

Joint ownership

(Lecture P1212/ 1213 – 13.15 /7.24 minutes)

Tax issues in relation to jointly owned assets are quite straight-forward, right? Simply split income and gains 50:50 and if one of the co-owners dies, charge IHT on the value of a 50% interest. Job done.

Well, yes and no. This is the UK tax system so things are never as simple as they may seem.

This article will consider jointly owned assets and in particular:

- How income is allocated between spouses;
- How income is allocated between joint owners who are not spouses.

This article will concentrate on income from jointly owned land and buildings (and in particular residential dwellings) simply because these are the assets which generate the most queries.

All references to “spouses” in this article should be taken to include civil partners and any legal references are to the law in England and Wales.

Legal and beneficial interests

Let’s get the legal stuff out of the way before we start.

Under English law, there can be separation of legal title and beneficial ownership. For example those persons holding the legal title of asset (ie, the owner of the property as registered at the Land Registry) may not necessarily be the same as those who hold the beneficial (ie, the financial) interest.

A person can be said to have a beneficial interest in land or property if he has a right to the income from the property (or the right to a share of it) or a right to the proceeds from the sale of the property (or part of those proceeds). Beneficial owners are not registered on the title deeds at the Land Registry.

A legal interest therefore gives the owner a right of control over the property. A beneficial interest is a right to benefit from the property (ie, an economic benefit). Where the legal and beneficial owners are different, the arrangement is effectively a trust under which the legal owners act as trustees and hold and control the property on behalf of the beneficial owners (beneficiaries).

Where two (or more) people buy property together, under English law they must register their legal co-ownership position as either joint tenants or as tenants in common.

A joint tenancy means that both co-owners are equally entitled to the whole property and one joint tenant cannot force a sale of the whole or part of a property without the consent of the other. On death, the deceased's share of the property will automatically pass by survivorship to his fellow joint tenant. This arrangement is common where the co-owners are spouses.

Alternatively the co-owners may register their co-ownership of the property as tenants in common, which means that each owns a specified share of the property (and is free to deal with this as he/she chooses). On death, the respective shares of the co-owners will pass in accordance with their Will (or under intestacy).

Declarations of Trust

Where property is registered jointly, the supposition is that beneficial interests are equal unless there is documentary evidence to the contrary.

Co-owners who wish to separate legal and beneficial ownership or who wish to record their different beneficial interests in a property can do so by a Declaration of Trust (DoT).

This is common in situations when two people (normally non-spouses) buy a property together and contribute unequal shares to the acquisition costs (for example one person may have contributed more savings towards a deposit for a mortgage and may naturally want a higher interest). The owners will want to ensure that their beneficial share of the property reflects their contributions and that income from the property and proceeds of sale are thereafter divided in proportion to those contributions.

If two (or more) co-owners hold a property as tenants in common and thereafter want to change their beneficial interests, the most common way to achieve this is via a Declaration of Trust. This is a specific agreement – most commonly a written document executed as a Deed - which confirms the proportions in which the property will be held going forward.

The DoT sets out the economic interests of each beneficial owner. The DoT can be worded so as to give beneficial owners rights to all economic benefits or just some. For example, a DoT could give the beneficial owners a right to the rental income but not to the capital proceeds on sale.

DoTs are typically drafted by a solicitor and are relatively standard documents. Templates are available on the internet if solicitor costs are prohibitive although care should be exercised when using these.

How property income is allocated between spouses for tax

The default position is provided by S.836 ITA 2007 which says that income from property held jointly by spouses who are living together is automatically split equally between them for income tax purposes. This 50:50 rule applies regardless of whether the joint owners are entitled to benefit equally from the property.

Therefore if a married couple (H and W) own a rental property and H is beneficially entitled to 75% of the asset and W to 25%, each would be taxable on 50% of the rental profits. Their actual beneficial interests in the property are ignored for income tax purposes.

This means that if (for example) X owns a rental property outright and wishes for some profits to be allocated to his spouse (Y), X could simply gift a 1% interest in the property to Y. The property would then be jointly owned (and registered as such), so income would be split 50:50. This is a simple and effective solution where X essentially wishes to share the income but retain the asset.

It is important to note that S.836 only applies for the purposes of income tax. The CGT and IHT treatment follow actual beneficial entitlement. Therefore on a disposal of the property, the gain would be split 75:25 between H and W (or 99:1 between X and Y).

Similarly on (say) H's death, his estate would include the value of a 75% interest (in this case being 75% of the whole under the IHT "related property" rules).

Exceptions

There are some exceptions to the 50:50 rule most commonly:

- Income from partnerships;
- Income from UK or non-UK furnished holiday lettings (FHLs); and
- Income from jointly held shares in a close company.

