The perfect storm

OMB Personal tax

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Simon Howley considers the legislation governing the transfer of property from personal to corporate ownership, including how this can trigger stamp duty land tax charges

Key Points

What is the issue?

On any transfer of property from personal to corporate ownership, there are a number of deciding factors when applying for the available reliefs from capital gains

tax, including whether the activity is classed as a business.

What does it mean for me?

A major drawback of property partnerships is that it is very easy for the unwary to trigger stamp duty land tax charges under anti-avoidance rules contained within Finance Act 2003 Sch 15 para 17A.

What can I take away?

HMRC is expected to look closely at any attempt to exploit the partnership rules to avoid a market value charge, with its first port of call to examine whether there is a genuine partnership in existence.

Back in the early 2000s, it used to be common practice to find property held within the trading company. As this was the main source of revenue, it was cheaper than extracting monies via dividends or salary, and then buying the property out of net income.

However, the downside to holding the property within the company was that the company paid corporation tax on any disposal, and then the individuals paid income tax on the extraction of the net proceeds. It felt like ‘double taxation’.

With careful structuring of a transaction and clever use of the then stamp duty land tax (SDLT) rules, it was possible to extract the property from the company without triggering either a SDLT charge or a capital gain within the company. This was never a perfect solution, but clients were happy that any future capital growth in the value of the property (from date of the transfer) would only be taxed once as a capital gain on the individual partners.

Modern times

Roll forward to modern times, and every ‘Tom, Dick and Harry’ owning a garden shed wants to incorporate, mainly due to the restrictions on finance costs relating to dwellings related loans. Of course, there is nothing wrong with incorporating a property portfolio for the correct client, but many of the clients I see fall at the first hurdle. They simply do not qualify as a business. I do not have the space to explain the nuances of what is or isn’t a ‘business’ in this article.

However, it is a deciding factor when applying for the available reliefs from capital gains tax, on any transfer of property from personal to corporate ownership, that the activity is classed as a business.

As there is no legislative guidance on the meaning of a business for tax purposes, we must refer closely to case law for guidance. The decision in Ramsay [2013] UKUT 226 is the most relevant in the context of incorporating a rental property business, as it was the first case to be heard on the subject of claiming incorporation relief from capital gain tax.

Another major consideration in the decision to incorporate a rental property business is the exposure to SDLT. However, special rules apply to partnerships, which can result in no charge arising on the transfer of property from a partnership to a new company, where each of the partners is connected with the new company.

The most common path to incorporation for clients is to form either a general partnership or a limited liability partnership. In this article, I will assume for the sake of simplicity that we are dealing with a general partnership.

Properties within a general partnership

The property portfolio will be introduced into the partnership as initial capital in the percentage shareholding it is currently held in. There will be no capital gain triggered on the formation of the partnership; due to the tax transparency of partnerships, we look straight through to the individual partners. With this being the case, the underlying beneficial ownership of the property portfolio introduced is unchanged. You cannot sell to yourself what you already own.

There should also be no SDLT triggered on the formation of the partnership, due to the reliefs offered within Finance Act 2003 Sch 15 para 10.
Holding the properties within the general partnership should also not disturb any current lending in place on the portfolio, nor should the client be required to notify their lenders of the partnership structure under their lender’s terms and conditions.

This is because general partnerships, unlike limited liability partnerships, cannot own property in their own name. The individual partners own and hold the properties on trust as partnership property.

Many people take the view that a property portfolio which is jointly owned by a married couple, or by two individuals, is effectively a partnership and they always ask: ‘Why do we need a formal partnership, as we own the assets together anyway?’ The simple answer is that HMRC does not view holding assets jointly as being in partnership. According to HMRC manuals, the definition of a partnership is: ‘The relation which subsists between partners carrying on a business in common with a view to profit.’ Legislation also says that ‘joint property, common property, or part ownership does not of itself create a partnership’ (Partnership Act 1890 s 2(1)).

Therefore, it is sensible to enter into a formal partnership agreement and then you must register the partnership for Self-Assessment with HMRC.

Anti-avoidance rules

However, a major drawback of property partnerships is that is very easy for the unwary to trigger SDLT charges under anti-avoidance rules contained within Finance Act 2003 Sch 15 para 17A.

