GETTING TO GRIPS WITH SDLT

Property deals can involve substantial SDLT costs, so it pays to be aware of the available reliefs, says **Peter Rayney**

Stamp duty land tax (SDLT) tends to be relevant to almost all business transactions where a property element is involved. Those involved in advising on such deals should therefore have a good grasp of the basic operation of SDLT and the opportunities for claiming reliefs or exemptions. This article deals with both these aspects. Unless stated otherwise, all statutory references are to the Finance Act 2003.

SDLT is payable not only on the 'normal' purchase of UK land but also on the creation, release, surrender or variation of a chargeable UK land interest (s43). Special SDLT rules apply on the grant of a lease.

SDLT is also charged on the value of any fixtures substantially attached to the land under land law. This could include, for example, lifts, escalators, furnaces, walk-in refrigerators, and so on. On the other hand, items that retain their character as chattels or moveable property, such as furniture or carpets, will not be subject to SDLT.

Broadly, SDLT is payable when a land transaction is 'completed' by the purchaser. However, the SDLT charge is brought forward where a land transaction is 'substantially performed', such as where a substantial (90%) amount of the consideration is paid (which includes the first 'rent' payment on a lease) or where the purchaser takes possession (for example, occupation) (s44). SDLT (at the appropriate rate) is applied to the chargeable consideration (including any VAT thereon) for the relevant land transaction.

SDLT RATES

SDLT rates are levied on the so-called 'slab system'. Thus, where the consideration exceeds the relevant threshold, the higher rate of SDLT is applied to the total amount. Different SDLT scales apply to residential property and non-residential/ 'mixed-use' property, as shown in the Table below. In recent years, there have been significant increases in SDLT on residential property.

The application of a nil or lower rate of SDLT also depends on the relevant land transaction not being part of a linked transaction. Broadly, linked transactions are those made as part of a single scheme or arrangement between the same seller and purchaser (or their 'connected' parties). If the transaction is linked, the rate of SDLT is fixed by reference to the total consideration for all the linked chargeable land transactions (s55 (4)). This rule effectively prevents transactions being fragmented to benefit from lower SDLT rates.

RESIDENTIAL V NON-RESIDENTIAL

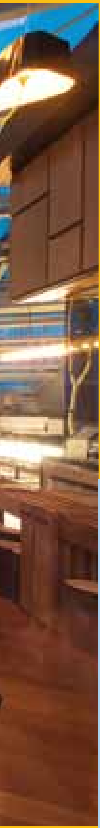
Residential property includes buildings that are used, or are suitable for use, as dwellings, their accompanying gardens and grounds, and residential accommodation for school pupils and students (other than those in higher education) (s116). Various properties are specifically excluded from being 'residential', for example, student halls of residence, care homes, and hospitals or hospices.

An important deeming rule applies to the transfer of six or more dwellings in a single transaction, which treats them (collectively) as 'non-residential' for SDLT purposes (s116 (7)). This means they would often attract a lower tax charge.

We will now consider how SDLT applies to a number of common business transactions.

INCORPORATION OF A SOLE TRADER

It is perhaps surprising that no special relief is available for property transferred on the incorporation of an existing business. In fact, where property is transferred to a company 'connected' with the sole trader, s53 effectively



CURRENT SDLT RATES

Residential property[1]			Non-residential property or mixed-use property	
Chargeable consideration	**Rate**		**Chargeable consideration**	**Rate**
Up to £125,000+	Nil		Up to £150,000	Nil
£125,001–£250,000	1%		£150,001–£250,000	1%
£250,001–£500,000	3%		£250,001–£500,000	3%
£500,000–£1,000,000	4%		More than £500,000	4%
£1,000,001–£2,000,000	5%			
Greater than £2,000,000[2]	7%			

Notes

1 FA 2011 introduced relief for transfers involving multiple dwellings. This relief can be claimed on acquisitions of two or more dwellings in one land transaction, the effect being that the applicable rate of tax is calculated by averaging the aggregate consideration over the relevant dwellings.