Husband and wife partnerships

In the case of a jointly owned (non FHL) property portfolio, the 50:50 default position can be circumvented by a husband and wife forming a partnership and allocating their property business profits in accordance with the partnership agreement.

Some care needs to be taken here because, according to HMRC:

"Joint ownership of property does not, of itself, create a partnership. There can only be a partnership if, exceptionally, the exploitation of the property constitutes the carrying on of a business jointly with a view to profit".

To verify the existence of a partnership, HMRC will often ask to see the partnership agreement and will look to see whether the income from the property has been declared as partnership income under self-assessment. Individuals can be in partnership without having a formal partnership agreement as long as it can be established that they are "carrying on a business in common with a view to profit". This requires the owners to be actively managing the properties on a day-to-day basis (rather than passively collecting rents).

In the absence of any evidence that a husband and wife partnership exists, profits will be split 50:50.

Furnished holiday lets

There are no such issues with qualifying furnished holiday lets. Assuming the appropriate letting and availability tests are met, profits are treated as arising from what is effectively a trading business and can be allocated for income tax purposes in whatever proportions the husband and wife so choose.

Overriding the 50:50 treatment

There may be reasons why a married couple may wish for the income from their jointly held asset to be taxed in a different way.

For example, one of the spouses may be a higher/additional rate taxpayer while the other may have unused personal allowances or may pay income tax at basic rate only. It may also be useful for the co-owners to reallocate income between them so that both have total income of less than £100,000 (to preserve full entitlement to personal allowances) or to bring income under the £50,000 threshold for clawback of child benefit.

If the couple wishes to be taxed in accordance with their actual beneficial interests in the property (thereby overriding the 50:50 default position), they can do so by making an election under S.837 ITA 2007. In practice this is achieved by making a declaration using HMRC's Form 17 ("Declaration of beneficial interests in joint property and income"). Like pretty much everything nowadays, this can be done online.

A Form 17 election sets aside S.836 and means that from the date of the declaration, each spouse is chargeable to income tax on the income to which they are actually beneficially entitled. So in the case of H (who is beneficially entitled to 75% of their co-owned rental property) and W (who is beneficially entitled to 25%), a Form 17 election would mean that rental profits are thereafter split 75:25, thereby pushing more taxable income into H's hands.

The Form 17 election cannot be used to alter the actual beneficial ownership of the asset and will not therefore permit the income from the asset to be divided in any way which does not align with beneficial entitlement. For example, if H and W own a property 75:25, they cannot use Form 17 to allocate rental income (say) 20:80. If the couple want a 20:80 split of income, they will have to take legal steps to change their actual beneficial entitlement (for example, by means of a Declaration of Trust).

On receiving Form 17, HMRC may ask the spouses to provide evidence that the couple are in fact entitled to a non-equal share in the property. In the event of an enquiry, the onus is on the taxpayer(s) to prove that the beneficial ownership is different from the legal ownership. Such evidence normally takes the form of a written declaration (DoT) or trust deed. Attaching the DoT to the Form 17 is common practice and puts this issue to bed.

Form 17 elections are made on an asset-by-asset basis and must state the asset to which the declaration relates.

The election must be signed by both spouses. The election is effective from the date of the last of the spouses to sign provided it is submitted to HMRC within 60 days of that date. It cannot be backdated.

For example, if a couple wish to make an election in respect of a rental property and wish to make the new arrangement effective from 6 April 2020, they must both sign and date on 6 April 2020 and submit the election to HMRC by 4 June 2020. If the election is submitted after the 60-day time limit has elapsed, it will not take effect and a new one must be submitted. Until the new one is in place, income will continue to be split 50:50. There is no limit on the number of declarations a couple can make in respect of the same asset.

Once in place, the election will apply until either:

- The couple separates;
- One spouse dies; or
- There is a change in the couple's beneficial interests in the property.

If there is a change in the couple's beneficial interests in the property, the existing Form 17 election becomes invalid and the default 50:50 position is reinstated until such time as a new declaration is put in place.

One very important thing to note (and one which is often overlooked) is that a Form 17 declaration can only be made if the co-owners hold the property as tenants in common. Most spouses tend to hold property as joint tenants (very often the "joint tenants" box on the Land Registry form is ticked without much thought), so if a Form 17 declaration is being contemplated, the joint tenancy would need to be severed in favour of a tenancy in common.

CGT issues

CGT follows beneficial ownership. In other words, it follows the money.

As mentioned above, neither S.836 nor Form 17 have effect for CGT, so on a disposal of the property, the capital proceeds (and as a consequence the resulting capital gains) will be split on the basis of beneficial ownership (as evidenced by the DoT). So if no Form 17 election has been made and income is split 50:50, capital gains may still be taxed in a different proportion.

