

Benefit Conundrum

October 9, 2008

The managing director and major shareholder of a small construction company wishes to acquire from his company, as remuneration, a piece of land with a house on it. The property was acquired by the company a few years ago (from an unconnected person) for £200,000, and has been rented out (to an unconnected person) whilst awaiting a suitable opportunity for redevelopment. The company has incurred no enhancement expenditure on the property since acquisition, but it (the property) is now worth £450,000.

Assuming that the legal paperwork is dealt with correctly, I initially assumed that the benefit in kind would be taxable on the director at £200,000 (the expense incurred in connection with the provision of the benefit — ITEPA 2003, s 204), and the company would pay Class 1A National Insurance on this same sum. The company would also seem to be taxable on its 'profit' (*Sharkey v Wernher* or FA 2008, Sch 15 applying as regards the deemed sale proceeds).

The director does not intend to live in the property, and he will continue to rent it out. One day he may decide to sell it and, under current capital gains tax rules, I believe that his base cost would be £450,000 (market value rules applying for the purposes of TCGA 1992), rather than the £200,000 on which he would have paid tax as a benefit in kind. But my concern now is the wording of ITEPA 2003, s 206(1)(b); viz, 'if the asset has been used, or has depreciated', whereupon market value is substituted for cost. The tenor of the section seems to suggest that the market value would (normally) be lower than cost, but it does not specifically say this.

Has the property been 'used' by the company for these purposes, and is the chargeable benefit therefore £450,000?

The opinions of *Taxation* readers are welcomed.

Query 17,283 — Houseman.

Reply by Stephen Parnham

Where an asset is transferred by a company to an employee or director at less than current market value, the undervalue invariably represents 'earnings' which are chargeable under ITEPA 2003, s 7(2) and s 62. The 'earnings' equate to the open market value of the property less what the employee pays for it if anything, as indicated in HMRC's Employment Income Manual at EIM8001. As the shareholder is also managing director of the construction company, it is assumed that he is a working shareholder. If correct, he would suffer an income tax charge on the undervalue element under ITEPA 2003, s 203(2), (3) and s 206. Where the property is recorded in the balance sheet under fixed assets and the shareholder controls the company as in this case, the company must substitute market value in calculating its chargeable gain on the transaction. The shareholder will then be deemed to acquire the property at its market value for capital

gains tax purposes. If the property is recorded in stock, there will be an equivalent charge to corporation tax, but the capital gains tax treatment for the managing director remains as above. Property acquired as trading stock will not cease to be trading stock merely because it has been let while awaiting redevelopment opportunities; see *Oliver (J & C) v Farnsworth* 35 TC 51 and *James Hobson & Sons Ltd v Newall* 37 TC 609.

The benefit is not taxed under the special rules in the benefits code because the money's worth of the property (£450,000) is greater than the expense incurred by the company (£200,000). Paragraph EIM21648 is well worth consulting for HMRC's view of these circumstances and for a very clear example.

In the unlikely event that the managing director was a non-working shareholder, the transfer represents a distribution within TA 1988, s 418 rather than additional employment income within ITEPA 2003, s 7(2) and s 62. The shareholder would then be deemed to receive a distribution of £450,000 taxable at up to 25% depending on the individual's marginal rate of tax. Again, the company has made a disposal for capital gains tax purposes. The disposal proceeds of an asset transferred to a non-working shareholder are deemed to be market value within TCGA 1992, s 18 and the company is assessed on the gain.