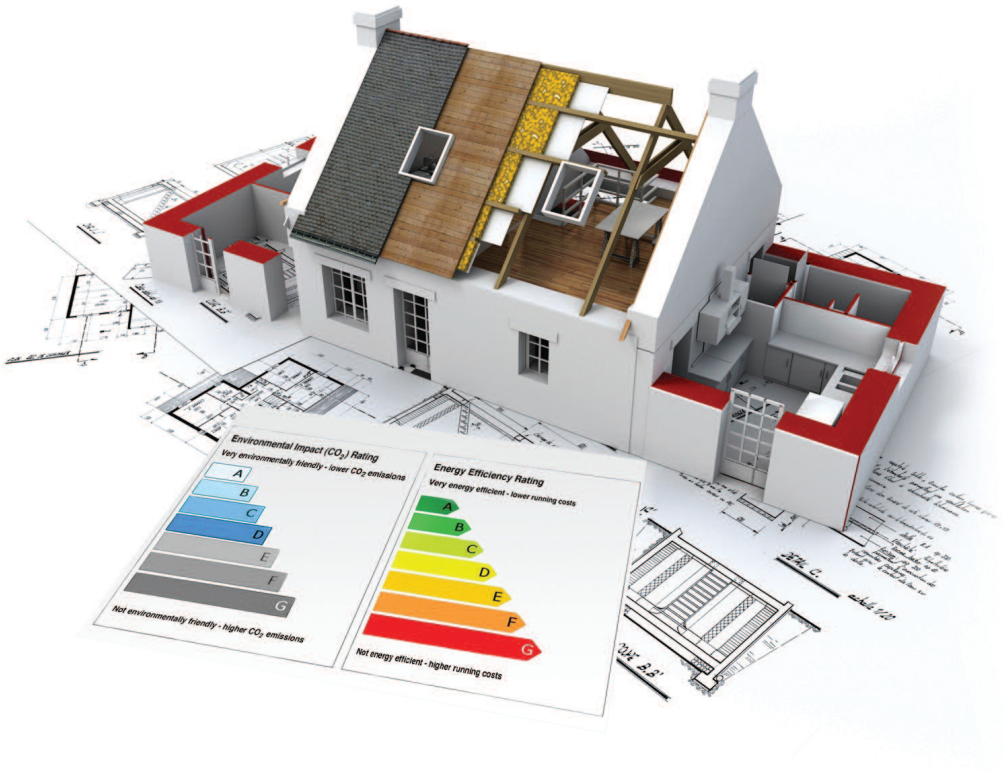
Summer 2012

Property Focus

Laying the foundations to future prosperity

Contents:



HAZLEWOODS

DRIVING LIFELONG PROSPERITY

The Property Ownership Conundrum

As people involved in the property market you may have already invested in property, or are currently considering it. One of the questions I get asked quite a lot is "how should I hold the property – in a company, personally, or something else?"

Unfortunately, my answer is always the same – it depends! There really is no "one size fits all" answer and there needs to be some number crunching carried out to decide on the most tax efficient route.

Let's consider the situation on a disposal for a gain of £100,000. If you hold it personally, the situation is relatively straightforward. Ignoring annual exemptions and assuming you are a higher rate taxpayer, any gain is taxed at 28%. So, on my £100,000 gain, the individual is left with £72,000.

What about for a company? Well, if we assume the company pays the small rate of 20%, this leaves £80,000 in the company. This may, at first glance, seem a better result than personal ownership, but we are not comparing like with like. With personal ownership, the cash rests with the individual. With company ownership, the cash is locked in the company, unless it is distributed.

There are two ways to distribute the cash tax efficiently, dividends or through a capital distribution on liquidation.

With dividends, a higher rate ("HR") taxpayer will pay an effective rate of 25%. If their taxable income exceeds £150,000 i.e. they are additional rate ("AR") tax payer, the effective rate becomes 36.1%. Table A below shows the net cash position depending on the individual's marginal rate of tax.

As can be seen, personal ownership provides the best result. What about distribution through a liquidation of the company? In that scenario, it is hard to see the company qualifying for Entrepreneurs' Relief as it is unlikely to meet the qualifying conditions. This leaves us with the situation that, either basic rate ("BR") capital gains tax is paid at 18% (unlikely unless numerous shareholders) or, more realistically, the higher rate of 28% is payable. This is shown in table B.

Again, personal ownership comes out on top.

This is not, however, the end of the story. If debt is being taken on to purchase the property, you need to consider the repayment of that debt. The capital is not tax deductible so the more post tax cash you have available, the quicker you can repay the debt.

It is, perhaps, not surprising that, given the

income tax rates of 20%, 40%, 60% (between £100,000 and £114,950 due to the erosion of personal allowances) and 50%, the corporation tax rate for small companies of 20% represents a much cheaper option and the ability to repay debt far sooner from the same level of rental income.

Still, we haven't reached the end of the story, what about pension schemes? Of course, there are some restrictions on what pensions can hold; residential property is not allowed, but commercial property can be held.

The benefit of the pension scheme holding property is that any income it receives and capital gains it makes are within a tax free environment, which is excellent news and represents far better tax efficiency than personal or corporate ownership. However, there are drawbacks.

Firstly, debt can only be raised equivalent to 50% of the pension's value. You may be able to raise more personally or in a company.

Secondly once the property is sold, the cash is still locked in the pension. You can obtain a 25% tax free lump sum, but the remaining 75% would be subject to income tax at one of the rates referred to above. This gives effective tax rates of 15%, 30%, 45% and 37.5%. Compared to the capital gains tax rate, only the 15% is favourable, but compared to income tax rates, the pension offers some savings.

So, is it possible to get the best of both worlds?

Recently, a few people have informed me that they have been advised to own the property, lease it to a company that they own, then allow the company to sub-let to tenants. This would seem to offer the benefit of profits being taxed in the company, at lower corporation tax rates, but the capital ownership resting with the individual. This must surely, then, be the ultimate arrangement.

Sadly not. What many advisers miss is the Stamp Duty Land Tax liability that arises on the granting of a lease to the company. This could give a significant cost to the arrangement.

Furthermore, you need to consider the bank's position where there is finance involved. They will want to see a certain level of rental cover from the individual, so locking the income in the company is no good. If the profits end up having to be distributed to the individual to assist with capital repayments or to give the bank the security they are after, no benefit has been achieved from structuring the ownership in this way.

On top of that, you will have two sets of leases to renew each time, giving rise to additional legal fees.

I am not saying that this would never work. Where there is no debt, it could represent an opportunity to save some tax, depending on the SDLT on the lease.

There are a couple of options though, that could work:

1. Set up a management company
2. Use a Limited Liability Partnership

The management company is a pretty simple trick. If you own the property personally, you set up a company to manage it on your behalf. The management company levies a fee, which reduces your income tax position, and puts profits into the company to pay the lower rate of corporation tax.

The only potential issue here is an HMRC challenge on the lack of commerciality. Therefore, it is always advisable that the company manages more than just your own property. Maybe a couple of friends hold some investment property and are willing for you to manage it on their behalf. This gives more substance to the company and reduces the risk of a challenge.

The Limited Liability Partnership (LLP) route is slightly more complicated, but does give a very good tax position. You can only really consider this for new acquisitions, rather than for existing arrangements, due to some anti avoidance legislation.

An LLP is formed. The Partners are you and a company that you (and maybe family members) control. The LLP agreement states that the company is entitled to 100% of the rental profits, but the individual Partners are entitled to 100% of any future capital profits (on disposal of the property).

By setting it up this way, you get the more beneficial capital gains tax position (with the individual paying tax just the once) and the more beneficial income tax position (with the company paying tax on the rental profits at a lower rate). If the shareholders of the company can then be paid dividends at the basic rate of tax, you could get the money into personal hands at no additional tax cost.

Of course, this is a more complex structure and will incur additional administrative costs, as well as legal fees for the LLP agreement, so you will need to carry out a cost/benefit analysis, however, it may just be possible to get to property utopia!!

I hate confusing things, I would far rather be able to give you a simple answer. However, despite HMRC's motto of "tax doesn't have to be taxing", nothing, unfortunately, could be further from the truth with property ownership!

Table A - Dividends

	Personal	Company and HR taxpayer (25%)*	Company and AR taxpayer (36.1%)*
Gain	£100,000	£100,000	£100,000
Corporation tax	£0	(£20,000)	(£20,000)
Income tax	(£20,000)	(£28,889)	
Capital gains tax	(£28,000)	£0	£0
Cash in hand	£72,000	£60,000	£51,111

Table B - Liiquidation

	Personal	Company and BR taxpayer (18%)*	Company and HR/AR taxpayer (28%)*
Gain	£100,000	£100,000	£100,000
Corporation tax	£0	(£20,000)	(£20,000)
Capital gains tax	(£28,000)	(£14,400)	(£22,400)
Cash in hand	£72,000	£65,600	£57,600

* Payable by the individual

Withdrawal of protected building reliefs

Background

Proposed legislation announced in the recent Budget will, if enacted in its current form, see the removal of most of the present VAT zero-rate reliefs which apply to protected (listed) buildings.

The proposals envisage the withdrawal, from 1 October 2012, of the zero-rating which currently applies to:

1. the supply of building services (and associated building materials) in the course of an approved alteration to a protected building.
2. the first sale or long lease of a substantially reconstructed protected building.

The changes will remove what HM Revenue & Customs consider are "anomalies" in the current system which they believe are often exploited by avoiders or non-compliant businesses.

Approved alterations

As regards item 1, "approved alterations" to "protected buildings" have hitherto enjoyed favourable VAT treatment in comparison with repairs to such buildings, which are standard-rated. "Approved alterations" cover works which are carried out under the relevant planning consents and which comprise changes to the fabric of the building (walls, ceilings etc). A building is "Protected" if it is a Listed Building and is used for a "relevant residential purpose" (i.e. as a dwelling or a home or other institution providing residential accommodation for various reasons (old age etc)) or a "relevant charitable purpose".

As a transitional arrangement, where a signed contract for the relevant "approved alteration" works was in place on 21 March 2012 (Budget Day), then any works under the contract performed up to 20 March 2013 will continue to qualify for zero-rating.

Depending upon the precise nature and circumstances of the project, it is possible that the reduced VAT rate of 5% might be available for work that would previously have qualified for zero-rating under the "approved alteration" heading.

First sale or long lease of substantially reconstructed building

As far as item 2 is concerned, the zero-rating is not to be removed entirely but will be retained for buildings reconstructed from a shell, so the position for protected buildings in that regard will be similar to that for other residential or charitable buildings.

Otherwise, unless the sale / long lease is of a protected building which has either been empty for 10 years, or has newly been converted to residential from previous non-residential use, the supply of the reconstructed building will be exempt from VAT, resulting in irrecoverable VAT on project costs and making projects of this type less attractive to developers.

Again there are transitional arrangements proposed, such that where a signed contract for "approved alterations" was in place on Budget day, then any grant of a major interest in the protected building up to 20 March 2013 will continue to qualify for zero-rating under the existing rules for "substantial reconstructions". This will also be the case if at least 10% (measured by reference to cost) of the reconstruction has been completed before Budget day, even if a signed contract does not exist.

Anti-forestalling legislation

The proposals contain measures to prevent owners and developers setting up prepayment arrangements to obtain zero-rating for works contracted for on or after Budget day which are performed on 1 October 2012 or subsequently.

Consequences of the proposed changes

- Owners of protected buildings who are contemplating having "approved alterations" carried out to those buildings (and developers who are sub-contracting such works) need to ensure that the work is performed by 30 September 2012 (if there was no signed contract for the works in place at Budget Day) in order to avoid a VAT charge on those works.

  We would also recommend a retrospective review of past property costs to ensure that VAT has not been charged incorrectly - if it has, then appropriate refunds should be sought.

- For the future, projects involving protected buildings may be less attractive as development opportunities, given that sub-contractors may well be charging VAT where they would not have done so previously, and also given that such VAT may be irrecoverable by the developer if the ultimate sale or long lease of the reconstructed property is exempt from VAT (where previously it would have been zero-rated).

- For ongoing projects, there is previous case law which indicates that the change in the liability of the ultimate supply of the building from taxable (zero-rated) to exempt does **not** require a developer to repay input tax to HMRC where such VAT has originally been reclaimed on the basis that the ultimate supply would be zero-rated.

Whilst the stated effect of the changes is to "level the playing field", the real effect is that the cost of using listed buildings will increase. May are used by charities as care homes and such organisations are unable to reclaim VAT that they incur. Whilst Ministers recently announced a £30m compensation package for churches to offset a proposed increase on VAT on alterations to listed buildings, other charities will suffer.

Whilst the stated effect of the changes is to "level the playing field", the real effect is that the cost of using listed buildings will increase. May are used by charities as care homes and such organisations are unable to reclaim VAT that they incur. Whilst Ministers recently announced a £30m compensation package for churches to offset a proposed increase on VAT on alterations to listed buildings, other charities will suffer.

To discuss these or any other VAT issues concerning listed buildings, please contact Julian Millinchamp or Adam Lloyd on 01242 237661 or e-mail: julian.millinchamp@hazlewoods.co.uk or adam.lloyd@hazlewoods.co.uk

Fixtures and Fittings in Buildings

There are many items in a building on which capital allowances (effectively a tax depreciation allowance for plant and equipment) can be claimed, such as heating systems, sanitary ware etc, which some people might consider an integral part of the building. As the allowances enable a person, or company, to write off the whole of the cost of these items against tax over a period of time, they are extremely valuable, as in most cases, now that industrial buildings allowances have been completely withdrawn, there are no other reliefs for the cost of a building (prior to sale).

We have advised many clients on the claims which can be made, when they have had new business premises built, or they have bought a new or second-hand building, and saved them significant amounts of tax. There were significant opportunities where a second-hand building was bought, and there was no allocation in the contract of the proportion of the purchase price which related to these fixtures and fittings items.

