property118.com /tax IN ASSOCIATION WITH COTSWOLD BARRISTERS

The Ultimate Guide to Landlord Tax Planning

and transitioning between ownership structures

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Introduction to landlord tax planning

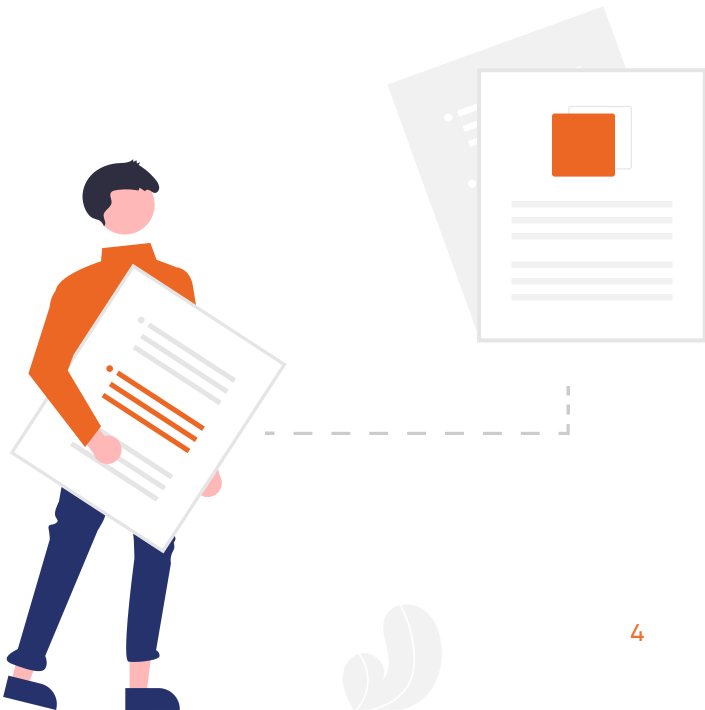
Introduction to Landlord Tax planning

Nobody in their right mind wants to pay more tax than they have to. However, most property investors simply don't know they ***can*** structure their tax affairs to reduce how much tax they legally pay, let alone ***how*** to go about doing it. Very few are aware of the existence of the many forms of tax relief or alternative ownership structures available to help reduce their tax burden.

In most cases, when property investors think of tax planning, they tend to focus on Income Tax efficiency. Why? Because it's ever-present and often we can make changes that bring about an immediate benefit.

However, the largest tax bill that most property investors fear - and quite rightly - is the tax that they pay when they sell property (Capital Gains Tax "CGT") and when they die (Inheritance Tax "IHT").

Another common mistake is to focus on the cheapest form of financing, especially in the early stages of business, which may prevent you from seeing the bigger picture.



Ownership structures & restructuring

When Capital Gains Tax and Stamp Duty were first introduced, the Government recognised that artificial taxation during critical phases of growth could stifle businesses and the economy. Accordingly, extra statutory concessions and reliefs were introduced to ensure that transitioning from one business structure to another (sole owner to Partnership for example) would not suffer the same tax consequences as sale of a business to an unconnected party. Similar reliefs apply when a Partnership transitions into a corporate structure, i.e. limited company.

With the correct planning, it may well be possible to utilise legislation to structure your property rental business without any requirements to refinance or to pay Capital Gains Tax and Stamp Duty (or the equivalents in Scotland and Wales).

The business structures and transitional reliefs recommended by Property118 and Cotswold Barristers are not 'loopholes' or 'tax dodges' - they are perfectly legal structures and reliefs that your average accountant might never consider bringing to your attention, even though they are very commonly used by other types of business. We specialise in bringing the 'big business' thinking that often costs a small fortune to the 'small business' property investor at an affordable price.

Property118 in Association with Cotswold Barristers will help you to understand what is achievable in law and to assist you with legal matters associated with implementation of our recommended strategies. We work with you and alongside your accountants to achieve these objectives. It is important that you involve your accountant at the early stages of discussions regarding a new business structure, because they will need to understand it in order to continue to deal with the accounting and compliance of your business following implementation.

For the avoidance of any doubt, neither Property118 nor Cotswold Barristers recommend 'tax avoidance schemes' that seek to abuse the tax system, or could fall foul of HMRC's General Anti Abuse Rules - 'GAAR legislation'. There are plenty of perfectly legitimate forms of tax relief and tried and trusted methods to structure your property rental business to optimise both your tax and commercial positioning and it is those structures and reliefs that we stick to recommending.

Why 47,100 Buy-To-Let Companies were formed in 2020

This case study illustrates just how unfair the UK tax legislation became for private landlords as of April 2020, by comparing the taxation of the business of a hotelier against the taxation of the business of a private rental housing provider.
Perhaps more importantly, it provides insight into what can be done to "level the playing field".

Let's assume that both businesses own assets worth £2,000,000 and have 75% mortgages secured on them at an interest rate of 5%. In other words, their annual finance cost is £75,000.

Now let's assume that both businesses make profits after finance costs and all other expenses of £50,000.

In the 2020/21 tax year, the hotelier would have paid £7,500 of income tax. This is broken down as follows; £nil on his first £12,500 of net profit and 20% tax on the next £37,500.

However, the private landlord cannot treat his finance costs as a legitimate cost of business in the same way as the hotelier. Accordingly, his tax bill is £27,500. This is because his taxable income is treated as being £125,000 due to being unable to claim his finance costs as business expenses. Furthermore, for every £2 of taxable income over £100,000 he loses £1 of his nil rate tax band. Accordingly, the landlord pays tax at a rate of 20% on the first £37,500 (which equates to £7,500) and then 40% tax on the other £87,500 (which equates to £35,000). This adds up to a whopping £42,500. The government then grant him a tax credit equal to 20% of his finance costs, in other words £15,000 off the £42,500 leaving him with a net £27,500 of tax to pay.

To summarise, the private landlord pays nearly four times as much tax as the private hotelier, even though their financing costs and business results otherwise produce identical levels of actual profit.

How unfair is that?

Now here's where things get even weirder. If both the landlord and the hotelier operated their businesses within a Limited Company structure, they would pay exactly the same amount of tax.

You could not make it up could you?

In fact, private landlords who provide much needed rental housing are the only business to be persecuted in this way. It's hard to believe that politicians turned a blind eye and a deaf ear to campaigning about the unfairness of this policy, which was introduced by George Osborne in the Summer Budget of 2015, but that is exactly what happened.

If you're affected by this problem, the first thought on your mind might well be to move your rental property business into a Limited Company. However, it's not always that straight forward.

> One thing is for certain though; you should NOT buy any more investment property until you have read this eBook.

