BLICK ROTHENBERG
Chartered Accountants

Third Annual Residential Property Tax Briefing

This White Paper provides a summary of salient points from our seminar for intermediaries held over 25 and 26 May 2016.

An overview

The UK residential sector remains under continuous pressure from the Treasury to yield more tax. The focus of new tax law has, at least for now, moved away from properties enveloped in companies to the whole private rental sector. The result is a new 3% Stamp Duty Land Tax ("SDLT") surcharge, a gradual restriction of income tax relief for mortgage interest and a 'look through' of foreign entities for Inheritance Tax ("IHT") purposes.

By 2020, mortgage interest relief for individuals and trustees will typically be cut by at least half, reducing the net profit of property businesses. It is not just the typical foreign domiciliary who is in the Treasury's sights, but a wider class of residential property owner. It is understandable why landlords are concerned. Any business needs to have a commensurate return on capital, and with rental yields relatively low and borrowing margins tight, the additional tax costs by 2020 may exceed one quarter of the gross yield. The loss of the '10% wear and tear allowance' which reduced furnished property rents for tax purposes will also come straight off the bottom line. The by-product of these changes is that landlords may push up rents, depriving young tenants of the ability to achieve the financial savings needed to access the Help-to-Buy Schemes.

If these measures were intended to cool the market they are probably starting to work. A last minute rush in March to beat the SDLT deadline accelerated transactions and yielded £1.2 Billion of SDLT in April alone. Delegates' own experiences confirmed transactions above the £1m mark are significantly reduced, with the exception of properties in excess of £10m where taxation is less sensitive. The expectation is that after the EU referendum a more paced return to transactions should ensue.

Frank Nash confirmed the combination of reduced interest relief and falling corporation tax rates has triggered substantial interest from clients looking to incorporate residential property businesses. An owner has to be very certain this move is right for them, because once property business assets are transferred to a company they cannot be moved back out without additional taxation and liquidation costs. Incorporating a property business is a 'one way ticket' so it has to be the right decision for an owner, made with a cool head in the cold light of day.

The tangle of residential property tax

With twelve different tax increases in the last four years, **Nimesh Shah** believes structuring UK residential property ownership has become one of the most complicated areas within the private client arena.

There appears to be little logic to some of the SDLT changes. Even the most benign transactions will now need to be carefully considered before proceeding. For example, a parent helping their adult child purchase their first property might accidentally stumble into paying the 3% SDLT surcharge unless the right steps are taken. Parental gifts or inheritances of property interests can lead to a 3% SDLT charge if the beneficiary then attempts to make their own way onto the housing ladder. The inclusion of foreign property interests to determine if a UK property is a second property and the complications of determining whether a trust interest is 'discretionary' or a 'life interest' in trust property just adds further complexity. Convincing a conveyancer, who may not practice tax law, that a transaction is not liable to the surcharge could also be problematic.

Whilst the sector focus has been on SDLT and the loss of income tax relief on financing costs, **Nimesh** believes that the 2017 IHT proposals will come into sharp focus when the legislation is eventually published.

Taking property businesses into a company

The UK rate of corporation tax will fall to 17% by 2020 and companies are not affected by the interest relief restriction. The attraction of incorporating is obvious.

An incorporation of a residential property business triggers a disposal for capital gains tax purposes. It also creates an acquisition by the company for SDLT purposes, unless the business is an existing partnership where SDLT relief may be due. Provided certain conditions are met, the sale of the business to the company in return for shares will defer the capital gain until the shares are disposed of. This may be never of course and so the capital gains tax may never be paid.

Incorporation has a number of traps, explained **Robert Pullen**. The business being transferred must be an 'active' property business. One which is carried out only at a low level, merely insuring property, collecting rents and rearranging leases periodically is unlikely to qualify. There must be some demonstrable activity, even if delegated to employees. Existing borrowing will need to be rearranged in the new company and personal guarantees will also be required. There must be a formal transfer of the business, with all business assets identified and the written transfer agreement must contain an 'adjuster clause'.

