

Opportunity knocks

PETER RAYNEY takes a client through the incorporation of a property business. The mitigation of stamp duty land tax is illustrated by means of a practical case study.

Many of my tax consultancy assignments over the past 18 months or so have been to advise property business owners on the incorporation of their residential, commercial or 'mixed' property rental businesses. Such incorporations are often driven by the realisation that companies are an effective tax shelter for those who wish to use their net property rental income to purchase new properties.

By operating as a sole trader, co-owner or in partnership, property owners will typically suffer tax rates of 40% to 45% on their net rents, leaving about 55% to 60% of the receipts to reinvest in more properties. On the other hand, operating the property portfolio through a company (taxed at 20%) will enable some 80% of the rental profit to be available for reinvestment. The 'penal' restrictions in income tax relief for financing costs (for residential properties only) that are about to 'kick in' will add a further incentive to incorporate.

While property incorporation cases have some common tax issues, such as stamp duty land tax (SDLT) and capital gains tax, each case tends to have its own special factors; for example, the need to novate debts or refinance loans through the new company. In practice, the most problematic areas are often the potential SDLT cost (especially with the new 3% additional surcharge for residential properties) and dealing with property owners who try to assert that they have been carrying on a property rental business in partnership!

This case study is based on real circumstances, although certain facts have been changed to preserve anonymity.

KEY POINTS

- Tax limits funds available for property reinvestment.
- Companies can be an effective tax shelter when reinvesting rents in new properties.
- The new 3% stamp duty land tax charge.
- The importance of ensuring that a partnership exists rather than co-ownership.
- Stamp duty land tax calculations if there are connected parties.
- The case of Mrs EM Ramsay provides authority for the use of s 162 incorporation relief in a property business.



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Case study

Lennie and Dianne were a successful music duo in the 1970s and have been married for 40 years. They spent most of their earnings on building up a large high-quality residential property portfolio in England and both work full time in running the business in partnership. They formalised the partnership in 2006, trading under the name of 'L & D Residential', and share profits and losses on an equal basis. Partnership tax returns were submitted from that date.

Lennie and Dianne live off their pension income and modest drawings from the partnership and prefer to reinvest a large portion of the net rental income generated by the business by adding to their property portfolio.

Having recently discussed the business structure with their accountant, Mr Hughie, it has been agreed that they will incorporate the business by transferring all 16 rental properties and related business assets to a newly formed company – W Homes Ltd (WHL). Mr Hughie feels that specialist tax advice will be required to ensure that no unnecessary tax charges are triggered.

A summary of the latest property business balance sheet (incorporating a 'formal' revaluation of the properties) is shown in **Balance Sheet**.

We will concentrate on the main areas of tax advice required for this consultancy assignment.

Dealing with SDLT

In England, Wales and Northern Ireland, SDLT is often the largest potential tax cost of incorporation because there is no specific exemption for such transactions.

As a general rule, the SDLT legislation applies the charge to the actual consideration changing hands (in its widest possible sense) and does not normally apply a deemed market value provision. Thus, for example, it is possible for property to be gifted (debt-free) without an SDLT charge.

BALANCE SHEET

<i>Fixed assets</i>	£'000	£'000
Residential properties at original cost		4,200
Uplift to current valuation		<u>1,500</u>
Residential properties at current valuation		5,700
Office equipment		145
<i>Current assets</i>		
Debtors	121	
Cash	<u>340</u>	461
<i>Current liabilities</i>		
Business creditors	(256)	
Bank loans re properties	(300)	
<i>Long-term liabilities</i>		
Bank loans re properties	<u>(3,600)</u>	<u>(4,156)</u>
Net assets		<u>2,150</u>

Unfortunately, one of the main exceptions to this rule applies where property is transferred to a connected company (within the meaning of CTA 2010, s 1122). In such cases, FA 2003, s 53 applies a deemed market value rule – largely due to HMRC paranoia with property ‘enveloping’ transactions.

Consequently, it does not matter how the transfer of property to the company is structured – for example, gifted for no consideration, transferred along with the business in exchange for shares, sold at undervalue for cash and so on – the company’s SDLT charge will always be calculated by reference to the market value of the property. (Strictly, SDLT is charged on the greater of any actual consideration that is given by the acquiring company and the market value.)

HMRC Stamp Office accepts that ‘market value’ does not include VAT, even if the seller is required to charge VAT. Of course, this issue does not arise with transfers of residential property – as in the case of Lennie and Dianne – because residential properties will invariably be VAT exempt.

