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Publications —— Winter 2018/19

Quarterly Housing Update

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Foreword

This issue of Trowers & Hamlins' Quarterly Housing Update includes articles on two of the defining themes of housing as we enter 2019 - how the lifting of the Housing Revenue Account debt cap can release the financial capacity of local authorities to deliver new affordable housing, and how the health and housing sectors are capable of converging and how housing associations can access NHS capital funding as part of their work in that space.

Looking to housing delivery more generally as we enter the new year, there are clearly conflicting signals. Certainly in London and the South East there are indications that the housing market may be cooling (I won't mention the B word….) which will undoubtedly impact on supply, but at the same time, there is absolutely no slowing down in the interest of institutional investors to deploy very significant sums in both affordable and market rental housing.

So it seems to me that the answer to addressing housing delivery is for the industry to re-think supply and to look beyond sales as the primary outlet. Not only was diversity of tenure a key theme of the Letwin review but it is something that we are starting to see being put into practice in the projects we are working on. We can expect to see more partnership deals involving housebuilders and institutional investors and that this will increasingly cross into the housing association and local authority sector.

Closer to home, I am proud to report that Trowers & Hamlins has secured 83rd place in the Stonewall Workplace Equality Index 2019 and is now a part of Stonewall's top 100 employers list. We champion the importance of diversity and we believe individuals should be able to be themselves at work- and it is fabulous to see us sit alongside many of our housing association, ALMO and local authority clients in the Stonewall top 100. This result is testament to the success of what we are doing and a great way for us to start 2019.

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What's the alternative to design and build?

The design and build procurement route remains ubiquitous for the construction of affordable housing in the United Kingdom. This is despite repeated calls for the construction industry to re-think its adherence to traditional procurement methods and its "deep-seated cultural resistance to change". Following the collapse of Carillion and the publication of the Hackitt Review, some housing associations and private developers are now exploring alternatives to the design and build route and revaluating the habit of passing all risk to a single contractor.

To recap, design and build is a procurement route where one contractor is appointed by a client (known as the employer) as the single point of design and construction responsibility for the works. The extent of the contractor's responsibility will be determined by the standard form contract used and the bespoke amendments to that contract.

The benefits of design and build are clear from an employer's point of view; most design and build contracts offer a fixed price lump sum contract where the contractor takes all (or the majority) of the risk for the design and construction of the works. The contractor, it is assumed, can add value to the project by "owning" the design, adding to its buildability and reducing the construction programme.

But not everything about design and build is positive. Following the collapse of Carillion in January last year, the principle of a single point of design and construction responsibility has lost its shine. Those with completed projects which had Carillion as its design and build contract will find it more difficult to bring claims for defective design and/or construction.

The Hackitt Review, the Government's independent review of building regulations and fire safety, has also criticised design and build contracts which result in "uncontrolled, undocumented and poorly designed changes being made to the original design intent". Concerns were also raised that design and build procurement incentivises a "race to the bottom" where risk is pushed by the contractor down the supply chain.

So what are the alternatives to the design and build procurement route? Below we set out some of the other procurement routes available:

Traditional

Under the traditional procurement route, design and construction are separate activities undertaken by the professional team and the contractor respectively. The employer appoints the professional team to design the works in detail. Once the designs are completed, the employer appoints the contractor, following a competitive tender, for the construction of the designed works. The contractor is not responsible for the works (although some forms of contract do allow the contractor to be responsible for certain elements of the works).

The traditional procurement route gives employers certainty in relation to design quality and cost as most traditional construction contracts are fixed price lump sum. Examples of traditional contracts include the JCT Standard Building Contract and the JCT Intermediate Building Contract.

Construction management

Construction management is a procurement route where the works are constructed by a number of different trade contractors appointed by the employer. The employer also appoints a construction manager who manages those trade contractors. As with the traditional procurement route, the employer appoints the professional team to design the works in detail; the construction manager is also appointed at this stage, effectively as a consultant appointed by the employer, to improve efficiency and buildability and to advise on trade contract packages.

