UK Property Accountants

A Complete Guide to

Partnership Incorporation



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Introduction to Partnership Incorporation

A partnership is a formal agreement between two or more individuals to jointly manage and operate a business with the goal of generating profit. In a partnership, each partner serves as a representative of the business, and all partners are personally liable for the partnership's debts and obligations.

In contrast, a limited company, also known as a corporation, is a distinct legal entity separate from its owners, known as shareholders. Shareholders are not personally liable for the company's debts and obligations, making a limited company an attractive option for partners looking to convert their business structure.

Awareness about the benefits of a limited company over a partnership has made partnership incorporation one of the most popular business structures. There are several reasons why a partnership may choose to convert to a limited company, including considerations of tax efficiency, protection of personal assets, and enhanced credibility.



Partnerships involve shared management with personal liability, while limited companies offer separate legal status and limited liability for shareholders, prompting many partnerships to convert for tax efficiency and asset protection.

Advantages of Transferring Properties to a Company

If you or your partner earn substantial income from employment or business ventures, establishing a limited company may be advantageous. This is particularly relevant if your property investments generate income that is not crucial for your financial stability.

Landlords opt to operate their property business through a limited company for a variety of reasons. Here are some key advantages:

1 Corporation Tax Vs Income Tax

The government charges income tax on the money you earn, and the more you make, the higher the tax rate you pay. It ranges from 20% to as much as 45%!
But if you set up a limited company, you'll only have to pay corporation tax, which is charged at 19% or 25%, depending on how much profit you make.

Let's take a closer look at the tax rates for the upcoming tax year (2024/25).

Income tax- for partnership business or when properties are in an individual's name:

Band	Taxable Income	Tax Rate
Personal Allowance	up to £12,570	0%
Basic Rate	£12,571 to £50,270	20%
Higher Rate	£50,271 to £125,140	40%
Additional Rate	over £125,140	45%

Corporation Tax

Band	Taxable Income	Tax Rate
Small Profit Rate	up to £50,000	19%
Main Rate	Above 250,000	25%

Any profit between £50,000 and £250,000 gets marginal relief, providing a gradual increase in the effective corporation tax rate.

If you earn up to £12,570, you won't pay any income tax at all (that's the personal allowance). But for the next £37,700 you earn (up to £50,270), you'll pay a 20% tax rate. The higher your income, the more tax you pay.

However, if you're a limited company, you'll only pay 19% tax on profits up to £50,000 and 25% on profits above £250,000.

So, if you compare the two tables, you'll see that individuals end up paying more tax on the same amount of profit or taxable income compared to a limited company.

2 Mortgage Interest is Fully Deductible for Companies but not for Individuals

In 2015, the government proposed changes to the tax relief that landlords could claim on interest and other finance costs. This has significant implications for people who run a property business.

Basically, you won't be able to deduct mortgage interest as an expense anymore. Instead, you'll get a tax credit of 20% on your interest payments.

So, if you are a higher rate taxpayer and have a rental income of £10,000, estate agent fees and other allowable expenses of £1,000, and mortgage interest of £7,000, your net rental profits will be £9,000. You'll then have to pay tax on that profit at a rate of 40%, which means a tax liability of £3,600.

However, you'll get a tax credit of £1,400 for your mortgage interest payments. This brings your total tax liability down to £2,200.

But, if you run your property business as a limited company, your net tax liability would only be £2,000, with a net tax liability of just £380 (at a rate of 19%). That's a saving of 82.72% on your tax liability!

3 Limited Liability in Company Vs Unlimited Liability for Independent Business Landlords

Imagine you're a landlord who owns a rental property. You're responsible for making sure the property is well-maintained and safe for your tenants to live in. But what happens if someone gets hurt on your property? Or if there's a fire and the building is damaged? If you're running the property business as an individual, you're personally liable for any damages or legal claims that might arise. This means that if something goes wrong, you could be on the hook for a lot of money, even if it means losing your personal assets like your car, your home, or your savings.

On the other hand, if you set up a limited company for your property business, you'll enjoy limited liability. This means that if something goes wrong, your personal assets won't be at risk. The company is a separate legal entity from you, and it's responsible for any damages or legal claims. You're only liable for the amount you've invested in the company.

