Capital Gains Tax on incorporating a property rental business

OMB Tax voice

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Pinny Olsberg focuses on CGT but points to the issues that await those considering incorporating their residential property letting business

Introduction

UK residential property has been a target for legislators in recent years. Immediately springing to mind are the provisions of ATED; ATED CGT; the 3% SDLT surcharge; CGT for non residents; the 8% “surcharge” on CGT rates; the restriction of relief for finance costs; the abolition of the wear and tear allowance; and the widening of the scope of Inheritance Tax.

Some of these changes only affect corporate businesses, some only affect personally held businesses and some affect both.

Of all the recent taxation changes, the introduction of finance costs relief restriction has been the most worrying for private residential landlords. Some highly geared property businesses that are currently healthy and profitable could suffer tax charges in excess of their profits once the restrictions are fully operational.

Therefore, incorporation may be an option as there is currently no restriction for finance costs wholly and exclusively incurred by companies in running their property rental businesses. From April 2017, a restriction on some finance charges is being introduced under Action 4 of the BEPS Action Plan; however, the UK version is likely to include a de-minimis threshold of £2million. Therefore a great majority of property rental businesses run by companies will not be affected by this.

Clients often wish to be advised as to the tax ramifications of an incorporation of the property rental business and this article considers some of the CGT aspects. Brief mention is also made in respect of other taxes.

Incorporation – background

Incorporation is simply the transfer of a business owned and run by an individual or a partnership into a company structure. In most incorporations (and especially for those that intend to utilise the CGT incorporation relief – section 162, TCGA 1992), the company “pays” the transferor for the business by way of an issue of new share capital. There is no requirement for the company to be a newly formed one – in some cases it can suit the transferor to use a company that he already owns to make the transfer.

Any profits or gains subsequently made by the company are assessable at the relevant rate of corporation tax (currently 20% reducing to 17% from 1 April 2020 – or even lower!). The extraction of accumulated profits will likely be a blend of salary and dividend – the discussion of which is beyond the scope of this article.

Capital gains tax

The transfer of the business into a company, would, prima facie, be a transfer for tax purposes at market value with a resulting capital gain on the transferor in respect of any assets standing at a gain.

The relieving section is s162 TCGA 1992 – generally known as “Incorporation Relief”. The relief operates by rolling the gain inherent in the properties at the time of transfer into the CGT base cost of the shares. The gain is thus brought back into charge if and when the shares are disposed of.

S162 TCGA 1992 – key issues

Incorporation Relief applies where:

> *"... a person who is not a company transfers to a company a business as a going concern, together with the whole assets of the business, or together with the whole of those assets other than cash, and the business is so transferred wholly or partly in exchange for shares issued by the company to the person transferring the business." (TCGA 1992 s162(1)).*

The transfer

The transferor must be an individual or a partnership (general, limited or LLP) and the transfer must be to a company, in exchange for newly issued shares. To the extent that consideration other than shares is paid by the transferee (for example by the creation of a loan account), CGT is chargeable.

The business

The requirement for there to be a "business" gives rise to what is often a point of contention between the taxpayer and HMRC. The word "business" is not defined by statute and therefore has its normal meaning. HMRC accept that the meaning is wider than "trade" and, in some cases a property investment business can indeed qualify.

The definition of "business" was considered in the Upper Tier Tribunal case of *Elizabeth Moyne Ramsay v HMRC* [2013] UKUT 0226. In this case, the taxpayer inherited a block of flats, eventually owning 10 flats in the same building. The taxpayer devoted some 20 hours a week on managing the block and had no other occupation during this period. The UTT held that the level of activity, and taking the activities of the taxpayer "in the round", was sufficient to deem the business as being beyond the mere passive receipt of income and could satisfy the "business" test of s162.

Taxpayers and their advisers would be well advised to examine the level of activity in the existing business to determine whether it is likely to be a business for s162 purposes. The turnover or profits of the business are not indicative of level of activity – a flat in Knightsbridge, London may bring in double the annual rent of 100 properties in West Lothian, but it is the Scottish business that is more likely to qualify for s162.