As the employer appoints and administers each of the trade contracts, the employer takes greater construction risk than the traditional or design and build routes. In addition, this sometimes leads to price uncertainty where detailed designs for the whole of the works have not been completed prior to the first packages being let. An example of a construction management contract is the JCT Construction Management Appointment and JCT Construction Management Trade Contract.

Management contracting

Under the management contracting procurement route, the management contractor manages the execution of the works through works contractors. As with construction management, the employer appoints the professional team but, in contract to construction management, the management contractor appoints the works contractors and is responsible for administering the works contracts. The management contractor, however, is not liable for any default by a works contractor and there is no single point of construction responsibility. This allows the employer to retain control of the design of the works and to engage an experienced management contractor.

Management contracting also does not provide cost certainty; the JCT Management Building Contract, for example, is a prime cost contract (plus the management contractor's fee). In recent months, there has been an increase in management contracting, mainly in relation to cladding works where employers want to engage experienced contractors to manage the works but such contractors do not want to take the risk for the works themselves.

Partnering/Alliancing

Unlike the other procurement methods outlined, partnering or alliancing intentionally moves away from an adversarial approach to construction. The employer, professional team, main contractor and specialist sub-contractors all enter into a partnering contract on the same terms, creating a contractual "hub" which aligns contractual processes throughout the project's lifetime.

While partnering can be used for a single project (known as project partnering), greater benefits are usually achieved through long-term strategic partnering. Examples of partnering/alliancing contracts include the PPC2000, the FAC-1 and the NEC 4 Alliance Contract.

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Removing the Housing Revenue Account debt cap

Readers of QHU, and not just those concerned with council housing, will be aware of the recent removal of the Housing Revenue Account (HRA) debt cap. This attracted a lot of attention, not least because it was unexpected.

We published an article here a year ago about a £1bn programme based on a partial relaxation of the housing borrowing limits. We little realised that within 12 months or so the debt cap would be removed completely for all local authorities.

And that is the point. For once, there are no strings attached. The Limits on Indebtedness (Revocation) Determination 2018, issued at the end of October last, does what it says in the title and it really is as simple a measure as the civil servants could achieve.

In other words, local housing authorities are no longer required to keep their debt within pre-determined limits, derived from the self-financing settlement in 2012.

This is a radical change. When local authorities with housing stock left the HRA subsidy system in 2012 it was on terms acceptable by the Treasury, which wanted to ensure that for the sake of public sector borrowing controls there were limits on the amount of housing debt local authorities could hold. Clearly, the Prime Minister's desire to encourage local authorities to build more homes meant that the Ministry of Housing, Communities and Local Government was able to persuade Treasury that the loss of these borrowing controls was a price worth paying.

The immediate question is what use local authorities will make of this new freedom? The Government is hoping that the result will be a significant boost to housing supply; and certainly the signs are encouraging. Local authorities have been vying with one another to announce substantial programmes of new homes. The scale may still be modest by comparison with the commercial house-builders and the larger housing associations, and long-lost development skills will need to be sourced; but local authorities are now real "players".

Local authorities may also use their new borrowing power to increase their stock numbers in other ways. Local authorities could look at expanding their acquisition programmes, whether 'off the shelf' new build units or ex-Right to Buy properties. They may even decide to acquire portfolios of properties, perhaps from housing associations looking to rationalise their scattered holdings.

In assessing these and other opportunities, local authorities will appreciate that though the Government has removed all the debt cap constraints, this does not mean that there are no constraints at all. The removal of the debt cap merely provides scope to borrow and a decision to borrow needs to take account of the advice of the so-called Section 151 officer, who must assess whether his or her local authorities can afford to take on the debt; and key to that decision will be the availability of surplus income to service the loan. Low-interest loans are available from the Public Works Loan Board but they still need to be repaid. Any debt is a direct burden on the HRA and an indirect one on local authority finances as a whole.

Local authorities will also be aware that the basic HRA rules have not changed. The HRA remains a ring-fenced account, which means that it must neither be subsidised by, nor subsidise, other local authority finances (called the General Fund). Complex rules apply to the appropriation of land from the General Fund into the HRA (although an interesting change to these rules is in prospect) and there are also specific rules attaching to the disposal of HRA property, requiring either general or specific consent from the Secretary of State. Sale proceeds, whether from the Right to Buy or otherwise, are also the subject-matter of regulations, guidance and so-called retention agreements (which are also likely to be revised).