So, imagine that same scenario where someone gets hurt on your rental property. If you're running the property business as a limited company, your personal assets are protected. The company is liable for any damages, and you won't have to worry about losing your car, your home, or your savings.

In summary, setting up a limited company for your property business can offer you peace of mind and protection from financial risk. While running a business as an individual might seem simpler, it's important to consider the risks involved and weigh the benefits of limited liability that a company structure can provide.



4 Retain Undistributed Profits

As a business owner, you may have heard about the strategy of retaining undistributed profits within your company, and for a good reason. By keeping a portion of your company's earnings within the business, you have the ability to take out cash as needed while also taking advantage of tax planning options.

Retaining undistributed profits can help your company maintain financial stability, invest in new opportunities, and weather economic downturns.

Additionally, it can offer tax advantages, deferring taxes on those earnings until they are distributed, which may result in lower tax rates for both the company and its shareholders. Ultimately, by retaining undistributed profits, you can maintain more control over your business's finances and position yourself for long-term success.

5 Effective Inheritance Tax Planning

Inheritance planning can be a complex and emotionally charged process, but incorporating a company into your strategy can offer numerous benefits. By transferring assets and wealth into a company, you can structure your inheritance plan to ensure a smooth transition of ownership and minimise tax liabilities for your heirs.

A well-crafted inheritance plan through a company such as a family investment company can also protect your legacy by shielding your assets from potential creditors and legal challenges. With careful consideration and guidance from legal and financial experts, you can develop a comprehensive and effective inheritance plan through a company that meets your specific needs and goals.





Considerations for Transferring Properties to a Limited Company

A typical tax implication when transferring properties into a limited company is that it attracts Capital Gains Tax for the seller (in this case, the individual) and Stamp Duty Land Tax for the buyer (in this case, the company.)

In this section, we will look into it in detail:

Capital Gains Tax

Capital gains tax is a tax on the profit made when selling an asset that has increased in value. Transferring a property to a company will be treated as a disposal and, therefore, will attract capital gains tax.

The capital gains tax is calculated by subtracting the purchase cost and any capital items from the sales price or market value. There are some reductions you can make such as Annual Exemptions. Thus, individuals transferring properties to a limited company often. Thus, individuals transferring properties to a limited company often face a substantial tax burden.

Stamp Duty Land Tax

Stamp Duty Land Tax (SDLT) is a tax that must be paid when you buy a property in the UK. It's like a fee that the government charges you for the privilege of owning a property.
As a rule, the company must pay SDLT at the same rate applicable to the second property purchased by an individual landlord. SDLT will be charged on the market value of the property at the date of transfer.

The amount of SDLT you must pay depends on the value (the consideration) of the property, and the SDLT bill can be significant in the case of high-value properties.

Don't get discouraged yet, as there is a strategy available to mitigate these tax liabilities when transferring properties to a limited company. We'll delve into this method in detail in the following section.

Save CGT and SDLT on Transfer to Company with Partnership!

When transferring properties to a limited company, it's advisable to do so via a partnership, as partnerships are eligible for both SDLT relief and incorporation relief, which provides relief for capital gains tax. Now, let's delve into what exactly incorporation relief entails.

Incorporation Relief

Guided by the Taxation of Chargeable Gains Act 1992 section 162, Incorporation relief basically helps you to defer your capital gains tax. During the transfer of business to a company, instead of having to pay the capital gains tax immediately, incorporation relief transfers the liability to shares.

In simple words, this section states that if you (individual sole trader or partnership) transfer your business to a company in exchange for shares in return, you might be able to get some tax relief. This only applies if you transfer the whole business, including everything it owns, except for cash. The business must also be transferred as a "going concern," meaning it will continue to operate under the new ownership.

The following must be satisfied before incorporation relief is given:

- You must be a sole trader or in a business partnership.
- You must transfer the whole of your business as a ‘going concern’.
- You must transfer all assets of your business to the company except for cash.
- The consideration paid to you by the company must be wholly or partly in shares.

The capital gains that would have otherwise been realised on the disposal of the chargeable capital assets are effectively held over into the value of share consideration issued to the transferors by the acquiring company through the application of incorporation relief.

As the deferred gain is rolled over, it is deducted from the base cost of the shares. When the shareholder sells his company shares, the gain will be charged.

