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The Chartered Tax Adviser Examination

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Application and Professional Skills

Owner-Managed Businesses

Suggested solution

REPORT

From: Bolmen Tax Consultancy

To: Peter Hoting

Date: 8th May 2019

Re: **Proposed Purchase of an Investment Property**

Introduction

As requested in your letter dated 1 May 2019 this report considers the availability of funds within Arsane Ltd (`AL`) to purchase a commercial investment property together with the ways in which this purchase could be achieved. This report does not consider the acquisition of a residential investment property.

1. Executive Summary

- AL currently has approximately £190,000 of cash of which £175,000 is available to purchase an investment property.
- A property costing £200,000 will result in a shortfall of funds of approximately £28,000 taking into account stamp duty land tax (`SDLT`) and estimated legal costs.
- The sale of AL`s shareholding in Bora Ltd would be tax free and is therefore the preferred way to make up this shortfall if a surplus asset is sold.
- Alternatively AL could take on additional borrowings.
- A direct purchase of the investment property by AL could mean that a future disposal of your shareholding in AL will result in capital gains tax being charged at the rate of 20% rather than 10%. It could also result in a double tax charge arising.
- An extraction of funds from AL followed by a direct purchase by yourself will be very expensive in tax terms.
- The use of another company as a vehicle to purchase the investment property with funds provided by AL would be overly complex and maybe expensive in tax terms.
- From a tax perspective, the preferred method would be to set up a self-administered pension scheme into which AL would make a significant pension contribution which could then be used to purchase the investment property.
- Such a contribution is likely to create a trading loss of approximately £40,000 which could be relieved to generate a corporation tax refund of approximately £7,600.

2. Options to Purchase an Investment Property

There are various ways in which the purchase of a commercial investment property could be made. This report will concentrate upon the following possibilities:

- A direct purchase by AL
- An extraction of available funds from AL followed by a direct purchase by yourself
- AL making a pension contribution with the purchase then being made by a pension scheme
- A brief consideration of other options

3. Direct Purchase by Arsane Ltd

Cash Shortfall

It is expected that the investment property will cost £200,000. The cash requirement therefore amounts to £203,000 ((£200,000 plus £2,000 (legal fees) plus £1,000 SDLT (200,000-150,000 x 2%). The SDLT charge assumes either (i) no VAT is charged on the property purchase or (ii) If VAT is charged an option to tax election is made. If this is not the case SDLT will be charged on the VAT inclusive price.

At 30 April 2019 the company has available cash of approximately £190,000**.** You state that £15,000 is needed for working capital so around £175,000 is surplus and not being effectively used. The shortfall is therefore £28,000 (203,000-175,000) on the assumptions made.

Funding Shortfall

Without borrowing you mention that there are to be two main options to generate the additional required funds in the near future, both of which relate to the sale of surplus company assets.

Land part disposal

As shown in Appendix I if the surplus land at AL`s freehold property is sold for £30,000 a chargeable gain of £19,826 will arise. The corporation tax thereon amounts to £3,767 (19,826 x 19%)**.** Net after-tax proceeds therefore amount to £26,233 (£30,000 – 3,767), so as well as a tax charge arising a small shortfall in funds required will remain using this option.

Sale of Shareholding in Bora Ltd

Again this will result in a chargeable gain but this gain will qualify for an exemption known as the substantial shareholding exemption (`SSE`). This is because; (i) AL`s shareholding in Bora Ltd is more than a 10% holding; and (ii) it will have been held for a minimum consecutive period of twelve months in the six years before disposal. This does, however, assume that Bora Ltd is a trading company, although there appears no reason to suspect otherwise. Assuming SSE applies this transaction will therefore not be taxable and the full £30,000 proceeds will be available to fully fund the shortfall.

Conclusion

Of the two surplus assets a sale of the Bora Ltd shareholding therefore seems to be the better option, particularly as returns from the investment are insubstantial commercially.

Borrowings

Apart from the above AL also has the option of taking on borrowings to make up the shortfall. In this event tax relief for any interest charged will be dealt with under the loan relationship rules such that it will be first offset against the small amount of interest received. The excess will create a deficit which can then be used against other (trading) income arising in the accounting period in which the interest is paid.

