Capital Gains Tax

Tackling Property Business Incorporations

Peter Rayney[*]

FCA CTA (Fellow) TEP, Peter Rayney Tax Consulting Ltd

Capital gains tax; Incorporation; Incorporation relief; Inheritance tax; Partnerships; Property businesses; Stamp duty land tax

Property business incorporations seem to be in vogue at the moment. As a tax adviser, I always first caution property business owners who wish to follow the "incorporation" herd. For some it is the right thing to do, especially if their objective is to retain and reinvest cash in the property business. However, for a good many others, who need to "draw" almost all their net property income, the tax paid on extracting profits from a company is unlikely to make it worthwhile, particularly if there are up-front stamp duty land tax (SDLT) costs that cannot be mitigated.

Another persuasive factor would be the ability to use the company shareholding structure to facilitate inheritance tax (IHT) planning for children and so on; for example, by transferring a suitable number of shares to a family discretionary trust.

This article assumes that incorporation will bring worthwhile tax savings (and possibly other benefits) for the owner(s). Having made the decision to incorporate, careful planning is necessary to ensure that the potential tax costs of transferring the property assets to the company — mainly capital gains tax (CGT) and SDLT—can be mitigated.

CGT and incorporation relief

Since the sale/transfer of the properties will be to a "connected" company, s.17 TCGA 1992 will deem the properties to be transferred at their market value (irrespective of the actual prices that may be involved in the "incorporation" transaction). (It is unusual for separate goodwill to be present in these transactions.) However, it is often possible to use "incorporation relief" under s.162 TCGA 1992 to defer the relevant gains on the properties used in the property investment business.

The key conditions are that:

- the business is transferred as a going concern;

[*] Peter Rayney runs a specialist independent tax consultancy practice — Peter Rayney Tax Consulting Ltd (*www.peterrayney.co.uk*). He is author of Bloomsbury Professional's Tax Planning for Family and Owner-Managed Companies — 2017/18.

- all the assets of the business (with the possible exception of cash) are transferred to the company; and
- the business/assets are transferred wholly or partly in consideration for an issue of shares to the seller(s) by the acquiring company.

Where these conditions are satisfied, s.162 TCGA 1992 relief is mandatory (although it is possible to make an s.162A TCGA 1992 election to disapply the relief).

Provided the consideration is fully satisfied by the issue of shares, s.162 TCGA 1992 will deduct (i.e. 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 CGT 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 net gains eligible for roll-over relief are restricted by reference to the following formula:

$$\text{Net gains arising on transfer} \times \frac{\text{Consideration satisfied in the shares}}{\text{Total consideration (}\textit{ie}\text{ cash, loans and shares)}}$$

The balance of the gains (referable to the "cash"/"loan" consideration) would become immediately chargeable (s.162(4) TCGA 1992). Where liabilities of the business are being transferred, this would not normally restrict the relief—see below.

Where a partnership is incorporating, HMRC deal 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. This might be useful if there are plans to sell one or more of the properties shortly after the incorporation. To avoid any "distribution" tax issues, the properties must not be transferred for more than their market value.

Where commercial properties are involved, the transfer of fixtures and integral features must be properly dealt with for capital allowance purposes, which should include making a joint s.198 CAA 2001 election. VAT issues must also be carefully considered. 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.

The Ramsay case

The Upper Tribunal ruling in *Ramsay v HMRC* [2013] UKUT 226 (UTT) provides pretty robust authority for treating substantive property letting activities as a business for the purposes of s.162 incorporation relief. In *Ramsay* the Upper Tribunal ruled that activities ordinarily associated with management of an investment property could be regarded as a business. However, in order to be treated as a business, the Upper Tribunal held that the activities must:

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

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

Dealing with debt

Care is required if the property business has material liabilities, such as bank loans. On a strict interpretation of the legislation, where the company assumes business liabilities as part of the incorporation process, this would constitute consideration that would *not* be in the form of shares, which would restrict the gains rolled over and therefore trigger a CGT liability.