Some uncertainty exists where the business is being carried on by an agent appointed by the taxpayer. HMRC have been known to argue that s162 is not available in such circumstances. Some clarity from HMRC would be welcome and it is only a matter of time until this point will be contentiously argued in Tribunal.

Going concern

The business must be transferred as a going concern. This condition is likely to be met by the vast majority of profitable property rental businesses.

Entirety of the business

Whilst the entirety of the business must be transferred, HMRC accept that any cash that may be held in the business need not be transferred. Practically, the cash is often lent to the company after the incorporation as a director’s loan in order to provide working capital to the company. In some scenarios it may be possible to remove certain assets from the business prior to incorporation and HMRC in their manuals (CG65710) acknowledge that such action may be taken and each case must be judged on its individual facts.

Only the business in question need be transferred – any assets that are not in that particular business are not relevant.

Liabilities

HMRC accept by concession (D32) that whilst the assumption of the business liabilities represents further (non-share) consideration for the business, it will not automatically limit the availability of incorporation relief by the amount of this consideration.

However, where the capital gain exceeds the cost of the shares, and because the base cost of the shares cannot fall below zero, such excess becomes chargeable on the transferor.

It is advisable therefore, prior to an incorporation, to carry out a financial “modelling” exercise of the business and the incorporation.

Claim

Incorporation relief is automatically applied, even when no claim is made. Where appropriate, an election can be made (under s 162A, TCGA 1992) to disapply the relief.

Partnerships

Relief is available to partners where the whole of a partnership business is transferred to a company. The relief is computed separately for each partner and relief is not precluded for one partner where the other partners receive cash or a combination of shares and other consideration.

Company’s CGT base cost of the properties

As explained, the gain is rolled into the base cost of the shares – it should follow that the capital gains base cost of the properties for the company will be their market values at the date of incorporation.

Clearance

Due to the inherent uncertainty in respect of whether the property business qualifies as a “business” for s162, it is advisable to obtain advance clearance from HMRC.

No statutory clearance is available; taxpayers must resort to the Non-Statutory Clearance service by writing to the HMRC Non-Statutory Clearance Team at Southend on Sea.

HMRC are particular in respect of the format of the application and taxpayers (or more likely, the taxpayers’ professional advisers) should refer to Annex A of HMRC’s Non-Statutory clearance technical guidance and follow the format therein.

Other important points

- Under basic principles, SDLT is payable on the market value of the properties transferred to the company (s53 FA 2003).
- The SDLT payable will be calculated by reference to the residential rates of SDLT (where relevant) plus the 3% surcharge thereon.

- Multiple Dwellings Relief should be considered when calculating the SDLT payable.
- Where more than six properties are transferred, the transaction may be taxed at the commercial rates of SDLT and this can represent a large saving.
- A 15% SDLT rate, ATED and ATED CGT will be applicable on any of the properties transferred worth in excess of £500,000 which is inhabited or intended to be inhabited by an individual connected to the company or its shareholders.
- In some scenarios, where a property partnership is incorporating, Part 3 Schedule 15 FA 2003 exempts the transfer from SDLT. The rules are extremely complex and careful consideration is required. There are also anti-avoidance provisions to stop the abuse of this exemption.
- If the properties transferred are commercial properties, VAT and Capital Allowances may need to be considered.
- Bank or lender consent would be required prior to transferring the properties into the company and the cost of financing may increase once the company becomes the borrower. Financial modelling would be very useful to consider both the commercial and tax implications of incorporation.

Summary

The decision to incorporate a property rental business is not one to be taken lightly – legal, commercial, taxation, administrative and refinancing issues need to be carefully considered.

Whilst it may be that incorporation can assist the owners of property rental businesses in streamlining their businesses and reducing the overall tax burden, those should not be the sole determining factors when considering a possible incorporation.