Property Investment - Tax Aspects

Investment in property has been and continues to be a popular form of investment by many people. It is seen as a route by which:

- relatively secure capital gains can be made on eventual sale
- income returns can be generated throughout the period of ownership
- mortgage finance is covered in repayment terms by the security of the eventual sale of the property and in interest terms by the rental income.

Of course, the net returns in capital and income will depend on a host of factors. But on the basis that the investment appears to make commercial sense what tax factors should you take into account?

This factsheet summarises the main tax issues which apply for the current tax year 2009/10.

There were a number of significant changes to the CGT system from April 2008. Further details of how CGT operates are outlined in the Capital Gains Tax factsheet.

Due to the changes to the CGT system any disposals of property could result in significantly higher tax liabilities compared to recent years.

Who or what should purchase the property?

An initial decision needs to be made whether to purchase the property:

- as an individual
- as joint owner or via a partnership (often with a spouse)
- via a company.

There are significant differences in the tax effects of ownership by individuals or a company.

Deciding the best medium will depend on a number of factors.

Commercial property

You are currently trading as a limited company
The personal purchase of new offices or other buildings and the charging of rent for the use of the buildings to your company is very tax efficient from an income tax position as:

- the rental you receive from the company allows sums to be extracted without national insurance
- the company will claim a corporate tax deduction for the rent
- finance costs will be deductible from the rents

Capital gains

Capital gains on the disposal of an asset are generally calculated by deducting the cost of the asset from the proceeds on disposal. Tax is paid on the gain after deduction of the annual exemption at a flat rate of 18%.

Capital gains tax and Entrepreneurs' Relief (ER)

Unfortunately ER is unlikely to be available on the disposal of business premises used by your company where rent is paid. This is due to the restrictions on obtaining the relief on what is known as an "associated disposal". These restrictions include the common situation where a property is currently in personal ownership, but is used in an unquoted company or partnership trade in return for a rent. Under the new ER provisions such relief is restricted where rent is paid from 6 April 2008 onwards.

Residential property

The decision as to who should own a residential property to let is a balancing act depending on overall financial objectives.

The answer will be dependent on the following factors:

- do you already run your business through your own company?
- how many similar properties do you want to purchase in the future?
- do you intend to sell the property and when?

Do you already have a company?

If you already run your business through a company it may be more tax efficient to own the property personally as you will be able to make use of your CGT annual exemption (and spouse's annual exemption if jointly owned) on eventual disposal to reduce the gain.

The net rental income will be taxed at your marginal rate of tax, but if you are financing the purchase with a high percentage of bank finance, the income tax bill will be relatively small.

In contrast, a company can still currently use indexation allowance to reduce a capital gain. This effectively uplifts the cost of the property by the increase in the Retail Price Index over the period of ownership.

Indexation is not available to reduce the gain on the disposal by an individual so in situations where indexation allowance is substantial, this could result in lower gains.

The net rental income will be taxed at the company's marginal rate of tax, which is generally lower than for an individual but again if the purchase is being financed with a high percentage of loan/bank finance, the corporation tax bill will be relatively small.

But there are other factors to consider:

- there is frequently a further tax charge should you wish to extract any of the proceeds from the company
- inserting the property into an existing company may result in your shareholding in that company not qualifying for ER
- if you form another company to protect the trading status of the existing company, that may increase the corporation tax bill on your trading company (because of 'associated company' rules).

If you do not have a company at present
Personal or joint ownership may be the more appropriate route but there are currently significant other advantages of corporate status particularly if you expect that:

- you will be increasing your investment in residential property and
- you are unlikely to be selling the properties on a piecemeal basis or
- you are mainly financing the initial purchases of the property from your own capital.

If so, the use of a company as a tax shelter for the net rental income can be attractive.

Use of company as a tax shelter
Profits up to £300,000 are currently taxed at 21%. This rate applies for trading companies or property investment companies.

Where profits are retained the income may be suffering around half of the equivalent income tax bills. That means there are more funds available to buy more properties in the future.

Tax efficient long-term plans
There are two potential long-term advantages of the corporate route for residential property:

- is there an intention to sell the properties at all? May be the intention is to retain them into retirement (see below Using the company as a retirement fund)
- can the shares be sold rather than the property?(see below for issues regarding Selling the shares)

Using the company as a retirement fund
A potentially attractive route is to consider the property investment company as a 'retirement fund'. If the properties are retained into retirement, it is likely that any initial financing of the purchases of the property has been paid off and there will be a strong income stream. The profits of the company (after paying corporation tax) can be paid out to you and/or your spouse as shareholders.

To the extent that the dividends when added to your other income do not exceed your personal allowances and the starting and basic rate bands (just over £43,875 currently), there will be no income tax to be paid.

Selling the shares
CGT will be due on the gain on the eventual sale of the shares.

The share route may also be more attractive to the purchaser of the properties rather than buying the properties directly, as they will only have 0.5% stamp duty to pay rather than the potentially higher sums of stamp duty land tax on the property purchases.

Stamp duty land tax (SDLT)
SDLT is payable by the purchaser and is a flat percentage of the consideration paid (up to 4%).

Where the consideration on residential property is £175,000 or less no SDLT is payable. This also applies to residential property in a 'disadvantaged area' (see www.hmrc.gov.uk/so for further details). This is due to a temporary increase in the threshold of £125,000 (£150,000 in the case of residential property in a disadvantaged area), which applies from 3 September 2008 until 2 September 2009 inclusive. Legislation will be introduced to extend the increased threshold to land transactions where the effective date for SDLT is before 1 January 2010.

How we can help

This factsheet has concentrated on potentially long-term tax factors to bear in mind.

You need to decide which is the best route to fit in with your objectives. We can help you to plan an appropriate course of action.