Future Implications

Rental Profits

If AL buys the property any net rental profits (calculated as rental income less rental expenses on an accruals basis) will be subject to corporation tax for the relevant accounting period. The net of corporation tax profits can then either be retained within the company or distributed to yourself. If you chose to extract the money (although you indicate that it may be retained to supplement pension income) the most efficient means of distribution (see further below) will be by way of a dividend. Such dividends, however, will be taxed at your marginal income tax rate (almost certainly 32.5%) making them expensive in tax terms. Such distributions will, however, not incur a national insurance contributions (`NIC`) charge.

Capital Taxes

If AL purchases an investment property there is a danger that it will become a non-trading company. This means that entrepreneur`s relief (`ER`) might be denied when it comes to disposing of your shareholding in AL. The effect of this would be that any chargeable gain arising would attract capital gains tax (`CGT`) at the rate of 20% rather than 10%. ER is therefore a very valuable relief to be preserved if at all possible.

AL will be regarded as a trading company if no more than 20% of its activities are non-trading in nature. In determining this the company`s split of turnover, asset base and how management time is allocated will be taken into account. No one factor is dominant, rather an overall judgement based `in the round` will be made.

Currently AL does have some non-trading elements (the investment in Bora Ltd, some interest income and surplus cash). Because of the dominance of trading, turnover and management time being allocated to trading activities, however, ER would almost certainly be currently available if you were to dispose of your shareholding in AL now.

You should be aware, however, that if AL acquires the investment property (with the concomitant increase in investment income) the balance towards potentially violating the 20% rule, with the consequential loss of ER, will increase.

Providing AL`s business is not `wholly or mainly` (ie more than 50%) an investment business for inheritance tax (`IHT`) purposes your shareholding in AL will attract business property relief (`BPR`) at the rate of 100%. Again a judgement is made in the round using similar factors for ER purposes. It is therefore very unlikely that AL acquiring the investment property will jeopardise this relief.

You should be aware, however, that BPR will be restricted if AL holds `excepted assets`. These are defined as assets neither (i) used for business purposes throughout the two years preceding a disposal of the related shareholding; and (ii) not required for future business use. A proportionate restriction of BPR is made based on the fraction - excepted assets/total assets.

The current shareholding in Bora Ltd and surplus cash will therefore be excepted assets. AL`s purchase of the investment property will, however, convert these currently held excepted assets to an asset (ie the investment property) which is not excepted as it is used for a business of letting. This acquisition will therefore reduce or even eliminate the current BPR excepted asset restriction.

Double Taxation

A double tax charge will arise either if the rental profits are distributed, or upon an eventual sale of the property (the rental profits/gain will be subject to corporation tax, with a further personal tax charge arising upon any distribution to yourself).

VAT

Without AL making an option to tax election (`OTT`) any rental income will be an exempt supply for VAT purposes. Any VAT incurred on expenses made in relation to this supply (eg property repairs) cannot therefore be recovered. This is unless this expenditure falls within the de minimis rules (broadly such VAT is less than £7,500 per year and also below 50% of all VAT on expenditure).

It is possible that VAT will be charged upon the purchase of the commercial property if (i) it is `new` commercial property (broadly less than three years old); or (ii) the vendor has made an OTT. The only way to recover this (re: (i)) or avoid this (re (ii)) would be for AL to make an OTT itself. In this event its rental income will become standard-rated. AL`s business would then be fully taxable with no restrictions on VAT recovery.

If VAT is charged (whether or not recoverable) it will present a short term cash cost which will require additional funding.

4. Cash Extraction and Direct Purchase of Investment Property by Yourself

Method of Extraction

A dividend will be the most tax efficient means of extraction. This is because whilst there is no corporation tax deduction for dividend payments there is also no accompanying NIC charge. However you are already well into your higher rate tax band meaning that such a dividend will be taxed at a rate 32.5% and then (once your income exceeds £150,000) at 38.1%. This will therefore be expensive in tax terms and as a consequence likely to be unattractive.

If additional salary is taken this would be even more expensive as it will then be subject to income tax at the rate of 40% (and then 45% once income exceeds £150,000), 2% employees Class 1 NIC and 13.8% employers Class 1 NIC. A corporation tax deduction would, however, be available which is likely to result in an available trade loss for the accounting period in which the additional salary is paid. This could be used to obtain a corporation tax refund (see further below).