Paragraph 17A imposes a charge to SDLT if, during the three years after a para 10 transfer of land to a partnership, the transferor or a partner connected with the transferor:

- makes a withdrawal of money or money’s worth from the partnership (other than income profit);
- reduces their interest in the partnership share; or
- ceases to be a partner.

A withdrawal of money or money’s worth would include the withdrawal of capital from the capital account and the repayment (to any extent) of a partner’s loan.

Therefore, paragraph 17A potentially gives rise to double taxation where, for example:

- a property is transferred into a partnership (claiming relief under para 10);
- the partnership sells the property to a third party (on which SDLT is paid) and the partners withdraw the proceeds within a three-year period; or
- the withdrawal is treated as a land transaction and SDLT is due.

Some ask whether an incorporation wouldn’t be treated as a ‘withdrawal’ for the purposes of para 17A? In my opinion, the answer is no.

A withdrawal is only a qualifying event if it is coupled with a partner withdrawing capital from his account, reducing his interest in the partnership, or exiting the partnership. It seems clear to me that this was intended to catch out partners who enter arrangements for the transferor partner to extract money or money's worth from the partnership, pursuant to arrangements that were in place at the time of the transfer of property to the partnership to avoid SDLT.

The above would clearly not be the case on an incorporation, as this would be viewed more as a distribution of assets on, or in connection with, an incorporation.

On an incorporation, all the conditions in Finance Act 2003 Sch 15 para 18 would be met on the transfer of properties to a NewCo, as a chargeable interest is being transferred from a partnership to a person who relates to one of the partners.

Therefore, on the face of it a para 18 charge should arise on the properties transferred but this charge should be nil where the partners as individuals are both connected for tax purposes with NewCo.

In my opinion, para 17A should not apply where para 18 does. The transaction should be taxed solely in accordance with the provisions of para 18, which takes precedence over para 17A.

The Office of Tax Simplification (OTS) published a report in January 2014 that suggests that para 17A is now effectively redundant due to anti-avoidance legislation contained in Finance Act 2003 s 75A.

Paragraph 17A is effectively an exit charge to the partnership with no time limit, but the OTS report notes that HMRC does not tend to apply the legislation, although it potentially can – which is why clients should be warned.

Another conflict exists between the SDLT partnership rules provision with Finance Act 2003 s 53, which imposes a market value charge on a transfer to a connected party. However, HMRC has confirmed that in this situation the partnerships rules take precedence.

Common misconceptions

Questions I get asked a lot are:

- What is a safe period to wait before incorporating a property partnership?

- Will the incorporation effect my lending?

These are good questions and I have heard, and seen on various social media platforms, many conflicting replies. Some are plain wrong, and some are borderline offences under the money laundering regulations.

One of the replies sometimes given is that you must wait three years from the date of the formation of the partnership before you can incorporate. This is wrong and stems from a misunderstanding of legislation and confusion with the three years rule relating to para 17A. As we have stated above, this rule should not apply in the case of a simple incorporation.

The actual answer to the first question is simple. There is no defined ‘safe’ period.

Another very common misconception is that incorporations can be carried out without any consideration for refinancing or notification to the lender, by simply using a Deed of Declaration. Any tax planning must take into consideration the commercial aspects of what is being proposed. The terms and conditions of the lender must always be considered before any incorporation; and the vast majority of lenders (if not all) specially require notification of any proposed change in legal and/or beneficial ownership of a property. Many lenders’ terms and conditions also now specifically prohibit the use of Deeds of Declaration.

The future of partnership rules

HMRC is expected to look closely at any attempt to exploit the partnership rules to avoid a market value charge, with its first port of call to examine whether there is a genuine partnership in existence. Common sense also dictates that forming a partnership for a brief period before transferring property into a company in order to obtain the exemptions will not survive HMRC scrutiny, and would be foolhardy by bringing the anti-avoidance rules under s 75A into play.

However, it is clear that a transfer of property from a well-established property partnership run by connected parties to a company owned by the same individuals will be exempt from SDLT.

It is also clear that changes are on the horizon with regards to capital gains tax, with the OTS soon to publish its second report to HM Treasury. When you combine these yet unannounced changes to capital gains tax with the now full effect of the income tax restrictions on interest relief on lending, it is helping to create a perfect storm of

new incorporations, many of which fall foul of s 75A – and to unscrupulous tax scheme promoters who are already circling.