



WHITELAW WELLS
CHARTERED ACCOUNTANTS

CLIENT MEMORANDUM

TAX PLANNING FOR PROPERTY INVESTORS OR DEVELOPERS

The purpose of this Memorandum is to set out some of the key tax issues which need to be addressed when you are carrying on a property business. It deals with both incorporated and unincorporated businesses, and describes a number of tax-saving opportunities.

ARE YOU TRADING?

The tax treatment differs according to the precise nature of the business.

It is important to determine at the outset whether you are trading or investing. This is a complex issue but – in broad terms – you will be carrying on an investment activity if you hold property on a medium-term to long-term basis, and are concerned with receiving rental income rather than short-term profits on disposals.

On the other hand, if you build houses/flats for sale or you develop offices/shops for sale this will almost certainly be a trading activity.

The position is more complex if you carry on a “mixed” business. For example, you might build or refurbish a block of 6 flats, sell 4 and retain 2 for investment purposes. You will then be carrying on both investment and trading activities, and it will usually be advisable to separate the two activities. This might be done by carrying on the trading activities in a company. The company could then sell the two “investment” flats to yourself to hold personally; the problem here is that the company will pay tax on the profit realised on the sale. However the ideal solution in this example might be for the proposed investment in the 2 flats to be held from the beginning by a separate entity or by you as an individual. In this way, any capital gain that accrues from the development profit will not be taxable until either or both flats are sold.

If you are contemplating trading as well as investment we can help you to review your choices to achieve the best operating structure.

CAPITAL ALLOWANCES

If you buy commercial properties for investment (whether directly or via a company) it may be possible to reduce tax liabilities by claiming capital allowances.

Generous reliefs are available on expenditure on commercial buildings in Enterprise Zones. These Zones are now all time-expired, but relief may still be due in respect of construction contracts which have previously been entered into. No relief, however, is available on the land element.

In some circumstances, allowances are available on hotels, industrial buildings and agricultural buildings. In the case of the latter, the buildings must be located in the UK. Unfortunately, all these allowances are being phased out between now and 2011. In any case no allowance can be claimed on the land element of the relevant expenditure.

It will often be possible to claim capital allowance on certain fixed items of “plant and machinery” expenditure in shops, offices etc, as well as on the “usual” items such as computer, cash registers, etc. Careful analysis may reveal that the qualifying expenditure is much greater than might initially be expected.

From April 2008, a business (incorporated or unincorporated) qualifies for an annual investment allowance of 100% on plant and machinery, up to an annual total of £50,000. If you have a group of companies, this allowance will be spread among all members of the group it is not possible for each company to obtain the full £50,000 allowance!

If the capital expenditure exceeds the £50,000 allowance, writing-down allowances are given on the excess. The rate is 10% per annum on the reducing-balance basis on “integral features” such as electrical systems cold water systems, heating systems, air cooling, lifts and escalators. The same rate applies to long-life assets (broadly, assets with a useful economic life of at least 25 years).

For other items of plant and machinery, such as computers furnishings etc, the writing-down allowance was reduced from 25% to 20% from April 2008.

There are a number of other allowances which may be relevant to property investment companies e.g.:

Capital expenditure on buildings used for research and development.

Investment in energy-efficient or water conservation assets.

Expenditure on bringing used business premises back into commercial use:

This applies to properties located in certain specified disadvantaged areas.

These reliefs are all quite complex and we shall be happy to advise in detail, if you think that they may be relevant to your business.

STAMP DUTY LAND TAX AND STAMP DUTY

This can be very costly. For instance, if you buy a property costing over £500,000 Stamp Duty Land Tax will be 4%.

It may be possible to reduce the Duty if the vendor is prepared to sell you the company which holds the property rather than the property itself. Stamp Duty will then be payable at only 0.5%

on the value of the shares.

However, great care is needed when considering the purchase of a company in these circumstances, since it may bring unexpected liabilities relating to its past history. Professional costs are also likely to be higher when buying or selling a company.

You may wish to consider using a separate “vehicle company” of your own each time you buy an investment property, so that you can offer Stamp Duty Land Tax savings to a purchaser in due course along the lines discussed above. There are anti-avoidance rules which can apply if a company transfers a property to a “vehicle company” which is a member of the group, prior to onward sale to an outsider, so it is advisable to use a vehicle company (where desired) from the outset.

As described later, “vehicle companies” can give rise to certain tax problems.

VAT

It is important to ensure that you minimise your VAT liabilities when dealing with properties. If you get it wrong, it may cost you an extra 17.5% on your expenditure!

It is particularly important to review your VAT position before you commence activities, before you begin a development or refurbishment and before you sell your business or any property.

It should be borne in mind that the VAT treatment of residential property differs from the VAT treatment of other properties. Special considerations apply if there is a mixture of commercial and residential usage.

SPECIAL RELIEFS

We give below brief details of how certain tax reliefs operate in connection with property matters:-

- The Enterprise Investment Scheme (“EIS”) offers Income Tax and Capital Gains Tax Reliefs when you subscribe for shares in a qualifying trading company, provided that a number of criteria are met.

For this purpose, a property development company does not normally qualify, but a company which builds houses on an ad hoc basis for individuals on land belonging to the individual is likely to qualify.

- Enterprise Management Incentives. This scheme enables options to be granted to employees of trading companies on a tax-efficient basis.

The treatment of property companies is as described above in connection with EIS.

