

I'M A PROPERTY DEVELOPER:

CAN I CLAIM ENTREPRENEURS RELIEF? ... AND IS IT WORTH CLAIMING?

By specialist property accountant Stephen Fay FCA



Many property investors – whether landlords or developers – have heard of ‘Entrepreneurs Relief’ (ER), but aren’t clear about what it is, and whether they could benefit from this tax relief. This article explains what ER is, when it can be claimed, and when it may not be beneficial to claim ER.

What is Entrepreneurs Relief exactly, and can I claim it?

ER is a tax relief available to property development and trading companies, enabling the company to be closed and a reduced rate of CGT (10%) paid on the total value of the company. This can be valuable compared with the alternative of paying 32.5% dividend tax to take out funds from the company for Higher Rate company owners, or the 20% CGT rate payable on the disposal of other capital assets (28% for residential property). There is a lifetime limit on ER claims of £10m/person (which of course is plenty for most smaller property developers).

ER is specifically not available to owners of property investment companies – therefore it is crucial to understand the difference between a property **investment** vs **trading** company.

A property investment company generally holds property for long-term investment, and generates a return via rental income. Property may be sold occasionally, but the intention at the outset for each purchase would be to rent, rather than flip, the property.

A property development / trading company generally buys land and property to develop / renovate and sell for a short term profit. Property would normally be financed using non-permanent finance (cash / bridge, etc) and sold when developed, realising a trading profit.



Does my company qualify for ER?

The following are the key criteria to assess whether ER is available:

- 1. The company is a trading company (ie, not an investment company or a property company with more than 20% investment activity)**
- 2. The individual owns 5% or more of the ordinary shares of the company**
- 3. The individual is an ‘office holder’ of the company, ie, a director or employee**
- 4. The shares have been owned for one year or more before sale**

The above criteria apply whether the company is sold or closed down (“liquidated”).

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OK, that's fine, except that my company buys property that might EITHER be rented or sold depending on market conditions at re-sale time – how does that work?

In most cases, a company's owner knows whether a property is earmarked for a quick sale (with or without development), or for rental – and usually the circumstances of the purchase give away the company's intention!

However, in the real world, property developers do sometimes need to rent a property (eg, in a Brexit-inspired mini property crisis), and so the following criteria provide a way to objectively assess the tax status of a property development company, where there is a mix of development and rental:

COMPANIES WITH MIXED PROPERTY DEVELOPMENT AND INVESTMENT ACTIVITY

The trading status of a company can be valuable, and so where there is a mix of trading and investment activity (broadly, development vs rental, respectively), it is important to know whether or not the company's shareholders still qualify for ER tax relief on the sale or closure of the company.

Fortunately, a property trading company is allowed to have investment activities, and still retain its trading tax status, if the investment activity represents 20% or less of the company's activity. Where it is not obvious whether this threshold has been reached, the specific criteria to be assessed in this regard are income, pre-tax profits, capital employed, management time, etc.

In reality, many small property companies never have an issue regarding their tax status; ie, it is obvious whether or not the company qualifies for ER. In fact, it can often be beneficial to have a single company to have both property development and investment activity if the accumulating balance sheet never reaches a significant value (since the owners can extract much of the company's profits as Basic Rate taxpayers and just pay 7.5% dividend tax, even after tax-free salaries and repayment of directors loans).

In marginal cases, it may well be prudent to form a second company for development vs investment activity, however this would normally become obvious as the company's activities and profits unfold over a period of time; ie, it often isn't necessary to start with two separate companies from the outset (which would incur two sets of accountancy fees) – though your accountant may be happy to collect two sets of fees!

What if I want to close down my company rather than sell it?

ER tax relief is available for companies meeting the qualifying tests, where the owners want to close down the company, rather than sell the shares to a buyer. This can be tax-efficient if paying a flat-rate 10% tax rate is preferable (in order to extract the company's profits immediately in one lump), rather than dribbling the profits out over several years via the traditional small salary (around £11k-£12k/year) and a Basic Rate dividend (around £33k/year), at which only 7.5% dividend tax is payable.

In other words, in many cases it is actually LESS tax-efficient to claim ER at 10%, rather than take a tax-free small 'Personal Allowance' salary, and a Basic Rate dividend taxed at just 7.5%. A good tax accountant will be able to crunch the numbers to work out which option makes most tax-sense ...

1. Intention when buying the property
2. Was substantial renovation work done to the property?
3. How often are properties that the company buys rented vs sold for a profit in a short timescale?
4. For properties that are rented, how long are they rented before sale?
5. Are those rented properties simultaneously marketed for sale?
6. How are the properties financed (short vs long term finance)?

