that the letting of the houses would not affect the developer's fully taxable VAT status. HMRC has confirmed that it does not consider this practice abusive since it does not produce a result contrary to the purpose of the VAT legislation.

Conclusion

There is a very real prospect that HMRC will see this as an opportunity to raise assessments and therefore care should be taken to deal with the VAT correctly and take specialist advice when required. We are working with a number of our property clients who are considering temporarily letting their dwellings, providing advice and helping them with the VAT calculations. If you require certainty and don't want the prospect of a large VAT bill, our best advice is not to wait until HMRC come knocking but instead to be proactive and assess the position ahead of making any exempt lettings.

If you would like further advice, please get in touch with your local office.

Property Registration on overseas entities

The register of Overseas Entities came into force with effect from 1 August 2022 and requires that previously anonymous beneficial owners of UK property and landowners be identified in a publicly available register.

The implementation of this legislation has been accelerated in response to concerns about the effective enforcement of sanctions following Russia's invasion of Ukraine. It will affect any individual or entity that owns UK land or property via a non-UK company, either now or at any time since 28 February 2022. Non-UK legal entities that own UK property are also now required to disclose their beneficial ownership to Companies House. Such companies must register with Companies House and provide beneficial ownership information no later than 31 January 2023.

Before a company can be registered under the new rules, the information being registered must be verified by a person regulated under the UK's anti-money laundering regulations. After registration, an overseas entity will be provided with an ID number which must be provided on the land registry whenever it buys, sells or transfers land or property in the future.

Who is a beneficial owner?

A beneficial owner is any individual or entity that has significant influence or control over the overseas entity.

It can be:

- An individual person
- Another legal entity, such as a company
- A government or public authority
- A trustee of a trust
- A member of a firm that is not a legal person under its governing law

The definition of a registrable beneficial owner (RBO) for the purpose of these regulations is similar, but not identical, to the definition of a person with significant control (PSC) for a UK company. If the RBO is acting as trustee of a trust, details of the settlor and beneficiaries must also be provided but will not appear in the public version of the register. They will be accessible to HMRC. Overseas entities that disposed of property or land in Scotland, England and Wales after 28 February 2022 will also need to report details of those disposals.

Next steps

Existing landowners must register within 6 months of the rules taking effect from 1 August 2022. Therefore, registration is required by 31 January 2023 for overseas entities that bought property or land on or after:

- 1 January 1999 in England and Wales
- 8 December 2014 in Scotland
- 1 August 2022 in Northern Ireland

Failure to comply could result in a fine or a prison sentence. If you are affected by the legislation and have not yet taken steps to comply, your advisor will be able to assist with the verification and registration process, which will require sufficient supporting evidence of the ownership structure.

If you would like further advice, please get in touch with your local office.

The reality for businesses raising funds in the current economic climate

Greg Taylor
Head of Banking & Finance

In my nearly 30 years in the Financial Services sector I thought I'd seen it all, but the challenges SMEs have faced over the past 3 years have been unprecedented.

Since the start of the global pandemic, firms have had to contend with inflation hitting a 30-year high, a once-in-a-generation energy crisis, the outbreak of war in Ukraine, interest rates undergoing the largest single increase since 1995 and the pound falling to a record low against the dollar. The list of challenges for businesses seems to grow almost daily.

While many of these challenges are indeed unprecedented, so too has been the response from businesses; to overcome, adapt, and thrive rather than just survive. Given this backdrop, can there ever be a "right time" to raise debt funding? Or should SMEs reflect more on their own performance & marketplace then separate this from the broader macro-economic outlook?

With UK banks continuing to reduce their exposure when it comes to SME lending it certainly could be seen as a rather a bleak picture. But business funding is no longer the sole preserve of the traditional high street banks. While high street lenders may have once been the only port of call for businesses looking to raise capital, many businesses are now benefitting from the increased flexibility and bespoke approach that Challenger Bank & specialist non-bank lenders can offer.

However, research conducted by BOOST&Co for the 2022 Geared for Growth Report suggests that up to a fifth of businesses with a turnover of less than £10m are held back by a lack of awareness around the alternative growth funding options.

What makes now the "right time" to access funding?

In an economic downturn most banks' appetite for lending to SMEs will decrease, as this segment of the market is generally considered a higher credit risk. But large institutional lenders are less agile than their smaller counterparts and will take some time to react to the environment, meaning that an SME loan application made now is more likely to be approved than in six months' time, assuming predictions of an economic downturn become the reality.

Specialist SME lenders are more likely to lend to creditworthy businesses throughout an economic lifecycle, so although businesses that react quickly to the current climate may capitalise on their fast decision-making, firms should be assured that alternative lenders will continue to offer support to creditworthy businesses with viable business plans.

If you are able to secure a fixed rate deal sooner rather than later, this will provide visibility over borrowing costs for the entirety of a loan term, in an environment where rates are moving quickly and expected to increase further. However, only a limited number of business lenders will offer these long-term fixed rates – and it is likely that the starting rate will be much higher than for a variable interest loan.

What about the risks of not raising funds right now?

As ever cash is king, so when the going gets tough it is often the larger and more established businesses with a capital buffer that will ride out any economic turbulence. For SME's, this is why having a strong balance sheet and access to additional working capital is undoubtedly a good idea when entering an economic downturn.

The risk of not raising funds, if working capital is not readily available, is that any change to cash coming into a business – via declining sales, or a squeeze on margins – has a significant impact on a firm's ability to reinvest and grow. Previous experience shows us that it is often the businesses that invest in market diversification, product development and accelerated digital transformation that not only survive but thrive in an economic downturn.

Bank lenders will likely begin decreasing their lending to smaller firms and economically exposed sectors within the next few months, if they haven't already. The better option then becomes a specialist SME or sector-focused lender that will have the expertise and experience to understand your specific business model, beyond broader market trends, giving businesses the chance to acquire that capital buffer to not only survive but also thrive.