Section two

‘Smart’ Property Company Structures

Smart Property Company Structures

As you may be aware, borrowing in your own name to acquire properties, using personal buy-to-let mortgages, might result in greater availability of mortgage products and lower interest rates, but only if you have fewer than four buy-to-let mortgages and only invest in 'single let' flats and houses; interest rates for HMOs, developments and semi commercial properties (i.e. flats over shops) are very similar whether you borrow in your personal name or through a limited company, regardless of the number of properties you own. Once you own four or more buy-to-let properties you are regarded by lenders as a 'Portfolio Landlord' and mortgage interest rates and terms on that basis are very similar to those offered to landlords operating through a limited company.

Also, personal ownership has tax consequences that could prove detrimental to your longer term objectives. These include:

- Income tax on profits at your marginal rate, likely to be 40% or 45%
- Capital Gains Tax when properties are sold, likely to be 28%
- Inheritance tax on capital growth, likely to be 40%
- Residential finance costs are no longer tax-deductible, i.e. mortgage interest

However, contrast this with the following common objectives of most property investors:

- To make better provisions for an increased retirement income
- To create a legacy for loved ones
- To minimise the impact of Inheritance Tax on the future capital growth of your property investments
- To be able to control the value of your personal estate which will eventually be subjected to Inheritance Tax, without giving up any rights to income or control of your property rental business

If you invest in residential property in your personal name, the impact of the Section 24 restrictions on finance cost relief is horrendous, because your finance costs will not be tax-deductible as a business expense. Instead, HMRC will only give you a 20% tax credit on your finance costs. This means that it is theoretically possible for your tax bill on your true rental profits to exceed your true rental profits. It is also possible to end up paying tax even if your property rental business is losing money, for example if interest rates were to rise, your rental income was to reduce, or your ongoing costs were to increase. However, the same rules do not apply to Limited Companies; they can still offset 100% of finance costs against rental income as a legitimate tax-deductible business expense.

There are several other commercial reasons to consider buying in a Limited Company, one of which is to ring fence your business liabilities away from your personal wealth. The legislation that landlords must comply with continues to intensify, as do the consequences of making mistakes. Furthermore, litigation is on an upwards trajectory.

In recent years, the Prudential Regulation Authority has imposed increased pressure on mortgage lenders to consider affordability of buy-to-let mortgage lending, particularly for portfolio landlords. This includes treating all landlords who own four or more buy-to-let properties as a business, by factoring in the appropriate taxation policies for their ownership structure into affordability criteria. As a result of this, and the fact that the Section 24 restrictions on finance cost relief does not apply to Limited Companies, borrower demand for Limited Company buy-to-let lending has intensified significantly. Likewise, it is now much easier for mortgage lenders to underwrite Limited Company buy-to-let mortgages than for individual borrowers. The consequence of this has been that the pricing of Limited Company buy-to- let mortgage products has fallen significantly and continues to do so, as lenders compete for market share.

If you buy property in a Limited Company, any capital you invest can be treated as a Directors Loan. This can be repaid to you from post Corporation Tax profits, or the proceeds of selling property or refinancing to raise additional funding when rental income and lending criteria allows, WITHOUT TAX CONSEQUENCES. If you buy the same properties in your own name, you will have no choice other than to pay income tax on profits at your marginal rate and keep your capital locked into the properties. However, within a Limited Company structure you can retain rental profits at the significantly lower rate of Corporation Tax and use that money to repay your Directors Loans, without having to declare salaries and/or dividends.

It is possible to buy an 'off-the-shelf' or 'dumb' limited company online and at very little cost. However, we never recommend that you do that, as it will not be appropriate for your specific long term needs, such as mitigating exposure to Inheritance Tax.

If you have a 'dumb' Limited Company that is not fully optimised for tax-planning purposes then don't worry, it's not too late, even if it does have a much standardised share structure and Memorandum and Articles of Association and no shareholders agreement is in place. The good news is that the share structure and the Memorandum and Articles of Association are usually amendable in accordance with the suggestions below and a shareholders agreement can be drafted and entered into at any time too.

As Inheritance Tax is almost certainly an issue you should address from the outset, a Freezer and Growth Share strategy for your Limited Company should be considered, possibly with the Growth Shares held in a Discretionary Trust.

Once any Directors Loans are repaid, you will continue to be able to extract profits in the form of dividends. One of the many benefits of structuring your property business on this basis is that your seed capital can be returned to you tax free to fund your lifestyle, whilst ensuring that all future growth in property values remains outside of your estate and giving you the ability to declare dividends to any shareholder should you wish to do so.

Smart property company share structures

Shares can be split into different classes and each class of shares can have its own rules.

Ordinarily, shareholders in a company own just one type of share, called 'ordinary' shares. These have:

- Voting rights
- Dividend rights
- All capital appreciation attributed

However, it is possible to have multiple classes of shares, each with different rights.

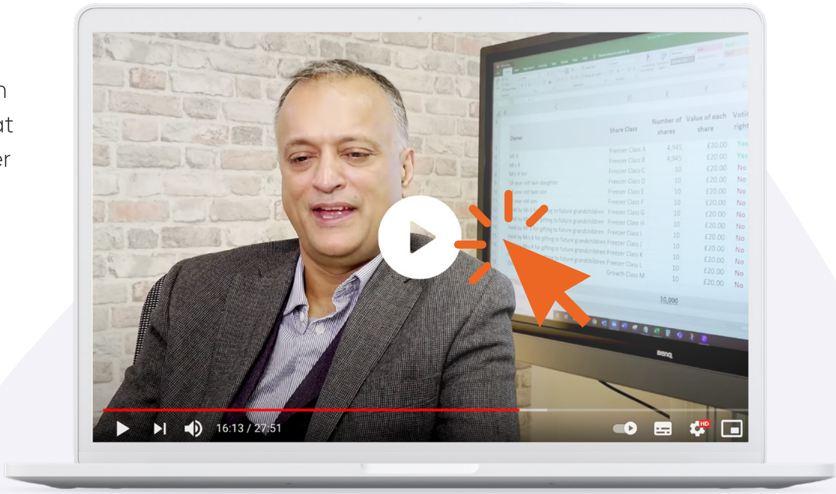
One good reason for having several classes of shares is that the Directors of the company can then decide which class of shares they wish to receive dividends. For example, it might be tax efficient to declare dividends to a class of shares owned by family members who are not fully utilising their tax allowances or fall into a low rate tax band. One classic use of this structure is to pay dividends to retired parents who are basic rate tax-payers and for them to use the money to pay school fees for their grandchildren.

Another classic example is to hold classes of shares with a frozen value to gift to children when they reach the age of 18. Dividends can then be declared on that gifted class of shares to assist with the costs of further education, to help them buy their first car, or to save for a deposit on a home of their own.

One of the keys to the success of this structure is knowing how to freeze the value of the majority of the share classes, so that they can be gifted at a later stage with minimal (if any) Capital Gains Tax implications and/or falling foul of the settlements Legislation. There are only a handful of lawyers in the UK who know how to do this properly, most of whom charge upwards of £5,000 + VAT just for an initial consultation, during which you are unlikely to receive as much information as we are giving away for free in this eBook.