Then there are rules which apply to council housing, whether within the HRA or not. Local authorities can only issue secure tenancies, conferring the Right to Buy; and there is to be a new rent standard, applicable to local authorities as well as housing associations. Some of the 'corporate' concerns that local authorities had – higher value voids and fixed term tenancies – have gone away; but regulatory pressures will increase and align local housing authorities more closely to private registered providers.

And beyond these rules, local authorities will need to allay tenants' concerns about using the new capacity to increase supply rather than improve existing homes, particularly to deliver an enhanced decent homes standard.

The removal of the HRA debt cap is indeed significant: it is the most radical (and positive) change since 2012; and we expect to see a good deal of new build and other activity arising from it. It does however bring into focus how both existing and new rules apply to the HRA and to council housing. Local authorities and those doing 'business' with them will need to familiarise themselves with those rules and, as in the past, form a judgement about whether it is best to work within the HRA or outside it.

The latest version of our Unofficial HRA Manual, reflecting the debt cap and other changes, is now available. If readers have not had a copy, please contact us.

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A tangled web?

Leasehold ownership structures have become more common, especially in the supported housing field. Why? And is this a good thing?

Traditionally (and very generally), if a housing association wanted to acquire housing, it bought the freehold. It might buy newly-completed stock from a developer, or it might buy land and develop itself. (Or, in the case of flats, it might take under very long leases for individual flats.) But freehold was what you wanted. Everyone understands it, it is safe, it is secure and it is simple.

There has been a trend over recent years, however, of housing associations taking shorter leases of dwellings, particularly in supported housing. Why?

Actually, let's pause for a second. Before we get into the whys and wherefores, let's take a moment to look at the way a typical transaction of this type might be set up.

Under a typical lease structure the housing association becomes the funder's tenant, entering leases generally of something like ten or fifteen year terms. Sometimes, a second "reversionary" lease is granted at the same time, but to come into effect only on expiry of the first. This gives a longer overall term, while preventing the housing association from exercising statutory enfranchisement rights and buying the freehold.

The housing association pays a rent, which will typically be indexed, and then lets to tenants in the usual way.

Why do things this way?

There can be sound reasons to adopt this structure:

- It is a quick and easy way to acquire new stock. Leasing property means you do not need a lump of capital up front, just the ability to meet the rent payments.
- Although owning freehold property is simple, it brings with it all the incidents of ownership. You are responsible for everything. A housing association tenant under a shorter term lease may have lesser repairing obligations and so on. This can be an advantage to a smaller housing association, or one moving into a new geographical area.
- It is an easy way to get access to funding. There are a variety of new funders in the market, offering this model. Especially for smaller housing associations, it might feel easier than more traditional routes to funding, such as charging. And the newer funders are perceived to be a bit lighter on their feet, too.
- Having part of your portfolio based on an index linked rent can be part of a considered treasury strategy.

What's the downside?

You will be aware that the Social Housing Regulator expressed concern about the potential implications of this model for some of the housing associations that pursue it. These concerns have been well publicised since the beginning of 2018, particularly in the context of the rapidly expanding specialist supported housing sector.

So then, there are clearly several risks to the model which need to be understood and which can include:

- The rent risk is the housing association's. The rent under the lease to the funder falls due every month, and increases with inflation every year. This is, therefore, a risk if dwellings become void, which can be for reasons completely outside the housing association's control. What if there are housing benefit delays? Similarly, housing association tenants' rents are subject to a large extent to government policy. The sector thought it had a long term rent settlement, until Government announced an unexpected cut. There may be parallel rent support agreements or similar, but these are all risks that need to be considered by an housing association.
- Closely tied to the first point, is the inflation risk. What if an economic shock prompts a spike in inflation? If that were to happen, can you be confident that housing benefit levels would increase correspondingly? Probably not; in fact, quite the opposite. You could be stuck with rents under the lease increasing substantially each year, with rents you can charge tenants flat or falling. Equally, are you confident the benefit arrangement will match the duration of your new obligations?
- These transactions are more complicated than a small housing association looking to grow may be used to doing. It is vital officers and board have a full, clear picture of what they're signing up to, and important to take professional advice early and throughout. In particular, it is clearly really important to appraise the various risks in the model.
- The skills to manage a transaction like this, and then the stock under it, are different. The housing association may not have all of the burdens of freehold ownership, but this can mean the various landlord responsibilities are spread across two or more parties. It is more important than ever that you are clear where responsibility lies for things like fire safety.