With such a disparate financial services market it is more important than ever to have a "trusted advisor" who can offer guidance to SME's on what alternative growth funding options are available to them.

Please get in touch for an informal discussion on the options available.

Alternatively, our latest podcast on Finance & Funding in the Construction & Real Estate Sector with Greg Taylor & Brendan Sharkey is available now:

Finance & Funding in Construction & Real Estate

The Net Zero and ESG reporting journey 2022 - considerations for industrial sectors

Jose De Mayne Hopkins
Sustainability & ESG

The Journey to an integrated ESG and Net Zero UK economy will prove to be the greatest business challenge of the decade, with significant risks and opportunities brought not just by climate change, but all environmental, social and governance factors that investors, consumers, capital providers, supply chains, colleagues and competitors are increasingly focusing on in their decision making.

Industrial sectors such as construction, manufacturing, and engineering, with a heavy reliance on high carbon intensive materials and processes, all face multiple and significant challenges in meeting the UK government national target of reaching net zero by 2050. At COP26, global leaders agreed the Glasgow Climate Pact, securing a near-global net zero target, with over 90% of world GDP now subject to net zero commitments.

A significant number of these climate commitments (such as replacing diesel engines with batteries) are expected to create significant supply issues, where demand is likely to outstrip the availability of key components such as copper, lithium, nickel and other vital raw materials. Unless a significant new supply of copper becomes available in a timely manner, aligned with the timing of net zero commitments, climate goals are likely to create material business disruption for the industrial sectors to become net zero, creating a perception of "green-wishing".

The medium (2030) to long term (2050) carbon emissions reduction targets set by the UK government are in anticipation of future innovation and reliance on technologies not currently available, rather than on what is achievable today. While many businesses in these sectors have begun to invest in technologies and materials that are more sustainable, as well as opportunities for innovation, there is a lack of transparent funding, direction and education on the technological solutions available.

Another important issue to highlight; industrial sectors include heavy industries and transport known as "hard to abate" due to the immense challenge of electrification and the costs of transitions. The net zero transition plans for these hard to abate sectors, rely on undeveloped technologies which are untested, such as green hydrogen and/or carbon capture.

Currently, concerns over availability, cost, long-term performance, safety and future maintenance of new technologies, as well as the skill sets required to install or use them, mean tried and tested solutions still provide greater confidence and less risk at the moment. Today, investors and financial markets are increasingly demanding a transparent and robust environmental, social, and governance (ESG) strategic plan and a credible transition plan to become net-zero. So, while the challenges are great, the commercial and societal importance of ESG mean that businesses do have to take action now to ensure future compliance.

Next steps

Whilst reporting requirements vary among businesses, there are a number of areas businesses in the industrial sectors need to consider in the journey to Net Zero.
We have listed our top 5 considerations those business need to consider when developing and implementing their net zero and ESG strategy

1. **Governance:** Climate change is a board level issue. Start discussions on the topic now. How are you expecting to allocate responsibilities between the board and management team in managing climate-related risks and opportunities? Is the board able to discuss and understand the meaning of Net Zero, the TCFD framework and scenario analysis to guide current reporting and assessment? Do you have the right set of skills and/or do you need external training on TCFD and scenario analysis?
2. **Risk management:** Perform a risk assessment as to the impact of physical risks (such as changes in the frequency and magnitude of weather events) on your operations, employees, engineers and supply chain!
3. **Identify your critical stakeholders:** There has been a significant number of companies who have and will disclose scope 3 emissions during the current reporting period, which will directly affect a significant number of industrial businesses net zero journey. Speak to your customers and understand their net zero journey.
4. **Awareness:** Do your employees understand what is going to be your roadmap? What are going to be the short term, medium term and long-term targets to become a carbon neutral & Net Zero organisation?
5. **Focus on the quick wins:** such as measuring scope 1 and 2 emissions!

We can support clients to:

1. Ensure financial reporting is compliant with existing and emerging legislation such as streamlined energy and carbon reporting and TCFD.
2. Keep you abreast of wider emerging legislation such as Future Home Standard, providing our view of the potential impact to tax and finances.
3. Support you to ensure that you governance, risk management processes and associated non-financial controls and data are robust enough to meet external reporting requirements including where applicable wider social and economic benefits.
4. Help you to assess and meet voluntary reporting standards that may aid stakeholder relationships and transparency on sustainability and climate change impacts.
5. Provide independent assurance across key non-financial metrics providing greater transparency and increased trust and confidence with key stakeholders.

If you would like further guidance on sustainability, please get in touch with your local office or email us at: info@mha-uk.com

Making Tax Digital – what businesses really think!

As we know, the nation is moving ever closer to the start of Making Tax Digital (MTD). From 1st April 2022, all businesses registered for VAT are making digital submissions, and from 6th April 2024 this will extend to landlords and businesses whose aggregate annual turnover exceeds £10,000.

On 27th May 2022, HMRC published research on "Customer readiness" and the results are not entirely encouraging.

2200 randomly selected taxpayers were surveyed to ascertain their readiness and attitude towards MTD. This sample was then subdivided into six groups and in descending order of enthusiasm for MTD these were:

- Receptive and capable (32%)
- Complex and capable (10%)
- Capable but disengaged (25%)
- Cautious and lacking confidence (15%)
- Resistant and less capable (16%)
- Short tax return (2%)

The 'receptive and capable' group were mostly younger and more IT literate. 90% had turnover below the VAT registration limit and 44% were already using an agent. This group was almost entirely comfortable with using business software and saw no difficulties in making regular submissions. Nonetheless, 31% of this group were still using paper-based systems.

In some respects, the 'complex and capable' can be ignored. These are mostly established businesses which are already using software, filing VAT returns online and with a support structure of agents and employees. Only 28% thought that using software would be difficult, but there was an even split on the question of whether submitting information would be easier or quicker. 23% of this group were, however, still using paper systems.