If commercial properties are being transferred, the VAT issues need to be considered carefully. This will often involve ensuring that the company makes fresh options to tax so that the transfer of going concern rules can be used to avoid a VAT charge.

Where a partnership or limited liability partnership (LLP) business is being incorporated (particularly if the partners are close family members), it will often be possible to transfer property without an SDLT charge.

This is not a ‘blanket’ SDLT partnership incorporation exemption. The nil SDLT cost arises due to the special way in which the chargeable SDLT consideration is calculated where partnership properties are transferred to partners or their ‘connected persons’.

Transfers from a partnership

Where partnership property or properties are transferred to a connected company, it is frequently possible to use the beneficial provisions in FA 2003, Sch 15, paras 18 to 20. Provided that individual partners are transferring the properties, the company would frequently be connected with

each of them within CTA 2010, s 1122 (3) (see also FA 2003, para 39). This section provides that:

‘A company is connected with another person (A) if:

- (a) A has control of the company; or
- (b) A together with persons connected with A have control of the company.’

For these purposes only, ‘connection’ between the partners in their capacity as partners is ignored, but close relatives are counted. Depending on the precise circumstances of each case, connection may also be established where persons are ‘acting together to secure or exercise control’ of the company.

Although the SDLT legislation is quite tortuous, if control of the company is established, the formula in para 18 will lead to the chargeable consideration being computed as nil (see ‘SDLT payable’ below).

Potentially, the deemed market value rule in FA 2003, s 53 applies in such cases. However, HMRC has confirmed that the more beneficial partnership SDLT rules take precedence (see HMRC’s *Stamp Duty Land Tax Manual* at SDLTM34160). To fall within the special SDLT partnership code, it is necessary to establish that a partnership exists.

Having become aware of the potential SDLT savings offered by the SDLT partnership legislation, I have seen many clients declare that their business is definitely run as a partnership. However, in many cases, it is found that the properties are simply co-owned without any partnership relationship being established.

For example, there is often no partnership agreement, no partnership bank account, the leases and other agreements are not in the name of a partnership and so on. Further, it would be very difficult to persuade HMRC that a property rental partnership exists where no partnership self-assessment returns had previously been submitted and where the share of the property income had simply been split and shown on the land and property pages of the self-assessment tax return.

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Clients are sometimes tempted to convert a sole trader business to a partnership by bringing in a family partner (as an intermediate step) before subsequently transferring properties on incorporation.

However, such arrangements are particularly vulnerable to the general SDLT anti-avoidance rule in FA 2003, s 75A to s 75C. If HMRC can demonstrate that the ‘partnership’ was inserted to avoid an SDLT charge, then this transaction would be set aside and SDLT would be charged on the market value under FA 2003, s 53.

SDLT payable

Lennie and Dianne are married and are therefore connected with each other for the purposes of CTA 2010, s 1122. Therefore, each controls WHL. Furthermore, they have been operating through a long-established partnership business, hence there can be no question of FA 2003, s 75A applying.

In simplified form, the SDLT analysis under FA 2003, Sch 15 para 20 to arrive at the 'sum of the lower proportions' (SLP%) would be worked through as follows.

- *Step One.* WHL is the 'relevant owner' – immediately after the transaction it is entitled to a proportion of the chargeable interest (ie the relevant properties) and immediately before it was 'connected' with a partner.
- *Step Two.* There is only one relevant owner – WHL – and its corresponding partners are Lennie and Dianne. They were partners before the transaction and are individuals connected with the relevant owner.
- *Step Three.* WHL is entitled to 100% of the chargeable interest after the transaction. This is apportioned between its 'corresponding partners' as Lennie (50%) and Dianne (50%) (this can be apportioned in any way).
- *Step Four.* The lower proportion for the corresponding partners is Lennie (50%) and Dianne (50%). For each partner, this involves taking the lower of their 'chargeable interest' arrived at in Step Three and their partnership (profit) share. In this case, the share of the chargeable interests and partnership profit shares are the same and no adjustment is required.
- *Step Five.* The SLP% is 100% (ie Lennie (50%) and Dianne (50%) per 'Step Four')

“The MDR offers a valuable relief where a number of dwellings are purchased in a single transaction.”