So – good thing or bad thing?

Ultimately, and like any other legal structure, it is not inherently right or wrong. There are certainly advantages and drawbacks. As long as the groundwork is done, the risks understood, and prudent steps taken to minimise them, this can be a good way to acquire stock relatively cheaply and quickly. But it is also a model to which the Regulator is paying very close attention. The long term success of the model will depend on well advised housing associations who understand (and can manage) the risks inherited in the model, and the evolution of the lease structure that better allocates rent risk between the funder and housing associations.

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Do you know your grant agreements?

Social Housing Grant has been accessible to RPs in one form or another since the introduction of the Housing Act 1974 and the broad rules attached to such grant are well known to them. Where RPs are looking to develop with NHS grant, it is important to understand the key differences between the two.

Since the mid-70s, the provision of social housing grant has evolved and adapted to fit changing political and economic environments. Its purpose, however, has largely stayed true; to help increase the rate of delivery of affordable housing and encourage ongoing use of dwellings as affordable once built.

Social Housing Grant comes with its own set of rules governing payment, transfer and importantly, repayment. RPs will be aware that once grant has been provided for the delivery of an affordable unit, the grant amount is "tagged" to that unit until a recovery event occurs, triggering grant repayment or recycling.

The recovery of grant is usually documented contractually in the grant agreements issued by the grant giving agencies. Statute offers Homes England and the GLA legislative backing to their recovery powers, identifying through the Recovery Determinations the specific circumstances (known as "relevant events") in which grant recycling or repayment will be required. Statute also operates to protect grant "tagged" in dwellings when those homes transfer to a third party. The underlying purpose of each "relevant event" (which focuses on restricting disposals, usage and monitoring solvency) is to ensure that the grant to be used for the purposes for which it was given (e.g. the provision of social housing).

The determination does however allow units to be transferred between RPs (with the grant giver's consent), without triggering repayment, and in such cases the grant liability "skips" to the new landlord. If the RPs does intend to change the use, sell a property out of sector, or staircase beyond the initial tranche on a shared ownership lease, grant will need to be repaid. Where grant is within the hands of a for-profit RPs or a private developer, an uplift on that grant would also be due.

In our experience, this has given rise to issues when looking at different sources of grant funding, in particular NHS Capital Grants. There is renewed focus on these, with the NHS England Transforming Care programme still underway and with much still to deliver.

NHS England's National Housing Lead is setting up a series of clinics (the first ones running in the Midlands and East, with more to follow across the rest of the country) to discuss NHS England's Transforming Care capital funding for 2019-21. These events are intended to allow an opportunity for you to come along to talk about your ideas for developing community accommodation and support in your area. They are a chance for you to talk to your Transforming Care Housing Lead and Local Government Advisor about your planned project(s) and to gain information about how the capital programme works and how it may support your projects. Please let us know if you would like to be put in touch with the Transforming Care team.

We have written before about the availability of NHS capital money to grant assist supported living and other similar schemes. NHS England's "new" grant package has been up and running for about three years now but there are still difficulties, stemming in part from use of different language and in part from a failure to understand each other's drivers and priorities.

The critical test is that the use of NHS capital in this way must be more effective than spending the same money on NHS care. In practice, there are many excellent examples of better outcomes for individuals, as well as financial savings, from people moving to community settings rather than being inappropriately kept as inpatients and that is, of course, what the Transforming Care programme exists to deliver.

The application process kicks off with a PID (project initiation document) and follows NHS England's standard capital projects approvals process. It is vital, therefore, to make the case as to how the project will improve the outcome for the affected individuals, as well as looking at ongoing revenue costs and any revenue or capital released by the change in setting.

