

Incorporating a property portfolio

(Lecture P1144 – 23.05 minutes)

Consider a client who has been buying residential properties over a number of years. The client and his wife are in their mid 60s and have only just started to think about IHT - a very common scenario and a real problem.

The have a portfolio of around 40 properties that they actively manage themselves. The rental income is their main source of income. State pensions will supplement this shortly.

As things stand, most of the current value of their estates is represented by the net value of their UK property business. The properties are currently valued at approximately £10 million. Outstanding mortgages against the properties currently total approximately £3 million.

If no advance planning is put in place, the IHT exposure in relation to their property business will be approximately £2.8 million!

This tax would be suffered by the beneficiaries of their estate. The beneficiaries could make an application to HMRC to pay this tax in 10 annual instalments (thereby deferring the need for their descendants to make immediate property sales to meet the liability). However, the tax - plus accrued interest on the instalments - would be payable in due course and would inevitably require sales of several of the properties.

Advice

Securing IHT Business Property Relief (BPR) on their property business would be an effective way to remove their IHT exposure. This can be achieved by transferring all their properties to a new company managed and controlled by the couple. Over a period of time the buy to lets would be sold to fund development opportunities in the company – we are essentially changing their business model from buy to let to property development.

Clients in this area generally feel comfortable with all aspects of property and given an influx of cash they may be able to take advantage of development opportunities that come their way. As and when tenancies come to an end they could look to sell the property rather than re-let. The clients would then need to move the money into development projects. Over the next 10 to 15 years the nature of the business could gradually transform into property development rather than letting. The couples children could be directors of the company and provide the energy to push the development motives forward in the long term.

BPR will be available on the shares in the new company provided that the company's main activity is the development of land in the two years to date of second death (assuming inter spouse on first death).

Some properties can then be retained for letting without this prejudicing BPR.

The transfer of their property business to the new company can be achieved free of CGT and SDLT. The SDLT savings are dependent on a positive review by an SDLT specialist concerning the existence of a partnership and the 'sum of lower proportions' principles applying on incorporation. In my opinion a couple running a property business of this size would have grounds for partnership status irrespective of whether there is a written partnership agreement, partnership returns etc.

IHT saving

IHT can be saved by securing BPR on the value of the property business. This can be achieved by forming a company to hold the properties and then securing BPR on the value of the shares.

The client would form a company and husband and wife would each have 50% of the issued shares. Those shares will qualify for BPR once they have been relevant business property for 2 years.

To be relevant business property, the business carried on by the company must not be one of 'dealing in land'.

A company that acquires land with a view to selling it on after it has appreciated in value, perhaps after the grant of planning permission, will be a business which is 'dealing in land' and is excluded from BPR.

However, a building company or property development company that operates a business of constructing houses or other properties for resale, will qualify for BPR.

This understanding is confirmed by HMRC in their IHT Guidelines which confirm that BPR is available for a business which at the time of the transfer:

- 1) Is carrying on a genuine building and construction business holding a number of properties (for example, houses or plots awaiting development) as stock in trade; or
- 2) Is a property development company provided that;
 - a) The land is acquired with a view to the development and disposal of the completed development; and
 - b) Most of the profit is derived from the enhanced value of the property resulting from the development (as opposed to increases in the value of the land from the obtaining of planning permission or a general rise in land values).

Case law clarifies HMRC's position by saying that a company whose business it is to acquire land with a view to promoting a development, and then realising the developed land once subcontracted building work has been completed, is not a land-dealing company. This emphasises the point that the development must be entered into for the purposes of an onward sale and not with the intention of retaining the properties for letting.

There can be a fine line between what constitutes 'property development' and what constitutes 'dealing in land', particularly in cases where the site is developed but the completed properties are then let for a period rather than sold (perhaps, for example, due to the absence of buyers in the market).

