

TAX PLANNING FOR PROPERTY INVESTMENT AND DEVELOPMENT

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. This might 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 situation in this example, would 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. No relief, however, is available on the land element.

Allowances are also claimable on industrial buildings, wherever they are located, but again the land element has to be excluded.

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Factsheet

It will frequently be possible to claim substantial amounts of capital allowances which will lower purchase costs on “plant and machinery” in offices and shops. This applies both to new buildings and to “second-hand” buildings. In the latter case, careful analysis often reveals that the plant element is much greater than might initially be expected.

The following are examples of types of expenditure which may qualify as plant and machinery.

Lifts and escalators.

Air conditioning.

Burglar alarms.

Installation of hot water supply.

Sanitary equipment.

Emergency/security lighting.

Boilers.

Computers.

Cold stores.

STAMP DUTY

This can be very costly. For instance, if you buy a property costing over £500,000, Duty 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 can be higher when buying or selling a company.

You may wish to consider using a separate “vehicle company” each time you buy an investment property, so that you can offer Stamp Duty 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 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.

As far as property companies are concerned, the position is as described above in connection with EIS.

- Taper Relief is a very attractive Capital Gains Tax relief for an individual who invests in an unquoted trading company, whereby the maximum effective tax rate on disposal after at least 2 years of ownership can be as low as 10%. This special “Business Assets” level of Taper Relief is available in respect of any trading company, so any property company which is taxed as a trading company will qualify.
- 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 or property dealing company, will normally fall within the terms of this relief.
- Companies. As from 1 April 2002, there is a new “substantial shareholding exemption”. This applies where a trading company disposes of shares in another trading company. There are various criteria, 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.

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 nil, 19% or 30%, depending on the circumstances, whereas the top rate of Income Tax is 40%.

You need to 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.

An investment company may mean “double Capital Gains Tax”. This is 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 58%, but it will generally diminish the longer the asset is owned. Despite this tax disadvantage, many 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 beneficial “business assets” level of Taper Relief which is available to individual shareholders in unquoted trading companies.

In addition, if an individual buys a property for investment and lets it to an unquoted trading company, then the maximum effective tax liability on disposal after two years’ ownership will be 10%. It can thus be seen that shareholders in property investment companies with unquoted trading companies as tenants should be reviewing their structure and Capital Gains Tax profile. From 6 April 2004, the relief will be extended to cover lettings by an individual to a sole trader or a trading partnership.

Farmers and other landowners will, of course, normally wish to qualify for Taper Relief at the business assets level, especially if land is being sold for development. It

is important to ensure that the land has been used as part of the business in these circumstances.

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 shall 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.

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.