For the tax nerds, the above points are set out in law in Part 8ZB Corporation Tax Act 2010.



ENTREPRENEURS RELIEF – STING IN THE TAIL FOR 'REPEAT DEVELOPERS' ...

In many cases, claiming ER on the sale or closure of a development company makes a lot of tax sense – however, the government / HMRC are aware of that, and so there are restrictions to prevent the repeated use of ER in what the government / HMRC consider to be an abuse of ER tax relief.

Since April 2016, there has been a restriction in place to stop shareholders in any trading company from liquidating a company and then setting up a new company with the same trade within two years of the liquidation. This applies to 'close' companies (five or fewer shareholders, broadly), unless there are valid commercial reasons for closing the company (eg, taking up a permanent PAYE job, permanent retirement from the trade, etc).

Closing down a company, taking the proceeds as a capital distribution (taxed @ 10% with ER), and then re-starting a new company immediately in the same trade (sometimes known as "phoenixing" companies) is deemed by HMRC to be abusing ER – if such a move were made by a shareholder, subsequent to an ER claim, the ER on the original capital gain would be re-calculated without ER being claimable – which could potentially increase the tax rate on that distribution from 10% to 28%.

It therefore makes tax sense to only claim ER where: (1) it is a better option than taking dividends and salaries, and (2) the shareholder(s) have no plans to do any further trading activity within a company in the following two years after a company closure.

SELLING VS CLOSING A DEVELOPMENT COMPANY PRACTICALITIES

Obviously, selling a company is straightforward in terms of the practicalities, ie, once a price for the shares is agreed, the funds change hands, and the share certificate(s) pass from the current to the new shareholder. Usually there would be a contract in place to mitigate any ongoing risk for the outgoing shareholder.

However, when a company is closed, where the company value is >£25k (which applies in the vast majority of ER claims), a formal liquidation is required. This means a liquidator must be appointed, and a formal legal process must be followed, in order to validly deal with the liquidation, plus there is a cost to this (typically £1.5k-£3k, depending on circumstances). This then enables a company to be properly closed down, creditors paid, and ER tax relief claimed on the final funds paid to the shareholders.

But when might claiming ER NOT be the right move for me?

A 10% tax rate to extract all of the funds in a trading company in one transaction is clearly beneficial as an option – however, it's not ALWAYS the best option, for example:

1. Where the shareholder could instead take a traditional combination of small (say, £11k) salary and top-up (say, £34k) dividend, and so stay under the 2018 tax year Higher Rate income tax threshold of £45k, and so paying 0% tax on the salary (which is also tax-deductible for the company), and 7.5% on the dividend – this is suitable for shareholders who (1) don't have another income source, and (2) are happy to dribble out the income over several tax years.
2. Where the shareholder DOES have income from another source, and DOES plan to operate a development company on an ongoing basis – in which case it may be better for that shareholder to have an investment company own the shares in the development company, as an ER claim isn't going to be beneficial. This would mean that the development company would simply pay out its dividend to its owner investment-company, as a non-taxable dividend (as UK companies don't pay tax on dividends received from UK companies) – this is suitable for investors who plan to use development company profits to accumulate value within their own investment company, for long-term investment rather than short-term extraction and spending.



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A FINAL POINT TRADING COMPANIES IN GENERAL – INHERITANCE TAX BENEFITS

Another benefit of having a trading company is the option to claim 'Business Property Relief' (BPR) on the value of the company's shares when considering estate planning. BPR enables 100% tax relief against Inheritance Tax (IHT) arising on the value of unquoted shares in a company, which also includes lifetime gifts of such shares.

For mixed companies (ie, companies with both property trading and rental activity), the tax status 'test' is less stringent than for CGT ER – only 51% of the company's activity needs to be of a trading nature.

Obviously, the above IHT benefit wouldn't apply to a company that is liquidated ... as the owner has sold the company prior to death.

IN SUMMARY ...

Using a company makes tax-sense for many property investors, whether for development or investment. Entrepreneurs Relief is a tax relief that can prove useful for investors with a very large development profit, which they want to extract immediately from the company, or where the property development trade activity is not likely to be repeated within a two-year period.

However, claiming ER has to be cost-effective (as there are costs payable to liquidate a company), and beneficial (as there may be better tax-planning options than ER). Although a nice 'soundbite' conclusion would be ideal, ultimately the final conclusion is dependent on the particular circumstances of the case ...