Sometimes the application may be for funds to improve an existing property – and those improvements might not lead to an increase in property value. That does not matter to the NHS; the key point is that the scheme cannot continue/cannot accommodate new or continuing or additional residents without the outlay.

The biggest difference that RPs need to understand is that the NHS grant is an equity stake in the property (secured by a legal charge), meaning it shifts with the value of a property even if such value goes down, unlike housing grant which is fixed (excluding the addition of uplift) and does not require a charge over the property. When the scheme ceases to operate, a repayment of the proportion of the open market value of the property that is attributable to the expenditure of the NHS capital grant must be made. In order to simplify this, the new NHS capital grant agreement provides for the initial contributions of the parties to be set out as percentages and there is a mechanism to recognise any future housing providers improvements (as opposed to routine maintenance) by revising the percentages accordingly.

With a well thought out business case and a clear understanding of the NHS "red lines", it is possible to get swift agreement to grant funded schemes. Where there are misunderstandings of the parties' positions, however, matters can drag on until the scheme itself is in jeopardy.

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Oh, what a (SDLT) relief…

Sometimes, tax is just taxing. And at other times, tax is just plain crazily complicated. Take SDLT[1] (I know, you would rather not); it is now more complex than ever with a myriad of different rates, a 3% surcharge, confusion over what is "residential property" and a wide spectrum of reliefs. So let's focus on reliefs for now and if you're a housing provider of whatever ilk, what SDLT reliefs should be on your radar?

Registered Providers (Private RPs/ housing associations)

Charities relief is the obvious one here, where the charitable RP is buying land 'for qualifying charitable purposes'. The problem, however, is where there is an element of land will be used for private sale (or other non-charitable use), even if it cross-subsidises the affordable/charitable element of a scheme (sorry, I don't make the rules). The RP may get the charities relief upfront but suffer a clawback later, or no relief at all depending on the value of the private element.

If the purchase is 'funded with the assistance of public subsidy' (basically section 18, section 126 or section 19 grant), then RP public subsidy relief may be the better relief to claim. This is provided that the grant is used to purchase the land, and there is no questioning the use of the land and no clawback.

Another useful relief, which is often ignored, is 'Qualifying Vendor' relief. This is available where a non-profit RP acquires land from a 'qualifying vendor' – more generally, a local authority or another non-profit RP. This is the top trumps of the RP reliefs, albeit limited to narrow but common circumstances of a RP acquiring land from a council: no clawback, no questioning how much grant has to be allocated to 'fund' the purchase and no debate as to when grant is to be treated as allocated to a particular purchase.

So what about for-profit RPs? Simply put, you are only going to get the RP public subsidy relief (provided you're purchasing with some or all of the relevant grant of course!). But all is not lost, as some of the non-RP focussed reliefs, which are mentioned below, may apply.

Investors/funds/REITs

Where an investor purchases residential portfolios (i.e more than one dwelling), the main relief to consider will be multiple dwellings relief (MDR). The relief operates by calculating the SDLT for one dwelling, based on the average consideration, that is, the total consideration attributable to all of the dwellings divided by the number of dwellings. The resulting SDLT charge (expect the higher 3%+ rates to apply) for that one dwelling is then multiplied by the total number of dwellings to arrive at the total SDLT cost. In this way (and depending on the number of units and the total consideration), one would expect less of the consideration to be taxed at the higher SDLT residential rates. There are conditions to be met (of course there are!) such as the dwellings not being subject to leases with an initial term in excess of 21 years and the relief can be clawed back, for example, if the number of units decreases in the following three years.

It is also worth remembering the 'six or more' rule. Whilst not a relief as such, if 6 or more dwellings are acquired as part of the same transaction, then the non-residential rates of SDLT will apply. So which to go for: residential rates with MDR or non-residential rates with no MDR? This is where things can get complicated and you just have to crunch the numbers. And if any of the units have an individual value in excess of £500,000, then things get even more complicated with apportionments and a flat rate of 15% potentially applying to such units.

[1] SDLT only applies to land and buildings situated in England and Northern Ireland with the relatively new Land Transaction Tax (LTT) applying to land and buildings in Wales and the Land and Buildings Transaction Tax (LBTT) applying in Scotland. Most, if not all, of the reliefs described appear in a similar format (but occasionally with some slight differences) in the LTT and LBTT codes.