It is also possible to create a class of shares that initially has only a nominal value, because they have no voting rights and no automatic rights to receive dividends, but to which all capital appreciation in the business can be attributed to in the future. This can be incredibly efficient for Inheritance Tax planning purposes.

> The link below is to a 27-minute video explaining more:



In the video we discuss the following example...

Owner	Share Class	Number of shares	Face value of each share	Voting rights	Dividend rights	Capital rights	Total share value
Mr X	Freezer Class A	4,925	£0.01	✓	✓	✗	£49.25
Mrs X	Freezer Class B	4,925	£0.01	✓	✓	✗	£49.25
Held for future gifting by Mr X	Freezer Class C	10	£0.01	✗	✓	✗	£0.10
Held for future gifting by Mr X	Freezer Class D	10	£0.01	✗	✓	✗	£0.10
Held for future gifting by Mr X	Freezer Class E	10	£0.01	✗	✓	✗	£0.10
Held for future gifting by Mr X	Freezer Class F	10	£0.01	✗	✓	✗	£0.10
Held for future gifting by Mr X	Freezer Class G	10	£0.01	✗	✓	✗	£0.10
Held for future gifting by Mr X	Freezer Class H	10	£0.01	✗	✓	✗	£0.10
Held for future gifting by Mr X	Freezer Class I	10	£0.01	✗	✓	✗	£0.10
Held for future gifting by Mrs X	Freezer Class J	10	£0.01	✗	✓	✗	£0.10
Held for future gifting by Mrs X	Freezer Class K	10	£0.01	✗	✓	✗	£0.10
Held for future gifting by Mrs X	Freezer Class L	10	£0.01	✗	✓	✗	£0.10
Held for future gifting by Mrs X	Freezer Class M	10	£0.01	✗	✓	✗	£0.10
Held for future gifting by Mrs X	Freezer Class N	10	£0.01	✗	✓	✗	£0.10
Held for future gifting by Mrs X	Freezer Class O	10	£0.01	✗	✓	✗	£0.10
Held for future gifting by Mrs X	Freezer Class P	10	£0.01	✗	✓	✗	£0.10
Discretionary Trust	Growth Class Q	10	£0.01	✗	✗	✓	£0.10
Totals		**10,000**					**£100**

The share classes C to P will be held by Mr & Mrs X until such time as they wish to gift them to their adult children, grandchildren, siblings, parents, etc, to assist them financially by declaring dividends to their class of shares and in order to utilise their tax allowances and lower rate tax bands. Given that the classes of shares created for this purpose will be frozen from day one, there will be no tax consequences to gift them at a later date.

All growth can accrue to the class of shares held in the Discretionary Trust, hence no longer exposed to inheritance tax upon your death.

This structure is extremely flexible and allows for changes in circumstances as necessary. For example, Wills and Letters of Wishes to the Trustees of a Discretionary Trust can be changed at any time. Likewise, Mr & Mrs X are not compelled to gift any of the share classes, nor are they compelled to declare dividends to any of the classes of shares if they do not wish to do so. As Mr & Mrs X will be the majority shareholders during their lifetime, they will have total control of the business, unless of course they decide to relinquish control by gifting their shares.

Legacy planning within a Smart Property Company structure

You may well have considered that property inflation could very quickly increase your net worth. For example, if the value of properties in your company was to double, this would have no impact on your mortgage debt but would have a very significant and beneficial impact on your net worth.

However, unless you take positive steps now, before the value of the properties in your company increase further, your estate will eventually be taxed at 40% of any property value growth in the form of Inheritance Tax. This is because the increased value of your properties will increase the value of the shares in your property company, which in turn will increase the value of your estate which is exposed to Inheritance Tax.

Without careful planning, even if the value of investment properties in your company was only to double in your lifetime, the capital growth alone could very easily result in hundreds of thousands - if not millions - of pounds of Inheritance Tax falling due when you die. Of course, you hope that you will live long enough to see your properties more than double in value and you may also acquire additional properties. On that basis, you will hopefully see why effective Inheritance Tax planning is so important.

The next section of this eBook outlines the options available to mitigate Inheritance Tax on the potential future growth in property values, together with solutions to ensure that your legacy remains within your bloodline and shielded from creditors or divorcing spouses.

The solution we recommend to deal with this issue is an established company share structure using "Freezer Shares" and "Growth Shares" which is badged as a "Family Investment Company" by HMRC who opened a special unit a few years ago to look into these structures but closed that unit down again in the Summer of 2021 when they reached the verdict that planning of this nature did not breach and of their General Anti-Avoidance Rules and associated legislation. Family Investment Companies "FIC's" or SmartCo's as we call them are now regarded by HMRC as perfectly legitimate form of business continuity and legacy planning.

How do Freezer and Growth Shares work?

Where the value of shares is frozen, but voting and/or dividend rights are retained, this share class is known as "Freezer Shares".

Future capital appreciation can be attributed only to the shares with a nominal value and no automatic voting or dividend rights. This share class is known as "Growth Shares".

Freezer Shares can easily be redistributed as necessary - without tax consequences - due to the fact that the value of these shares will never increase. A good example of why this might be necessary is the availability of financing, e.g. when you are too old to qualify for mortgages.

Another good reason might be to gift Freezer Shares to children or grandchildren who may not have even been born yet, so that in time you can pay dividends to that class of shares to help them financially.l

> Growth shares can be gifted whilst they are virtually worthless and the outcome of that is that future capital growth accrues outside the estate of the voting shareholders.

Tying everything together

You may already have Wills in place, but it is very important these are reviewed to ensure the structure remains intact for the next generation, i.e. so that your beneficiaries then have control of the company in terms of voting rights and dividends, but the value of the business also continues to accrue outside of your estate for Inheritance Tax purposes. That provides your beneficiaries with control over whether to continue the business after you have died and to declare dividends to themselves, or to liquidate the company, which is something we rarely recommend.

Lasting Powers of Attorney "LPAs" are also vital for landlords. The law works on the basis that if you do not have an LPA, in the event of you being unable to make your own decisions, an officer of the Office of Public Guardian will make decisions for you. Can you imagine being in a coma and your spouse and/or family being powerless to make important decisions, such as whether to turn off life support, or to evict your tenants and sell your properties? Without an LPA, a Civil Servant makes those decisions for you.

Summary of the benefits of a SmartCo structure

- ✓ No income tax until seed capital has been repaid
- ✓ An optimised share structure, to provide more classes of shares and flexibility to utilise the tax-allowances and lower rate tax-bands of other family members
- ✓ Corporation tax from just 19% on company profits
- ✓ Future investment growth can occur outside of your estate for Inheritance Tax purposes
- ✓ Legacy protected for your bloodline
- ✓ The ability to offset finance costs against rental income, even for residential buy-to-let property

Section three

Transitioning between ownership structures

Transitioning between ownership structures

What about any existing investment properties?