For the remaining groups, the position was rather different. Looking at them together, less than 10% felt that using the software would be easy, and less than a quarter believed that information would be quicker and easier to submit. Usage of paper-based systems was highest in these groups ranging from between 41% to 76%.

The full report extends to some 46 pages. Aside from the statistics, it includes a number of quotes from respondents including some which suggested that, rather than comply, taxpayers would take early retirement or wind businesses down to below the £10,000 level. Circumstantial evidence suggests that this has already happened for some small VAT registered businesses.

Commenting on the report, Partner at MHA, Joe Spencer said,

"Looking at the figures in aggregate, and disregarding the "complex and capable", it appears that over two thirds of those likely to be affected by MTD are feeling somewhere between unenthusiastic and hostile. One wonders if the increased level and difficulty of compliance may even have the effect of suppressing new businesses or encouraging the black economy? With less than two years to go, HMRC need to step up awareness or better still, to raise the entry limit – four years of deferrals and rising inflation will undoubtedly bring in far more taxpayers than was originally suggested."

Cyber Security -Phishing, smishing, ransomware & cyber attacks!

The number of large contractors finding themselves caught up in cyber security issues that have led to substantial 'pay-off's' and management time to resolve has brought into focus even more clearly, the need for effective IT systems and processes to combat the ever-increasing number and sophistication of cyber threats as well as the need for cyber insurance.

A government cyber security breaches survey that was done earlier this year reported that only 34% of businesses feel they invest enough in their cyber defenses with many businesses not having cyber insurance cover in place or cover that could be inadequate. Cyber-attacks are a threat to all businesses and the Government and Met Police have both highlighted some of the underhand tactics fraudsters have used to try and breach systems and processes. The most serious threats are to the financial stability and reputation of your firm, to client confidentiality, and to the protection of intellectual property and sensitive commercial or business trading information, including research and development projects.

Fraudsters are finding ever more inventive methods of infiltrating your systems, from installing malware attached to a seemingly innocent CV to using the stolen identities of Directors at other construction firms, or suppliers to obtain financial information, trade secrets, or even insider information relating to patents or mergers and acquisitions. For international firms, commercial espionage may even be a concern, where overseas state-sponsored efforts to obtain business and technology secrets may pose a risk. To address this significant challenge many are turning to cyber-insurance.

Many insurers won't provide terms at all unless you can demonstrate a certain level of risk management. They are looking at IT controls, procedures and practices in place supported by regularly updated risk assessments. To obtain insurance, underwriters need to understand the nature of the business and what risk management plans are in place that demonstrates security around IT and internal controls, such as signatories required for payments.

Many of the mid-size and larger construction firms will have their own in-house IT function, who can often be sceptical about the need for cyber cover. Unfortunately, cyber criminals are very capable, and do find their way through system defences.

When going to market for insurance, you ideally need packaged cover to protect first party and 3rd party losses. The key here is making sure that you can demonstrate to insurers that you are a risk worthy of the level of cover that you want. This is effectively achieved via a due diligence exercise focused on IT systems, with a questionnaire to establish your controls, such as MFA (muti-factor authentication), how do you deal with your accounting, what you have in the way of a firewalls, what systems you are using etc.

Some organisations use outside consultants to support them with cyber security, which can help to demonstrate that the risk management in place is as robust as it can be. The more layers of protection that you have in the business will give the underwriter added confidence when determining premiums.

We've found that there aren't any specific rates that you would apply like you would do for employers liability or public liability insurance. It is an assessment of the overall risk. However, in an age when cyber security leakages can have far reaching financial and reputational consequences it is surprising that only 1/3 have got adequate cover in the industry. Clearly, cyber security should be covered in any business continuity plan and insurance will have its place within that plan.

You can discover how to navigate the insurance market by listening to our podcast here: Insurance issues in Construction & Real Estate

HMRC v UK R&D?

Jay Bhatti
Research & Development

HMRC R&D scrutiny and investigations are now firmly focused on the construction sector.

Any good Research & Development (R&D) claim involves a check that the Company qualifies under the 3 Pillars, i.e. Legislation (can the company claim as a legal entity), Technical (do the projects qualify) & Financial (do the costs qualify). It is extremely important to check which scheme the claim qualifies under, as although the SME R&D Tax Relief Scheme is more valuable (approx. 25p/£1 claimed) it has more conditions to be satisfied. Conversely, 'Large Companies' or SMEs with projects in specific funding scenarios must claim within the less generous R&D Expenditure Credit (RDEC) Scheme (approx. 10p/£1p claimed).

It should be noted RDEC does not allow you to claim for expenditure relating to subcontractors, except in special cases, for example where payments are made to qualifying bodies, such as a University. The SME Scheme on the other hand allows for the inclusion of subcontractor expenditure, in addition to the other claim categories (staffing, consumables, software & externally provided workers).

Over the past 5 years, the R&D Tax Incentive Schemes, especially the SME R&D Tax Relief (RDTR) Scheme has seen double digit growth in the number of claimants. As the R&D Schemes are unregulated, this has resulted in the proliferation of many stand-alone boutique firms that offer a no win / no fee claims preparation and submission model. This worked well initially, however there are increasing concerns of fraudulent or inappropriate claims being put through, often without the proper checks conducted or a review against all the legal requirements.

Even before the pandemic, HMRC had turned its attention to the interpretation of the R&D definition for tax purposes within various industries. The legislation is purposely open ended to enable inclusivity of various forms of technological and scientific work, without trying to accommodate every single scenario, however this has led to an overly liberal interpretation in some cases.

After the IT & software technology sector came under increased scrutiny, the focus has shifted to the construction sector. This is not unexpected, as the qualifying costs involved within this sector tend to be large, and whilst many companies are undertaking fantastically innovative work, many are simply dealing with 'routine' complexity or logistical challenges.

New Changes vs Precedent:

HMRC have recently departed from precedent regarding the appropriate scheme quite drastically. The MHA R&D Team have been at the forefront of understanding this, often through resolving HMRC enquiries of claims originally prepared by companies themselves.