Stamp Duty Land Tax Relief

As discussed earlier, if a property is transferred to a limited company, the higher rates of stamp duty land tax apply on the market value of the property. So, simply gifting the property to the company will not help you avoid stamp duty land tax.

However, if you are transferring your property from a partnership to a limited company, you might be able to get stamp duty land tax relief.

If you are transferring your whole business from a partnership to a limited liability company in exchange for shares, this shall be a transaction between connected persons for Stamp Duty Land tax purposes.

This transaction would be guided by Schedule 15 of the Finance Act 2003 transfer of chargeable interest from a partnership: Sum of Lower proportions.

In order to make sure you are eligible for both stamp duty land tax relief and incorporation relief, the partnership business must be legitimate during the transfer.

In the next section, we will delve into what exactly makes a partnership legitimate.



Partnership Business as a Qualifying Business

HMRC manual PM120100 states, a partnership is a business relationship between people who work together with the goal of making a profit. This can include individuals, companies, and other organisations. The partnership is created through an agreement, either written or oral, and there is no limit to the number of partners who can be involved.

While partnerships are not considered legal entities in England, Wales, or Northern Ireland, they are still recognised as "persons" for tax purposes. This means that partnerships are subject to the same tax laws as individuals and corporations.

To qualify for partnership incorporation, one essential criterion is that the partnership must constitute a qualifying business. The determination of whether a partnership exists hinges significantly on the intentions of the parties involved. As no single factor is typically conclusive on its own, it's crucial to gather all pertinent information to ascertain the true nature of the relationship between the involved parties.

The presence of a partnership agreement, coupled with a business operation, serves as a pivotal factor in determining the existence of a partnership. Besides this there are other legal requirements a partnership business needs to follow when it is established such as:

- Notifying HMRC of incorporation of partnership;
- Submission of partnership return on timely basis;
- In case of rental business having tenancy agreement between the partnership and tenants and so on.



One of the very famous case law on whether business exist is “Ramsay vs HMRC” where key indicators of a business were set out, some of the key indicators were:

- Is the activity a ‘serious undertaking earnestly pursued?’
- Is there an occupation or function actively pursued with reasonable or recognisable continuity?
- Is there a certain measure of substance regarding turnover?
- Is the activity conducted in a regular manner and on sound and recognised business principles?
- Is the activity predominantly concerned with the making of taxable supplies to consumers for consideration?
- Is the activity of a kind which, subject to differences of detail, commonly made by those who seek to profit by them?

Therefore, partnership business will include, but is not limited to:

- separate partnership bank account,
- contracting with utility companies in the partnership name,
- having customer accounts with suppliers of other goods and services in the partnership name,
- issuing invoices, rent demands in the partnership name,
- preparing partnership accounts,
- submitting partnership tax returns,
- recording partnership decisions.

Do partners need to participate in a partnership for a business to exist actively?

A common concern is whether all partners need to participate actively in the commercial activities of the partnership.

These considerations are particularly crucial in the context of family partnerships when one individual may perform fewer tasks even while all family members are technically partners and share in the profits made.

HMRC Partnership Manual 132400 has provided a very useful point of reference in this regard. HMRC's guidance confirms that certain partners contributing more to the activities of a partnership than others do not necessarily compromise the existence of a partnership or, indeed, the partner status of non-active members.



Case Study – SC Properties and R Cooke V HMRC

The issues of partnership existence, SDLT charge, and CGT charge were examined in the case of SC Properties and R Cooke v HMRC. This case highlights the significance of thorough documentation and adherence to tax regulations, especially in the context of intricate arrangements such as partnerships. In this section, we will explore this case to grasp its implications fully.

Background

Mr. and Mrs. Cooke (Appellants) owned a farm, Marepond Copse (MC), on which they wanted to develop a property. However, they claimed that before starting development works on the property, a development partnership was created in September 2014, when they were granted planning permission.

Furthermore, the property was appropriated to the partnership's trading stock. Money was borrowed against the property's value.

SC Properties Ltd (SCP), a company owned by the appellants, was granted an option to purchase the property, and the company purchased the property in April 2016, with the consideration being taken to a loan account. The property was subsequently disposed of by the company.