In a perfect world, you would simply be able to transfer your existing properties into your Smart Property Company structure without having to worry about any tax implications. This is referred to as 'incorporation'.

However, real life is never that simple.

Incorporation might result in you having to pay Capital Gains Tax, because the transfer could be regarded as a sale of investment assets. Also, your company might have to pay Stamp Duty Land Tax to acquire the properties.

Can Capital Gains Tax be legally avoided?

For established property rental businesses, there is a form of rollover relief called 'incorporation relief' available to reduce or completely negate Capital Gains Tax at the point of incorporation. Essentially, the capital gains are rolled into the shares of the company into which the business as a whole is being transferred into as a going concern.

Can Stamp Duty be legally avoided?

Likewise, legislation exists to minimise or completely negate the Stamp Duty problem (SLDT in England / LBTT in Scotland / LTT in Wales), but only for established business Partnerships.

> If you already operate an established property rental business Partnership **click here** to skip straight to section five of this eBook, which explains incorporation in far more detail.

Section four

More about Partnerships

More about Partnerships

With careful planning, transfers between various ownership structures can occur without Capital Gains Tax or Stamp Duty falling due. The key to this planning is to ensure that you do not fall foul of a piece of legislation called G.A.A.R. "General Anti Abuse Rules", or other anti-avoidance legislation.

For example, if you were to form a Partnership for a very short period of time, simply to avoid paying Stamp Duty at the point of incorporation, HMRC has the power to disregard this and treat it as a contrived series of stepped transactions.

However, if there are legitimate reasons for forming a Partnership, such as ring-fencing business liabilities from other personal wealth, that is fine, so long as it is clear that the whole process is not just a sham.

Time is an important factor in this equation. For example, anti-avoidance legislation includes special provisions for Stamp Duty to be charged if 'Partnership to Incorporation' occurs within three years.

Another scenario that is commonly regarded as a genuine commercial reason for forming a Partnership is 'business continuity planning'. For example, the founders of a business may well wish to bring their adult children into the business with the expectation of their children taking over the running of the business when the founders wish to retire.

What type of Partnership?

The legal definition of a Partnership is 'two or more persons engaged in business with a view to profit'.

There can be no doubt that a Limited Liability Partnership "LLP" is both a business and a Partnership, because it is registered at Companies House and has the same filing obligations as a Limited Company.

As the name suggests, LLPs carry limited liability status too, which is one of the many reasons we recommend them over ordinary Partnerships, despite the fact that accounting and compliance is slightly more onerous and costs a little more, although not significantly more.

Other reasons we recommend LLPs as opposed to ordinary Partnerships are:

- HMRC could argue that an ordinary Partnership cannot exist if they choose to regard investment properties as jointly owned investments as opposed to a business.
- In an ordinary Partnership, the Partners need to own at least a proportion of the beneficial interest in the Partnership properties. This is not the case in an LLP, where Members can join without any property ownership whatsoever and even a zero-value capital account. This can be particularly important for young adults who wish to retain their eligibility to claim First Time Buyers Stamp Duty reliefs.

Tax benefits of a Limited Liability Partnership

Members of an LLP are allocated profit share proportionate to their capital account balance. However, disproportionate allocation of profit may be achieved by allocating Individual Members a 'partner's salary' in recognition of the work they do on behalf of the partnership. For example, an individual Member may contribute little or no equity, but take on a significant share of the management of the business. The primary benefit of this approach is to optimally utilise all lower rate tax bandings of individual Members.

In very simple terms, for every £10,000 of profit allocated to a nil rate tax-payer as opposed to a 40% tax-payer, the saving is £4,000. Likewise, for every £10,000 of profit allocation to a basic rate tax- payer as opposed to a 40% tax-payer, the saving is £2,000.

Tax and lending consequences when transitioning to LLP status

An LLP is transparent for tax purposes, which means that so long as the LLP's opening Capital Account balance for each member reflects the market value of the equity in the properties, there are no consequences in regards to Capital Gains Tax or Stamp Duty Land Tax. This can be achieved by legally documenting the economic beneficial interest in rental properties that are held 'on trust' for the LLP in a bespoke Members Agreement.

There is no requirement to refinance or even obtain consent from mortgage lenders, because the legal ownership of the properties, the existing mortgage contract terms and the lender's security all remain completely unchanged.

Operating the business of letting your properties through an LLP will not hamper your ability to raise mortgage finance whatsoever. Quite the opposite in fact, it could actually improve the availability of mortgage finance, because you will continue to own the existing properties personally and be able to obtain finance just as you have always done. However, mortgages can be applied for by any one, or a combination, of the LLP Members, because they can hold the property 'on trust' for the LLP. Equally, if you choose to, you could raise mortgage finance in the name of the LLP itself, as it is a separate legal entity. Whilst this is less common, an increasing number of mortgage lenders have buy-to-let mortgage products specifically designed for LLPs.

Structuring your LLP

We commonly recommend the opening Capital Account balance for each Member to be the value of the net equity in their share of beneficial interest in properties transferred to the LLP. There are a few reasons for this.

1. Capital Gains Tax only applies if there is any capital shifting. HMRC has produced a help-sheet to explain the rules.

2. Likewise, you can view the legislation showing that no Stamp Duty is payable if there is no capital shifting.

3. Also, settlements legislation will not apply to your children or family members over the age of 18 in terms of taxing them at your marginal rate of tax

It is permissible for one or more new Members to join the Partnership at the outset or at a later date with a zero Capital Account, providing they do at least some work in the business. There is no requirement for them to be able to do everything necessary to run the business, providing that they have a role within it. Likewise, a person might only introduce capital, in which case they would be deemed to be a 'sleeping partner'.

LLP Rules

An LLP must be incorporated with at least two 'Designated Members'. Other Members, if there are any, may be referred to as 'Non-designated Members' or 'Ordinary Members'. There is no upper limit on the number of LLP Members.

A Designated Member will command the same rights and responsibilities as a Non-designated Member, with the following exceptions.

- A Designated Member has the freedom to appoint an auditor.

- A Designated Member may sign the accounts on the behalf of another member.

- A Designated Member may deliver the annual accounts to the Registrar of Companies at Companies House.

- A Designated Member may notify the registrar of any secretarial changes via the appropriate Companies House form, e.g. change of registered office address, change of member particulars, etc.

- A Designated Member may prepare the annual return and fulfil any procedures necessary in dissolving the limited liability partnership.

- Designated Members are accountable by law in the failure to exercise any of the above mentioned duties.