Either option will also result in the loss of your personal allowance as your income will exceed £100,000 in the tax year of purchase.

Shortfall

The large personal tax liability will mean that the shortfall to get to the £203,000 cash requirement will be significantly larger than if the investment property was purchased directly by AL. In the absence of any personal savings this could only be made up, if you are able to, by taking on personal borrowings.

Future Implications

Rental Profits

You will be liable to income tax on any net rental profits received. Because the property is commercial, in arriving at net rental profits, a full deduction will be available for interest charged on any personal borrowings used to assist with the purchase. If a loss arises (ie allowable expenditure exceeds rental income) this could only be carried forward for offset against future property income.

Apart from for the tax year of purchase (see above), based on current income levels, it seems unlikely that your future income, including the rental income will exceed £100,000. Your full personal allowance should therefore remain available for future tax years.

You will need to personally register for VAT and make an OTT to recover any VAT if charged upon acquiring the investment property. Alternatively you could restrict your property search to properties without VAT although commercially this maybe too restrictive.

Advantages

Despite the high tax charge in extracting the funds a direct purchase by yourself has the advantage that there will not be any double taxation on a future property sale. A chargeable gain will, however, arise when the property is sold calculated as the difference between the eventual sale proceeds and purchase price. From this you will be able to deduct any unused annual exempt amount. Any resulting net gain will suffer a CGT liability at non-residential rates (ie either 10% (to the extent any future gain falls within your basic rate band) or 20%). Entrepreneur's relief, however, will not be available.

There will also be no VAT partial exemption implications.

Conclusion

The personal tax expense of extracting cash from AL as described above to enable you to directly purchase the investment property is likely to make this option expensive in tax terms and therefore prohibitively unattractive.

5. Cash Extraction Via a Pension Contribution

The following is only intended to make you aware of the tax implications and general benefits of pensions and not to constitute any specific investment recommendation. Specific advice regarding such matters as the suitability of pensions as an investment vehicle, the merits of property as a suitable investment, specific pension products to use etc. should be obtained from a suitably qualified independent financial adviser.

Method of Extraction

From a tax perspective a far more efficient option would be to extract the cash from the company by it making a pension contribution. The pension fund itself could then purchase the investment property with the contribution funds received or make other investments to provide for retirement.

The reasons why the use of pensions is tax efficient are as follows:

Providing the pension contribution passes the `wholly & exclusively` test AL will obtain a corporation tax deduction for any pension contributions paid.

There are no income tax or NIC implications either for AL or yourself.

The pension fund will not be taxed on any net rental income it receives. Any gain on a future sale of the property within the pension fund is also tax free.

Surplus cash will be removed from AL helping to preserve full entitlement to ER and BPR.

Unless you want the company to do so there will be no need to sell off other surplus spare company assets.

This will also effectively remove that asset value from creditors in the event of a future company failure.

In the context under consideration it would be highly unusual for H M Revenue & Customs to seek to deny AL entitlement to a deduction for any pension contributions paid. In addition the contribution proposed (see further below) are not high enough for spreading of relief to apply over several accounting periods. Please note, however, that relief for pension contributions is given in the accounting period in which they are actually paid and not on an accruals basis.

Any pension benefits ultimately drawn are subject to income tax although the rate of tax charged will depend upon your income levels when you retire. It should be noted that because you are now aged over 55 retirement benefits can be taken straightaway. These days these benefits can be taken flexibly although the general principle is that only amounts in excess of 25% of the withdrawn amounts are subject to income tax.

Annual Allowance

The annual allowance places an annual cap on the amount of pension contributions that can attract tax relief. The annual allowance is currently £40,000 with excess contributions attracting an annual allowance charge.

The annual allowance can be reduced for high income individuals. It is noted, however, that because your current (`threshold`) income amounts to £71,850 (£11,850+£60,000) and this is less than the prescribed £110,000 threshold, you will not be regarded as a high income individual. Your £40,000 limit will therefore not be reduced

Any employer contributions, however, will count towards your annual allowance. In this regard it is noted that AL makes contributions on your behalf of £5,000 per year so your `spare` annual allowance is therefore £35,000 (£40,000 - £5,000). As a member of a registered pension scheme you can, however, use the brought forward spare allowances of £105,000 (3x £35,000) from the previous three years. Total contribution of £140,000 can therefore be paid into a pension fund. Contributions in excess of this will give rise to an annual allowance charge at your marginal income tax rates. This therefore effectively provides an upper limit to the amount of pension contributions that can be paid.

