

Property incorporations (Lecture B1332/ B1333 – 15.42/14.43 minutes)

Interest relief

It is clear that interest rates are increasing and may increase significantly more in the future. This leads to some interesting discussions between property landlords and their advisors. Those conversations may lead to the thoughts, again, of incorporation. Let's consider the potential problem and what the impact might be. Are we panicking too soon?

What is the problem?

Since 6 April 2017, there has been a restriction on the deduction of finance costs from a 'dwelling related loan' on let residential properties. Instead there is a tax reduction for such costs at the basic rate of income tax.

It does not impact commercial property landlords and does not apply to companies with residential letting businesses unless they are acting in a fiduciary or representative capacity. It also does not apply to loans to purchase furnished holiday accommodation. This was phased in over a number of years and is now fully operational.

The basic mechanism is that you do not get a deduction for any interest costs in computing the profits of your property business. Instead, a 'tax reducer' (basically a tax credit) at a rate of 20% of the allowable interest, is applied in the tax computation. There is a further potential restriction since the 20% can only be applied to a maximum of the rental profits for the year, so that if you have losses being utilised to reduce those profits, then the relief is restricted. It can also be restricted to the adjusted total income of the year excluding savings and dividend income. To make this even more complicated, each property rental business (not property, but each business where someone is holding property in a different capacity) is considered separately. Any interest which is not utilised in calculating the reducer is carried forward and can be used in subsequent years but many businesses are carrying forward large amounts due to historical losses.

But what might the impact be of an increase in the interest rate?

Let's consider an individual who has property worth £1m which has £650,000 of borrowing. That property generates £4,000 per month and the other expenses are around £500 per year.

The individual has been lucky to obtain a fixed mortgage rate of 2.29% and is paying £1,240.42 per month in interest on the borrowing.

This interest amount will remain fixed even if the person is repaying capital also, although funding the capital repayments will be an issue which also has to be considered.

The tax calculation is as follows:

	BR taxpayer	HR taxpayer	AR taxpayer
Income	£48,000	£48,000	£48,000
Expenses	£500	£500	£500
Net profit	£47,500	£47,500	£47,500
Tax on profit	£9,500	£19,000	£21,375
Less tax reducer: $(1,240.42 \times 12) \times 20\%$	£2,977	£2,977	£2,977
Net tax liability	£6,523	£16,023	£18,398
Net income after interest and tax	£26,092	£16,592	£14,217
Net income if interest deductible	£26,092	£19,569	£17,938

The capital repayments on this loan over, say, 20 years would be an additional £2,137.84 per month, giving a total of £25,654 per year. This would leave a deficit unless you were a basic rate taxpayer, but in reality, the same is true even if you had a deduction for the interest. It is appreciated that many landlords have interest free mortgages.

What if the interest rate increased to 7%? The interest payable each month would then increase to £3,791.67. The table then looks like this:

	BR taxpayer	HR taxpayer	AR taxpayer
Income	£48,000	£48,000	£48,000
Expenses	£500	£500	£500
Net profit	£47,500	£47,500	£47,500
Tax on profit	£9,500	£19,000	£21,375
Less tax reducer $(3,792.67 \times 12) \times 20\%$	£9,102	£9,102	£9,102
Net tax liability	£398	£9,898	£12,273
Net income after interest and tax	£1,599	(£7,910)	(£10,285)
Net income if interest deductible	£1,599	£1,193	£1,093

Both higher rate and additional rate taxpayers who would not be generating enough income to pay the interest and the tax, it is clear to see that the net income for even a basic rate taxpayer is going to be significantly reduced (although it is important to note that the income for such a landlord would have been significantly diminished even if the 'old' rules had not changed). There would clearly be no capacity for repayment of capital.

Any landlord who is coming up to the end of a fixed rate term, there are still some deals around 2.5% but the standard variable rate is now around 6% on buy-to-let mortgages (at the time of writing). So further increases in the base rate are going to see problems for landlords.

What about incorporating?

Incorporation is a disposal for CGT purposes and a land transaction for stamp tax purposes. Broadly the same provisions apply for SDLT, LBTT and LTT.

Many lenders may use this as an opportunity to charge higher interest rates for the company so it is not necessarily going to become more economically viable simply by incorporating.

It should be noted that the restriction on interest relief cannot be circumvented by putting in place a licence for a company to exploit the property on behalf of the owner. The author has seen schemes where accountants are claiming that such a licence does not give rise to property income and therefore no interest restriction applies. This is not correct.

Capital Gains Tax

All the properties will be transferred to the company at current market value which will create a capital gain in many cases. This gain could be set against the value of the shares if incorporation relief is available under s.162 TCGA 1992.

If the consideration given by the newly incorporated company is not wholly satisfied by the issue of shares, there will be a pro-rata restriction of the s.162 relief. The assumption of bank debt is not regarded as consideration – HMRC accept that bank debts were business liabilities and hence covered by ESC D32.

The 2013 Upper Tribunal decision in Ramsey provides good authority for treating a substantive property letting activity as a business for s.162 purposes. In Ramsey, the Upper Tribunal ruled that activities ordinarily associated with managing an investment property portfolio can be regarded as a business.

In order to be treated as a business undertaking for s.162 purposes the activities must:

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

Furthermore, the activities must have a degree of substance with a reasonable amount of time being spent on property related activities. Mr and Mrs Ramsey owned a residential block with 10 flats. They spent about 20 hours a week attending to the building, making sure the rent was paid on time, cleaning communal areas, forwarding post to tenants who had left, and ensuring the property was insured and complied with fire regulations. This level of activity convinced the Upper Tribunal that Mr and Mrs Ramsey had a property business for the purposes of s.162.

It would be reasonable to assume that a property portfolio of one or two properties with minimal management time will not satisfy the test.

