CURTIS BANKS

CASE STUDY

ADDRESSING TAX ISSUES WITH COMMERCIAL PROPERTY

APPROVED FOR ADVISER USE ONLY | MARCH 2024

An engineer addresses a range of tax challenges for himself and his business by using a SIPP to purchase his business premises.

The Challenges

Bill is an agricultural engineer who works in partnership with his cousin Angela. Bill's grandfather was a farmer, who left Bill a barn and a small plot of adjacent land with a probate value of £60,000 when he died. Bill and Angela use the barn as an office, workshop, and storage space for their tools, equipment, and stock.

Bill and Angela's business has grown significantly over the last few years. Their turnover has increased substantially and they now employ several people. Their accountant has suggested that they should incorporate their business, converting from a partnership to a limited company, which would provide an opportunity to restructure their remuneration. They have family members who are prepared to subscribe for shares in the company to inject the capital they need to develop the business further.

To date, Bill has had a rather relaxed attitude towards rent for the property, as he had inherited the barn at no cost to himself and thought it was more important for the partnership to be profitable than for him to take rent. Now that the business is growing and there will be other stakeholders, Bill feels it is appropriate to formalise the rental arrangements.

Bill updates his financial planner Abbie about his plans to restructure the business at their annual review.

The Actions

Abbie has some thoughts about the property for Bill to consider.

Income tax

The rental income from the property would be taxable income for Bill, which he does not need. Bill's share of the net profits from the partnership is £75,000 a year, and he expects to take a similar level of income from the limited company through a combination of salary and dividends. His income comfortably covers his expenditure.

Capital Gains Tax (CGT)

As the value of the property increases over time, Bill may face a CGT liability if or when he eventually sells it. The greater the increase in value since his grandfather's death, the greater the potential liability.

Inheritance Tax (IHT)

The property is currently an asset of Bill's estate, and the business restructure is likely to make the IHT position worse. As a privately owned asset used within his trading partnership, the property might benefit from business relief at 50%. However, when the business converts to a limited company, Bill will lose the business relief unless he has control of the company. As Bill and Angela will hold identical shareholdings and there will be other shareholders as well, Bill will not have control (typically 50% + voting rights).

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Abby suggests that Bill establishes a SIPP and sells the property to it. Bill has £70,000 in a personal pension, and believes the property is worth approximately £90,000 on the open market. Abbie explains that his SIPP could borrow up to 50% of its net value in order to raise the funds needed to buy the property and pay the associated costs. Bill and Angela's company will then pay rent into the SIPP, which can be used to repay the mortgage and create liquidity so that Bill can diversify his pension. Abbie explains that as these transactions will take place between connected parties, the purchase cost of the property and the rent will need to be set at market value.

The Results

Bill follows Abbie's advice and establishes a SIPP in order to purchase the property.

Bill realises a capital gain of £30,000 on the sale. With the £12,300 annual exemption for the 2022/23 tax year, this leaves Bill with a £17,700 taxable gain. This would be taxed at 20%, leaving Bill with a £3,540 CGT charge to pay.

Abbie explains that a potential option for Bill to reduce or remove this charge would be to transfer 50% of the property to his wife Gillian on a no loss/no gain basis before selling it to the SIPP. This would enable them to use both Bill's and Gillian's CGT annual exemptions. The couple could also consider phasing the sale of the property to the SIPP over two tax years, in order to effectively quadruple the annual exemptions available. However, phasing the sale over two tax years is also likely to incur additional costs.

Bill decides to proceed with his original plan to simply buy the property from himself. This leaves him with two issues to consider: CGT and IHT.

CGT

Bill's £17,700 taxable gain is charged at 20% because he is a higher rate tax payer. Assuming Bill has no other plans for the £90,000 sale proceeds, he could consider making a personal pension contribution. This would extend his basic rate tax band by the amount of the gross contribution.

Bill will pay higher rate tax on £24,730 of his income this year (£75,000 less the personal allowance of £12,570 and the basic rate band of £37,700). If he makes a net personal contribution to his SIPP of £19,784, his SIPP provider will reclaim basic rate tax relief (£4,946) to give a gross contribution of £24,730. As these funds would have been subject to higher rate tax, Bill can then gain an additional £4,946 of tax relief. This means the income tax relief he receives exceeds his CGT liability for the year.

Alternatively, if Bill made a net contribution of £33,944, this would give a gross contribution of £42,430 with the basic rate tax relief, and Bill would still be able to gain the £4,946 higher rate relief. This would also extend Bill's basic rate band to the extent that it would cover all of his income and his taxable capital gains for the year. His taxable gain would instead be charged at 10%, saving £1,770.

IHT

SIPPs and their assets won't normally form part of a person's estate, so Bill's property is now outside the scope of IHT. However, the £90,000 sales proceeds are now in Bill's estate instead.

Bill has already considered some of the £90,000 to make a pension contribution this year, partly due to the additional CGT advantages. However, contributions will also help Bill to build his retirement funds and help clear the mortgage, while benefiting from tax relief and removing the money from his estate. Bill may consider using the rest of the sales proceeds to make additional contributions for himself and Gillian over the next few years.

Important points to consider

The value of pension funds may fall as well as rise. Your money is tied up until you take your benefits. Benefits can generally be taken any time after age 55, although this is due to increase to 57 in 2028.

This information is based on our understanding of current legislation, including (but not limited to) FCA, PRA and HMRC regulation. It does not constitute any form of advice.

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