

Keeping Company

July 2009

In 2002, there was a stampede to incorporate property investment businesses, to take advantage of the new tax rules governing companies. Much has changed since then and Peter Bean looks at whether property companies are still worthwhile – his conclusion is that things have not changed as much as we might think.

On the face of it, owning investment property in a limited company looks far less favourable than owning property personally or within a partnership: basic rate taxpayers pay income tax at just 20% on rental profits, which, for the first time in many years, is actually less than their corporate counterparts.

Admittedly, higher rate income tax at 40% is still much higher than corporation tax rates but this is only part of the story. A higher rate taxpayer withdrawing the remaining net-of-tax profit from their company as a dividend however, must pay income tax on those after-tax profits. At an effective rate of 25%, this gives rise to an overall effect tax charge of 40.75% on company profits wholly withdrawn as dividends for higher rate taxpayers.

Perhaps most significantly of all, individual property owners would pay capital gains tax at the new flat rate of just 18%.

Adding all of this up, it seems clear that property companies are less attractive than they were seven years ago. So where does that leave us?

So What has Actually Changed?

Back in 2002, companies with profits of up to £10,000 paid no corporation tax and so a higher rate taxpayer withdrawing all their company profits by way of dividend could make an overall saving of £1,500 when compared to the previous regime.

This advantage was reduced to £375 when profits exceeded £50,000 and so perhaps, with hindsight, the rush to incorporate might have been a little hasty but many individuals did make significant savings while the 2002 rules were in place, especially those that did not need to withdraw all of the profits from the business. A reasonably profitable property investment company run by an individual with other financial means of support could act as a tax efficient money box, with little or no tax leakage.

Those marginal savings which used to exist have, sadly, now been wiped out. Gordon Brown's bombshell in his 2006 Budget that the 0% rate for companies was being abolished, caused a shock wave through the business community and private landlords were no exception. Suddenly investors were trapped in a limited company vehicle that was no more tax efficient for the majority of landlords but were also faced with the possibility of a double tax charge if they wanted to withdraw all of their profits.

Reinvestment

What we saw in 2002 was that significant savings could only be achieved if profits were reinvested within the company over a long period of time.

For higher rate taxpayers, the story in 2009 is still the same. The amount saved has reduced from 21% to 18% of the company's profit before tax (from April 2009) but that is still a pretty significant saving and can still pay out handsomely, when profits are reinvested over many years.

The one thing that has changed since 2002, however, is that basic taxpayers should not generally use a company even when they do intend to reinvest the profits.

What about Capital Gains?

So far, we've looked at rental profits. The position on capital gains looks very different.

For property disposals taking place after 6th April 2008 individuals are subject to capital gains tax at the flat rate of 18%, regardless of the level of the property owner's income - and regardless of how long they have owned the property.

So, an individual who is subject to higher rate income tax at 40% will still only pay capital gains tax at 18% on a sale of investment property.

A company pays corporation tax on its capital gains at the same rate as it pays tax on income. From April 2009, that rate will be at least 21% (it increases where the company's total annual profits and gains exceed £300,000).

On the face of it, therefore, the company pays 3% more tax on its capital gains than an individual does; even before we take account of any income tax on dividends paid to the company owner. At first, this might seem like the final nail in the coffin for property investment companies.

As always, when considering the tax implications of a transaction, we need to look at all aspects. The one saving grace for a company, is that they are entitled to claim indexation relief, whereas under the new flat rate regime, individual property owners no longer get any form of capital gains tax relief for long-term investments, since both taper relief and indexation have now been abolished for individuals.

The indexation relief which companies continue to be entitled to is calculated by reference to the Retail Prices Index and is thus based on retail price inflation. The current level of retail price inflation therefore means that companies will see significant reductions in their taxable capital gains on disposals of investment property that have been held for many years.

In other words, although the company pays a higher rate of tax on its capital gains, it is taxed on a smaller capital gain in the first place.

Remember, however, that the company owner could also have further tax to pay if they extracted the after-tax sale proceeds from the company.

Interest Relief

A major difference between company and private ownership that is often overlooked, is the impact of loan interest. Unlike an individual, a company's interest costs on borrowings used to fund its property investments are treated as general overheads for tax purposes.

This means that the company can set those interest costs against any of its income - not just its rental income - arising in the accounting period in which the interest is paid.

Better still, the company may also offset its interest costs against capital gains arising in the same accounting period.

Note however, that such unused losses carried forward cannot be used to offset future capital gains but may be available to offset future profits from the same business.

Remember, an individual property investor can only offset the interest on borrowings used to fund property purchases against their rental income. Frequently, this gives rise to rental losses which can only be carried forward to be set off against future rental profits (except in the case of furnished holiday lettings, where losses can be set against the individual investor's other income).

Whilst the company does pay tax at a higher rate on its eventual gain, this is far better than the position for the individual investor, who gets no relief for the effects of inflation and whose accumulated rental losses brought forward cannot be set against capital gains. This leaves them fully exposed to tax on their capital growth, even when they have endured years of rental losses.

In Conclusion

Whilst there is no doubt that property companies are not quite as attractive as they once were, there are still savings to be made in the right circumstances.

Fundamentally, however, the position remains much the same as it was seven years ago. A property company can produce significant savings when used as a long-term investment vehicle but is generally of no benefit when all of its profits are extracted every year.