How To Use Companies To Reduce Property Taxes

By

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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 small children – not because he likes them, but because he wants to make sure that his office is not used exclusively for business purposes…

About This Guide

One of the most common questions tax advisers often get asked is “should I use a limited company 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.

Over the last few years, there has been a rush to *incorporate* (i.e., to transfer their business into a limited company) by many small businesses, egged on 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 These tax breaks were withdrawn with effect from April 2006, and as a result, the decision whether to incorporate or not has become more difficult.

Most notably, the 2015 Summer Budget heralded a significant increase in the effective rates of dividend taxation, such that company dividends have 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. People will, however, need to keep an eye on the current Chancellor, who seems to be alive to the potential savings to be made by operating through a company.

Unless otherwise indicated, we shall be using 2018/19 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; 2018/19 will see a significant divergence when comparing Scotland with the rest of the UK, as the Scottish government has not just moved thresholds this time but has introduced entirely new bands, and rates.

Interestingly for tax geeks, the Scottish devolved taxing powers basically cannot affect savings income (including dividends) so that the Scottish Higher Rate threshold for bank interest, dividends and the like will be £46,350 in 2018/19, just like the rest of the UK – which potentially makes for some quirky calculations around the c£43,000 - c£46,000 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, Scottish 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 modest. **This book will apply the ‘standard’ UK rates and thresholds throughout.**

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” will be 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

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.

1. 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 structures that are commonly used.

1.1. Sole Trader

This is the simplest form of business.

A sole trader owns and runs his 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 owns all the profits he has made (after he has paid tax on them!).

If things go badly, he is liable for all the debts of the business. He has “unlimited liability” – if his business fails, his private property can be taken to pay off the debts of the business. In other words, even his wealth outside of his business is at risk.

1.2. Partnership

Where two or more people own and run a business together, they are known as a partnership.

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

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

1.3. Limited Company

A Limited Company is a “legal person”. This means that it exists independently of its shareholders, and it can make contracts, and be sued for its debts.

Here, the word “Limited” means that the shareholders’ liability is limited to the money they have invested in their shares. If things go wrong, 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 in fact always the case.

1.4. 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 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 a jointly owned property is rented out, and this can have significant tax consequences, as we shall see later.

We have seen how the partners in a partnership are jointly liable for the business debts.

There are some varieties of partnership where this is not entirely the case and these are detailed in the following sections.

1.4.1. A "Limited Partnership"

A "Limited Partnership" is one where one or more of the partners has his 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 unlimited liability, as in 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 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.

1.4.2. A Limited Liability Partnership (known 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 "transparent" like an ordinary partnership.

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, the most suitable form of partnership for the property investor is likely to be the traditional Partnership Act type, as described above.

2. Getting to Grips with Limited Companies

In this chapter we will start to understand the structure of Limited Companies.

2.1. The Different Types of Limited Company

There are several types of Limited Company:

A Private Limited Company is the type we shall be concentrating on in this guide. It is the basic type of limited company, used by hundreds of thousands of businesses.

A Public Limited Company ("plc.") is allowed to raise funds by selling shares to the public, but it is also subject to much stricter legal controls than a Private Limited Company.

A Listed Company is a plc. whose shares can be traded on the Stock Exchange.

There are some other types of company, such as a **company limited by guarantee** – this is normally used by charities, and because it is not allowed to distribute its profits to its shareholders, it is ideal for that purpose – and useless for a property investor!

> For the rest of this guide, when we use the word "company" we shall be referring to a **private limited company**.

2.2. The Basic Rules for a Company

The basic rules for a company are:

- It must have at least one shareholder. The shareholders own the company, and their ownership is evidenced by the number of **shares** they own. If, for example, a company has a total of 100 shares issued to its shareholders, someone who owns 51 of those shares owns 51% of the company.

  He also **"controls"** the company, because in normal circumstances he will have 51 out of 100 votes if decisions are to be made about the company's policies.

- It must have at least one director. Directors are responsible for running the company's business affairs. The shareholders own the company, but the directors run it on a day to day basis. In the case of the typical smaller property business company, the directors are often the shareholders as well.

- A company must prepare and file accounts each year with Companies House (the government agency that regulates UK companies). These must be filed within 9 months of the end of the period covered by the accounts.

- A company must also file various returns of other information with Companies House, notifying such things as the appointment of new directors, and so on.

- A Company must have a **Memorandum and Articles of Association.** These are formal documents which set out the basic structure of the company – the number of shares it can issue, the rules for transferring shares from one person to another, and the purposes for which the company has been formed.

  Although these "Mem & Arts" are available as standard format documents, it is important to be sure that they are appropriate for your particular company.

  If necessary, the "Mem & Arts" can be altered or updated, but there is a formal process for doing this.

- Decisions made by the directors or shareholders of a company should be recorded in the company's **Minutes** – which comprise a formal record of such things as appointing new directors, issuing shares, or paying dividends.

  There is an example of a company **minute** in section 6.4.1 of this guide.

If this sounds a daunting list of tasks, do not despair – there are a number of specialist companies that offer help with these tasks, and your accountant will be able to advise you on compliance with the routine requirements.

It is important to realise, however, that a company is a more formal structure than a sole trader or a partnership, and that there are penalties for failing to comply with the rules.

The accounts of a company must be prepared according to certain rules and in a certain format. **You will need an accountant to prepare these for you.**

Companies over two out of the three following thresholds are also required to have their accounts "audited" – that is, checked for accuracy by an independent accountant. These thresholds were increased in 2016 to:

- a turnover of over £10.2 million,
- assets of more than £5.1 million,
- an average of over 50 employees

Even if your company falls below these limits and an audit is not required, you should include the cost of having company accounts prepared by an accountant when you look at the figures for your company.

All the above requirements for companies mean that you should budget for at least £1,000 in "compliance" costs for each year – to cover preparation of accounts, submission of the various statutory returns, and working out the tax payable by the company.

This is a rough minimum figure – but it will be the one we shall use in the case studies that compare companies with other business entities.

Once a company has filed its accounts, they become **public information.**

Anyone (including your employees or your competitors) can access Companies House' website and get a copy of the accounts, together with information on the shareholders and directors of the company.

For companies that are excused from being audited, only "abridged" (previously referred to as "abbreviated") accounts need be filed and made public – "abridged" accounts do not show as much detail as full accounts (for example there may not be a profit and loss account) but nevertheless, they give quite a lot of information about the company.