



Personal Tax

Tax Aspects of Property Investment

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.

Who or What Should Purchase the Property?

An initial decision to be made is 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.

Which is the best medium will depend on a number of factors but if the property is commercial rather than residential, the likely answer is that the investment is made as an individual or as a joint owner.

Commercial Property

The current capital gains tax (CGT) regime makes personal investment in commercial property a potent source of tax savings.

Since April 2000, a sufficient condition for 'business assets taper relief' to be due on eventual sale of a commercial property is that the property is used in the trade of an 'unquoted trading company'. Indeed from 6 April 2004 relief is also due where the property is used in the trade of an unincorporated business.

Where the maximum amount of business assets taper relief is available, 75% of the capital gain is removed from the charge to tax and therefore the maximum CGT rate applying would be 10% (assuming that the top rate of tax in the year of disposal is 40%).

So in the following scenarios, there would be a low tax rate on a gain if:

- you own a property which is used by your trading company
- your (prospective) tenant is trading as an unquoted company/unincorporated business.

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. In addition to the low CGT rate compared to corporate ownership:

- 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
- the net sale proceeds will be received in your hands (and not the company's).

An alternative route would be to have a company pension scheme owning the property. In this situation, the rental would be tax free in the pension fund (but then there would be no relief for the financing costs).

Your prospective tenant is trading as an unquoted company

The same benefits as described above are also applicable. The company using the property does not have to be your company or, indeed, one with which you have any connection other than through the landlord/tenant relationship.

This also means that, if you are currently trading as a limited company, it is possible for your spouse to have a joint interest in the property (or own it entirely) without prejudicing CGT business assets taper relief.

But note that you do need the right type of tenant otherwise the maximum taper relief would be 40% (giving an effective top CGT rate of 24%) and that is only available after ten years of ownership. Currently the tenant needs to be either an unquoted trading company or an unincorporated business to qualify.



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Residential Property

The decision as to who should own a residential property to let is much more evenly balanced.

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 will generally be more tax efficient to own the property personally.

This will enable you to have the benefit of taper relief of 40% after ten years ownership and use of your CGT annual exemption (and spouse's annual exemption if jointly owned).

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, the company has an indexation allowance to reduce the capital gain. This effectively uplifts the cost of the property by the increase in the Retail Price Index over the period of ownership. So this may, or may not, give less relief over the ten years.

But there are other factors to consider:

- there may be 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 business assets taper
- 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 still be the more appropriate route due to the CGT taper advantages 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 £10,000 benefit from the 0% corporation tax starting rate. Profits between £10,000 and £50,000 benefit from marginal relief, whilst profits between £50,000 and £300,000 are taxed at 19%. These rates apply for trading companies or property investment companies.

From 1 April 2004, the benefit of corporation tax rates below 19% where profits are below £50,000 is only available where profits are retained within the company. A new regime imposes a minimum 19% corporation tax rate where profits are taken out of the company as a dividend.

Where profits are retained the income may be suffering less than 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 which mitigate the disadvantage in losing taper relief on the disposal of properties:

- is there an intention to sell the properties at all? or
- can the shares be sold rather than the property?



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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 £36,000 currently), there will be no income tax to be paid.

Selling the shares

The advantages of taper relief can still be achieved if the shares in the property investment company are sold (after ten years of ownership) rather than the properties.

This 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.

Other recent tax changes – stamp duty land tax (SDLT)

SDLT which replaced stamp duty from 1 December 2003 is payable by the purchaser and is a flat percentage of the consideration paid (up to 4%).

If the property is in a 'disadvantaged area' (see www.inlandrevenue.gov.uk/so for further details) there is no SDLT on residential properties where the consideration is £150,000 or less and no SDLT at all on any commercial property.

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 for you to fit in with your objectives. We can help you to plan an appropriate course of action.