According to HMRC's Partnership Manual https://www.gov.uk/hmrc-internal-manuals/partnership-manual/pm132050 (our emphasis added):

> *There are few restrictions on who can be a partner.*
>
> AND
>
> ***It is not a requirement of a partnership that each member is physically capable of performing the full range of the activities of the partnership business,*** *but each must be capable of performing a part of the activities,* ***even if that role is only to provide finance.*** *A partner who plays no active part in the business but has contributed capital is often described as a 'sleeping partner'.*
>
> ***Spouses and civil partners can enter into partnership with each other.*** *Sometimes this is done* ***for tax planning reasons*** *as it may be advantageous for a person to share their business profits with his or her spouse to maximise the use of their personal allowances and basic rate tax bands.* ***HMRC is unlikely to challenge such an arrangement.***

According to HMRC's Partnership Manual [https://www.gov.uk/hmrc-internal-manuals/partnership- manual/pm132400](https://www.gov.uk/hmrc-internal-manuals/partnership-manual/pm132400) (my emphasis added):

> ***A spouse or civil partner is sometimes taken into partnership wholly or mainly to maximise the benefit of the tax reliefs that are available.***
>
> ***You cannot challenge the apportionment of profits,*** *as you can a wage, by reference to the value of the partners' contribution to the firm's activity. It may be possible in these cases to challenge the spouse or civil partner's status as a partner, but such a challenge can be difficult to sustain. It is sometimes overlooked that there is no need for the spouse or civil partner to contribute capital; or to participate in management; or, in a trading context at least, to be capable of performing the main activity of the business. Indeed* ***to be a partner one need not take an active part in the business at all. Where the spouse or civil partner has signed a deed declaring an intention to carry on the business and the deed gives a right to share in the profits, and subsequently the accounts of the business show that that person has been allocated a share of the profits, there will not usually be much chance of mounting a successful challenge.***
>
> ***It is worth emphasising that a partnership is not a sham merely because it is set up to save tax,*** *as indeed the spouse or civil partner who is deserted by a partner leaving them to meet the firm's liabilities may at their own cost.* ***There will always of course be some cases which will be worth investigating and challenging, but these are more likely to be found among those where there is no current partnership deed, and particularly where there is a clear attempt to antedate the setting up of a partnership by more than a few months.***

Whilst a person under the age of 18 cannot own property, there is no statutory prohibition on persons under 18 years of age being proposed as Members of an LLP. Although partnerships involving minor children are rare, in law, a person under the age of eighteen may be a partner provided that they have the intellectual capacity to understand the nature of the business and the obligations of partnership. The age at which they reach this point will vary according to the individual and the business. Whether they become a partner is a question of fact. A minor, though, is not liable for any debts of the firm.

If you are currently employing members of your family then you will be paying employers National Insurance Contributions "NIC" and they will be paying employees NIC. If they are self-employed contractors, they will be paying Class 2 and Class 4 NIC. However, if they were to become Members of a Property Investment LLP they only pay £3.05 a week of Class 2 NIC and no further NIC would be due whatsoever.

> Making children Members of an LLP will not require them to own property. Therefore, their ability to claim First Time Buyers Stamp Duty relief will remain unaffected. However, their share of profit allocation will improve their ability to obtain mortgages if/when they do decide to purchase their first home.

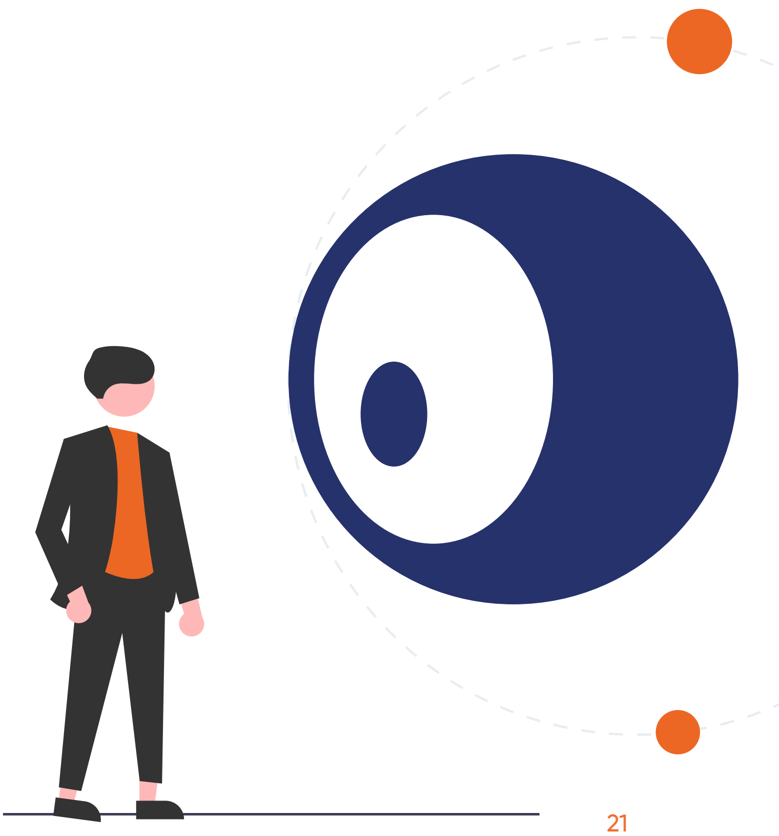
Why we don't recommend Mixed Partnerships

Neither Property118 nor Cotswold Barristers recommend "Mixed Partnerships", i.e., an LLP with a Corporate Member for the following reasons.

- Mortgage Lenders do not like Mixed Partnerships - the lending criteria of Paragon Bank and The Mortgage Works specifically precludes lending to them and we anticipate several other mortgage lenders following suit as a result of mis-selling of these structures and the tax related risks associated with that mis-selling.
- The advantages of being able to transfer income to a corporate Member of an LLP in order to facilitate a lower rate of tax on retained profits has been legislated against year after year for over a decade by HMRC.
- Mortgage liabilities cannot be transferred to a Corporate Member of an LLP without transferring the underlying assets at either legal or beneficial ownership level. These transfers trigger Capital Gains Tax, because mortgage liabilities cannot be offset against the transfer of legal or beneficial ownership and there is no 'incorporation relief' either, unless the 'whole business' is transferred and all other eligibility criteria for incorporation relief are also met.
- Annual Tax on Enveloped Dwellings (ATED) is an annual tax payable by Mixed Partnerships that own residential property valued at more than £500,000. The same rules do not apply to LLPs without a corporate Member. Furthermore, whilst there are exemptions to the tax where properties are let, there are no exemptions for filing returns where an LLP includes a corporate Member, i.e. a Limited Company.