To maximise the potential for the shares in the new company to qualify for BPR, the client must have a clear intention throughout the process to develop land or properties for sale, and this should be recorded in Board Minutes and company accounts. If the company diverts from this original plan, the reasons for doing so should also be documented.

Case law also suggests that the business activity needs to be commercial. A business plan is recommended to show that the intention at the outset is for the business to be profitable. This helps avoid any claims by HMRC that the development is 'fake' and only exists for the purposes of securing BPR. I would therefore recommend that a professional business plan is drawn up before any project begins.

It is important that the business is a genuine property development business "at the time of the transfer". The 'transfer' is the event which triggers the charge to IHT. It is likely that the couple have Wills which leave their respective estates to each other with the survivor's estate then passing to your descendants on the second death. As transfers between spouses are fully exempt from IHT, this means that no IHT will be due on the first death. The conditions for BPR do not therefore need to be satisfied until the death of the survivor. This could give the company the additional time to really establish itself as a development company.

On second death BPR will be secured if there is a business consisting of the development of land with the intention of resale and the surviving spouse has had that business for two years. It is not essential that a project is complete or that any of the developments have been actually sold, as long as it is clear to HMRC that the company is in the process of actively developing for sale.

Retaining properties for letting

Some businesses will engage in both property development and the holding of let properties. HMRC call such businesses 'hybrids'. It is likely that many companies will operate such a hybrid business.

BPR is available on shares in a company that is "wholly or mainly" engaged in trading activity (property development being a trading activity). "Mainly" in this context means more than 50%. This means that as long as more than half of the activities of your company are concentrated in property development, the shares will be eligible for BPR.

Activities are measured by looking at criteria such as business turnover, assets employed, expenses incurred, and time spent by directors in managing the company. As existing rental properties are sold by the company to fund the development, the activities will gradually shift more into the development side such that we will reach a point where the company is "mainly" trading.

This will be the tipping point for BPR. That point will then start the "clock" running, and once two years have elapsed from that date, BPR will become available.

This 'wholly or mainly' approach means that development companies can hold some stock for property letting without this prejudicing BPR. HMRC accepts that where a trading company has a secondary non-trading business – for example, property letting – BPR is available on the full value of the shares without any restriction. This is because the let properties are still used in the wider business of the company, albeit not used to generate trading profits.

For example, if you have a company worth £6 million of which £4 million of its assets are employed in the property development side with the remaining £2 million of assets being properties held for letting, it does not necessarily follow that BPR is restricted to 4/6ths of the value of the shares. As long as the property rental arm is run as a “business” – requiring a degree of activity and input from the company directors as opposed to the properties merely being held as passive investments – the full value of the shares will qualify for BPR.

Forming the new company

Creating a new company is quick and inexpensive.

The client would need to choose a name – preferably with the words “property development” in there somewhere! The clients’ would be 50:50 shareholders and co-directors (certainly to start with – their older children can come on board as directors and become more actively involved as the development progresses).

Once the company is formed, the clients would then transfer the whole of their property business to the new company. This will require a solicitor re-registering each of the properties in the name of the company. New financing will be required in the company name to repay the existing funding.

The clients would be disposing of their properties meaning that the transfer has CGT implications. However, where the whole of a business is transferred to a company in exchange for shares, the gains arising on the transfer can be deferred. ‘Business’ in this case will include a property business. The effect of the deferral is that the shares in the new company will inherit the same CGT base cost as that of their current property business.

CGT only then becomes an issue if the shares in the company are either sold or gifted during the client’s lifetime. If they were to retain the shares until their death, the deferred gains would be extinguished and the recipients of the shares would inherit them at an uplifted CGT base cost equal to their probate value.

From the company’s perspective, it would be treated as acquiring each property at its value at the date of the transfer. This means that as and when properties are sold by the company to fund development projects, chargeable gains within the company structure are likely to be very low.

The company would pay corporation tax on its rental profits. The current corporation tax rate is 19% but this is falling to 17% shortly.