To summarise our insights and the learnings:

Previous precedent on subcontracted R&D:

For RDTR, the legislation specifically addresses cases where:

- A client or client team (SME) might contract a Construction Tier 1 Contractor, who in-turn subcontracts packages of the work out to the supply chain: Clearly the case here is complex to determine who the R&D belongs to, and care should be taken to make sure that the same work is not being claimed for by the contractor and the contracted. Following this, a test was used to check if a project or a technical package of works indeed belongs to a company for inclusion in its RDTR claim:
  - The Claimant Company (Subcontractee) owns the IP
  - The above also has the Lead Technical Professionals
  - The R&D work is done at cost, i.e. there is no direct relationship between the project funding and R&D work. For example, if the company is able to bill its additional hours and materials to its client for the R&D work, then this fails to meet this criteria, and the project must be claimed under RDEC.
- A Project may be contracted to an SME Company by a Large Company – where the IP specifically belongs to this Large Co. and the R&D work is accounted for in the contractual agreement – the Large Co. cannot claim for the subcontracted work (as per RDEC rules), but the SME can claim this work under RDEC.

New HMRC Treatment on Subcontracted R&D:

For RDTR claims, the precedent presented above was in place for more than 5 years and was a sensible way for the industry to self-regulate. Although some extreme or outlandish cases were encountered, the test for Subcontracted R&D above proved to be very useful, for example many Tier 1 & 2 general construction contractors recognised that much of the specialist work, such as M&E Design for example, belonged to that specific subcontractor – and abstained from claiming this as their own. However, our recent experience with HMRC has shown a much more aggressive stance being adopted – where:

- ANY work that comes about due to the need to fulfil a contractual deliverable, is considered Subcontracted R&D.

This is obviously an extreme, and highly idealistic position that has been adopted recently by HMRC. No construction company has the resources or the means to develop a prototype of a building, and then proceed to build the actual deliverable separately.

The R&D activities within construction are almost always naturally tied into the need to resolve problems in being able to achieve a deliverable.

We, and the R&D industry has pushed back significantly over this, with some cases proceeding to First Tribunal Hearing.

We do not expect HMRC to relent or clarify this position further, and therefore assuming the most pessimistic scenario, where the contractor is also an SME, claims could no longer be made where the R&D work has come about as part of a deliverable in a contract. Where the contractor is a Large Company or Individual, claims can still be made under the less generous RDEC Scheme, even though the company & project may meet the other RDTR Requirements. Clearly, this contradicts the previous position ignoring IP ownership and the presence of competent professionals within the claimant company. This also suggests that SME companies could claim for any R&D work encountered by their subcontractor regardless of involvement in the project, which goes against the principles of the scheme.

With the increased frequency of enquiries being opened by HMRC into the construction sector, and also this new highly-adverse position on Subcontracted R&D, the risk for continuing to put claims into the RDTR Scheme based on the previous precedent becomes a risk.

This new position on Subcontracted R&D has emerged since Summer 2021, with HMRC clarifying that it will certainly be applied to all cases since it was published. Within an enquiry, Tax Inspectors will check not only the compliance of the claim, but also how it was prepared & the intentions behind certain actions, leading to fears it could be applied retrospectively.

Our R&D Team have resolved over a dozen complex enquiries recently, on claims that were originally prepared by the clients themselves, or boutiques – and thankfully we have been successful achieving a zero penalty rate, i.e. HMRC was satisfied that the preparation of the claim was not willfully misleading or negligent. However, we expect HMRC to continue enforcing this new position on Subcontracted R&D aggressively, unless they are ruled against by a judge in both a First Tribunal hearing and then an Appeal – the latter confirming the position into case law.

The case of Hadee Engineering vs HMRC, Is often cited by HMRC – however, this was an extremely niche case where there was a direct relationship between the payment made by the claimant's client and the additional hours & materials needed to complete the R&D work. In our opinion claims should continue to be judged on a case-by-case basis.

Subsidised R&D – Precedent vs New Position:

Like the Subcontracted R&D position above, any R&D projects carried out by a company that would otherwise claim in RDTR, would have to claim these in RDEC where there is a direct relationship between the payment made and the R&D work done. Specifically:

- **The previous precedent** involved consideration of the levels of funding the project received, whereby claims have to be made within the RDEC scheme to the extent they are subsidised. Within construction, an argument was made that contracts are often fixed price, with additional payments only relating to variations or change in scope of the works. Therefore, there was no direct relationship between the R&D work and the payments from the client, as the latter was only received when the deliverable was satisfactorily handed over.
- **The updated HMRC Position,** in addition to the adverse Subcontracted R&D treatment detailed above, now asserts that since the company ultimately realises a commercial gain from the work done, it is considered subsidised. This was recently challenged in a First Tribunal Hearing, of Quinn vs HMRC, where the judge admonished HMRC's position, specifically stating that the legislation, as written was never meant to be applied in this way. In addition, the Judge commented that it is unreasonable that the only case that would qualify for RDTR in the construction sector is where purely internal R&D work at cost is being done. HMRC did not take the case to appeal, to avoid the position becoming legal precedent.

Conclusion

The UK R&D schemes are one of the reasons why British Construction and Engineering still competes on a world stage as a centre of innovation. With the UK schemes in competition with other similar schemes across the western world, we do not subscribe to much of the doom & gloom speculation that HMRC are poised to scrap it.

However, we highly recommend a refresh and a review of claims and processes involved. The gradual shift of claims into RDEC is not all negative, as the credit rate here is expected to increase gradually. Most importantly, we recommend a back-to-basics approach with claims, ensuring that succinct, clear, and strong arguments are made for the projects qualifying as R&D, and if there is indeed internal or unsubsidised/uncontracted work, it can safely be ringfenced and claimed within the more generous RDTR Scheme.

Lastly, beware of boutique firms advising on R&D claims that lack the skills and resources available to deal with HMRC enquiries.