Other factors you need to take into consideration

- You will need to open a new business bank account in the LLP name and arrange for all rents to be paid into that account. Mortgages will continue to be paid from your existing bank account, because the contractual relationship between you and the lender is a different contractual relationship from the one between you and the LLP, which will reimburse your mortgage expenses.
- Accounts will need to be produced annually for the LLP and filed with Companies House.
- Each partner will need to complete a self-assessment tax return annually to record his/her partnership profit allocation.
- Each Member of a Property Investment LLP is required to pay Class 2 National Insurance contributions of £3.05 per week, unless they are already in receipt of state basic pension or have other earnings on which National Insurance Contributions are paid.



LLP Case Study

The following case study explains how a private landlord managed to use an LLP structure to facilitate a whopping 85% reduction in tax for his family.

Mr X has a property rental business in his own name, which produces real profits of £100,000 a year, but taxable profits of £200,000 after factoring in the restrictions on finance cost relief. Let us also assume that he has an income of £150,000 from another profession or trading company, but his wife has no earnings and neither do his three adult children who are studying at University, showing an active interest in the property business and wanting to get more involved when they can.

In this scenario, it would be fair to say that income tax, inheritance tax and legacy planning are very much 'on the mind' of Mr X.

By transferring the beneficial ownership of his property rental business into an LLP, his opening 'Capital Account Balance' would be the value of his properties minus the liabilities, i.e. his mortgages. This can be achieved without remortgaging and reliefs exist to ensure that Capital Gains Tax and Stamp Duty do not fall due either, as explained at the beginning of Section 3.

His wife and his children can then become Members of the LLP, because they all have an active interest in the business. The opening value of their Capital Accounts is £nil, because they have not contributed anything to the business at that stage.

The purpose of the restructure goes far beyond income tax planning, because succession planning is also an important consideration.

A year later, the business has produced the same profits as before, i.e. £100,000 of real profit and £200,000 of taxable profit after factoring in the restrictions on finance cost relief. Previously, Mr X would have paid tax as follows:

- £45,000 of tax on the real profit
- A further £25,000 of tax on the additional £100,000 of disallowed finance costs, after factoring in his 20% tax credit
- Total tax £70,000

This represents a tax bill of 70% of the real cash profit of the rental property business.

However, under the new structure, now that his wife and three children are taking a more active role in the rental property business, the taxable profits are allocated differently. Mr X takes none of the profits and instead allocates £50,000 of taxable profit as a 'Partners Salary' to his wife and each of his three children.

As they do not have any other taxable income, they can utilise their full £12,500 personal allowance and pay only 20% basic rate tax on the other £37,500, i.e., £7,500 each. The restrictions on finance cost relief do not bite, because none of the Members to whom profits have been allocated are higher rate taxpayers.

The total tax ordinarily payable under the new structure is just £30,000. However, his wife and his children also get a 20% tax credit on the £25,000 of finance costs allocated to each of them, so that reduces the total tax by another £20,000, leaving just £10,000 of tax payable.

> That is a whopping tax saving of £60,000 in the first year alone!

To put it another way, the net effective tax rate on the real profit of the business is reduced from 70% to just 10%.

Yet another way of looking at it is that a reduction in tax from £70,000 to just £10,000 is a saving of nearly 86%.

So, whose money is it now?

After paying the tax, the Capital Account values of the wife and the three children now stand at £47,500 each. A well-drafted LLP Members Agreement can determine that drawings from the business are at the discretion of the Senior Partner, e.g. the person with the highest value Capital Account, or indeed until the death of the founder of the business. The Senior Partner could, of course, allow drawings to be taken by other Members if he chooses to do so. He might, for example, agree to this if the incoming Member's work results in the profitability of the business increasing as a direct result of their efforts.

Assuming no other drawings are taken by his wife and children, save for the money needed to pay their tax bills, the LLP bank account would have accumulated £90,000. That is £60,000 more than would previously have been the case without this structure; in other words, more than double the amount!

The Senior Partner could, if he wished to do so, withdraw and spend all the £90,000 of cash in the bank. This would be recorded as a debit against his Capital Account, the outcome of which is that his Capital Account would reduce.

Over time and assuming he lives long enough, it is quite feasible for Mr X to have reduced the value of his Capital Account to zero. Meanwhile, the Capital Account balances of his family Members would be growing very nicely indeed. A further benefit of this is that when Mr X eventually passes away, the net value of his estate for Inheritance Tax purposes will also be significantly lower that it would otherwise have been, because the value of his property rental business would have been transferred to the next generation in this very tax efficient manner and completely within the legislation and spirit of HMRC's rules.

Section five

Transferring an established Partnership into a Smart Company

Transferring an established Partnership into a Smart Company

You should seriously consider the sale of an existing property rental business Partnership as a going concern to a 'Smart' Company Structure if any one or more of the following apply to your circumstances.

1. You and your Partners are already higher rate tax-payers and you have mortgages secured against residential properties. This is because the impact of restrictions on finance cost relief to the taxation of your business might already be horrendous and could become catastrophic if interest rates increase. Not only might you be paying higher rate tax on your rental profits, but your finance costs are also not tax-deductible. Instead, HMRC only gives you a 20% tax credit on your finance costs, which means that it is theoretically possible for your tax bill on your rental profits to exceed your rental profits. It is also possible to end up paying tax even if your property rental business is losing money, for example if interest rates were to rise, your rental income was to reduce or, your ongoing costs were to increase.

2. Your residential properties have appreciated in value considerably since you first acquired them. Without careful planning, selling any one or more of these could result in you having to pay a substantial amount of Capital Gains Tax, even if you immediately reinvest the net sale proceeds into different properties.

3. You already have a significant Inheritance Tax problem, which is set to continue to grow as your properties appreciate in value.

Benefits of incorporation

- The ability to offset 100% of finance costs against rental income as a business expense (private residential landlords can no longer do this).
- The ability to retain profits to repay debt or for further investment at the corporation tax rate (currently 19%).
- Washing capital gains out of properties into shares, thus enabling you to sell properties to repay debt or reinvest without having to pay Capital Gains Tax on all capital appreciation to date.
- Opportunities for Inheritance Tax and bloodline legacy planning by transferring future capital appreciation to the next generation using a 'Smart' Property Company structure.

> "It is not the strongest of the species, nor the most intelligent that survives. It is the one that is most adaptable to change"
>
> **- CHARLES DARWIN**

Capital Gains Tax and your eligibility to claim incorporation relief

Arguably, one of the best reasons to consider incorporation is that incorporation relief can 'wash out' some or all capital gains to date', by rolling capital gains into the shares of your company.

This means that you could sell any number of your properties the day after incorporation at market value without having to pay any Capital Gains Tax, because the company would be selling them for the same price as it acquired them. This is particularly useful if you want to use net sale proceeds to pay down debt, or if you would like to sell any poorly performing properties and utilise the proceeds of sale to purchase other properties with better returns.

