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PROPERTY INVESTMENT V PROPERTY TRADING

Lee Sharpe

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'Property Investment v Property Trading'

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About Lee Sharpe

Lee is a creative Chartered Tax Adviser with more than 20 years' experience of advising property investors and family businesses on tax matters.

He is also an experienced tax writer: As well as writing for taxationweb.co.uk and Bloomsbury Professional, Lee is a lead writer for Property Tax Insider (taxinsider.co.uk) and its sister publications, and has written a number of specialist property tax saving reports that are available through the Tax Insider website.

Introduction

This report will consider the main differences between property investment and property trading activities, and their implications from a UK tax perspective (predominantly Income Tax). We shall look at some of the opportunities and pitfalls of both activities, and we shall evaluate different vehicles to undertake the respective activities.

This report uses the anticipated 2021/22 tax year rates and allowances, (where they have been announced), unless otherwise indicated. But they could be revised in the 2021 Budget, currently scheduled for early March 2021.

1

Assumptions

There are some common assumptions unless otherwise indicated in the text:

- the activity is being contemplated by a UK-resident (and domiciled) person;
- all property activity will be undertaken in the UK;
- activity is to be undertaken on a commercial basis – with a view to making a profit; and
- property Investment is generally taken to mean letting property on a long-term basis, *as well as* the holding of property with the intention or hope of achieving a capital gain on sale.

By default, we shall focus on standard residential properties. Where there are different treatments depending on the nature of the property held, they shall be identified.

2

Overseas business

Trading in land/property and income from investing in property in the UK are, usually, activities that are taxable in the UK, even if undertaken from overseas ownership, but special rules can apply in the latter case. Budget 2016 introduced a new regime that attempts to ensure that all non-resident structures *developing* UK land/property will be taxed in the UK, regardless of whether or not the business has a 'Permanent Establishment' in the UK. (See the new sections BIM60515 to BIM60900 in the Business Income Manual of the HMRC (Gov.UK) website).

Non-residents have also been subject to Capital Gains Tax (CGT) on the disposal of UK residential property (as defined) since 6 April 2015 (to the extent/proportion of the gain that is deemed to have arisen post-April 2015). From 6 April 2019, the infamous NRCGT regime was extended to cover disposals of commercial properties and, in some cases, disposals of shares in a company that is 'land rich' – i.e., has substantial or valuable UK land or property interests. Often, non-residents can be taxed both in the UK and where they are tax-resident, when letting out UK property – although UK tax law usually provides relief from excessive or 'double' taxation in the absence of specific provision through a Double Tax Treaty. This report will not dwell further on property-related activity undertaken by non-residents, as it can be complex and generally requires tailored advice that accommodates the UK regime and whichever regime(s) in which the taxpayer also resides.

3

Furnished holiday lettings (FHLs)

FHLs are non-standard, short-term residential lettings and, as such, hold an unusual status so as to be eligible for some of the advantages usually associated with trading activities, such as:

- capital gains tax reliefs such as Entrepreneurs' Relief, (strictly now 'Business Assets Disposal Relief', although hardly anyone outside of a tax office has adopted the neologism), Gifts Relief for business

assets, and Rollover Relief for the replacement of business assets (we shall look at these in a little more detail, later on);
- capital allowances for assets used in the residential areas of the property; and
- profits count as 'relevant earnings' for the purposes of making pension contributions.
- FHLs do not qualify as trading sources for the purposes of the COVID Self-Employed Income Support Scheme.

FHLs have to fulfil several criteria, primarily:

- available to let for 210 days or more;
- actually let for 105 days or more; and
- lettings in excess of 31 days do not usually 'count'.

There is some flexibility in these rules, such as averaging occupation across several eligible properties. The flexibility in some of the conditions will likely be pushed to the limit in periods during the novel coronavirus pandemic era.

Whilst CGT reliefs, etc., will be covered in more detail later in this report, FHLs and overseas businesses are not a focus of this report.

4 Summary of terms

4.1 Property trading essentially means:

Buying and selling land/property with the intention of making a profit; usually this will involve some kind of development work, either to enhance an existing property, or to develop a new property for re-sale. But development is not essential: a grocer who buys and sells fruit, vegetables, and tinned goods will have done nothing to 'develop' his stock, but he will nevertheless be trading for tax purposes.

4.2 Property investment basically means:

Holding property for the long term. There may be an intention or hope to benefit from capital appreciation, but there is no intention to sell on for a profit immediately that the property is acquired. While a property investor does not strictly need to let out his or her property in order to be considered an investor, it is commonplace. It could be considered akin to dividend income that might accrue to a person holding shares in a company for the long term: the asset may or may not yield income while held, but that does not change the basis on which it is held.

The tax treatment of these activities can be quite different. The principal distinction is that, in the case of property development/trading, the land or property is an item held for re-sale at a profit, much like a laptop might form part of the stock of a computer shop. A property investor, on the other hand, holds properties as 'fixed' (long-term) assets on their balance sheet.

Many property businesspeople struggle with this distinction because property is almost always a slow process: it can take years to develop a property and then re-sell it – does this time interval make it a long-term

investment? The simple answer is that it does not: your intention when you buy a property and its subsequent use in your business are strong indicators of whether there is a trading or investment activity, even if it takes years to come to fruition.

4.3 Intentions can change!

One of the more interesting – and potentially quite problematic – aspects of differentiating between property investment and property trading, is that things do not always work out as planned. A good example of this is the recession in 2008/09, where property developers suddenly found that they were unable to sell their new properties at a tolerable price, so in many cases, they were rented out for the short term, in the hope that the market would eventually pick up. On a smaller scale, an investor might develop a property with the firm intention of letting it out but get an uninvited offer to purchase the property that is simply too good to pass up. How does tax deal with these changes? We shall look at these scenarios in more detail, later on – see Pitfalls and challenges – Changing your mind.

5 Trading or investment: Why do we care?

5.1 individuals and non-corporate entities: Income tax v CGT

There can be a substantive difference between the tax, etc., applied to a trading activity when compared to an investment activity – at least for unincorporated businesses (by 'unincorporated', I mean those run by individuals solely or together, as distinct from those run in a company).

There can also be a significant difference in the treatment for losses.

There is no 'hard and fast rule' as to which is the better approach; nor is there often a choice. But let's say for simplicity that a residential property is being sold by an individual for £500,000 that cost only £300,000. The profit or gain is £200,000. In such a simple example, the profit would be the same as the gain:

Trading (Income Tax)	Band	Rate	Investment (Capital Gains Tax)	Band	Rate*
Personal Allowance	Up to £12,570	0%	Annual Exemption	Up to £12,300	0%
Basic Rate	Over £12,570 (next £37,700)	20%	Any unused Basic Rate	Up to £37,700	18%
Higher Rate	Over £50,270 (next £99,730)	40%	Excess		28%
Additional Rate	Over £150,000	45%	Doesn't matter		28%

(NB Income Tax rates differ in Scotland, but not by so much as to substantively affect result.)

While the CGT Annual Exemption is slightly less generous than the Personal Allowance, capital gains are generally taxed less harshly than income.

*In fact, these are the CGT rates for **residential** properties. For property disposals on or after 6 April 2016, where the capital gain is on a **commercial** property the rates fall to 0%/10%/20%.

Furthermore, trading income attracts a Class 4 National Insurance Contributions charge:

Trading (National Insurance)	Band	Rate
Lower Profits Limit	Up to £9,568	0%
Main Rate	Over £9,568 (next £40,702)	9%
Additional Rate	Over £50,270	2%

(There is also a fixed Class 2 NICs charge, currently £158.60 for the year, for most trading activity.)

On the basis that the band for the main rate of Class 4 NICs broadly overlaps the Basic Rate Band for Income Tax purposes, the main combined rates for trading are 0%/29%/42%/47%.

This opens up a huge margin between the tax that will be levied on a trading profit when compared to a capital gain on the same amount – the combined tax and NICs rate of 29% in the 'Basic' Rate Band is *almost three times* the rate of 10% that would apply to the capital disposal of a commercial property in that band. (Investment income, such as from rental profits, has no National Insurance charge.)

Since property tends to be 'lumpy', profits and/or gains commonly end up at many tens or even hundreds of thousands of pounds, so even relatively small rate differences can result in dramatically higher tax bills through being taxed as a trade, for non-corporates.

This difference is exacerbated for non-corporates with long-term projects that might span more than one tax year because unused Personal Allowances/Basic Rate Bands, etc., in Year 1 cannot be rolled into the following year to soak up large profits from, say, a property development profit in Year 2. (While this approach applies also to capital gains, the rates are lower, so it is less problematic.)

The end result is that a great deal of self-employed property development profits may well end up being taxed at 47%, compared to 28% at most for capital gains on the sale of a residential property (or as little as 20% for a commercial property gain).

We wait with great interest – and no little trepidation – to see if the Chancellor bows to pressure to increase capital gains tax rates, etc., to help pay for the immense financial cost of COVID support. There are (at least) one or two reasons why raising CGT is not a simple or immediate fix:

1. If CGT is dramatically increased, it will discourage people from selling their assets, at least in the short term, which would risk