You can hear more from Jay Bhatti and Brendan Sharkey on R&D by listening to our podcast:

Research & Development in Construction & Engineering

If you would like further advice, please get in touch with your local office.

Property Insolvencies

Georgina Eason
Restructuring & Recovery

The construction industry experienced the highest number of insolvencies in the second quarter of 2022 with 3,665 failures, accounting for 19% of the total, or almost one in five. There were 5,629 company insolvencies registered in Q2 2022, 13% higher than the previous quarter and 81% higher than during the same quarter in the previous year. This is the highest figure since 2009, just after the global financial crisis in 2008.

With Company Voluntary Liquidations (CVLs) the most common insolvency procedure (87% of cases) it is clear that in the current economic environment, a number of business owners faced with rising costs and an uncertain future lack confidence in their future trading prospects.

The Office for National Statistics has also reported that total construction new orders decreased by 10.4% in Q2 2022, compared with Q1 2022, with both private new housing and private commercial falling below their respective pre-coronavirus pandemic levels.

There is no doubt that rising inflation, interest rates and soaring energy prices, along with skills shortages, supply chain issues and a potential recession on the horizon are creating significant challenges for the sector.

Against this backdrop, there are ways to prepare your business to better weather the storm. Below, we cover the warning signs to look out for, reducing the impact of insolvency, and how to minimise your risk as a Director.

What are the warning signs of insolvency?

- Reduced standard of work – increased defects
- Decrease in labour and minimal materials on site
- Failure to adhere to timescales or silence
- Request for upfront deposits
- Late filing of accounts
- County Court Judgments

Reducing the impact of insolvency

- Check the financial status of the company before entering into a contract and ask lots of questions
- Review contracts and ensure you identify when payments are due and address any issues as soon as possible
- Consider a performance bond as an insurance position
- Ensure you have a valid retention of title clause
- Take guarantees from a third party
- In case of any warning signs, ensure you are at the front of the queue for payment
- Work with companies that you know and trust
- Check you are complying with the terms of your existing contracts. If there are any breaches, seek remedy
- Be sure to check what is happening on other sites

If you are facing insolvency, how can you minimise your risk as a Director?

- Keep up to date financial information. You need to regularly monitor, review and update your financial records, management accounts and cash flow projections
- Hold regular board meetings and keep records of decisions and minutes. You must document why your decisions were best for the business
- Co-ordinate with key stakeholders (in particular lenders) and HMRC where a default may occur
- Discuss short term facilities for working capital. However, look at the terms as any loans will have to be repaid eventually and could end up compounding the problems
- Reduce cost and review any reliefs and assistance available from the government
- Ensure you understand your position in relation to lender's terms and those under contracts to which you are a party
- Seek advice as soon as possible in relation to your contract wording, the impact of insolvency and what it would mean
- Take advice in relation to your duties as a Director
- Take all possible steps to avoid loss to company's creditors – wrongful trading action may be suspended but there are plenty of other options available to Insolvency Practitioners

Next steps

It is imperative to discuss options at an early stage to help better understand your business' financial position. The earlier advice is sought, the more options that are available. Professionals can help you recognise the warning signs of insolvency and understand whether your situation is one that you can trade out of.

The current economic environment will inevitably result in challenges for construction and real estate firms, but those who take expert advice early will be better placed to deal with the situation and hopefully reduce the impact on their business.

Please get in touch with your local office to discuss any concerns in confidence.

CIS – Gross Payment Status – has anything changed?

HMRC did make some subtle changes to the CIS scheme from April 2021 to tackle perceived abuse and this did include a change to the penalty regime relating to the application for CIS status.

The changes expanded the scope of existing penalties to now included the liability for a penalty if someone is in a position to exercise influence or control over the person making an application, and either they:

- Encourage the making of a false statement or supply a false document; or
- Actually make a false statement or supply a false document themselves.

This includes:

- agents,
- directors,
- company secretaries, or
- anyone HMRC believes in position to exercise influence and control over making CIS registration

Therefore, to help protect the reputation and financial security of your business, your clients, and your subcontractors, you must be adhering to the rules laid down by HMRC to maintain your gross status. Even the tiniest slip up can lead to a loss of gross status which, once lost, can be extremely hard to regain.

It is also worth a reminder that for the purpose of CIS tax, construction work includes:

- Most construction activity on permanent or temporary buildings, structures, roads, bridges, or other civil engineering works
- Preparing the site, such as laying foundations and providing access works
- Demolition & dismantling
- Building
- Alterations, repairs, and decorating
- Installing heating, lighting, power, water, and ventilation systems.

A business can be both a 'Contractor' and a 'Subcontractor' at the same time and the terms can often be misunderstood. How many times do we hear a Contractor saying that they are ok for CIS as their 'Main Contractor' is fully registered. This 'Main Contractor' is actually a Subcontractor who may engage Subcontractors to whom they are then a Contractor.

Added to this is the supply of workers (subcontractors) by or through an agency, where the worker carries out construction operations under the terms of a contract they have with the agency. The agency supplying the worker will be a Subcontractor as far as the Contractor, and HMRC, is concerned. The Contractor must apply the scheme when making payment to the agency.

Therefore, even in the most basic of supply chains, the worker, recruitment agency, and payroll (CIS) provider should all be registered under CIS and manage payments compliantly to avoid devastating financial losses for all parties.

How Can You Lose Gross Status?

HMRC conducts regular checks to ensure that a subcontractor continues to qualify for gross status after their initial application. HMRC uses computer-generated reviews on a rolling programme to evaluate the compliance performance of gross-paid subcontractors over the previous 12 months.

A business might fail the scheduled review if any of the following apply:

- Any contractor returns have been late for four or more occasions
- Any one contractor return is over 28 days late
- Any PAYE or CIS payments have been late on four or more occasions
- Any one PAYE or CIS payment is more than 14 days late
- Any self-assessment payment is more than 28 days late
- Any Corporation Tax payment is more than 28 days late (or is outstanding at the date of the review)
- A P35 is still outstanding at the time of review
- Any self-assessment return (Income Tax or Corporation Tax is outstanding at the time of review)
- Any payment of £100 or more due to HMRC is outstanding at the time of review.