Fortunately, ESC D32 prevents the assumption of business liabilities being treated as "non-share" consideration. However, the transfer of the business liabilities must be structured to fall within the terms of the concession. Some lenders can be difficult about this and treat these arrangements as triggering the making of a new loan (with arrangement fees and perhaps higher interest rates). All this may require some tricky negotiations. In some cases this may involve refinancing with a more receptive lender. In my view this approach is preferred to the use of the so-called "beneficial interest" structures, which are being advocated by some. I am not convinced these "beneficial interest" arrangements are robust and are open to being considered a "mortgage fraud". Furthermore they probably fall on the wrong side of the "Professional Conduct In Relation to Taxation" guidance issued by the leading professional bodies.

I have also seen lenders wishing to grant new loans to the company, with the loan monies being used to repay the existing loans in the name of the property business owner or partners. In my view, this is not within the terms of ESC D32, which requires the assumption of the business liabilities. The lender must therefore agree to transfer the debt to the company under a "novation" agreement. If the company borrows the money, which is then used to pay off the business owner's personal borrowings, HMRC is likely to regard this as cash consideration (which would restrict the s.162 TCGA 1992 roll-over relief). Alternatively, the monies advanced would constitute a loan to the shareholders, with potential s.455 CTA 2010 liability issues.

Dealing with SDLT

SDLT is often the largest potential tax cost of incorporating (in England, Wales and Northern Ireland) since there is no specific SDLT exemption for incorporation. Incorporating property businesses in Scotland falls within the Land & Buildings Transaction Tax (LBTT) regime. (The LBTT legislation is similar to SDLT but there are some notable differences, which are not examined further here.)

As a general rule, the SDLT legislation generally applies the SDLT 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) to an individual or trust without an SDLT charge. However, there is an important exception to this rule in s.53 FA 2003 which imposes a deemed market value charge where property is transferred *to* a company *and*:

- the seller is connected with the company; or
- some or all the consideration consists of the transfer of shares in a company, with which the seller is *connected*.

The "connection" test in s.1122 CTA 2010 is used for these purposes.

Thus, where landlords wish to transfer their properties to their "own" (connected) company, the company's SDLT liability is based on the market value of the relevant properties (irrespective of the actual consideration and/or the type of consideration that is given by the transferee company). This deemed market value rule is largely due to HMRC paranoia with property "enveloping" transactions!

Furthermore, since the buyer is a company, the transfer of residential properties would always be liable to the additional 3% SDLT surcharge. However, where at least two dwellings are transferred, it should be possible for the company to claim the multiple dwellings relief (MDR) in Sch.6B to the FA 2003, which may result in a more palatable SDLT charge. MDR works by calculating the SDLT on each dwelling by reference to the average price of all the dwellings. SDLT savings are achieved due to the multiple use of the "lower rate" SDLT charging bands. There is no similar relief for commercial properties.

Where there is a sale of six or more "dwellings" in a single transaction, the entire purchase of those dwellings will count as a "non-residential" property transaction (which generally has lower SDLT rates). Nevertheless, it will invariably be better to base the SDLT on an MDR claim than pay SDLT at the "non-residential" (commercial) rates.

However, where the transfer is taxed under the *partnership SDLT legislation* (which includes transfers from LLPs), HMRC accept that the partnership SDLT rules take precedence (see HMRC SDLTM34170). Depending on the facts, this may lead to a smaller or indeed "nil" SDLT liability.

Beneficial SDLT rules for partnerships

Where partnership property/properties are being transferred to a "connected" company, it is frequently possible to use the "beneficial" provisions in paras 18–20 of Sch.15 to the FA 2003.

Provided *individual* partners are transferring the properties, the company would frequently be connected with each of them within s.1122(3) CTA 2010 (see also para.39 Sch.15 FA 2003).

This 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 be also 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, then the formula in para 18 will lead to the chargeable consideration being computed as "nil". This is not therefore an SDLT exemption but a formula that results in "nil" chargeable consideration and the SDLT1 return must be filed on this basis. The relevant SDLT provisions are explained further in the "case study" below.