Local authorities

There are a number of obscure reliefs available to local authorities which apply when a local authority acquires land by way of a CPO (CPO relief) and also when a local authority acquires a land interest (not necessarily limited to housing) pursuant to a planning obligation which is enforceable against the vendor (generally, pursuant to a s.106 agreement).

The 'planning obligation' relief can be useful to local authorities in minimising tax costs where they are to acquire land or rights over land (such as nomination rights) as part of a large regeneration project for which the local authority is granting planning permission i.e. include the obligation to transfer the land or grant rights within the s.106 agreement.

Given the increasing tendency of local authorities looking to exploit their land assets, for example via subsidiary companies and strategic partnerships, SDLT group relief will be relevant where land is transferred from one group company to another. Here, a local authority is treated as a company so that the relief is in theory available in respect of land being transferred from the local authority to a wholly owned subsidiary.

SDLT group relief is not limited to local authorities: it is generally available in respect of transfers of land between companies within a SDLT group. Companies are part of an SDLT group if one is the 75% subsidiary of the other company or both companies are 75% subsidiaries of a third company. The 75% test relates to the holding of at least 75% of the ordinary share capital and the economic value in the company. So if you have a company limited by guarantee in the corporate structure, this can break the SDLT group.

The availability or otherwise of SDLT group relief can be of particular importance since if the relief proves not to be available or is clawed back (yes, there is clawback, if, for example, the purchaser company leaves the group with the land in question within 3 years of the purchase) then SDLT will be charged by reference to not less than the market value of the land at the time of acquisition by the group company. So transferring land assets between group companies for nominal value of say, £1 does not necessarily mean there is no SDLT liability.

Where land may be contributed to a partnership by a local authority (or any other land owner), such as a limited liability partnership (LLP) of which the local authority (land owner) is a member, then the SDLT partnership rules could apply to mitigate the SDLT cost arising to the LLP. This is not a relief as such and the SDLT partnership rules are notoriously complex but can work in favour of reducing SDLT costs.

Private developers/housebuilders

There is a specific relief aimed at property developers/house builders that part exchange dwellings with the vendor. However, of more significance will be SDLT subsale relief where the developer flips on land (or a part of it) that it has contracted to acquire.

Here, the developer would want to make sure it doesn't pick up a SDLT cost on the land it does not hold on to. This relief was heavily abused in the past (according to HMRC at least) and the rules were changed in 2013 so that we now have the concept of pre-completion transactions. Safe to say, in a straightforward 'standard' subsale where A contracts to sell to B and B contracts to sell to C then provided the B-C contract completes at the same time as the A-B contract and party B has not 'substantially performed' the A-B contract beforehand, then B should be able to claim subsale relief. The rules differ depending on whether the subsale is effected by way of contract assignment, a true subsale or a novation, and as ever, the devil will be in the detail of both the SDLT rules, what the contracts say and what the parties have done, if anything, in relation to the land in question (such as inadvertently taking possession or having access ahead of completion).

Sale and leaseback relief is generally available to all taxpayers, not just developers and will be available to relieve SDLT costs on the leaseback element. For the relief to apply, the only other consideration for the sale must be cash and/or the assumption of debt. Without the relief, there is a risk that the developer would suffer an SDLT cost based on the market value of the lease. This is because the sale and leaseback will be treated as a land exchange for SDLT purposes so that market value will be imposed if such value is higher than the actual value paid or given for the land transaction.

The reliefs mentioned above are not exhaustive and the availability of a particular relief or exemption under the SDLT code will ultimately be specific to the facts, the parties and the transaction in question. The SDLT costs of a particular transaction and whether a relief is available should be thought through in advance of exchange and not left to the last minute. Any available relief will generally need to be claimed by the purchaser in the SDLT return to be submitted to HMRC. So, it is important to remember that as from 1 March 2019, the filing period for SDLT returns is being reduced to 14 days. So be prepared to be pestered by your conveyancers and solicitors to sign off the SDLT returns sooner rather than later, whether or not a relief is being claimed. You have been warned.