The intention of the planning was to defer the gain until the property was sold by the company. This was to be achieved first by a TGCA 1992 s161 election to defer the gain on appropriation to stock and then under ITTOIA 2005 s178 for transferring stock to the company at an initial cost.

Decision

When HMRC inquired into the self-assessment, they claimed that no partnership existed; therefore, their claim was denied. The basis of this decision was as follows:

There was no evidence of the existence of the partnership; it had no bank account, no contacts, no invoices, and no correspondence.

There were no partnership formalities between Mr and Mrs. Cooke.

The business was not carried out with a view to making a profit, as the property was transferred to SCP as a part of an option agreement.

Despite the taxpayer's counsel making a valiant effort to show that the normal formalities are often missing in a family partnership, the tribunal found that although that might sometimes be correct, 'no reasonable person would consider that such informality would be appropriate for the significant development activity being undertaken here'.

Final Verdict

It concluded that the partnership had no legal reality and existed only in the minds of Mr Cooke and his advisers. The elections which had been entered into had no effect, and Mr. Cooke was chargeable on his share of the gain on the disposal to the company. Stamp duty land tax was also due on the transfer. Thus, the taxpayer's appeal was dismissed.



Practical Example of Tax Savings Via Partnership Incorporation

Let's analyse the tax position of John (a residential landlord) when he operates his property portfolio as a sole trader and via a limited company structure to understand better how incorporation into a limited company might lower your tax liability.

Suppose John, a higher rate taxpayer, owns a company with a net worth of £5,000,000 and mortgage payments of £200,000. The turnover for the period is £1,000,000, and the operating costs amount to £250,000.

Particulars	**Individual**	**Company**
	Amount (£)	**Amount (£)**
Turnover	1,000,000	1,000,000
Less: Operating cost	(250,000)	(250,000)
Less: Mortgage interest	-	(200,000)
Taxable Amount	750,000	550,000
Tax Amount before relief	337,500	137,500
Less: Basic rate relief on mortgage	(40,000)	-
Final tax payable	283,703	137,500
Tax savings under company	**£146,203**	

While you compare John's tax situation when managing his property portfolio individually and limited company structures, the tax savings are pretty obvious. His total tax obligation under a partnership is £283,703 compared to £137,500 under a restricted business.

So, even though the operating profit and mortgage costs for both landlords are the same, the tax liability as a sole trader is nearly two times more than the tax paid in a limited company.



Incorporating a limited company for your business can offer numerous advantages, including tax efficiency, protection of personal assets, and increased credibility. If you are a sole trader or in a partnership and are considering transferring property business into a limited company, it is crucial to understand the benefits, challenges, and tax implications involved. **Consult with a tax advisor or professional to assess your specific situation and determine the best course of action.**



FAQs

1 **Can property be transferred from a 'partnership without a formal agreement' to a company?**

When transferring property to a limited company and engaging with HMRC, it's essential to ensure the legitimacy of the partnership involved.
While not mandatory, having a partnership agreement in place adds a structured framework to the partnership, documented in writing, enhancing its organization and coherence. This written agreement serves as compelling evidence to evaluate the legitimacy of the partnership.

2 **I, along with a few other people, have been working on the business for the past few years. Does it count as a partnership?**

Here, we need to look at the legitimacy of the partnership.
As discussed earlier we need to see the following, we need to see the following: Have the HMRC been notified? Have the legal requirements to have a partnership in place filled? Etc.

3 **How many properties are required to be qualified as a business for incorporation relief?**

While HMRC does not specify any fixed requirements, we typically advise our clients to consider having a minimum of five properties.

4 **What happens to partnership liabilities when transferring the partnership business to the company? Are we still eligible for the relief?**

There are no restrictions on transferring liabilities for incorporation relief. However, transferring borrowings from an individual to a partnership may raise concerns with mortgage providers regarding borrowing terms.

5 **Which type of partnership is more likely to undergo conversion into a company with minimal challenges from HMRC?**

Demonstrating the existence of an Limited Liability Partnership (LLP) is typically simpler due to the meticulous preparation and filing of regular accounts and compliance documentation. These records are updated in real-time on Companies House, reducing the likelihood of manipulation. As a result, HMRC is less inclined to raise challenges in such cases.

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Let's Talk

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