



End of the slump?

Are we at the bottom of the slump in the property market? That is the question being asked up and down the country and throughout the property sector. Property developers and investors are keenly watching out for signs that would indicate the market is about to rise again. So, are there any grounds for optimism?

On the plus side, the financial stimulus introduced by the Bank of England is indeed substantial. Interest rates have been cut to near zero in all the major economies and central banks are creating money to purchase assets under the policy of quantitative easing. With interest rates so low and with so much money being thrown at the economy, it should surely be just a matter of time before we do see green shoots of recovery.

Many economic commentators believe that the collapse in economic activity towards the end of 2008 was so sharp and so severe that the bottom of the market could be reached sooner rather than later.

That's as good as the news gets so far. There are many indicators and reasons

why those involved in the property sector should remain cautious. First and foremost, business measures across the board still suggest that activity is contracting even though the pace of contraction has slowed. More importantly, consumer confidence remains extremely low.

As the economic commentators scour the data for any positive indicators, it appears that for every piece of positive news there is a gloomy picture being painted elsewhere. An example is March's 0.09% rise in the Nationwide House Price Index, which was soon followed by the 1.9% fall announced by the Halifax in their data.

In many ways this is a very different type of recession and it is unlikely we will see a straightforward recovery purely stimulated by interest rate cuts. The banking sector remains extremely fragile and the continuing lack of liquidity has hampered the banks' ability to lend to needy businesses. The sector that has been most acutely affected has been the property sector.

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So when will we reach the bottom of this market? No one really knows the answer to the question. However, all businesses, whether they are property developers, investors or trading companies that own property, should use the current circumstances to their advantage.

Now is the time to carry out some basic housekeeping to ensure that your business is ready for when recovery does happen. Things that you should think about include the following:

- If property is held within a company, this might be a good time to transfer it into a more tax efficient vehicle.
- If you are vacating premises but intend to hold them as an investment and rent them out, you may be in danger of losing capital gains tax reliefs in the future.
- Landlords and tenants should take a careful look at their break clauses within their leases.
- Property developers must renegotiate land options to avoid potential sites becoming unviable.
- Land and options over land that have yet to receive planning consent should be transferred into tax-efficient structures.

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Structuring property investments through Limited Liability Partnerships

Historically, property investment has been structured through the use of a Limited Liability company because of the attraction of limited liability in the context of a geared property activity. However, using the corporate structure to hold investment properties will result in a double tax charge on disposal of the property and a subsequent extraction of the proceeds by either dividend or bonus. The overall effective tax rate will be approximately 46%.

By holding investment properties through a Limited Liability Partnership (LLP), individual shareholders can take advantage of Capital Gains Tax (CGT) rates at 18% on the future growth.

Overall therefore, the benefits of using a LLP to hold new investment properties are:

- Tax transparent i.e., avoids double tax charge to income and gains;
- Enables investors to benefit from lower CGT rates;
- Flexible in respect of investors' income and capital shares and;
- Offers similar protection to that of a company.

Specifically, if the LLP is structured so that it has both a corporate member and individual members, this gives the ability to allocate income and capital rights more tax efficiently. For example, income rights can continue to be allocated to the investment company and taxed at 22-28% and capital rights on future growth can be allocated to individuals (and trusts) and taxed at 18%.

For each £1 million in increase in value, this could result in a tax saving of around £280,000.

There are other general benefits of using LLP which are:

- It allows investors to participate using a private legal agreement;
- Future growth in value of land can be taken outside the confines of the structure of a company;
- Non-resident individuals could avoid paying any tax on capital gains;
- Individual members of the LLP are self employed and therefore there is no employers' NIC on profit allocations;
- Capital growth can be diverted into the estate of the next generation if the individual's interests are held through trusts.

As mentioned above, the LLP is transparent for tax purposes and is deemed to be a partnership as if the business is carried on directly by the members themselves. Thus rental profits, net of interest will be taxed on the individual members under Schedule A at the member's marginal rate. The income will be assessed on the individual members whether it is distributed to them or not. Therefore, where profits are significant and are likely to be retained for future investment, it is worth considering the use of a corporate member for this purpose. Profits will be assessed on the company at a maximum rate of 28%.

It is also possible to offset capital allowances, interest on loans and other expenses against the income of the partnership in the normal way.

In conclusion therefore, we would suggest that consideration is given to new property investment businesses being structured through an LLP where either existing property investments are being acquired or land and buildings are being developed



for retention as investment properties. There are, as always, issues that need to be considered such as Stamp Duty Land Tax and CGT on the transfer of existing properties to the LLP, but it maybe that the current depressed values of property and appropriate planning can avoid any charges.

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Growth by acquisition

Many businesses are finding that increasing marketing efforts and cutting costs is just not enough to counter a continuing decline in revenues.

One approach that we believe should be seriously considered is making a strategic acquisition. Businesses may have discounted an acquisition as being too costly or too risky given current economic conditions but this need not be the case. With many businesses struggling, their value will have dropped significantly and in some cases a sale or merger may be the only way they will survive. The consideration paid for a business can be structured to reduce risk and immediate cash outlay.

Methods commonly used are:

- **Deferred consideration** – here consideration is fixed but paid over a number of years.
- **Contingent consideration** – here consideration is variable and only paid if certain performance criteria are met.

Opportunities for tenants and landlords

A major impact of the economic downturn for landlords has been a reduction in the demand by prospective tenants for commercial premises. This has arisen following some companies going out of business and many others taking action to consolidate their businesses by reducing their office or factory space.

In these recessionary times, companies have taken a more cautious outlook when it comes to committing to premises leases, which has led to an increase in void periods for landlords. This has put pressure on the landlords to reduce rents and in some cases offer incentives to encourage the take up of a lease by a prospective tenant.