The client would no longer pay income tax on these rental profits. Instead they would pay tax on any dividends declared by the company. The current dividend rates are 7.5% for basic rate taxpayers and 32.5% for higher rate taxpayers with the first £2,000 of annual dividends being tax-free.

The other advantage of holding property via a company structure is that the new rules on interest restrictions for individuals do not apply to companies.

SDLT issues

As a general rule, there is no SDLT charge when properties are transferred to a company for no consideration. However, there is an important exception to this principle in that S53 FA 2003 imposes a market value charge if:

- (i) property is transferred to a company; and
- (ii) the transferor is connected with the company (see S1122 CTA 2010 for the meaning of 'connected').

Given that several rental properties will often be put into the company at the same time, this is likely to involve an unacceptably high SDLT charge since they will constitute 'linked' transactions (see S108 FA 2003). At present, the maximum rate is 15% on the top slice of the value acquired by the company.

There are three main ways by which this charge can be mitigated:

- (i) The first is to take advantage of an important deeming rule in S116(7) FA 2003 where six or more properties are involved. Under s.116(7) the properties are treated as one commercial purchase and as such you avoid the additional 3% when corporates buy residential property.

So if 20 properties had a total valuation of £5m the SDLT would be £239,500 i.e. the first £150,000 of consideration is charged at 0%, the next £100,000 at 2% and the balance at 5%. SDLT of **£239,500** is a significant sum but a mortgage free property could be sold to settle this liability.

- (ii) The second relief is known as 'multiple dwellings relief' (MDR) under FA 2003 Schedule 6B. For this you work out the residential SDLT on the average value of one property – and then multiply the result by the number of properties to arrive at the total SDLT due. Do remember that corporates have a 3% supplement on each SDLT rate band.

So a £5m valuation divided by 20 properties gives an average value of £250,000. Residential SDLT on £250,000 is £10,000 being £125,000 at 3% and £125,000 at 5%. For 20 properties this would amount to **£200,000** so it would be more beneficial to claim MDR in this instance. Again, one mortgage free property could be sold to clear this liability.

- (iii) The third arrangement is more complicated but can sometimes eliminate the SDLT charge completely. It requires a partnership – or, better still, an LLP – to transfer the properties to the company and the relevant legislation is set out in Sch 15 FA 2003. It is important to appreciate that the partnership SDLT provisions take priority over the market value rule in S53 FA 2003 – see Para SDLTM34160 of the Stamp Duty Land Tax Manual for confirmation of this statement.

The salient measure is found in Para 18 Sch 15 FA 2003 which uses the following formula to determine the quantum of the SDLT charge:

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

where:

- MV = the market value of the properties transferred; and
- SLP = the 'sum of the lower proportions'.

The SLP definition is provided by Para 20 Sch 15 FA 2003. This involves what is essentially a three-step procedure:

Step One

Identify the partners who are connected persons and who have an interest in the properties after the transaction (ie. through their shareholdings) – they are known as 'relevant owners'.

Step Two

For each relevant owner, find their percentage interest in the properties after the transaction.

Step Three

Add together all these percentage interests – this produces the SLP percentage.

Note that the SLP will be 100 where these partners (eg. husband and wife or mother and daughter) become the only shareholders in the new company. In these circumstances, the application of the above formula will always produce a tax rate of 0%. This is the case even if the aggregate market value of the properties transferred into the company is, say, £8,000,000.

So if the couple are operating as a partnership there will be no SDLT on the transfer of their property business. This couple may not have a written partnership agreement or have ever submitted a partnership tax return BUT they could be operating as a partnership for SDLT purposes. What if this has been their only business for the past 15 or so years and they run it together – seven days a week. The husband and wife could find the properties, her husband obtains the finance and deals with the refurbishments and the wife is the main point of contact for tenants. A profit and loss account is prepared and they split the profit 50:50. In my opinion this would be a true partnership – the lack of paperwork should not alter this fact.