On the other hand, if a client has lots of properties and spends in excess of 20 hours a week managing their property business, they should have no problems securing s.162 relief. It should be noted that the key factor is time spent rather than number of properties. I would also argue that the time spent could be undertaken by a property manager but HMRC may take a different view. This latter point has not been tested in the Courts.

SDLT (and LBTT and LTT)

S.53 FA 2003 imposes an SDLT charge on the market value of property where it is transferred to a company and the seller is connected to the company or some or all of the consideration consists of the transfer of shares in a company with which the seller is connected. Although these notes refer to SDLT, equivalent provisions apply for LBTT and LTT purposes.

The connection test in s.1122 CTA 2010 applies for s.53 purposes.

Under s.1122 CTA 2012 the following persons are treated as connected with you:

- your husband, wife or civil partner.
- your brother, sister, ancestor or lineal descendant (“relatives”) and their husbands, wives or civil partners. Relatives do not include nephews, nieces, uncles and aunts.
- your husband’s wife’s or civil partner’s relatives and their husband’s wives or civil partners.
- if you are in business in a partnership, your partners and their husbands, wives, civil partners and relatives. Business partners will not be connected in relation to acquisitions or disposals of assets of the partnership pursuant to genuine commercial arrangements.
- a company that you control, either by yourself or with any of the persons listed above.
- the trustees of a settlement of which you are a settlor, or which a person who is still alive and who is connected with you is a settlor.

An incorporation of a property portfolio will undoubtedly fall under s.53. However, where the transfer is under the partnership SDLT legislation, HMRC accept that the partnership “sum of lower proportion” rules take precedence over s.53. Depending on the facts this can result in the consideration being regarded as £nil and as a consequence no SDLT is due on incorporation (FA 2003, Schedule 15, Para 18 – 20).

Schedule 15, Para 18(2) will apply where a chargeable interest is transferred from a:

- partnership to a person who is or has been one of the partners, or
- partnership to a person connected with a person who is or has been one of the partners.

Para 18(2) states that the chargeable consideration shall be taken to be equal to:

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

SLP (which is an abbreviation of the sum of the lower proportions) is calculated using the following steps.

Step 1: First you need to identify the relevant owner or owners. A person is a relevant owner if immediately after the transaction he is entitled to a proportion of the chargeable interest and immediately before the transaction he was a partner or connected with a partner.

Step 2: For each relevant owner, you need to identify the corresponding partner or partners. A person is a corresponding partner to a relevant owner if immediately before the transaction he was a partner and he was either the relevant owner or was connected with the relevant owner.

Step 3: For each relevant owner, you then need to find the proportion of the chargeable interest to which he is entitled immediately after the transaction and this is apportioned between any one or more of the relevant owner's corresponding partners.

Step 4: The next stage is to find the lower proportion for each person who is a corresponding partner in relation to one or more relevant owner. The lower proportion is the lower of the:

- proportion of the chargeable interest attributable to the partner (i.e. the sum of all interests allocated to him under Step 3) or
- partnership share attributable to the partner (see below).

Step 5: The final stage is to add together the lower proportions of each person who is a corresponding partner in relation to one or more relevant owners. This is the SLP.

It must be remembered that the legislation determines the partnership shares by reference to income shares and not capital shares; so the same formula applies even where the land is held within the partnership by one or more partners in isolation to the others.

What this broadly means is that if your property partnership is family owned, it is likely that no SDLT will arise on incorporation although it is important to remember that nephew/nieces are not connected to aunts/uncles so extended families may not fall within the same provisions. Remember that unmarried couples are not connected.

Examples:

Partnership of husband and wife with the transfer to a company which they jointly own. SLP will be 100 because both of them are connected with the company. It would not matter what proportion they held the partnership or the company shares as there is attribution of rights of associates to determine control.

Partnership of John and Nikki who are not connected (the normal rules which say that partners are connected is disapplied for these purposes). They own the partnership 75:25 and transfer to company which they own in same proportion. The SLP will be 75 and so SDLT on 25% of MV. This is because Nikki is not connected to company as it is controlled by John.

Partnership?

One very important issue is whether the properties are held in a partnership or simply owned in joint names. To have access to the partnership SDLT rules you must be operating as a partnership and this is a question of fact. Although many advisors have been very relaxed about this point in the past, the case of *SC Properties Ltd v Anor* [2022] TC08537 confirms that joint ownership is not the same as a partnership. This was not a classic incorporation case but does show that this is not an area for complacency. This case is discussed in detail in the Capital Taxes section of these notes.

Key issues to consider would be as follows:

- Is there a written partnership agreement?
- Have the partners actually been carrying on the business together with a view to profit?
- Has a partnership tax return been submitted to HMRC?
- Is there a partnership bank account?
- Are the partners held out as partners to the outside world?
- Does the partnership enter rental agreements and raise rental invoices in the name of the partnership?
- Have partnership accounts been prepared?
- Do the partners share profits and losses?
- Have the partners contributed capital to the partnership?
- Is business stationery in the partnership name?

If a partnership does not exist then the s.53 FA 2003 market value rules will apply on incorporation so SDLT is payable on the full market value of the properties.

It is also important to be aware of the SDLT general anti-avoidance rules within s.75A FA 2003 where steps have been taken to deliberately use the partnership rules to obtain an SDLT advantage. This might entail moving a property portfolio into an LLP with a view to incorporating within a short period of time. Where a partnership is not currently in existence, it may well be prudent to move a portfolio into an LLP and then sit tight for a while. In reality, if a partnership is formed, it cannot be incorporated for 3 years because of specific anti-avoidance provisions contained within the SDLT partnership rules but if you were to make that move at 3 years and 1 day, HMRC might also be looking at the application of s75A.

Contributed by Ros Martin