These rules are the same for everyone, whether you are applying for gross payment status for the first time, trying to regain it after failing an earlier test, or being reviewed as an existing gross payment subcontractor. This means that any re-applications for gross status will be unsuccessful until you can demonstrate at least 12 months of compliance.

HMRC can also cancel a contractor's gross payment status if they fail to operate the scheme correctly.

The most common error relates to Contractor's paying a Subcontractor under-deduction and not having sufficient detail and checks in place to confirm the material element that is not subject to deduction.

This is particularly an issue where the Subcontractor supplies plant or equipment i.e. scaffolding or a Digger. If this equipment is owned by the Subcontractor who does not have Gross Payment status then the cost relating to this does not qualify as materials and so that tax deduction should be made on the cost of that plant or equipment as well as labour.

If you would like further advice, please get in touch with your local office.

So, what can you do?

1. Make sure all those who need to know in your business have access to the up-to-date guidance and training.
2. Provide simple policy and process documentation
3. Engage a third-party professional advisor skilled in the workings of CIS to undertake a review of your CIS compliance, usually every 3 years

House price growth

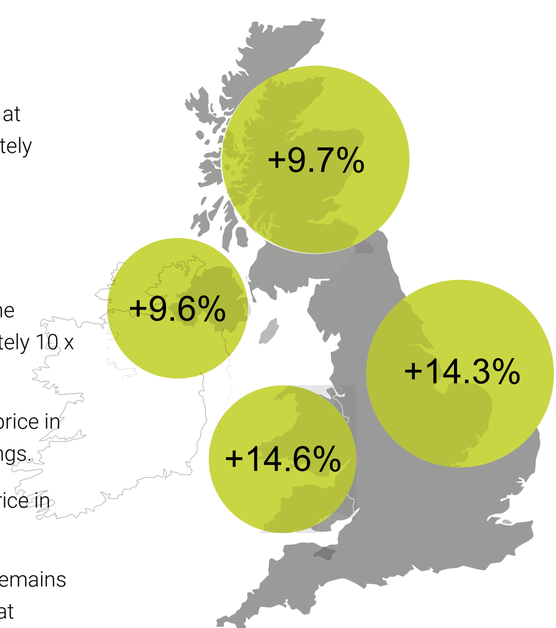
The latest house price data was published in October 2022 by HM Land Registry on GOV.UK which provides data up to August 2022. It reveals that average house prices in the UK increased by 13.6% over the year to August 22, down from 16% in the year to July 22. The average price of a house now stands at £316k in England, £220k in Wales, £195k in Scotland and £169k in Northern Ireland.

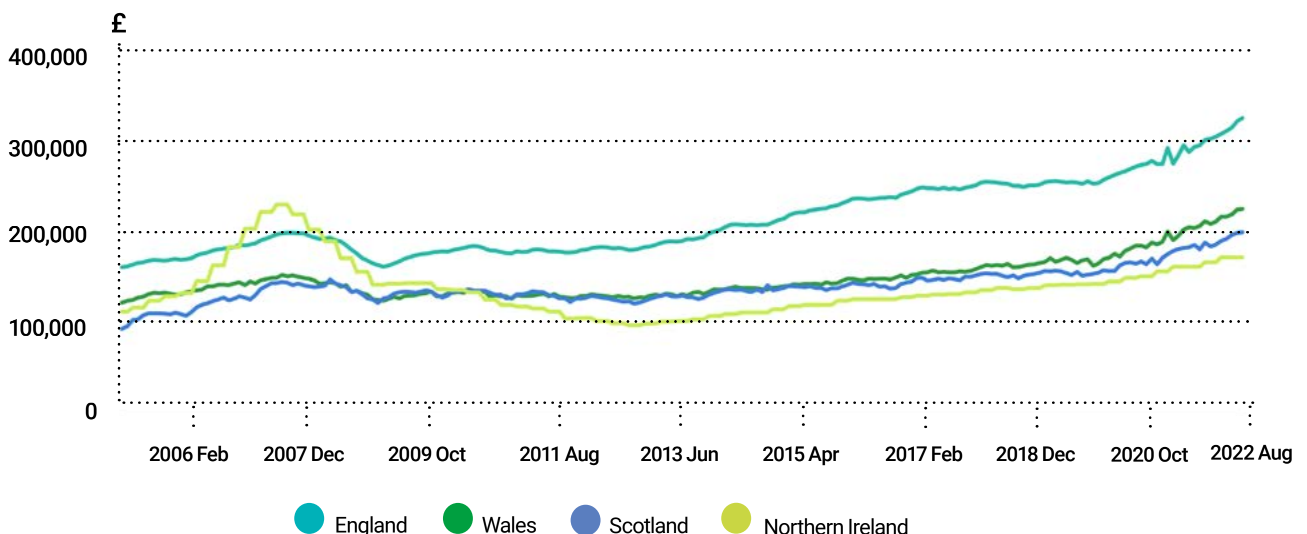
Monthly house prices changes across the UK and Ireland

The UK average house price was £296,000 in August; which is £36,000 higher than at the same point last year and is currently over 9 x the UK average salary (approximately £31,447 p.a. for someone working full time).

England house prices remain the highest in the UK

- House prices in England increased by 14.3% over the year to August 2022, with the average house price in England now at a record level of £316,000 and approximately 10 x average UK earnings.
- Wales increased by 14.6% over the year to August 2022, with the average house price in Wales now at a record level of £220,000 and approximately 7 x average UK earnings.
- Scotland increased by 9.7% over the year to August 22, with the average house price in Scotland now at a record level of £195,000 and 6.2 x average UK earnings.
- Northern Ireland increased by 9.6% over the year to August 22. Northern Ireland remains the cheapest UK country to purchase a property in, with the average house price at £169,000 and approximately 5.4 x average UK earnings.