2 Since 21 March 2012, residential dwellings purchased by a company for more than £2m may be charged SDLT at a penal 15% rate (unless one of the 'business-related' exemptions is available).

imposes an SDLT charge based on the market value of the property. The 'market value' basis always operates for SDLT regardless of the type or the amount of the consideration given by the 'acquiring' company (eg, gift, sale at undervalue or full market value, or a transfer in consideration for an issue of shares by the company) – see example 1 overleaf.

For these purposes, the Corporation Tax Act (CTA 2010), s1122 determines whether an individual is connected with a company. This rule invariably applies to most business incorporations since the sole trader (perhaps together with their close family members) will 'control' the transferee company. Section 54 provides for certain limited exemptions from the market value but none of them are relevant to business incorporations.

When a business is being transferred to a company, it will generally consist of various assets, which may include land and property (which is subject to SDLT), and goodwill (which does not attract any stamp taxes). In recent years, there have been 'valuation' difficulties with property-based businesses, such as hotels, bars and restaurants, and care homes.

HMRC has generally sought to increase the property valuation for SDLT purposes by what it believes to be 'inherent goodwill', ie, goodwill that arises from the particular location of the property or its special design. This challenge is made under the 'just and reasonable' apportionment provisions in para 4, Sch 4. HMRC and the Valuation Office Agency's practice in this area has been widely criticised since it seems to lack any commercial or legal justification.

RETAINING THE TRADING PROPERTY

Many proprietors often prefer to leave the property 'outside' the company in their personal ownership and lease the property to the company instead. The grant of a formal lease to the company may still create an SDLT liability. However, in many cases, it should be possible to avoid SDLT altogether by granting the company a non-exclusive licence to occupy the property. This is because a (mere) licence is an exempt interest for SDLT purposes (see s48 (2)(b)).

Although a licence does not give the occupier any legal protection, this should not be an issue since the 'landlord' owns the company. Care is required to ensure that the legal document is drafted correctly – if it grants an exclusive right of possession to the occupier, it will be treated as a lease (*Street v Mountford HL [1985] 2 All ER 289*).

PARTNERSHIP INCORPORATIONS

The deemed market value rule in s53 also potentially applies where property is transferred to a company on a partnership incorporation. However, the partnership SDLT charging regime contains special provisions that cover the transfer of property from a partnership to a partner or a 'connected' person, which would often apply where a family partnership incorporates (para 18, Sch 15).

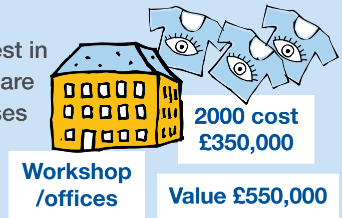
In such cases, HMRC confirms that the partnership rules in para 18, Sch 15 take » 52

EXAMPLE 1

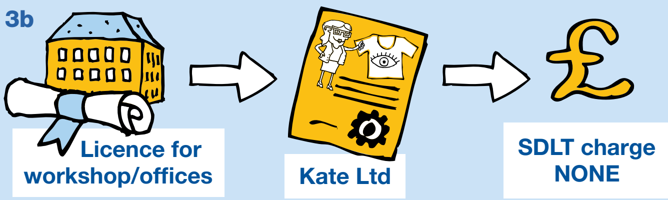
TRANSFER OF PROPERTY ON INCORPORATION OF SOLE TRADE

1. Kate has traded for many years as a self-employed manufacturer of pop-inspired merchandise but now wishes to incorporate her highly profitable business.

2. She owns the freehold interest in a workshop and offices, which are used exclusively for the purposes of her business. The property cost £350,000 in July 2000 and is currently worth £550,000.



3. If Kate transfers the freehold property to 'her' company (say) at its original cost of £350,000, it will incur an SDLT charge based on the current market value of £550,000. Given that this will cost £22,000 (£550,000 x 4%), Kate may prefer to retain the property in her personal ownership and give 'her' company a licence to occupy it, which would avoid any SDLT liability.



precedence over the general s53 provisions. The same treatment applies for limited liability partnerships (para 1, Sch 15). These provisions apply where a partner is connected with the acquiring company within CTA 2010, s1122, but for these purposes the rule that makes partners connected with each other in their capacity as partners is 'switched-off' (para 39, Sch 15).