If this is not desired, a DoT to change beneficial rights to capital proceeds can be entered into just before the sale of the property to ensure that gains are taxed in a CGT efficient way (for example, to use annual exempt amounts, 18% bands and brought forward capital losses). This sort of planning is rarely challenged by HMRC (even where the gap between the DoT and the sale are perilously close) because this is simply seen as the couple maximising reliefs entitled to them.

Where spouses enter into a DoT and change their beneficial rights to capital proceeds, this is a disposal by the spouse whose beneficial interest is going down. However this is of limited concern as the transfer will be treated as taking place at no-gain-no-loss.

Watch out for the "settlements legislation"

The only real danger lurking at the bottom of this particular pool is the shadow of the settlements legislation which HMRC can (and will) use when one spouse (typically the higher earner) tries to divert income to the other spouse to reduce their overall income tax burden but without accompanying that with a right to capital.

A "settlement" is widely defined and includes any disposition or arrangement which confers "bounty" or has gratuitous intent. A transfer of assets between spouses is therefore a settlement.

Under S.624 ITTOIA 2005, where a spouse (“A”) creates a settlement for the benefit of another spouse (“B”), the income of the settlement is taxed on spouse A unless:

- The gift is an outright gift of an asset;
- The gift is unconditional;
- The gift carries a right to the whole of the income; and
- The gifted property is not substantially a right to income.

The settlements legislation will be in play where spouses enter into a DoT to change their beneficial interests in a property, but the DoT deals with income only. If the DoT acts simply to divert a right to rental income from spouse A to spouse B but does change beneficial entitlement to proceeds on disposal, the gift can be construed as being a gift of a right to income. S.624 will then tax spouse A on the income diverted to spouse B, making the planning ineffective.

Therefore where spouses wish to play around with DoTs and Form 17 elections to ensure that income is “in the right place” for income tax purposes, they must ensure that the paperwork is drafted so as to ensure that income and capital rights are aligned. If spouse B is to be allocated (say) 80% of the rental income, spouse B must similarly have a beneficial right to 80% of the proceeds of sale. Otherwise a HMRC attack under the settlements legislation should be expected.

Main residences

I know we’re talking here primarily about let properties, but we could be dealing with a property which was previously used by one of the co-owners as a home. In which case care needs to be taken when transferring interests between the spouses to ensure that PPR relief is not prejudiced.

Where the property in question was previously the main residence of spouse A, a transfer of beneficial ownership to spouse B may mean that private residence relief is lost accidentally.

S.222(7) TCGA 1992 deals with PPR relief on dwellings transferred between spouses and says that spouse B will only inherit the ownership and occupation history of spouse A where the property is transferred while it is the main residence of both of them. [This was discussed in detail in a previous TSO in December 2017: “Spouses with Houses”.]

If the property is not the couple’s main residence at the time of the transfer of beneficial ownership, the full PPR relief which spouse A would have been entitled to on sale of the property, will not apply to a disposal by spouse B.

How income is allocated between joint owners who are not spouses

The 50:50 rule in S.836 ITA 2007 only applies to spouses living together. It does not apply to jointly held property in any other relationship.

Where S.836 does not apply, income (and indeed gains) are divided between the joint owners in accordance with their actual beneficial ownership.

Neither does the “equal split” rule apply in cases where a husband and wife co-own property with a third (or fourth) party. Per the HMRC Trusts, Settlements and Estates Manual (TSEM9810):

“Sometimes a married couple or civil partners hold assets jointly with others. The 50/50 rule does not apply in such cases. It applies only to income arising from property held in the names of individuals who are married to, or who are civil partners of, each other, and who live together.”

So in cases where parents co-own a rental property with (say) their two adult children, any rental profits will be divided between the four parties in accordance with their actual beneficial ownership. No Form 17 election is necessary.

Changing beneficial interests by Declaration of Trust

Where the joint owners are spouses, the DoT itself will not change the income tax position as this is determined by S.836 (which automatically divides income 50:50). The division of income will only be changed if the DoT is followed by a Form 17 declaration. Gains will be split in accordance with the beneficial entitlements specified in the DoT with effect from the date of the DoT (as S.836, and by definition Form 17, has no effect for CGT).

Where the joint owners are non-spouses, the position is more straight-forward. The execution of a DoT to alter beneficial entitlement will drive the tax treatment from that point. Income and gains will thereafter be divided in the proportions specified by the DoT. No Form 17 is required. We simply follow the money.

The income tax position is very simple. Income will be split in whatever proportions the parties have agreed in the DoT. This can be tailored to the tax situations of the co-owners, so (for example) an unmarried couple can agree to divide income from their rental property in any way they choose so as to utilise allowances and tax bands in the most efficient way. This can be varied year-on-year depending on their financial circumstances.