The latter half of 2020 saw the UK's average house price growth accelerating, with the trend continuing into 2021, fuelled largely by a stamp duty holiday introduced in the summer of 2020. The tax break continued through to March 2021 in Scotland, June 2021 in Wales and October 2021 in England and Northern Ireland to help mitigate against the effect of the pandemic on the housing market and house price growth has remained strong since the start of 2022.

UK house prices experienced sharp, temporary rises in March 2021, June 2021 and September 2021. This corresponded with each of the original and extended end dates of the Stamp Duty holiday's. The final Stamp Duty holiday extension applied to England and concluded in September 2021. It is likely that average house prices were slightly inflated during these months as buyers rushed to complete their house purchases ahead of the Stamp Duty holiday deadlines. Trends have been more stable in 2022.

The provisional seasonally adjusted estimate of UK residential transactions in August 2022 was 104,980, which is 7.6% higher than August 2021 and 1.1% higher than July 2022.

Regional variation

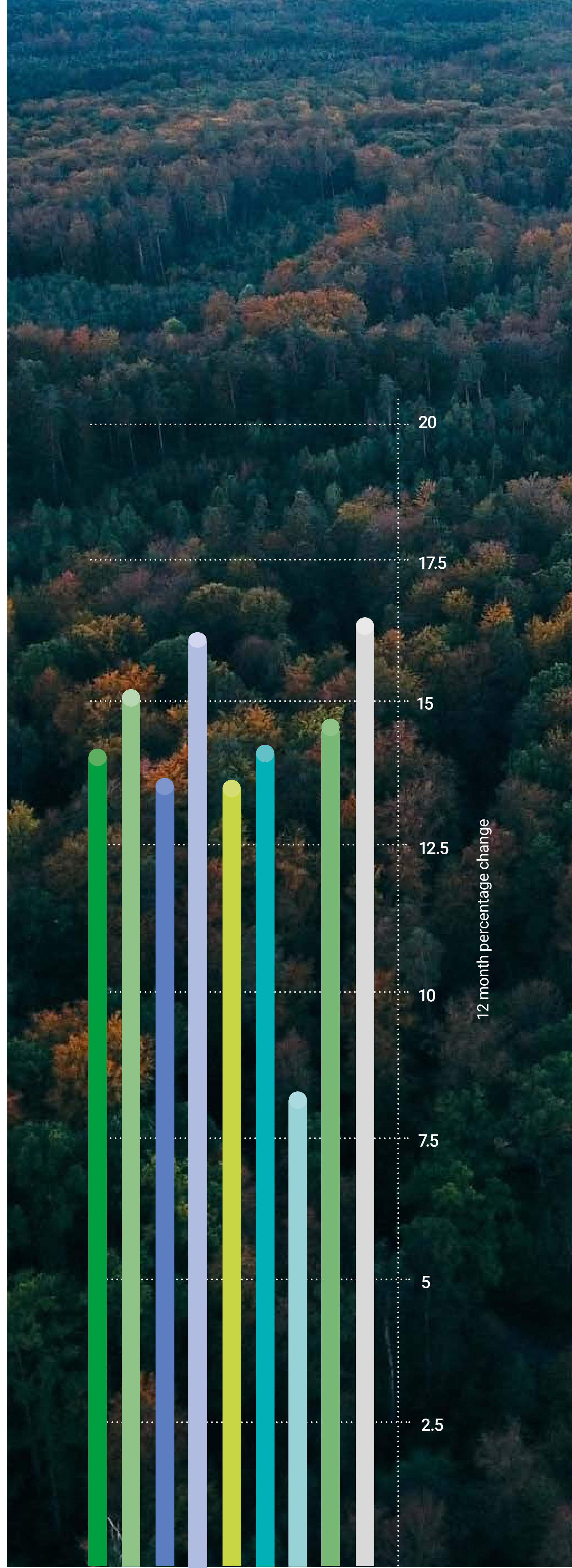
The South West was the region with the highest annual house price growth, with average prices increasing by 17.0% in the year to August 2022. This was down from a growth rate of 21.1% in July 2022.

The lowest annual house price growth was in London, where average prices increased by 8.3% over the year to August 2022, down from 10.1% in July 2022.

Despite having the lowest annual house price growth rate, London's average house prices remain the most expensive of any region in the UK, with a record average price of £553,000 in August 2022.

The North East continued to have the lowest average house price at £164,000 in August 2022, which is a record high for the region.

North East
North West
Yorkshire and the Humber
East Midlands
West Midlands
East
London
South East
South West



News bites

Benefit reform for low-income mortgage-holders

Support for Mortgage Interest (SMI) is a lifeline for mortgage holders who have lost their job. Available to those in receipt of certain benefits for at least 9 months, SMI is a repayable loan that supports people to pay the interest on their mortgage up to £200k. Currently the interest rate used to calculate the benefit is 2.09%, with a repayment rate of 1.4% on sale or transfer of ownership. The Resolution Foundation have urged the government to reform the benefit to extend help to low-income workers.

SMEs to see threshold extended to reduce red tape

Firms with up to 249 employees are considered to be SMEs and are exempt from certain financial reporting regulations. The Government are considering plans to extend the threshold to businesses with up to 500 employees as part of a package of moves designed to cut red tape and help stimulate growth.

Two million homeowners face sharp rise in mortgage payments

According to the trade body, UK Finance nearly 2 million homeowners will be facing a sharp rise in their mortgage payments as they come to the end of their fixed rate deal over the next 12 months, many of which took advantage of the last Stamp Duty holiday.

After more than 500 mortgage deals were pulled in the aftermath of the mini budget and rising interest rates, banks have started to relaunch their mortgage ranges. However, typical fixed rate deals for two years have now surpassed 5%, for the first time since November 2009, according to Moneyfacts.co.uk. Average rates for two year deals are also now typically more expensive than a five-year fixed rate.