Applying the formula

Once the SLP% is determined, the formula in FA 2003, Sch 15, para 18 can be used to compute the chargeable consideration for SDLT purposes. It should perhaps be emphasised that the structure of any actual consideration, including the assumption of debt, is totally disregarded for these purposes. The charge is based on the market value (MV) of the property interest transferred, but only a proportion of it (or nothing) becomes chargeable for SDLT, which is calculated as follows:

$$MV \times (100 - \text{SLP}\%)$$

The total market value of the residential properties (this will be a linked property transaction) is £5.7m (see *Balance Sheet*). Therefore chargeable consideration for SDLT purposes would be computed as nil, as shown below:

- £5,700,000 x (100% – SLP%)
- £5,700,000 x (100% – 100%)
- £5,700,000 x 0% = nil

Those who have tried to report these transactions on the SDLT1 form will understand that the form is not overly helpful in such cases. It is not possible to put a 'relief code' in Box 9 (Question 9) because the operation of the SDLT partnership rules is not an SDLT relief. Strictly, the total (chargeable) consideration for the 'incorporation' transaction is 'nil'. In the absence of a relief, a 'nominal' entry in Box 10 would not be readily understood by HMRC. Unfortunately, there is no 'white space' on the SDLT return in which to provide additional explanatory details. Therefore, to protect the company against a subsequent HMRC discovery, it is good practice to write to HMRC's Birmingham Stamp Office setting out the full SDLT analysis and calculations.

Other SDLT outcomes

If, for one reason or another, the company must pay SDLT, it may be possible to mitigate the charge in a number of ways.

Where there is a sale of six or more dwellings in a single transaction, the entire purchase will count as a non-residential property transaction (which generally has lower SDLT rates). However, where it is possible for the company to claim the multiple dwellings relief (MDR) in FA 2003, Sch 6B, it will frequently be better to do this than pay SDLT at the non-residential (commercial) rates.

The MDR offers a valuable relief where a number of dwellings are purchased in a single transaction or linked transactions. For these purposes, a dwelling is defined as a building that is used or is suitable for use as a dwelling. It also includes properties that are in the process of being constructed or adapted for use as a dwelling together with any appropriate gardens or grounds (see FA 2003, Sch 6B para 7(2)(3)).

MDR works by calculating the SDLT on each dwelling by reference to the average price of all the dwellings. This calculation will include the 'additional' 3% charge. SDLT savings are achieved due to the multiple use of the lower rate SDLT charging bands. There is no similar relief for commercial properties.

Capital gains tax

Capital gains tax is another key tax that must be dealt with on incorporation. Because the sale or transfer of the properties is to a connected company, TCGA 1992, s 17 deems the properties to be transferred at their market values for capital gains tax

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purposes, irrespective of the actual prices that may be involved in the incorporation.

However, it should frequently be possible to use the incorporation relief under TCGA 1992, s 162 to defer the relevant capital gains. This relief can be extended to property rental businesses. The key conditions are as follows:

- the business is transferred as a going concern;
- all the assets of the business (with the possible exception of cash) are transferred to the company; and
- the consideration for the transfer of the business/assets is satisfied wholly or partly by the issue of shares to the seller.

If these conditions are satisfied, s 162 relief is automatic – although it is possible to elect to disapply the relief under s 162A.

Where the consideration is fully satisfied by the issue of shares, s 162 will deduct (roll-over) the total chargeable gains (net of capital losses) arising on the transfer against the consideration given for the new shares. The consideration given for the shares will equate to the market value of the assets (net of business liabilities). The gains therefore become deferred against the shares and will only crystallise on a subsequent capital gains tax disposal of the shares.

If the consideration is only partly satisfied in shares (the balance possibly being cash or amounts left outstanding on loan account), the gains rolled-over will be restricted by reference to the share consideration, with the balance of the gains (referable to the cash/loan consideration becoming immediately chargeable (TCGA 1992, s 162(4)).

On a strict interpretation, if the company assumes business liabilities, this would constitute consideration that would not be in the form of shares. Technically, this would cause the s 162 roll-over to be restricted with a capital gains tax liability arising. Fortunately, extra-statutory concession D32 prevents the assumption of business liabilities being treated as non-share consideration.

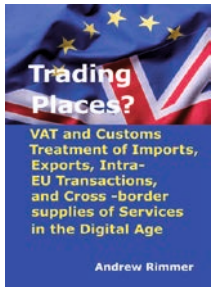
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Where a partnership is incorporating, HMRC deals with each partner's share of the net gains separately and it is possible for each partner to take a different mix of shares and cash/loans.

Another important advantage of s 162 is that the company acquires the relevant chargeable assets at market value, effectively rebasing the company's base cost of the assets.

