



# Property developers – they're interesting, varied and demanding

Mortgage availability and the house-price boom, plus a few TV shows, have created a whole new client sector. And *Julie Butler* and *Ian Wright* think there's room for more of them

It is fair to say that the 'property owner' client sector forms a large part of the client base of all firms that advise on tax, and there is great scope to attract new property clients to those firms.

For the smaller organisations this type of client is interesting, varied, demanding and often unaware of potential tax problems, potential tax planning and potential tax savings.

What has caused the growth of this property sector? The influence of television programmes such as *Changing Rooms* and *Property Ladder*. What about the impact of the property-price boom and the availability of mortgages and relatively low-interest rates? Enthusiasm for the market has been bolstered by the much-discussed city bonuses. Children in their 40s, 50s and 60s have parents who are now not just leaving two tins when they die, one marked 'funeral' and the other marked 'funeral party' – there is often substantial property in the estate and a lot of associated planning.

## Ten-year rule – inherited property

The inheritance tax rules have the advantage of a 10-year payment term. But many clients forget that this crystallises when the property is sold.

It would be easy to focus on 'buy-to-lets' (BTLs), but there are permutations and combinations of client tax problems in all areas of the small property investor, speculator and trader – how can we help these clients?

## Dwelling-house rebuilds and flat conversions

With the housing shortage reaching critical levels and the need for more affordable housing increasing, it is becoming rather popular for certain homeowners to consider either converting their homes into flats or possibly knocking down the whole house and building a block of flats or affordable housing on the plot.

There would appear to be some confusion about what taxes are involved with such a project, and conflicting advice is apparently being given in relation to the possible profits and gains. Some may say that this is a trade and taxed as income, some may say that it is *ITA 2007*, s. 756 (*ICTA 1988*, s. 776) and some may say it is tax free. The actual legislation that comes into force is *TCGA 1992*, s. 224(3).

## Taxing the profits of property conversions

'S. 224 Amount of relief: further provisions (3) Section 223 shall not apply in relation to a gain if the acquisition of, or of the interest in, the dwelling-house or the part of a dwelling-



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house was made wholly or partly for the purpose of realising a gain from the disposal of it, and shall not apply in relation to a gain so far as attributable to any expenditure which was incurred after the beginning of the period of ownership and was incurred wholly or partly for the purpose of realising a gain from the disposal.'

This section of the principal private residence (PPR) relief provisions basically enables HMRC to adjust the level of PPR available on the sale of property that has been sold wholly or partly for the purpose of realising a gain.

### Just an extension?

Before anyone panics and decides not to build the extension for the kitchen or landscape the garden, the rules are in place to capture those who enhance their properties for profit, and not those who wish to improve their homes and enjoy their improvements. An example of those who would be captured would be those who build an extension and sell the property immediately to benefit from the increase in the property's value.

### Two flats?

An even better example would be those who renovate their house into two flats.

The rules for applying *TCCA* 1992, s. 224(3) do not just apply to visual changes to the property but also financial changes. As per guidance given by HMRC at CG65257, if your client purchases the freehold of their flat to enhance the value of the property before sale, the profit will be captured and PPR will be restricted.

### Renovation for a profit?

There may be cases where people have not renovated their properties for profit but have been forced to sell for other reasons. If the taxpayer can prove that the motive to sell was not for profit then he should avoid the rules. An example of this would be clients who run out of money for a project and have to sell. However, it would not be possible for this misfortune to be used in the case of a flat conversion because of the obvious motives behind the project; although, if you were creating a flat for granny, this could possibly avoid the rules.

### Purchase for profit

Any property purchased with the profit motive in mind could be caught under *ITA* 2007, s. 756. But to silence those who fear the horrors of that section (old *ICTA* 1988, s. 776 rules, which convert capital gains into income gains), this legislation cannot come into force because *ITA* 2007, s. 767 basically says that if the property falls under CGT

legislation regarding principal private residence at *TCCA* 1992, s. 222 to s. 226, then s. 756 does not apply.

### Adventure in the nature of a trade

This is a very interesting question and one over which we think that those knocking down their houses may come unstuck. Demolishing a house and building a new one, or flats, to sell is most likely to be 'an adventure in the nature of a trade' and as such any profits earned from such a venture should be taxed as a property development business.

How the capital gains and income tax would operate in such a case would be similar to the rules under s. 756, and effectively the client would have a mixed CGT and income tax liability at the date the developed property was sold. *ITA* 2007, s. 765 confirms that the part of the income made on sale that is fairly attributable to a period before the intention to develop was formed is exempt from income tax, and therefore this would be taxed under CGT rules. This principle would no doubt be applied in the case of trade.

### Property development

The property would be entered into the property development business as stock at the market value, and all costs and sales dealt with through a profit and loss account. Simple! But what if the client is going to live in one of those houses or flats? This is where it all becomes extremely complex and 'true and fair' principles need to be applied.

### Principal private residence – the large garden

Structured correctly, disposal of part of the garden, half-a-hectare or larger, can be tax free under the PPR rules provided it meets the 'character appropriate' rules. To take full advantage of PPR on the large garden there has to be a sale for development as opposed to self development, which would be caught under *CGTA* 1992, s. 224(3).

### Buy to let (BTL)

Many BTL owners have purchased via a mortgage where the interest and expenses exceeds the income. The negative income position leads the owner to consider that there is no need to disclose the income stream to HMRC. This creates a huge market of potential tax clients that need tax help with non-

disclosure, unclaimed losses, future CGT problems and possible FHL conversion.

### Furnished holiday lets (FHL)

Most tax advisers are well versed in the income tax rules of FHLs, but what of Business Property Relief (BPR)? This can be achieved on one FHL property, provided that all the business services conditions are achieved. This can make vast differences to a family who inherit a FHL and want to keep the property in the family without large inheritance tax (IHT) penalties. The key is the provision of services. Please remind clients now of the future benefit. The need to keep photographic, contemporaneous evidence of the 'meet and greet' can prove very useful...

### Rolling over a gain into a FHL

If a business gain is rolled over into the purchase of a FHL, tax planning can be achieved around the future status of the property. The FHL can change status to a normal furnished let, and CGT will only crystallise upon the disposal.

The FHL (with the rolled-over gain) can be gifted to the owner's children with a holdover election as a business asset. The child can then use the PPR provisions to minimise CGT on disposal. The potential for efficient interaction of FHL and PPR is huge.

### Conclusion

Many taxpayers are entering the tax return compliance and tax planning markets due to the growth of the smaller property investor. Strong links should be formed with our local estate agents and conveyancing solicitors to attract the new clients and make them aware of the advice on offer.

Many existing clients are 'developing' (excuse the pun) their property portfolios and again need compliance and planning help. Have they recently been asked about their expanding property interests? There is strong marketing potential to capture and serve these clients, and one thing is certain: this DIY property magnate client base will not be dull and undemanding.

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