New Homes Quality Board (NHQB)

The New Homes Quality Board (NHQB) has been launched to enforce a new code of practice , offering better protection and increased transparency for homeowners. The watchdog will compel developers to provide more information to buyers before a sale, ensure homeowners get what they saw in the original plans and stamp out high-pressure selling tactics. If a buyer takes a complaint to the ombudsman that succeeds, they can be awarded up to £75,000 in compensation. More than 100 developers have already registered with the board and agreed to its framework.

A Buyer's Market

A report by Zoopla indicates a return to more of a buyers' market following two years of a market favouring sellers. According to their research, 6% of homes listed for sale have seen the asking price adjusted downwards by 5% or more, the highest level since before the pandemic. The property platform stated in the report that they do not believe that this is a precursor for big price falls but an indication that the rate of price growth will start to slow more rapidly in Q4 and into 2023 as buyers react to the rising cost of borrowing.

Features 'most attractive' in a home according to buyers

Tapi, a carpet and flooring company, has shared results from their study on features that add the most value to a property. 54% of respondents claimed they would increase their offer on a home with a good garden, 50% said a nice kitchen, 44% said good parking or garage space, 36% said a nice bathroom and 29% said natural light. A further 26% said they would increase their offer on a home with double or triple glazed windows. Flooring is also important to buyers with 20% of respondents claiming they would increase their offer on a home with carpets or flooring that didn't need replacing.

Hertfordshire to get a new town?

Plans to build a new town in Hertfordshire have been submitted by developers Sovereign Centros and Peveril Securities, who hope to have the town built by 2025. The £500m scheme is earmarked for a site near Cheshunt, where the M11 and M25 motorways meet. The development will include both residential and commercial property with around 250 homes, offices, civic buildings, shops, bars, restaurants and a cinema and hotel. The new town centre is intended to support Brookfield Garden Village, a separate nearby scheme building 1,250 homes after Sunset film studios were granted planning approval.

Current mortgage rates mean housing is at its 'least affordable' since records began

Analysis by Leeds Building Society suggests mortgage affordability is at its lowest level since ONS records began in 1999. Today's average mortgage rates of 6.43% is equivalent to a rate of 25.7% in 1980.

In 1980 the average UK house cost £21k, with mortgage costs accounting for 11.3% of disposable income. Today, the average house price is £292k, with mortgage costs accounting for over 45% of disposable income.

With the average home costing 9.1 times the average local wage, compared to 3.5 in 1997 (Source ONS), home ownership among 25-34 year olds have collapsed over the last 30 years from around 65% in 1996, to just 27% in 2016.

Relief on energy prices

For domestic customers, the governments support package to address soaring energy prices will see the price charged per unit of gas or electricity capped at £2,500 at least until April 2023. This is in addition to the previously announced £400 energy bill discount and at the same time, green levies costing £150 will be temporarily removed. There will be a Treasury led review to consider how to support those most in need after April 2023.

The Government have confirmed that energy bills for UK businesses and public sector bodies, such as schools will also receive assistance with energy bills being cut by around half their expected level for six months under a support package expected to cost up to £150bn. Companies that agreed fixed deals at higher prices on or after 1 April as well as those on variable and flexible tariffs will also be eligible. After this period support is likely to be focused on those industries deemed vulnerable.

Landlords selling up

Rising costs, regulatory burdens, tax changes, rising interest rates and diminishing profits have all led to an increasing number of landlords fleeing the market. While competition for tenancies is still strong, data issued by Hamptons suggests that the average higher-rate tax paying landlord, re-mortgaging last month could expect their annual net profit to decline by 72% compared to the same point last year due to rising rates. Any further rate increase is likely to see their investment potentially unprofitable in the near future and without much in the way of capital appreciation to offset any loss.

With a sluggish property market and less availability of buy-to-let mortgages, many have resorted to auction houses in the hope of a quick sale.

Waiting list for student accommodation

A record number of university places accepted this year along with an acute shortage of suitable accommodation has meant demand has far outstripped supply. Finding student accommodation is often a struggle, especially for those who go through clearing, but the issue appears to be particularly bad in Bristol, Manchester, Glasgow and Edinburgh where some students were allocated accommodation over an hour away from campus. The issue of oversubscription needs to be addressed and better communication between the government, universities and the private rental sector could open opportunities for investment and a review of legislation and incentives for PBSA (Purpose built student accommodation) and HMO (houses in multiple occupation) to help match the growing demand year on year.

'Extreme energy prices' causes successive hikes in Steel

British Steel imposed a further £150 a tonne rise in structural section prices with immediate effect in September, just three weeks after it was raised by £100 a tonne in August, due to "extreme energy prices". Since then, the government has introduced support to reduce energy prices for businesses.

These increases come after the record £250 a tonne rise in March, after which commodity prices appeared to stabilise. Now, the Chinese firm Jingye, which owns British Steel have asked the UK government for a £500m cash injection to ensure a more viable future for the business. These increases are having a knock on effect on contractors, who are seeing significant increases in prices throughout the supply chain.

Landlords may be left out in the cold with possible rent freeze

Emergency legislation to impose a rent freeze and a ban on evictions for public and private rented properties in Scotland has been announced by Nicola Sturgeon in efforts to help tenants with the cost-of-living crisis. The cap has initially been set at 0% until at least March 2023. At the same time, the Department for Levelling Up, Housing and Communities has launched a consultation on a possible cap of between 3% - 7% for social housing tenants in England from April 2023, with the potential to keep the cap until 2025. The Government is understood to be "engaging fully" with social housing landlords on the impact of the cap, but it has led to fears more properties will be withdrawn from the market.

Remediation work on cladding & other unsafe materials

Developers slow to undertake remediation work to fix dangerous cladding and other unsafe materials will be barred from obtaining planning permission and building on their existing planning permission, under regulations in the Building Safety Act which came into force on 1 September (sections 126-129). Developers that refuse to comply with the rules will also face difficulty getting building control signed off.

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106

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19

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