This has resulted in the tenant being put into a strong negotiating position. A potential tenant should be able to agree a reduction in the proposed rent payable,

or agree a rent-free period, or maybe favourable terms regarding repairs and dilapidations to a leased property.

The advantage of a rent-free period for a tenant is that in the short term there is no rental payment due, which enables the company to preserve cash for other demands. This will help ease any immediate cash flow pressure and enable management to focus on their business strategy for when the market recovers.

The accounting treatment (under UK GAAP) of a rent-free period is to recognise the rent-free element over the shorter of the period of the lease and any rent-review period.

We recommend that companies looking to move or acquire new premises, or existing tenants with rent-review period/break clause approaching, should take this opportunity to negotiate with their landlord.

From the landlord's point of view, they would typically prefer to ensure the premises are rented out and reduce void periods where they receive no rental income or commitment.

However, we also believe there are good prospects in this market for the landlord. As a result of falling property prices, if a landlord has or is able to raise finance, there are excellent opportunities for acquiring freehold premises.

In addition to benefitting from a reduction in the asset purchase price,

Example:

You acquire a 5-year lease for £100,000 p.a. with an initial 1-year rent-free period. Although no rent would be payable in the first year, the company accounts would show an £80,000 charge (i.e. £100,000 x 4 years / 5 years). The advantage of this is that the tax treatment follows the accounting treatment and therefore tax relief will be available on the £80,000 in year one. If the company pays tax at 28%, this would mean it would receive tax relief of £22,400, which combined with the negotiated rent-free period, would equate to a cash flow advantage in year one of £122,400.

following the Government's reduction to the VAT rate, further savings can be made. For example, a commercial property (which has opted to tax) purchased for £2 million, will save £50,000 as a result of the lower VAT rate of 15%.

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- **Deferred and contingent** – a balance of fixed and variable consideration. This gives a degree of certainty to the vendor whilst protection to the acquirer and deferred payment terms.
- **Non-cash consideration** – here the acquirer can either issue its shares to acquire the target business or issue share options which allow the vendor to purchase shares subject to the acquired business performing to certain criteria post acquisition.

What are the benefits of a strategic acquisition?

There are potentially many benefits of making a strategic acquisition at the current time, some of which are set out below:

- **Cost effective** – you may be able to acquire a business in the current market at a greatly reduced cost.
- **Economies of scale** – an acquisition can increase turnover and contribution to your fixed overhead base. Duplicated costs

such as premises and administration costs can be saved, making the combined businesses far more profitable than they were as individual entities.

- **Geographical expansion** – an acquisition could let you enter new geographical markets both in the UK and internationally.
- **Diversification** – an acquisition can let you increase the range of services offered by your business, enabling you to increase your client base as well as the services offered to your existing clients.

Why would a business want to sell in the current market?

Despite business values being depressed there may still be some significant benefits to selling your business now, such as:

- **Extracting value** – depending on the structuring, a sale may allow the vendors to extract at least some value that may otherwise be lost.
- **Upside gain** – if structured correctly,

a sale may allow further consideration to be received as the market picks up.

- **Release from liabilities** – a disposal may facilitate the release of the vendors from onerous lease commitments and guarantees.
- **Preservation of employment** – whilst an acquirer would often look to reduce costs, the employment of the key staff would normally be retained.
- **Tax efficient** – where entrepreneur relief applies, capital gains arising on business disposals are only taxed at 10%.

Overall, an acquisition strategy or a possible sale should not be dismissed in the current market and our view is that we will see increasing activity in this area during the current year.

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Budget 2009

Disappointment for the sector

The property sector has been keenly looking forward to the 2009 Budget in the hope that the Chancellor would reach out to provide assistance to the ailing sector. Unfortunately there is no fresh assistance for the commercial property market and the limited measures targeted at the residential market are unlikely to have any real effect.

In the run up to the Budget, the property industry has been placing pressure to reinstate business rates relief for empty commercial property, or to extend the one-year holiday from rates for properties with a rateable value of less than £15,000. Neither of these measures has been introduced. There had also been high hopes that the Budget would introduce measures to encourage institutional investment in the housing market. It had been hoped that stamp duty on bulk purchases would become payable at a marginal rate for each property rather than 4% as is the case at present in most transactions.

So is there any good news for the property sector? Perhaps the most interesting development was the announcement of government guarantees for new high-quality Residential Mortgage Backed Securities (RMBS). In view of the lack of availability

of mortgages and the impact it has had in accelerating the correction in the housing market, any measures that would improve the availability of credit to the market could bring significant benefits. However, the pool of loans to be used to back the newly guaranteed RMBS must on average have a loan-to-value of no more than 75% and not include loans made to borrowers with adverse credit histories. It is, therefore, unlikely to help reverse the recent tightening in lending criteria and many industry commentators have already commented that the RMBS guarantees are unlikely to give a boost to the housing market.

The extension by the Chancellor of the stamp duty holiday for properties under £175,000 until the end of next year is welcome news. However, again many commentators are disappointed that the cap of £175,000 was not increased to a higher level to encourage first-time buyers in the historically more expensive region of the south east of England.

In reality, given the state of the public finances, there was always a limit on just how much assistance the property sector could expect from the Budget. While there were some small positives, overall the Budget can only be described as disappointing for the sector.

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Improved tax position for overseas furnished holiday lettings – if you're quick!

The preferential tax treatment of UK properties let by individuals, partnerships and companies, which meet the tests to be treated as furnished holiday lettings (FHL) has been extended so that it also applies to properties situated in the European Economic Area (EEA).

Unfortunately, the advantage will be short-lived because the Government has announced that the preferential tax treatment of all these properties, including those situated in the UK, will be repealed from the end of the current tax year.

For further information, including qualifying conditions, the full article can be found on our website.

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