Where commercial properties are involved, it will be important to ensure that fixtures and integral features are properly dealt with for capital allowance purposes. This should include making a joint election under CAA 2001, s 198.

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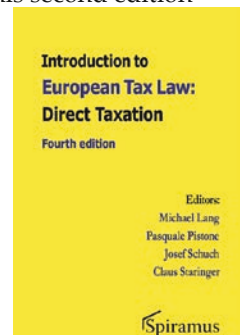
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SECTION 162 CALCULATION

	Total	Lennie	Dianne
	£'000	£'000	£'000
Partnership share		50%	50%
Share of partnership total gains (say = uplift of £1,500k per balance sheet)	1,500	750	750
Base value of consideration shares (current value of net assets £2,150k less £340k cash retained – (say))	1,810	905	905
Less: S 162 relief – gains as above	(1,500)	(750)	(750)
Revised capital gains tax base cost of shares	310	155	155

CGT PAYABLE ON TRANSFER

Details	£ '000
Chargeable gains (say)	1,500
Less: Annual exemptions (x2)	22
Taxable gains	1,478
Capital gains tax at 28%	414
Value of loan account (say)	1,810
Effective tax rate	22.8%

The ‘other’ Ramsay case

The Upper Tribunal ruling in *Mrs EM Ramsay v HMRC* [2013] STC 1764 provides robust authority for treating substantive property letting activities as a business for the purposes of s 162 incorporation relief. The tribunal ruled that activities ordinarily associated with the management of an investment property could be regarded as a business. However, to be treated in this way it held that the activities must:

- represent a seriously pursued undertaking;
- be conducted on sound and recognised business principles; and
- be of a type that is commonly made by those who seek to profit by them.

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Further, the activities must be of a significant nature with a reasonable period of time being spent on property-related activities. In *Mrs EM Ramsay*, the taxpayer had devoted some 20 hours a week to managing, maintaining and carrying out property business-related work. The case also shows that it is the quantity not the quality of the activity that is important. It clearly helps if the property owners have no other employment or trade.

Based on all the relevant facts, Lennie and Dianne should comfortably meet the relevant conditions for s 162 relief. Simplified **Section 162 Calculations** are shown above.

Alternative sale structures

It is not possible to use the TCGA 1992, s 165 business asset gift relief to defer the capital gains tax on incorporation. This is because (in this context) s 165 only applies to chargeable assets used in a trade (TCGA 1992, s 162 (a)(i)), as distinct from a (property) business.

Some may prefer to sell the net assets to the company for cash, with the balance being left outstanding on director’s loan account. Unfortunately, for residential properties this means incurring a capital gains tax rate of 28% on the gains.

To avoid any distribution tax issues, it is important that the properties are not transferred for more than their market value.

However, applying the facts in this example, the real effective tax rate for the creation of the director’s loan account is likely to be around 23%, as shown in **CGT payable on transfer**.

Although the company would have to pay 20% corporation tax on the cash-flows used to repay the loan account, many would still consider the overall tax rate palatable when compared with typical dividend extraction tax rates.

If commercial property is involved (or a trading activity is being transferred), the headline capital gains tax rate would be 20%, which should produce more preferential extraction tax rates. The main point here is that – even though the 10% entrepreneurs’ relief is not available – the possibility of selling the assets for cash/loan accounts should not be dismissed.

Some conclusions

It will be seen that the incorporation of a property business can be structured tax efficiently in a variety of ways. The preferred structure will depend on the precise facts of each case and the property owners’ future business and personal objectives.

The potential SDLT cost tends to be a major concern. In some cases, there will be a robust case for benefiting under the often-favourable SDLT partnership legislation. However, if this is not possible, it may be possible to mitigate the SDLT by (for example) claiming MDR etc.

Some property business owners take a more philosophical view and accept the SDLT charge, which they factor into the ‘costs versus benefits’ of the incorporation exercise. It is often found that the SDLT costs are easily recouped from the overall medium to long-term tax savings.

Finally, this article does not cover the equivalent land and buildings transaction charge for land transactions in Scotland, although it is understood that the relevant legislation is broadly similar to the SDLT law.

Peter Rayney FCA CTA (Fellow) TEP runs a specialist independent tax consultancy practice – Peter Rayney Tax Consulting Ltd (peterrayney.co.uk).

Peter is chairman of the ICAEW’s Tax Technical Committee and author of *Bloomsbury Professional’s Tax Planning for Family and Owner-Managed Companies – 2015/16*.