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Managing incumbent contractors in procurement

Landlords often struggle to deal with incumbent contractors when running public procurement exercises. Here are some tips on how to manage your incumbents without jeopardising the reprocurement or the new contract.

Check the terms of existing contracts: Make sure that you understand when your current contract will expire, if and how it can be terminated, so you can structure your reprocurement timetable to be in contract by the time your current contract comes to an end. If there is going to be a gap between the expiry of the current contract and the start of the new one, check whether you are able to extend the current contract, and ensure that any contract extension is properly documented.

Terminating existing contracts: Ensure that you follow any termination provisions to the letter and serve any termination notices correctly on the contractor. A failure to terminate a contract properly may prompt a damages claim from your contractor for repudiatory breach (ie.. that you are acting in a way that suggests you no longer wish to be bound by the contract terms). Check if there any consequences to early termination of the contract, such as a requirement to compensate the contractor for their anticipated lost profit?

Applying in-house knowledge: Can clients apply their knowledge about an incumbent bidder's performance when assessing their bid at pre-qualification or tender stage? The Public Contracts Regulations 2015 are silent on this point, but academic opinion suggests that clients should be able to use any knowledge at their disposal, provided that it is applied in a fair and proportionate way. So if you've experienced performance issues not reflected in their selection questionnaire or tender response, this discrepancy can be raised with the incumbent in the clarification process.

Get necessary information: Incumbent contractors often hold key information about the contract, such as updated stock conditions lists, performance data and lists of outstanding works, as well as employee information relevant in the event of a TUPE transfer. Check you can retrieve this from contractors, so it is available to bidders in good time for the reprocurement exercise.

Assessing incumbent bidders: Where an incumbent contract bids in the reprocurement of the same contract, there is a concern that the incumbent will have an unfair advantage, which might conflict with legal obligations to treat bidders fairly and without discrimination. A pre-qualification stage focusing on bidders' past performance on other contracts may be seen as an "easy win" for the incumbent, who will have more detailed knowledge than other bidders. Level the playing field by asking bidders about past experience on a number of contracts, and ask a range of questions (e.g. examining bidders' health and safety records, relevant qualifications and accreditations, and participation in social value initiatives), which will allow everyone to demonstrate their competence. Tender assessments can ask bidders how they would improve poor performance and achieve innovations and efficiencies in the new contract, encouraging incumbents to rethink their current service delivery model.

Managing poor performance: If an incumbent isn't reappointed, clients need to manage the contract attentively to ensure there are no slips in service delivery. The parties should be clear about the incumbent's contractual and legal obligations to provide information to the client or the new contractor during the transition stage, and any TUPE transfer that might apply.

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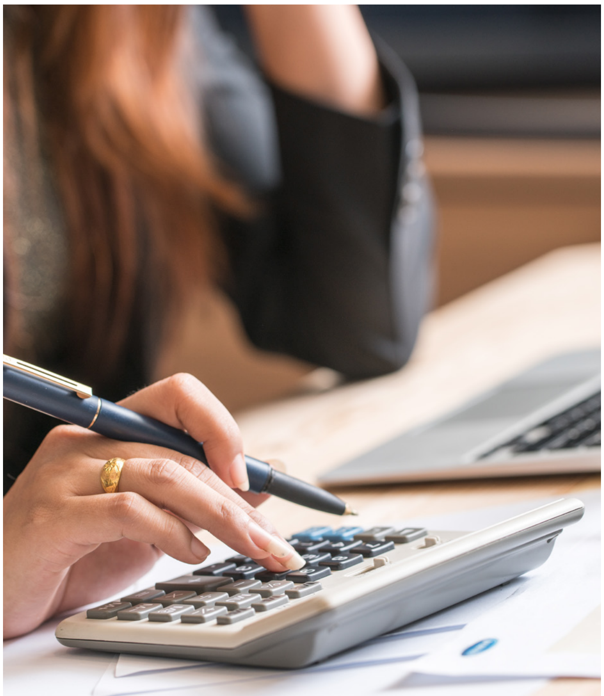
Charity groups and the Corporate Interest Restriction

Beginning on 1 April 2017, there is a potential restriction on the amount of loan interest that can be deducted for tax purposes in corporate groups.