Perhaps the area that can easily get overlooked is determining the 'net value of the business' which is transferred. The company can only issue shares equal to that net value because that is what it is buying. If the capital gain on the transfer exceeds the net value of the business, it can never be the case that the whole of the gain is rolled over into the company shares. In that case, what appears to be a tax-free transaction will be partly chargeable to capital gains tax. A careful crunching of the numbers is essential, particularly if the business has a recent history of borrowing to allow the proprietors to withdraw capital from their business.

An often overlooked benefit of incorporation is that properties are rebased in the company for corporation tax purposes. This allows a company to reinvigorate its investment property by immediately selling old assets and reinvesting in new assets with little, if any, gain arising. Where the incorporation is combined with succession planning, and younger family members are introduced at that time, reinvestment may in fact be the very thing that is carried out.

Getting income to shareholders

Placing a residential property business into a company is all very well, but finding ways to draw later profits out for personal consumption was an area that **Frank Nash** discussed.

Dividends are paid out of the post-tax profits of the company and are then taxed at up to 38.1% on the shareholder. Salaries are tax-deductible against the company's profits, but come with the added cost of employers' National Insurance Contributions at 13.8%. The choice of income to put shareholders in funds will depend on company cashflows, shareholders' personal tax rates and the family dynamic.

As a result of transferring the property business to a company, a shareholder will be sitting on a large and valuable block of shares. Tempting as it may seem, the use of an investment company's rental cashflows to buy-back or redeem its shares does not provide a shareholder with a regular payment in capital form to side-step the income tax charges. Existing rules, together with changes proposed in the Finance Bill 2016, look through the capital nature of the payment to identify distributable profits in the company. If those profits exist, the capital payment is characterised as income and the shareholder pays income tax at up to 38.1%.

Incorporation works particularly well where the 'rent-roll' is strong producing a regular high stream of income for the landlord. If that income is going to become surplus to personal annual needs, incorporation allows the company to receive the profit, adopt a low dividend policy retaining surplus profits for higher working capital.

It is entirely possible that a future government might raise the corporation tax rate in residential property investment companies. That risk will always remain, but with the April 2016 increase of 7.5% in shareholders' personal tax rates on dividends the Treasury is expected to raise an additional £2.5 Billion per annum. The SDLT entry-fee of placing real property in a company and the desire for the Treasury to maximise the 'public record' through company disclosures, may be two further reasons why any government in power might be well advised to leave corporation tax on investment companies alone.

Value Added Tax opportunities

Developers of residential property have a range of VAT benefits. **Alan Pearce** explained that zero-rate relief is available for new residential construction even where part of an existing building is required to be retained under the planning conditions. However this relief only applies where a single façade, or in the case of a corner plot, up to two facades are required to remain in place. .

Conversions from non-residential to residential use can benefit from the reduced 5% rate as will a change in the number of dwellings in a building already in residential use. The reduced rate does not apply to refurbishments or alterations unless a there is a change in the type of residential use or the residence has been unoccupied for at least two years before the work commences.

Work must generally be carried out in accordance with planning conditions and consent. Where Permitted Development Rights are engaged, HMRC announced on 3 May 2016 that evidence of written notification from the relevant Local Authority of prior approval, or that prior approval is not required, is sufficient. Deemed consent, where a developer can prove they have not received written notification within 56 days, is also acceptable.

Seminar closing remarks

There have been twelve significant changes to shift the tax burden onto the residential sector since 2012. Landlords who operate as individuals might now wish to consider incorporating their residential businesses, but this is unlikely to appeal to those that may dispose of property in the short term. Each client is different and comes with unique objectives. Their businesses should be structured to complement their long term commercial goals and personal ambitions. Tax should play 'second fiddle' to those objectives, but awareness of tax opportunities can enhance the bottom line, enable greater profits for reinvestment in the business and increase its longevity.

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