Possibility of corporation tax loss

It is noted that AL`s profits have been reasonably stable at around £100,000 over the last few years. Assuming this continues a pension contribution of £140,000 will give rise to a trade loss of approximately £40,000. This could be used to offset against any other current year income (ie the small amount of interest) with any balance carried back for offset against total profits arising in the previous twelve months. This will generate a corporation tax refund of approximately £7,600 (£40,000 x 19%).

6. Other Options

It would also be possible to set up a new limited company (`newco`) to acquire the investment property either as a subsidiary of AL or owned directly by yourself. In either case a central issue would be funding.

If a subsidiary is created AL could lend the required funds to it to make the purchase. AL would then have a shareholding in a non-trading company which will not improve on the ER or BPR position detailed above if AL were to make a direct purchase.

If newco was owned by yourself directly it is unlikely that external lenders would provide sufficient loan capital directly to it to fully fund the investment property purchase. To overcome this one possibility would be for you to extract the required funds from AL and lend these onto newco. As described above, however, this would be very expensive in tax terms although it would improve the ER and BPR position for your shareholding in AL.

Another possibility would be for you to personally borrow the funds from external lenders (if you are able to) and then again lend these onto newco. In this event you should be aware that because newco will be an investment company you will not receive tax relief for any interest paid whilst you will probably need to extract any profits from newco, and be taxed upon them, to make the loan repayments.

Overall there does not seem to be any strong reason to introduce a further limited company to make the purchase.

Conclusion

Based upon the above analysis whilst a direct purchase of the investment property by AL is the simplest option from a tax perspective the best approach will be to make the purchase via a pension fund. This is providing you can cope with not having complete control of the investment property and are willing to pay the additional fees involved.

Appendix I

Potential Part Disposal of Freehold Property

			£	
Proceeds				30,000
Less:	cost 75,000 x [30,000/((290,000+30,000)]			(7,031)
	Indexation	7,031 x ((278.1-192.2)/192.2)) 7,031 x 0.447		(3,143)
Chargeable gain				19,826 ======

ASSESSMENT NARRATIVE

Structure

A simple pass or fail will be awarded.

Identification and Application

The following are the relevant topics for assessment with their weightings:

1	15%	Identifying that a direct purchase by Arsane Ltd is not the only option to purchase the investment property. Specify and explain other available options (excluding use of pension fund)
2	15%	Identify the use of a pension fund maybe beneficial. Explain mechanics and reasons
3	20%	Identifying need to make up cash shortfall for all identified options. For Arsane Ltd compare sale of surplus assets. Explain borrowing option for all identified options
4	25%	Identify importance of ER and BPR and that each option has an impact for these reliefs. Explain the reliefs in the context of each option. Discuss the extent to which these reliefs are available.
5	15%	Identify and explain other tax issues that maybe appropriate (in particular VAT and SDLT, income tax aspects of extraction of funds)
6	5%	Identify differences in ways rental profits are taxed for each option
7	5%	Identify possibility of a corporation tax loss with salary/pension contributions. Explain how this may be used

A grade of 0,1,2,3, or 4 is awarded to each topic. The weighting is applied to that grade to produce a weighted average grade. This is then converted to a final absolute grade by rounding up or down to the nearest grade. Thus, scores in the range 2.5 to 3.49 will be a grade 3. In this example, the candidate will score a grade 3 overall and secure a pass for this skill.

Relevant Advice and Substantiated Recommendations

The following are the topics for assessment with their weightings:

20%	Advice and recommendation on which asset Arsane Ltd should sell (sale of Bora Ltd shares better due to SSE)
30%	Advice and recommendation on direct purchase of investment property by Arsane Ltd (potential impact on ER, BPR, double taxation, potential VAT complications)
30%	Advice and recommendation on direct purchase by PH (very expensive, need to extract money, over complicated)
20%	Advice and recommendation on the use of a pension fund to save for retirements (most tax efficient, overcomes potential ER problems, could potentially purchase the property)

The final grade will be determined for this skill in the same way as for Identification and Application.