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Should you let those unsold developments?

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Paul Windsor (pictured left) examines the tax consequences of letting those unsold developments until market conditions improve

Like the ebbing tide across the beach, the liquidity of the markets seems to have disappeared over the horizon leaving rental as the only solution for all those many unsold flats in recently completed development projects across the country. If by generating some rental income you can offset that rapidly accumulating interest it will keep the bank manager happy - for the time being at least.

A common theme which makes good commercial sense - but what are the potential tax pitfalls of hanging on to a rental portfolio?

Firstly, and most importantly, it is essential to establish whether you are renting temporarily or actually converting to an investment company and the intention at this stage must be evidenced in writing.

Trading v investment

It is essential that any board has agreed and documented the strategy behind the deal when the land or property was first purchased. HMRC often asks for contemporaneous evidence as to whether the purchase is an investment or a trading asset. The asset's position when it first appears in the balance sheet will give a strong indication of the intention - stock for development or a fixed asset allocation for investment, but there are a number of other factors to consider as well.

Why is this important?

Well, it informs the whole basis of the future tax treatment of the profits - is it to be taxed as a capital gain or is it profit from trading? This is important as it can lead to adoption of either capital gains or income regulations.

These different rules will lead to some elements of income and expenses being taxed or relieved at different times and can prevent the granting of loss relief which might otherwise be available - pretty important issues when cash flows are tight.

In the vast majority of cases letting on a temporary basis is going to be the most likely, but it is always possible that a permanent change from trading to investment may provide an opportunity to crystallise otherwise un-relievable tax losses.

VAT

HMRC is already warning house-builders faced with the dilemma of having to let unsold property to check that they are not breaking tax rules by changing the purpose of their build. Residential first time sales are generally zero-rated for VAT purposes enabling the developer to reclaim construction VAT costs. Thereclamation of input tax is voided if a property is built to be rented - thus potentially leaving the developer with significantly higher costs. If the intention is not changed but the property is rented temporarily the loss of VAT can be reduced.

Deductibility of interest

Interest should be deductible for both development and investment properties; however care must be exercised on a change of use to prevent interest unrelieved to date being "locked in" to trading tax rules and not allowable against a future capital disposal.

Entrepreneur's relief

The recent replacement of Business Asset Taper Relief (and the effective 10% rate of tax) on the sale of an SPV with the new 'entrepreneur's relief', taxing up to £1million of gain per investor on the sale of the company at 10%, has reduced the impact of this exit route but none the less it is an important planning tool for trading company owners. Letting the underlying assets for a few years could jeopardise the trading company status and leave the relief open to question by HMRC - potentially increasing the tax charge on the withdrawal of profits by 80%. Again the intention, documentation and evidence are all important!

SDLT

As ever with property transactions the additional cost of stamp taxes should not be overlooked if there is a transfer or deemed transfer of property for actual or deemed consideration.

Solutions

Most tax problems can be solved one way or another provided proper planning has been put in place. If a change in the type of business is inevitable, a correcting structure to mitigate the risk or impact of a change in status may be available - perhaps selling to a second 'investment' company in order to retain the trading status of the first. Great care also needs to be taken not to create additional tax problems with the increased complexity of the structure and closer inspection by HMRC which may be expected to scrutinise property companies carefully in the current climate.

So in the end what have we learned?

Well - don't make the obvious snap decision to let without thinking it through and taking some professional tax advice first. Every developer has different circumstances and although it is sensible to take action to minimise outgoings in the current market, it is vital that you check it out first - and don't be stuck in the sand when the tide of fresh finance comes flooding back in!

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