When you sell property, or your business as a whole, you would ordinarily crystallise any capital gains. Your capital gains are calculated by deducting the acquisition costs of your properties from the current market value of your properties. Please note that your acquisition costs are not necessarily just the purchase price of your properties; you also need to factor in any other capitalised costs, i.e. those which have not already been offset against rental income. These might include extensions to buildings, lease extension premiums, Stamp Duty paid or professional fees in regards to the capital structure of your business.

The value of your shares would ordinarily be the value of your equity, i.e. properties and other assets minus mortgages and any other liabilities.

The way that incorporation relief works is that the value of your shares is offset against your capital gains.

In regards to your eligibility to claim 'incorporation relief', HMRC's manual cg65700 says:

TCGA92/S162 applies where a person other than a company transfers a business as a going concern with the whole of its assets (or the whole of its assets other than cash) to a company wholly or partly in exchange for shares. Provided that various conditions are satisfied, see CG65710, the charge to CGT on the whole or part of the gains will be postponed until such time as the person transferring the business disposes of the shares.

The way the relief works in practice is that all or part of the gains arising on the disposals of the assets are 'rolled over' against the cost of the shares.

Relief under TCGA92/S162 is sometimes referred to as 'incorporation relief'.

A key factor in regards to your eligibility to utilise 'incorporation relief' is that it is only applicable if you are running a business.

HMRC's definition of a business, which is based on case law, is that:

- Activities are a serious undertaking earnestly pursued
- Activity is a function pursued with reasonable or recognisable continuity
- Activity has a certain measure of substance in terms of turnover
- Activity is conducted in a regular manner and on sound and recognised business principles

Activities are of a kind which, subject to differences in detail, are commonly made by those who seek to profit from them

HMRC's manual CG65715 says:

> *You should accept that incorporation relief will be available where an individual spends 20 hours or more a week personally undertaking the sort of activities that are indicative of a business. Other cases should be considered carefully.*

When you transfer your business to your company you will be exchanging your equity for shares. It is the value of these shares that your capital gains are rolled into.

If the value of shares created is less than the amount required to absorb your capital gains you would still have Capital Gains Tax to pay on your "latent gains" (the amount by which your mortgages exceed your base costs).

Solutions to mitigating this tax are as follows.

- If you have any capital losses you can offset these
- Pay down debt so that it is equal to your base costs
- Consider becoming non-resident for tax purposes so that your base costs are increased to the April 2015 valuation of your properties
- Transfer cash into the company at incorporation as part of the business sale. Such cash cannot be borrowed by the business, because the cash borrowed and the cash invested would cancel each other out and leave you with the same problem. However, if you do have cash to put into the business, prior to its sale to the company, which is equal to the latent gain then that would solve your problem. Likewise, any amount of cash transferred into the company as part of the business sale would reduce the problem. However, that cash would be treated as share capital and not as Directors or Shareholders loans.

Capital Account Restructuring for optimal tax efficiency

Capital Account Restructuring can completely change the dynamics of your business post incorporation, because it allows you to take available cash out of the business without incurring income tax. This phenomenon is a quirk in the tax system, but certainly isn't a loophole to avoid tax either.

If you have more equity in your portfolio than you would need to exchange for shares to wash out capital gains, this is money that you have personally invested into the business from funds that have already been taxed, or has resulted from paying down finance using taxed money. You are perfectly entitled to withdraw this money from the business before you incorporate without further tax consequences. If you leave it in the business you would pay tax on it again to withdraw it, which makes no sense at all.

You are perfectly entitled to borrow money in order to withdraw your own capital from your business. This is not tax avoidance and examples can be found in HMRC manual BIM45700.

It may well be that you don't need that money now and if that is the case you probably don't want to go to the expense or the trouble of refinancing and being tied into new mortgage deals either.

This is how the Capital Account Restructure can work:

- We assist you to arrange finance to increase your business debt to equal your acquisition costs before incorporation
- You then withdraw that cash from the business
- Liability for repayment of the finance is transferred ('novated') to your company at the point of incorporation
- Cash raised from the new financing remains in your name
- You then lend the cash withdrawn from the business pre-incorporation to the company post- incorporation
- The company then uses that cash to repay the new finance, if that is what you want to do. The alternative is to arrange for longer term financing such as a mortgage

Financing of this nature must be arranged commercially at arm's length and must be transacted in the correct order. Likewise, a clear audit trail of the flow of funds is imperative.

The involvement of your accountant is usually required to calculate the optimal level of new financing.

The outcome of this restructure is that the company will owe you money in the form of a Directors Loan.

When the company accumulates cash, it can begin to repay Directors Loans to you. Such repayments do not attract personal taxation.

There are several ways the company can accumulate cash, including:

- Net proceeds of property sales
- Refinancing to release cash
- Profits retained within the business after paying corporation tax

When considering the significant benefit of a Capital Account Restructure, it is also worth considering how your situation would be further improved if you were to become non-resident prior to incorporation. Normally, your base value for Capital Gains Tax calculation purposes is the purchase price of your properties plus any capital costs incurred, such as Stamp Duty, legal fees, lease extensions, improvements, etc. However, if you were to become non-resident prior to incorporation, your base value for Capital Gains Tax calculation purposes is the value of your properties as of April 2015 plus any capital costs incurred since then (or your original purchase price plus capital costs, whichever is greater).

The beneficial effect of this is to potentially increase the size of your Directors Loan Account by inflating the base value of your property assets.

Non-resident tax planning opportunities

Moving to a different country is a huge decision to make. Whilst this step may or may not be appropriate for you now, it is worth at least considering the benefits. They can be VERY significant.

When you are non-resident, you don't pay tax on dividends in the UK. Instead, you pay tax in your country of residence. However, some countries do not charge tax on overseas dividend income. One of the most tax efficient countries in Europe at the moment is Portugal, under their NHR scheme, because you do not pay tax on UK dividend income for the first 10 years. This could save you an absolute fortune!

The main qualification to become tax resident in Portugal under the NHR scheme is to own a home there. If you purchase a property in Portugal for over £500,000 you can obtain a "Golden Visa". This opportunity is open to people from most countries, even those outside the EU.

Many High Net Worth individuals now register as being resident in Portugal under the NHR status. Some of these people are somewhat 'nomadic', in that they spend time on their yachts and in holiday homes in other countries, whilst ensuring they do not spend too much time in any one particular country in any year so as to be considered tax resident there. Several of these individuals are also British, so they do fly back to the UK from time to time. As with most countries, the UK has a Statutory Residence Test.

When you first become non-resident you are considered to be temporary non-resident for the first five years. You can visit the UK without becoming tax resident again in this period, but there are limits. The amount of time you can spend in the UK in the five-year period, without being deemed resident again for tax purposes, is based on how many ties you have to the UK. The more ties you have, the less time you can spend in the UK before losing your non-resident tax status.