In broad terms, the amount of deductible interest is restricted to 30% of its taxable earnings before interest, taxes, depreciation and amortisation (known as "EBITDA"). There are other optional calculations available, which may or may not be advantageous, depending on the circumstances, and there is no restriction at all for groups with interest costs of £2 million or less for a period of account. Unused interest capacity may be carried forward for, broadly, five years; and interest for which deductions are denied may be carried forward indefinitely.

Importantly, where a group has interest payable of over £2 million, and there is a restriction, then it is required to file an Interest Restriction Return in order to allocate the restriction around the group as it sees fit.



There has been some correspondence with HM Revenue & Customs (HMRC) in relation to the implications for charities. If HMRC is correct, this will impact charities with interest costs of more than £2million a year, and Registered Providers are likely to be particularly affected. Although it is unlikely that they will suffer a corporation tax charge, nevertheless they will be required to file the return mentioned above, and allocate any interest restriction to the charity (up to the amount of the charity's net interest expense) where it will have no tax effect. The Return must be filed within 12 months of the end of each accounting period.

The issue arises because it had been assumed that interest paid by charities did not count towards the £2million figure. So if a charity had an annual interest cost of, say, £5 million it would not suffer a restriction; and if the external interest paid by its non-charitable group companies was below £2 million the restriction could not apply.

However, HMRC's view is that interest paid by charities cannot be ignored for the purpose of the restriction rules, so the Return will be required.

This appears to be an unforeseen or unintended consequence of the legislation, since there is no tax advantage for HMRC, but the safest course of action would be for charity groups to allocate any interest restriction to the charity and file an Interest Restriction Return.

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The discontinuation of LIBOR

The Financial Conduct Authority has announced that it will no longer compel or encourage banks to provide quotations for the London Interbank Offer Rate (LIBOR) after 2021. It is suspected that this will be the end for LIBOR.

Given its prevalence in loan documentation, two issues have arisen:

- which benchmark will replace LIBOR in the loan market? and;
- how will parties mitigate the change in existing loan agreements that refer to LIBOR?

A number of benchmarks have been proposed for its replacement. The most prominent is the Sterling Overnight Index Average (SONIA). Lenders cover their short term funding requirements by entering into unsecured overnight transactions and SONIA is calculated from the average interest rate across those transactions. It is fixed overnight in arrears and published on the next business day. LIBOR is fixed in advance and requires a judgment call from the quoting bank. Such judgment calls have been open to manipulation. LIBOR is also speculative and includes a risk premium to ensure that the quoting bank is protected from any unexpected spikes in its cost of borrowing during the LIBOR term. As SONIA is based on actual transactions, there is no need to include any risk premium and it is less susceptible to manipulation.

The advantage of LIBOR is that it provides a borrower with interest rate certainty for the LIBOR term and cashflow can be planned accordingly. SONIA is not a "look forward" benchmark. Further, it is unclear whether the banks will have the infrastructure to be able to deal with a daily SONIA rate and apply this to their existing loans by the end of 2021. Loan documentation is also likely to be required to be heavily amended as LIBOR calculation mechanics are not analogous to calculating SONIA.

The Bank of England is considering the most effective way to combine the best elements of LIBOR and SONIA. A term SONIA benchmark has been mooted which would combine the look forward element of LIBOR with the real transaction basis of SONIA. Whatever benchmark is selected, the Bank of England concedes that a fair spread adjustment will be required to ensure that neither party is too adversely affected by the change to ensure that there is no transfer of value.

In existing loan agreements, the temporary suspension of LIBOR is often anticipated but the permanent discontinuance is not. The Loan Market Association (LMA) has been proactive in preparing for a world without LIBOR and in October 2018, it published its "Replacement of Screen Rate" wording. Although this has not been universally accepted by lenders, crucially it requires that any selection of a replacement benchmark is for both the lender and the borrower to agree. We recommend to any borrower that this wording be included as it is vital that they have a seat at the table, given this will directly affect the cost of their existing loans.

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Front cover image: Shutterstock