The most relevant connection test is in CTA 2010, s1122 (3) which treats someone ('A') as being connected with the company where A and persons connected with A (for example, spouses and close relatives – see CTA 2010, 1122(5)) have control of the company. CTA 2010, s1124 provides that someone has control of a company where, broadly speaking, they (by reason of voting power or the articles etc.) have the power to ensure that company's affairs are conducted in accordance with their wishes. There is also another 'connection' test in CTA 2010, s1122 (4) that might possibly be invoked for 'non-family' partnerships.

Under FA 2003, Sch 15, para 18, the chargeable consideration for the transfer of the partnership property to a 'connected' company is based on the following special formula:

MV x (100 - SLP) % Where:
MV = the market value of the property; and
SLP = the sum of the lower proportions.

Calculating the SLP (the sum of the lower proportions) can be a complex matter and reference should always be made to para 20, Sch 15 and HMRC's SDLT manual (SDLTM 33710 to 33780). The operation of these rules is shown in example 2, which demonstrates that where property is being transferred by a family-owned partnership there should be no SDLT liability as a result of para 18 and 20, Sch 15 and the CTA 2010 'connected party' rules.

The beneficial effect of these provisions might tempt some sole traders to form family partnerships shortly before a proposed incorporation. However, where such arrangements are made, HMRC is likely to be successful in invoking the general SDLT anti-avoidance rule in s75A. This would enable HMRC to ignore the interposition of the partnership prior to the incorporation as a method of reducing the (normal) charge to SDLT under s53.

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DISTRIBUTIONS IN SPECIE

Owner-managed companies often transfer properties to their shareholder(s) in the form of a distribution in specie (ie, in kind). It is not always understood that this should be an 'SDLT-free' transaction. A 'distribution' of property to a shareholder is generally 'exempt' from SDLT because it is a voluntary transfer for no 'chargeable consideration' (para 1, Sch 3). However, if the shareholder also assumes a mortgage or loan attached to the property, this will represent consideration and SDLT would be based on that amount (para 8, Sch 4).

The transfer of the property may, of course, produce a taxable capital gain for the company and a tax charge on the recipient shareholders (subject to any reconstruction reliefs).

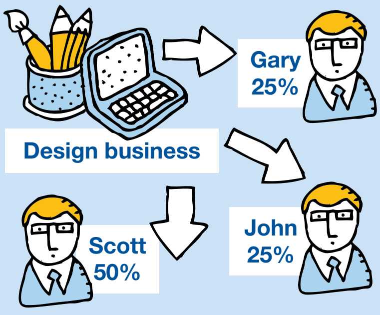
To benefit from the SDLT-free treatment, it is important to ensure that the legal documentation for the distribution in specie is prepared correctly. The dividend resolution must specify that the property is being transferred as a distribution in specie. There is a potential trap. If the resolution provides for a cash dividend (equivalent to the market value of the property), this would create a pre-existing debt. Consequently, the transfer of the property to the shareholder would effectively discharge that debt, which would again constitute chargeable consideration for the purposes of para 8, Sch 4, and trigger an SDLT charge.

COMPANY RECONSTRUCTIONS

Some successful companies grow to the stage where they have a portfolio of valuable investment