- From 6 April 2008, the maximum rate of Capital Gains Tax for an individual is 18%. This applies to the sale of investment properties, shares etc. In some cases, it will be possible to qualify for the new “entrepreneurs” relief”, which (effectively) produces a Capital Gains Tax rate of 10% for an individual. The rate applies to the first £1m of gain in a person’s lifetime (from 6 April 2008 onwards). The gains must relate to disposal of shares in a

trading company in which the individual is a director or employee and holds at least 5% of the share capital; it can also apply to the sale of business assets (e.g. goodwill on trading premises), where the individual owns the business or is a partner in it, and the sale occurs in connection with the disposal of part or all of the business. There are a number of other conditions to be met and we shall be happy to advise further. Please note that this relief is still going through the Parliamentary process, and the rules may change in this process.

- Rollover relief. If a property is owned and used by a business a gain on disposal may be “rolled over” into the cost of a replacement building. This means that the gain crystallises only on the disposal of the replacement building. There are a number of criteria to be met, e.g. the investment must normally take place within 1 year before or 3 years after the disposal, although the time-limit can be extended in certain circumstances. The relief does not apply to properties which are held as trading assets). Special rules apply if one or both of the properties is leasehold and the lease runs for less than 60 years.
- Business Property Relief. This is a very attractive relief which applies for Inheritance Tax when an individual makes a gift of shares in his (or her) family trading company or holds these shares in his (or her) estate on death. A number of criteria have to be met, but a property development company (but not a land holding or property dealing company) will normally fall within the terms of this relief.
- Companies. As from 1 April 2002, there is a special “substantial shareholding exemption”. This applies where a trading company disposes of shares in another trading company. Various criteria must be met, for instance the shareholding must be at least 10% and it must have been continuously held for at least 12 out of 24 months preceding disposal. This means that a group of property trading companies could sell one or more companies and realise a gain without incurring any tax liability provided the criteria are met. This should be contrasted with the situation where the individual properties are sold, when any trading profit would be fully taxable, and any capital gain would be taxable on the company.

REAL ESTATE INVESTMENT TRUSTS (“REITs”)

After much lobbying from the property industry, the Chancellor has introduced a new tax-efficient medium for use by property investment companies: UK REITs have been able to operate from 1 January 2007.

The rental income from relevant investment properties is exempt from corporation tax, and capital gains on their disposal are also exempt from corporation tax. Dividends paid by the REIT will be taxed as rental income in the hands of the shareholders.

The proposed legislation is very complex, and the use of REITs is subject to important conditions. The main areas are:

- The company must be UK-resident.
- The shares must be listed on a recognised stock exchange.
- When a company enters the new regime, it must pay a one-off charge of 2% of the value of the investment properties.

- 75% or more of its assets must be investment property, and 25% or more of its income must be rental income.
- No single investor can hold more than 10% of the share capital.
- At least 90% of the tax-exempt profits must be distributed each year.

Clearly, REITs are not suitable for small family-owned property businesses, but they will have an important role to play, and may have a profound impact on the property market in due course.

For instance, suppose that a family runs a company which holds a valuable commercial property as an investment. The family decide to sell the property. A sale by the company would give rise to tax on the company in respect of the resulting gain. However, there may be tax savings if the family can cut a deal to sell the company to a REIT: Thus the inherent gain on a sale of the property can be avoided by both parties. The family will have a tax liability on the sale of the shares in the company but not on the property. The REIT has to pay the 2% “conversion charge” when the property enters its portfolio, but a later disposal by the REIT will be tax-free. The REIT and the vendor may be able to agree a mutually acceptable sale price for the family company to take account of the tax savings.

HOW SHOULD I STRUCTURE MY PROPERTY OPERATIONS?

This is a very difficult question to answer. The most tax-effective structure will depend upon your own personal circumstances and objectives. It will also be necessary to review the structure regularly to take account of changes in tax law and changes in your particular circumstances.

As mentioned earlier, there could be future Stamp Duty advantages in operating through a company. In addition, a company pays lower rates of tax than an individual: Corporation Tax is 21% or 28% depending on the circumstances, whereas the top rate of Income Tax is 40%. For an individual the top rate of Capital Gains Tax is 18%.

You should bear in mind that if you operate through a company you will pay Income Tax and National Insurance Contributions if and when you draw your salary. If you take dividends from the company, the top rate of tax on the dividend is 25%, not 40%, and no tax at all is payable on the dividend unless your total income falls into the top band for Income Tax purposes.

Operating through an investment company may mean “double Capital Gains Tax”. This situation arises because the company will have a Corporation Tax liability on the gain on disposing of a property (subject to a deduction for Indexation Allowance), and you will have a further tax liability if you take the net of tax profit from the company by way of liquidation. The total tax liability on the gain in these circumstances can be as much as 42.4%. Despite this tax disadvantage many property investments are made by companies; the benefit of limited liability, so far as the shareholder is concerned, may be an attraction where investment funds are borrowed.

We referred earlier to the very attractive new entrepreneurs’ relief which is available in certain circumstances.

Farmers and other landowners will, of course, normally wish to qualify for this relief. It is

important to ensure that the various conditions for relief are met.

Before investing in a business property for letting you will need to weigh up the various tax pros and cons having regard to your own personal circumstances. We will be happy to assist.

SUMMARY

It can be seen from the above that there are many different issues which need to be balanced when considering the most tax-efficient way to operate a property business or hold property investments. We will be happy to review your situation in order to achieve the best outcome.

Naturally, this Memorandum cannot deal comprehensively with all the tax issues. In addition it is important to consider commercial issues as well, as these may outweigh the tax benefits in some situations.

FOR GENERAL INFORMATION ONLY

Please note that this Memorandum is not intended to give specific technical advice and it should not be construed as doing so. It is designed to merely alert clients to some of the issues. It is not intended to give exhaustive coverage of the topic.

Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein