How to Use Companies to Reduce Property Taxes

By

Lee Sharpe

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About Lee Sharpe

Lee is a Chartered Tax Adviser and tax consultant with over twenty years' experience in helping individuals, families, businesses and advisers with their tax affairs.

Lee writes extensively on tax matters for taxpayers and their advisers, including through the Tax Insider publications, Bloomsbury Professional and the TaxationWeb website. He also lectures taxpayers, accountants and other financial advisers on tax issues.

While he has appeared on TV to comment on tax matters, it was only long enough to establish that he really has a face for radio, and to give fellow members of his local CIOT branch sufficient ammunition with which to embarrass him at committee meetings.

When he is not giving tax advice or writing about tax matters, he is busy looking after his two children – not because he likes them, but because he wants to make sure that his office is not used exclusively for business purposes…

1. About This Guide

One of the most common questions tax advisers often get asked is “should I use a limited company for this business, or not?”

There is no simple answer to this question, and there is a great deal of myth and misunderstanding about limited companies.

The purpose of this guide is to set out the benefits and drawbacks of using a limited company as a vehicle for a property business, and to compare them with other possible business structures. This guide assumes you have no previous knowledge or experience of limited companies. By the time you finish it, we hope you will have a much clearer idea of the way a company works, and whether it is the right vehicle for your business, and what you hope to achieve.

1.1. Background

Over the last couple of decades, there has been pressure to *incorporate* (i.e., to transfer their business into a limited company) by many small businesses, as exemplified by the tax breaks introduced by the Chancellor of the Exchequer in 2000 and in 2002. These tax breaks were withdrawn with effect from April 2006, and as a result, the decision whether to incorporate or not has become a finer one to gauge.

Most notably, the 2015 Summer Budget heralded a significant increase in the effective rates of dividend taxation, such that company dividends (and perhaps even incorporation itself) lost some of their shine. But the Chancellor also announced tax relief restrictions for Buy-to-Let landlords operating as individuals (whether solely, in joint names or in partnership) that left companies largely unaffected. In some sectors, the race is very much back on.

1.2. Tax Rates and Devolved Taxes

Unless otherwise indicated, we shall be using 2020/21 rates and allowances. 2017/18 saw the first tangible divergence in Scottish Income Tax rates when compared to the rest of the UK: for non-savings income; 2020/21 will continue a reasonably significant divergence when comparing Scotland with the rest of the UK, as the Scottish government has not just moved thresholds but has introduced entirely new bands, and rates (although the differences are quite modest).

Strictly, 2019/20 was the first year of Welsh Income Tax rates. However, the National Assembly for Wales agreed to continue its alignment with “rest of UK” rates for the 2019/20 and 2020/21 tax years.

Interestingly for tax geeks, the Scottish and Welsh devolved taxing powers basically cannot affect savings income (including dividends) so that the Scottish and Welsh Higher Rate thresholds for bank interest, dividends and the like will be £50,000 in 2019/20, just like the rest of the UK – which potentially makes for some quirky calculations around the c£40,000 - c£50000 income band for Scottish taxpayers, depending on the mix of incomes at that level.

There are also potential knock-on implications, such as eligibility for the new Marriage Allowance. However, it should be emphasised that in very many cases, ‘devolved’ taxpayers will end up with similar results to rest-of-UK taxpayers and, even where they

do not, the differences are likely to be relatively small. **This book will apply the 'standard' UK rates and thresholds throughout.**

1.3. Stamp Taxes

The Scottish tax regime also includes "Land and Buildings Transaction Tax" (LBTT) instead of the Stamp Duty Land Tax (SDLT) with which most readers will be familiar. From 1 April 2018, "Land Transaction Tax" is payable in Wales, instead of SDLT. While very similar, there are differences between the three regimes, and **readers operating in Scotland or Wales should get specific advice on LBTT and LTT respectively**; this guide follows the SDLT regime such as it applies in the rest of the UK.

2. Choosing the Right Structure

Anyone wishing to run a business in the UK has a wide choice of ways to organise it. Each possible structure has its own advantages and disadvantages.

This chapter gives an overview of the three basic types of business structure that are commonly used.

2.1. Sole Trader – "One Man Band"

This is the simplest form of business.

A sole trader owns and runs his or her business directly – he is "self-employed". All the risks and rewards are his directly, and all the decisions about the business are his.

If things go well he or she owns all the profits that have made (after having paid tax on them!).

However, if things go badly the sole trader is liable for all the debts of the business. We call this "**un**limited liability" – if the sole trader's business fails, his private property can be taken to pay off the debts of the business. In other words, even his personal wealth outside of his business is at risk.

In summary, there is no real distinction or 'barrier' between the individual and his or her "one man band" business

2.2. Partnership

Where two or more people own and run a business together, they are generally referred to as operating in partnership.

Like a sole trader, all the risks and rewards belong to the partners – but the crucial point is that, in an ordinary partnership, EACH partner is JOINTLY liable for ALL of the partnership's debts.

If things go wrong, any money owed by the partnership business can be recovered from the partners – and if one of them has no money to pay, the other partners will have to pay that person's share of the debts as well. Like the sole trader, a partner's liability is "unlimited" – even non-business personal wealth is at risk.

Note that the Scottish treatment for partnerships differs from the rest of the UK in some aspects of partnership law (although this makes little difference in terms of partnership taxation).

There are also some more specialised forms of partnership that can restrict a partner's potential exposure or liability, which we shall cover in more detail below.

2.3. Limited Company

A Limited Company is a "legal person". This means that it exists independently of its owners – its shareholders – and it can make contracts, and be sued for its debts in its own name and on its own behalf.

Here, the word “Limited” means that the shareholders’ liability is limited to the money they have invested in their shares. If things go wrong then, in the vast majority of cases, the worst that can happen to the shareholders is that they will not get their money back - though as we shall see, this is not always the case.

One of the key consequences of this legal distinction is that a company’s money does not automatically ‘belong’ to the shareholders in the way that it does with one man bands and ordinary partnerships. Even if you own all of the shares in your own company, its assets – including its cash – are primarily the legal property of the company. How the company decides to transfer its wealth to its owners, etc., is what we shall look at in more detail, in the coming chapters.

2.4. Types of Partnerships

There is really only one kind of sole trader, but there are different kinds of partnership.

The basic type of partnership is defined by the Partnership Act 1890, and involves “persons carrying on a business in common with a view of profit”.

A partnership is not a separate legal person from its members, and for tax purposes it is “transparent”. In other words, the partnership itself does not pay tax – each partner pays tax on his or her share of the profits.

(In Scotland, a partnership *is* a legal person, but for tax purposes, it is treated in the same way as an English partnership, and is “transparent” like them).

In some cases, although two people may agree to share the income from a project, they are not strictly a partnership because they are not carrying on “a business in common”.

In such a case, the activity is commonly referred to as a “joint venture”.

HM Revenue and Customs (HMRC) will sometimes claim that this is the case where one or more jointly owned properties are rented out, and this can have significant tax consequences, as we shall see later.

We have noted above that the partners in a partnership are jointly liable for the business debts.

There are, however, some varieties of partnership where this does not apply, and these are detailed in the following sections.

2.4.1. A “Limited Partnership”

A “Limited Partnership” is one where one or more of the partners has his or her liability limited to the capital he contributes to the partnership when he joins – like a shareholder, the worst that can happen to him is that he loses the money he invested, unlike an ordinary partner who might lose everything.

There are special rules for such partnerships:

- At least one of the partners must be a "general partner" who has **un**limited liability, as with an ordinary partnership, and is responsible for running the business.
- A limited partner is not allowed to withdraw any of his capital from the partnership until he leaves the firm.
- A limited partner is not allowed to take part in running the partnership's business, or to make contracts, etc., on behalf of the firm – if he does, he loses his limited liability and becomes an ordinary partner.
- There are restrictions on how much tax relief such partners can have for any losses made by the partnership, and they cannot get tax relief for the interest on any money they borrow to invest in the partnership.

Such partnerships are rather specialised entities, but they can have their uses.

Case Study - 1 A "Limited Partnership"

Mary wants to set up a new business, and her Aunt Sally is prepared to invest 60% of the capital needed to help her, in exchange for a fair share of the profits.

She doesn't want to have "unlimited liability" so the obvious solution seems to be a company, but Mary would rather not incur the expense of setting up and running one.

Instead, the new business is set up as a limited partnership, with Mary as the General Partner and Sally as the Limited Partner.

This way, Sally has limited liability, as she would have had with a company.

In other words, a limited partner must be a "sleeping partner" – that is, a partner who does not get involved in running the partnership.

2.4.2. A Limited Liability Partnership (also referred to as an "LLP")

This is a fairly new sort of business entity, which was made possible by the Limited Liability Partnership Act 2000.

Unlike a normal partnership, it is a separate legal person from its members, but for tax purposes it is basically "transparent" like an ordinary partnership – each partner pays tax personally on his or her share of the partnership's profits.

As the name implies, the partners in an LLP have limited liability, like shareholders in a company.

LLPs have proved popular with large professional firms such as accountants and solicitors, but as a general rule they are not appropriate for the smaller property investor or trader, being rather cumbersome to administer.

The idea of LLPs was that they would combine the advantages of a company (limited liability) with those of a partnership (informality and flexibility).

Some would say, however, that they also combine the disadvantages!

Except for unusual situations like Case Study - 1, where someone wants to invest but not to be actively involved, the most suitable form of partnership for the property investor is likely to be the traditional or general Partnership Act type, as described above.