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"! In a large number of these cases it is found that the properties are simply co-owned without any partnership relationship being established. For example, there is no partnership agreement, no partnership bank account, leases and other agreements are not in the name of a partnership and so on. Furthermore, it would be very difficult to persuade HMRC that a property rental partnership exists where no partnership returns had previously been submitted and where the shares of the property income had simply been split and shown on the "Land and Property" pages of the SA return.

Some are often tempted to "convert" a sole trader business to a partnership one by bringing in a close "family" partner (as an intermediate step) prior to making a subsequent transfer of properties on incorporation. However, such arrangements are particularly vulnerable to be set-aside under the general SDLT anti-avoidance rule in ss.75A–75C FA 2003. If HMRC can demonstrate that the "partnership" was inserted to avoid an SDLT charge, then this transaction would be ignored and SDLT would be charged on the "market value" under s.53 FA 2003.

Lennie & Dianne—case study

The case study illustrates the main tax consequences of the incorporation of a residential property business (based on an actual case, although certain facts have been changed to preserve anonymity).

Lennie and Dianne were a successful music duo in the seventies and have been married for 35 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 2005 trading under the name of "L & D Residential", and share profits and losses on a 50:50% 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 property business in 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 the 16 rental properties and related business assets to a newly formed company—Welcome Home 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 as follows:

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

Operation of CGT incorporation relief for Lennie and Dianne

Based on all the relevant facts, Lennie and Dianne should comfortably meet the relevant conditions for s.162 TCGA 1992 incorporation relief.

Lennie and Dianne took advantage of the option under s.162 TCGA 1992 to retain the firm's cash balance. Consequently the value of the new shares issued by WHL would be £1,810k, representing the current value of the transferred net assets being £2,150k (per above balance sheet) less cash balance of £340k).

The total bank debt would be novated to WHL (and hence covered by ESC D32), and the trade creditors will be paid from the £340k cash retained.

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

Simplified capital gains calculations for Lennie and Dianne are shown below:

	Total	Lennie	Dianne
Partnership share		50%	50%
	£000	£000	£000
Share of partnership total gains			
Uplift of £1,500K per balance sheet	1,500	750	750
Base value of consideration shares	1,810	905	905
Less s162 relief — gains as above	(1,500)	(750)	(750)
Revised CGT base cost of shares	**310**	**155**	**155**

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 an up-front CGT rate of 28% on the gains.

SDLT payable by Welcome Home Ltd

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

The "para 20" SDLT analysis to arrive at the "sum of the lower proportions" (SLP%) would be worked through as follows (in simplified form!):

Step One	WHL is the "relevant owner"—immediately after the transaction it is entitled to a proportion (100%) of the chargeable interest (i.e. 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). It should be noted that a

	corporate partner cannot be a corresponding partner and hence some SDLT would be payable if there were one or more corporate partners—the actual SDLT charge would depend on the size of their partnership interest.
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 shares of the chargeable interests and partnership profit shares are the same and no adjustment is required.
Step Five	The SLP% is 100% (i.e. Lennie (50%) plus Dianne (50%) per "Step Four").

Once the SLP% is determined, the formula in para.18 Sch.15 FA 2003 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, etc. 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 none of it) becomes chargeable for SDLT. The chargeable portion is calculated as follows:

$$MV \times (100 - SLP)\,\%$$

The total market value of the residential properties (this will be a linked property transaction) is £5,700,000 (see above summary balance sheet). Therefore chargeable consideration for SDLT purposes would be computed as "nil" as shown below:

$$£5{,}700{,}000 \times (100\% - SLP\%)$$

$$= £5{,}700{,}000 \times (100\% \text{ less } 100\%)$$

$$= £5{,}700{,}000 \times 0\% = £\text{nil}.$$

Those who have tried to report these transactions on the SDLT1 form will understand that the form is not overly helpful in dealing with these types of cases. It is not possible to put a "relief code" in Box 9 (Question 9) since 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.

Some conclusions

It will be seen that property business incorporations 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 v benefits" of the incorporation exercise. Depending on the facts, the SDLT costs may be easily recouped from the overall medium to long-term tax savings!