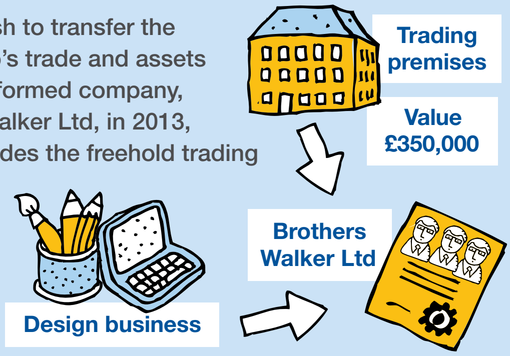
EXAMPLE 2

SDLT ON TRANSFER OF PARTNERSHIP PROPERTY TO 'CONNECTED' COMPANY

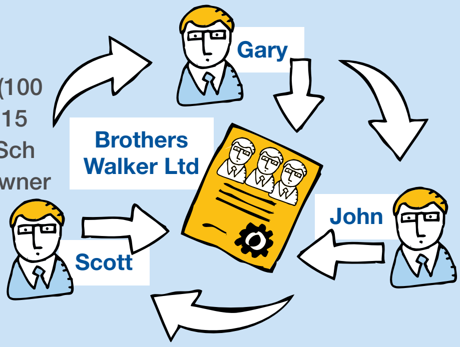


1. Three brothers, Scott, Gary and John have been trading successfully in partnership as a graphic design and website development business for a number of years, sharing profits in the ratio: 50%: 25%: 25%.

2. They wish to transfer the partnership's trade and assets to a newly formed company, Brothers Walker Ltd, in 2013, which includes the freehold trading premises currently valued at £350,000.



3. For SDLT purposes, the 'MV x (100 – SLP)%' formula in para 18, Sch 15 must be applied. Under para 20, Sch 15, the company is the relevant owner (under step 1) and (as brothers) all the partners are connected with each other and hence also the company (under step 2).



4. Thus, under steps 3, 4 and 5 in para 20, the SLP (sum of the lower proportions) would be 100%. The SDLT charging formula would thus be MV x (100 – 100)%, meaning no SDLT would arise on the transfer of the property.

properties. Typically, the shareholders then decide that they would prefer to 'ring-fence' the investment properties from the commercial and financial risks of the trading operations. This can often be achieved by implementing a suitable company reconstruction under s110, Insolvency Act (IA) 1986.

Under an s110 IA 1986 arrangement, the existing company is wound-up, with the liquidator then distributing the property investment business and trade(s) to new companies owned by the shareholders. The property investment business and trading operations therefore end up in 'new' separate companies and hence the property portfolio is 'protected'.

Provided it is properly implemented and the relevant tax clearances are obtained, the s110 arrangement should be 'tax-neutral' for corporation tax purposes and for the shareholders (see *Corporate break-ups, Oct 2011*). However, the SDLT treatment is more difficult since it depends on whether the original shareholding relationship is maintained in the new companies.

Broadly, if the original shareholding relationship is exactly 'mirrored' in the new companies, it is possible to obtain complete exemption from SDLT under the 'reconstruction' relief provisions in para 7, Sch 7. These require that there is a 'scheme for the reconstruction' of the distributing company – which is largely construed by reference to case law. A number of other conditions must be satisfied, including a requirement that the reconstruction must be motivated by genuine commercial reasons and not tax avoidance.

In some cases, the original shareholders will seek to partition or split the company's business activities between them. Clearly, this would not qualify for the para 7 'reconstruction' exemption. However, it may be possible to benefit from the SDLT acquisition relief, which reduces the SDLT rate to ½% (para 8, Sch 7). It is important to note that the acquisition relief does not extend to property investment or property dealing businesses. Thus, no SDLT relief is available where the property investment business is effectively being transferred 'into' a different shareholding ownership. Full SDLT rates will often apply, which is likely to be a substantial cost. In such cases, advisers should seek to plan the reconstruction so as to minimise the impact of stamp taxes.

Both the SDLT 'reconstruction' and 'acquisition' reliefs are subject to a clawback charge (effectively removing the original exemption/relief) where (broadly):

- control of the 'acquiring' company changes within the three years following the relevant property acquisition; and
- it still holds the relevant property (para 9, Sch 7).

The most obvious case where a clawback would be triggered is where a company is sold to a third party.

SDLT is now seen as an important tax in the context of business transactions. A failure to appreciate its intricacies and exemptions can often lead to unnecessary or needless SDLT costs being incurred. Those engaged in advising on corporate transactions would therefore benefit from having a good grasp of the basic SDLT concepts.

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