

## Hybrid partnerships with property (Lecture B1402 – 14.20 minutes)

In a recent article, we reviewed a Spotlight published by HMRC on a tax avoidance scheme relating to school fees. There is another one (Spotlight 63) on a scheme involving property businesses.

As a reminder, the Spotlight regime was instigated some years ago by HMRC where the department has identified a scheme which they believe does not work. These are schemes which HMRC has not yet had the opportunity to formally challenge but where they are indicating, in advance, that they will enquire into any taxpayer who has utilised the planning. So, these are meant to act as a warning. If someone uses a scheme which has been highlighted by a Spotlight, it is likely HMRC will argue that a deliberate offence has been committed and so penalties will be higher if it is shown not to work.

HMRC contends that the arrangements seek to avoid tax by allowing individual or joint property landlords to transfer their properties to a limited liability partnership (LLP) with a corporate member. The LLP then allocates profits on a discretionary basis to members.

The arrangements claim to work as follows:

1. The individual landlords or their family members, or both, set up a limited company.
2. The individual landlords set up an LLP alongside the limited company – the limited company is considered the corporate member.
3. The individual landlords transfer their properties to the LLP.
4. The members of the LLP (the individual members and corporate member) allocate the LLP profits to themselves on a discretionary basis to make sure that
  - a. The individual members remain basic rate taxpayers
  - b. The remaining profits are allocated to the corporate member
5. The corporate member claims a deduction for finance costs (such as mortgage interest) relating to the properties.

Landlords are advised that this arrangement results in less tax being payable for the following reasons:

- The transaction relating to the contribution of properties to the LLP has no upfront tax cost and properties' base costs are uplifted to their market value at the date of transfer for CGT;
- The landlords remain basic rate taxpayers meaning they are not impacted by finance cost restrictions;
- The corporate member can claim a full deduction for its share of finance costs as finance cost restrictions do not apply to it;
- The corporate member is subject to Corporation Tax on its net profit share instead of paying higher or additional income tax rates that would apply if the profits had been allocated to the landlords;

- Calculating the capital gain using an uplifted base cost at the date the properties are contributed to the LLP reduces the Capital Gains Tax paid compared to using the original purchase and improvement costs, if the property is sold;
- Business Property Relief (BPR) may be claimed in respect of a hybrid structure carrying on a property rental business resulting in no Inheritance Tax being due, if the landlord dies.

This scheme is seeking to address issues which we have also discussed in previous articles where property landlords are suffering a higher rate of tax due to the interest relief restrictions introduced in 2017.

Whilst transferring into a limited company would remove that problem, there is a CGT cost unless it can be shown that the property rental is a business so that incorporation relief under s162 TCGA 1992 can be claimed and an SDLT cost unless there is a pre-existing partnership (and joint ownership does not mean a partnership exists).

In HMRC's view, there is a long list of reasons why this scheme does not work and it is actually difficult to disagree with the technical analysis put forward by HMRC:

- The mixed member partnership legislation introduced in 2013 attacks excess profit allocation to a corporate member;
- This may be caught by the disposal of income streams anti-avoidance legislation in ITA2007;
- The transfer of assets to a partnership does not result in an uplift in the base cost as the LLP is transparent for CGT purposes so the partners are treated as continuing to hold the property; and
- A property rental business is unlikely to qualify for BPR even if it is conducted via an LLP as it is still an excluded business of 'making or holding investments'.

One interesting aspect of this Spotlight is that HMRC states 'if you think you're already involved in this arrangement and want to get out, HMRC can help. HMRC offers a range of support to get you back on track ...'. It is unclear what they propose but it may be that they are willing to allow such arrangements to be unravelled without triggering further tax charges or penalties. The normal warning about what will happen for those who don't choose to stop using these is obviously included.

As someone who advises on this area of tax, it is a scheme which is familiar and one of a number that are currently marketed aggressively by the many property websites available to property landlords.

Further investigation shows that these schemes typically involve declaring a trust over the property in favour of the LLP without actually transferring the property. An added benefit of this is that there is 'no need to tell the mortgage lender'. Although not a tax issue, this is likely to cause a default on the mortgage and may make the property impossible to mortgage.

The HMRC commentary also does not mention the SDLT position. Transfer into a corporate partnership would trigger an immediate SDLT liability since the rules which would normally exclude SDLT applying where property is transferred into an LLP do not apply in the same way where there is a corporate member. Since the SDLT partnership provisions rely on income shares rather than

capital shares, this would be triggered. There would also be an SDLT charge every time there is a change in the property sharing as this would be a property investment partnership.

It is important to note that there are other schemes out in the market which are also subject to some debate as to their effectiveness.

One such scheme involves transferring a property into a company in exchange for shares but with the completion being deferred so that the individual remains the registered owner of the property with a trust arrangement put in place instead. This means that the mortgage lender (in the promoter's view) does not need to be notified. Incorporation relief is claimed and it is recommended that this is done by a partnership so that no SDLT is due. The individual continues to pay the mortgage but the company agrees to indemnify the individual against the interest and so reimburses the interest to them. The company claims tax relief on these payments.

It is likely that this puts the individual in default on their mortgage. The likelihood is that the individual is taxable on the indemnity payments but can't claim relief for the interest as they are no longer running a property rental business. The company would not be able to claim a deduction for the interest costs as these are governed by the loan relationship provisions and these payments do not arise from a transaction for the lending of money. HMRC could then potentially disallow them as not being wholly and exclusively for the purposes of the property business.

Finally, another scheme was promoted to a client of mine which involved formation of an LLP into which property was transferred. The LLP was then put into liquidation and the property transferred out of the LLP into a new company. This is done within 12 – 18 months.

The technical analysis by the scheme promoters was that the LLP would get uplift to market value for CGT purposes at the time that the property is introduced into the LLP as it would lose its transparency when it goes into liquidation. It can therefore transfer into the company without any tax being paid (assuming no uplift in value since the LLP is formed) with the amount left outstanding on loan account for the previous individual owner but without tax having been paid on the uplift. The SDLT partnership provisions are not disapplied by the liquidation but the anti-avoidance provisions which would normally stop this being done within 3 years are not relevant due to the circumstances.

The arguments made in this case seemed more plausible but were backed up by lots of statements stating that barrister's opinion had confirmed their technical analysis but was not available for us to see because they could not find them. My advice to the client in the end was that there was scope for HMRC to make arguments which could be difficult to counter. We had been told that HMRC had considered this in other enquiries and agreed it worked but that they could not give us details due to client confidentiality. I could not recommend the client used this scheme as I felt it relied (in my actual words) on a 'somewhat twisty interpretation of the legislation'. In the end, he did not go ahead due to the eye-watering level of fees that they wanted to proceed.

Whilst there is obviously room for tax planning when advising clients, this is obviously an area where there needs to be detailed scrutiny of anything being promoted to clients. As has been said before, if something seems too good to be true, it probably is!

*Contributed by Ros Martin*