To summarise the Statutory Residence test, which is extremely complicated, the ties are:

1. You were UK tax resident in the last three years

2. You have a home available for your use in the UK

3. You have a spouse or children living in the UK (e.g. if your children went to boarding school)

4. You are employed in the UK

If you have all 4 ties you will become UK tax resident if you spend more than 15 days in the UK in any 365 rolling days.

If you have 3 ties you will become UK tax resident if you spend more than 45 days in the UK in any 365 rolling days

If you have 2 ties you will become UK tax resident if you spend more than 90 days in the UK in any 365 rolling days

If you have one or less ties you will become UK tax resident if you spend more than 90 days in the UK in any rolling six month period.

There are two supplementary rules to also consider.

1. If you are working in the UK for more than 40 days a year that is another tie

2. Even if you have one or less ties, if you spend more than 120 days in the UK within your first three years of being Temporary non-resident then HMRC will tax you as if you are UK resident

Retention of competitive existing mortgage terms

Contrary to advice often given by people selling mortgages, there is absolutely no requirement to refinance at the point of incorporation. In fact, HMRC manual CG65745 makes this very clear, as follows:

> *The transferor is not required to transfer business liabilities to the company but often does so.* ***This is normally done in practice by the company giving the transferor an indemnity in respect of those liabilities.***
>
> *In strictness, business liabilities taken over by the company represent additional consideration for the transfer and relief under TCGA92/S162 should be restricted. However, ESC/D32 enables any business liabilities taken over by the company to be ignored when quantifying 'other consideration' in recognition of the fact that the transferor is not receiving cash to meet any tax liabilities on the transfer and that the shares in the company are worth less than if the business had been transferred unfettered by liabilities.*

The costs of refinancing can be a major obstacle for many landlords when considering the viability of transferring their property business into a Limited Company. After factoring in valuation fees, lenders arrangement fees, conveyancing and searches the cost can be upwards of 3% of existing finance balances. In addition to that, you then need to factor in the ongoing costs associated with swapping historically low mortgage rates for potentially more expensive mortgage products.

Where existing mortgage terms are particularly competitive and/or when the costs typically associated with refinancing are prohibitively expensive, that is when the Substantial Incorporation Structure (SIS) comes into its own.

How does it work?

The Substantial Incorporation Structure is quite the opposite of avoidance from a tax perspective, in that it utilises anti-avoidance legislation to hasten the deemed completion of a business sale from a tax perspective and dovetails with the reliefs described earlier in this report.

Anti-avoidance tax legislation includes provisions to say that where a sale is "substantially" completed it is deemed to have completed whether the sale has been legally completed and registered or not.

In regards to Stamp Duty, HMRC internal manual SDLTM07700 states the following.

> *where such a contract is substantially performed before it is formally completed, the contract is treated as if it were itself the transaction provided for in the contract. Broadly, substantial performance is the point at which*
>
> - any payment of rent is made
> - payment of most of the consideration other than rent is made
> - the purchaser is entitled to possession of the subject matter of the transaction

The legislation in regards to Capital Gains Tax is TCGA92/28(1), which states the following.

> *where an asset is disposed of and acquired under a contract the time at which the disposal and acquisition is made is the time the contract is made (and not, if different, the time at which the asset is conveyed or transferred).*

The Substantial Incorporation Structure involves substantially completing the sale of the 'whole business' of a rental property business.

Contracts are exchanged to sell the 'whole business' to a Limited Company, but long-stop completion dates are agreed based on outstanding mortgage terms.

A deposit is paid by the company in the form of shares to the value of the equity in the properties (gross value minus liabilities).

Completion of the transfers of legal ownership in properties is deferred until the end of the existing mortgage contracts, or earlier at the behest of the company. A business sale agreement acknowledges that, as a condition of the sale, the company adopts responsibility, in the form of an Indemnity, for the servicing and repayment of any mortgages yet to be redeemed.

The legal owners contract to act as Agents for the company and make payments to their mortgage lenders on behalf of the company.

The insurable interest in the properties reverts to the company at exchange of contracts.

Also, as a condition of the Business Sale Agreement, from this point forwards the business is conducted within the company.

The business sale transaction is substantially completed when contracts are exchanged in regards to the Business Sale Agreement.

When the company wishes to sell a property, the completion of the contracted sale of the corresponding property to the company is executed simultaneously with the onward sale of the property. The net proceeds of sale belong to the company along with any taxation, e.g. corporation tax on any capital appreciation in the property from the date the company contracted to buy it.

The company can take legal ownership of the property at any time, by completing on the purchase contracts already exchanged. If the company requires new finance to complete the purchase, it can apply to borrow on the basis that it is completing a property purchase, in the same way as it would when buying any other property. The deposit has already been paid.

If/when you decide to transfer your mortgage lending to a Limited Company you may need to instruct a conveyancing solicitor to deal with that for you.

Stamp Duty Land Tax

An exemption against paying Stamp Duty Land Tax "SDLT" automatically applies when a business partnership transfers its 'whole business' to a company at the point of incorporation.

The applicable legislation in England is FA2003/sch15, as amended by FA2004/Sch41. The Partnership Act 1890 Act describes a partnership as follows. 'the relation which subsists between persons carrying on a business in common with a view of profit.'

Please see https://www.legislation.gov.uk/ukpga/Vict/53-54/39/section/1

In order for a Partnership to fully benefit from the SDLT exemption it will need to have enjoyed the benefit of the business assets for 3 or more years.

If you operate your property rental business in partnership with one or more other people and share risks and rewards as 'co-adventurers in business', you might legally be operating a Partnership, despite not registering it with HMRC.

The existence of a Partnership is a matter of fact, so if this applies to you, your accountants should have advised you to register the Partnership with HMRC and submit SA800 Partnership Returns. However, if you are a Partnership but have not registered with HMRC, given that you would have paid no more or less tax as a result of this, HMRC is likely to take a pragmatic view on oversights of this nature. The reason for this is that property investment was not regarded as a business activity by HMRC until they lost their case against Elizabeth Moyne Ramsay in the Upper Tier Tax tribunal in 2013. That case wasn't widely publicised until much more recently, so in fairness to your accountants, that may well be why they wouldn't have thought to register your Partnership with HMRC.

Section six

What you can expect from a Property118 Tax Consultation

What you can expect from a Property118 Tax Consultation

There is no substitute for bespoke professional advice, so please **DO NOT** take any action based on the contents of this eBook without completing a full tax planning consultation with us.

Tax planning consultations with Property118 (in association with Cotswold Barristers) come with a guarantee of total satisfaction or a full refund of the £400 consultation fee.

The consultation process includes all the following:

- Know Your Customer checks
- Software to analyse the viability of incorporating your existing rental property business, if you have one
- Email correspondence with your Property118 consultant and Cotswold Barristers, as required
- A video conference with your Property118 Tax Consultant. We are very happy for you to invite your existing professional advisers to this meeting
- An action plan confirming 'next steps' and a link to the recording of the video conference

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