However the opportunities for such claims in the future will be limited, because the 2012 Finance Bill includes a provision forcing the parties to submit a formal record of agreement ('ROA'). The ROA will show how much of the purchase price relates to plant fixtures. It is intended that this apportionment should be based on market values, and will be just and reasonable. This will mean that the purchaser cannot, after the purchase has been completed, try to allocate as high a proportion of the price as possible, to such items to reduce their tax liabilities.

It may be the case that the parties would prefer to use a lower allocation to fixtures, although one would expect this to be unusual as far as the purchaser is concerned. This will still be possible, because the parties can make a joint election to use that lower figure (under CAA 2001 S.198).

The ROA has to be completed within two

years of the transaction, otherwise no Capital Allowance claim can be made by the purchaser. In practice, this is undoubtedly going to mean that as part of purchase documents the ROA will need to be prepared. At that stage there is the incentive to get the documentation done, whereas experience demonstrates that trying to get documentation signed by both parties, six months or more after the transaction, is often difficult.

One can anticipate that there will be some interesting discussions as to the market value of the fixtures in the building. The vendor will probably want a low value to maximise his claim to capital allowances, whereas the purchaser will want a high value, for the same reason. Whether you are a purchaser or vendor, you will need to be certain what items, which are integral to a building, can be treated as fixtures for the purpose of capital allowances. This is an area where we are happy to advise, based on our experience of dealing with similar claims in the past.

If you are having your own premises built for your trade or for letting, or you are extending existing premises, and you are paying the contractor under a contract, then you will not be affected by this new legislation. However, it will still be important to identify those items which can be treated as fixtures, and their cost, so that a capital allowances claim can be made.

For more information contact David Pierce, david.pierce@hazlewoods.co.uk or Tel 01242 680000

Closing down - final offers!
(but one offer to remain)

In last year's Budget, and again this year, we have seen the Government looking to withdraw some tax breaks under the guise of tax simplification, on the basis that so few people claim the reliefs, that it is not worthwhile continuing to have them in the legislation. A couple of these reliefs relate to property or the development of property. The reliefs have not yet been withdrawn but will disappear in the near future. Therefore if you are eligible make sure your claim has been made. Some of the relevant reliefs affected are as follows:

- Flat conversion allowances - these were introduced in 2001 and were designed to increase the availability of low cost rental accommodation in urban areas. There were 100% capital allowances available if the conversion was for residential use of empty or underused space above shops and other commercial premises. The flats must be available for short term letting. The allowances are not available if the flats are of high value, or the property where they are situated was built after 1980. The allowances are to be withdrawn for expenditure incurred on or after 1 April 2013 if you operate as a company, or 6 April 2013 if your business is subject to income tax.

  Whilst the potential claim was for 100% of the cost in the years of expenditure, it was possible to claim part of the allowance and claim at the rate of 25% per annum on the residual expenditure. This latter claim will also cease to be available from the above dates.

- Safety at Sports Ground Relief – This relief was introduced before 1988 to help with the costs sports ground operators were required to incur to make upgrades to sports grounds to comply with recent safety standards, and which would not have otherwise qualified for capital allowances. Again the relief is being withdrawn for expenditure incurred from either 1 April 2013 or 6 April 1013, depending on the nature of the business.

However the enhanced allowance for Business Premises Renovation of 100% of the cost, which was due to end on 10 April 2012, has been extended to 2017. This allowance is available for expenditure in converting or renovating a qualifying building into qualifying business premises, or for repairs to a qualifying building. The building has to be in a disadvantaged area. Firstly for the building to qualify, it must be the whole or part of an unused commercial building, or to have been unused for a year before any work starts. The last use made of the building must not have been as a residence.

Secondly, the building has also to be a qualifying business premises, which is defined as one used, or available and suitable for letting for use as a commercial building. The person who owns the premises must not be the person carrying on the trade at the premises. There are certain trading activities which will mean the property will not qualify.

If you think you may qualify for these reliefs and require more information contact David Pierce on 01242 680000 or david.pierce@hazlewoods.co.uk

David Pierce
Partner

Nick Haines
Partner

Richard Pontin-Medes
Manager

Adam Lloyd
VAT Director

Julian Millinchamp
Senior VAT Manager

Services

The services we provide include:

- Accountancy and bookkeeping
- Taxation planning
- Management accounts
- Strategic planning
- Audit
- Raising finance
- Sage advice and training
- Financial planning
- Payroll assistance to include bureau service
- VAT
- Stamp Duty and SDLT mitigation
- Inheritance Tax and estate planning
- Transactions, planning and support
- Benchmarking and profitability advice
- Incorporation

Hazlewoods Property Team

Cheltenham Office:
Windsor House
Bayshill Road, Cheltenham, GL50 3AT
Tel: 01242 237661 Fax: 01242 584263

Staverton Office:
Staverton Court,
Staverton, Cheltenham, GL51 OUX, UK
Tel: 01242 680000 Fax: 01242 680857

www.hazlewoods.co.uk