The main issue to consider for unmarried co-owners is CGT. Where beneficial interests in the property itself (not just the rental income) are changed by a DoT, this is a disposal of an interest in a chargeable asset by the co-owner whose interest is decreasing. As this will not be a bargain at arm’s length, the disposal will be treated for CGT as taking place at market value, potentially giving rise to a chargeable gain (depending on the CGT base cost – part disposal rules will apply to determine this).

As most rental properties (FHLs excepted) are not “business assets”, deferral relief will not be available. There may be the option to pay the CGT in instalments under S.281 TCGA 1992, but this merely postpones the inevitable. And the instalments will be interest-bearing.

The solution is to draft the DoT such that it deals with the allocation of income but leaves capital entitlements unchanged. There is then no disposal and no resulting gain.

This will be a “settlement” - being an arrangement which confers bounty in the form of a right to income - but as the settlements rules in S.624 only catch income diverted to spouses, these are of no consequence.

The settlements rules will impact on the arrangement if the DoT allocates a beneficial interest in an asset away from a parent and into the hands of a minor unmarried child. In this case, the income that thereafter arises to the child (assuming it exceeds £100 per annum) will be taxed on the parent settlor under S.629.

“Minor” children are those under the age of 18. Therefore parents can use DoTs to divert rental income into the hands of children over 18 in order to use personal allowances and basic rate bands (which may otherwise be wasted). This could be a useful way of funding (say) college / university costs and is more tax efficient than simply making cash gifts from post-tax income. As a matter of good practice, if income is diverted using a DoT, the income should be paid into the bank account of the beneficiary (not the gifting parent(s)).

Example

Fred and Gina own an investment property which is rented out and generates profits of £10,000 per annum. This income is split equally between them. Both are higher rate taxpayers. The net income (being £6,000) is gifted to their daughter Imogen who is 19 and at college. The gifts go towards paying Imogen’s rent and college expenses.

Fred and Gina sever their joint tenancy and enter into a Declaration of Trust under which Imogen is given a beneficial right to 100% of the rental income. The Declaration of Trust gives Imogen no entitlement to proceeds of sale.

For income tax purposes, Imogen has rental income of £10,000 per annum. This is covered by her personal allowances. There is no attribution of income to her parents as Imogen is over 18. Imogen now has £10,000 to spend on rents and college fees. HMRC is now helping fund her education.

Inheritance Tax

Any mention of “gifts” makes an IHT practitioner prick up his ears, so if the donor’s estate has diminished as a result of the transfer of income, a PET could arise. However given that this is a gift of income, it is likely that the exemption for normal gifts out of income (S.21 IHTA 1984) would apply and a PET would be avoided.

As IHT also follows beneficial ownership, where a beneficial interest in an asset (and not just a right to income) has been shifted from person A to person B, this will be a PET and IHT will be an issue if the donor dies within 7 years.

Given the nature of the asset, Business Property Relief is unlikely to be available. This is the case even where beneficial interests in furnished holiday lets are being transferred (FHLs might be a trade for income tax and CGT but case law suggests otherwise for IHT).

Stamp Duty Land Tax

Stamp Duty Land Tax will always rear its head where arrangements include transfers of property interests, but SDLT is a percentage of consideration and if there is no consideration there is no SDLT.

Remember however that the assumption or transfer of debt is treated as consideration for SDLT so if beneficial interest changes are accompanied by a parallel shift in liability for a mortgage, SDLT could be payable (and at higher rates if the “purchaser” simultaneously has another residential interest which will often be the case).

The effects of consideration

Where the joint owners are non-spouses, a DoT to alter beneficial entitlement is more likely to be done in return for consideration.

For example, where two friends co-own an investment property and friend A agrees to reduce his beneficial interest in the property in favour of friend B, it is not unreasonable for friend B to pay consideration to friend A for relinquishing part of his rights to income and proceeds on sale.

The payment of consideration has no effect for income tax. For CGT, the consideration will act as sale proceeds as long as the arrangement has no gratuitous intent. If the transfer does not constitute a bargain at arm's length, market value will stand in place of actual proceeds.

For IHT, as long as the consideration represents fair value for the beneficial interest foregone, there is no fall in value of friend A's estate and no PET. A transfer of value will only arise if friend A is deliberately selling at undervalue.

The consideration will be liable to SDLT being an amount paid by a purchaser to acquire an interest in land. Higher rate duty will be due if friend B already owns a residential property. However be aware that no SDLT will be due if the consideration paid is less than £40,000.

Other issues

Finally don't forget that shifting beneficial interests in property using Declarations of Trust has non-tax considerations as well and may impact on things such as:

- Mortgages – in most cases the mortgage lender will need to be informed about (and may need to give consent to) changes in beneficial ownership;
- Wills – these may need to be revisited if estates are substantially changing.

Contributed by Steve Sanders