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BUY TO LET STRUCTURE

TAX REPORT ON STRUCTURE OF CURRENT AND FUTURE PROPERTY INVESTMENTS

Dear XXXXXX,

Thank you for completing the online questionnaire and we summarise our opinion on the most suitable options for property investment ownership based on your individual circumstances.

Summary of current position

We note that you and your associates are all higher rate taxpayers, with an existing buy to let portfolio of properties held in personal names. Rental profits are not required to supplement your income at present and we note that you intend to purchase further Buy to Let (BTL) properties together in the future for the long term.

Existing properties

Option 1 – Leave the properties in personal names

Your rental profits will be taxed at 40% and 45%, but you will benefit from being able to use the excess cash (if any) generated by the properties for your personal use. The main tax impact of holding the properties personally is the change in loan interest relief as summarised below:

Historically you were permitted to claim relief for finance costs (e.g. mortgage interest) incurred on your let property, giving tax relief at 40% and 45% for landlords paying tax at the higher and additional tax rates. This relief will be restricted to the basic rate of income tax only (20%). Implementation will be phased in from April 2017 as follows:

- 2017/18 – the deduction from property income will be restricted to 75% of finance costs with the remaining 25% available at the basic rate.
- 2018/19 – 50% of finance costs available for full tax relief and the remaining 50% available at the basic rate.
- 2019/20 – 25% of finance costs available for full tax relief and the remaining 75% available at the basic rate.
- 2020/21 – all finance costs incurred by a landlord will be given as basic rate tax reduction.

Once the interest relief restrictions have been fully implemented in 2020/21 you will only be able to obtain interest relief at basic rate. Therefore, assuming loan interest figures of £50,000, the additional tax liability per person would be as follows:

£50,000 interest @ 20% = £10,000

£50,000 interest @ 25% = £12,500

Taxable income will also be calculated without the deduction for finance costs which could push you into the additional rate tax band. Where your income exceeds £150,000, you will be taxed at 45%. A credit for basic rate tax relief will be given when calculating your overall tax liability.

Option 2 – Incorporate the "property rental business"

It is possible to incorporate a property business into a company and defer Capital Gains Tax (CGT) using incorporation relief. The key indicator to successfully incorporating using s162 incorporation relief and thus deferring any capital gains is establishing with HMRC that a property business exists. The defining case that provides guidance is Elizabeth Ramsay (2013) UKUT 226 (TTC). Some of the principles are as follows:

- It is more likely that a larger portfolio e.g. 10 properties– rather than a small one – will be treated as a business
- It is more likely that properties that are not within the same block would more likely be treated as a business
- Anything that makes a rental business 'look' more like a 'true' business would help, such as having a website, business cards, an office to work from, a brand name etc.
- Realistically, landlords would need to be providing 'services' to tenants such as cleaning/laundry services – not just the normal repair works etc. This is the most challenging hurdle for most landlords to overcome.

You can apply for advance clearance for approval by HM Revenue & Customs to ensure incorporation relief will be given. You should also consider any early redemption charges that may arise if you are going to refinance the properties within the company. A point to consider should you consider incorporating your property portfolio is that you may need to inform your mortgage lender and they may require you to remortgage into the company name. You would need to factor in any break clauses and associated costs of transferring the mortgages into the company name. We would recommend that you speak to your mortgage broker who would be best place to discuss suitable refinancing solutions with you.

There are promoters who mention that it is possible to keep the existing mortgages in your personal name via a beneficial company trust and as they expire, remortgage them into the company name. We believe that this method has pitfalls with the main issue being individuals are unable to transfer an income stream into a company for tax reasons.

The relatively recent Annual Tax on Enveloped Dwellings (ATED) legislation means that anyone connected to you or the company or other shareholders will not be able to inhabit any properties transferred into the company otherwise it will attract a tax charge.

Transferring properties into a limited company will also trigger a Stamp Duty Land Tax charge (SDLT). Under basic principles, SDLT is payable on the market value of the properties transferred to the company. The charge is calculated by reference to the residential rates of the SDLT plus 3% surcharge. Where 6 or more properties are transferred, the transaction may be taxed at the commercial rates of SDLT and this can represent a large saving.

SDLT may be avoided if the business is run within a 'true' partnership and the partnership is then incorporated, on the basis that the partnership has been in existence for a reasonable period of time of at least 3 years.

Some of the advantages of incorporating are set out as follows:

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- The formation of a company produces a new base cost for calculating tax on profits from disposal of properties.
- When building a rental property portfolio, profit is often retained for reinvestment into buying more property or paying down debt. Comparatively, companies pay less tax on profits at 19% in 2017/18 and scheduled to decrease year on year to 17% by 2019/20 as opposed to individuals who currently pay tax at 20%, 40% and 45% depending on overall income.
- Shareholders can each take up to £5,000 a year in tax free dividends, subject to profitability.
- Companies are not affected by restrictions on loan interest relief. The effective rate of tax on highest rate of tax on dividend income together with corporation tax is by contrast considerably lower than it is for individual landlords and especially so for landlords with substantial finance costs.
- Liabilities are limited to the value of the company. Mortgage lenders often require personal guarantees but there are many other liabilities that are ring fenced as a result of corporation tax.
- Ability to make pension contributions.

As you currently have a portfolio of properties and your rental property business is your main business, it would be likely that you would obtain incorporation relief if this business is carried on as a partnership. The costs of incorporating the existing properties would not appear to outweigh the benefits of saving higher and additional rate tax in the short to medium term.

<u>Further purchases of "BTL" properties</u>

<u>Option 1 - Property held in personal names</u>

With the government bringing in the interest restriction charges as summarised above, you would only obtain relief at basic rate on qualifying loan interest and the additional rental income without the deduction of interest as a tax reducer may push you into higher tax bands. As you will be paying tax on the rental profits at the higher and additional rate, holding investment property for the long term personally would not be as beneficial as holding new purchases within a limited company.

If you were to sell property owned personally you would benefit from the annual CGT exemption and be taxed on the gain at 28% as a higher rate taxpayer.

<u>Option 2 - Property held in a company</u>

The main advantage of purchasing new properties within a company as opposed to buying them personally is that you will avoid tax being paid at the higher and additional rates along with the interest restrictions that apply to you personally.

As you are looking to hold the investment properties for a long time and looking to grow your portfolio without taking income for personal use, the company structure would be advantageous for you as the company does not pay corporation tax on surplus profits retained within the company. The company will pay corporation tax on trading profits (19%; current; reducing to 17% by 2020), as opposed to higher and additional rate tax paid currently as individuals.

From April 2017, the Dividend Tax Credit has been replaced by a new tax-free Dividend Allowance of £5,000.

The money you lend to the company to use as a deposit for the property purchase can be drawn back out of the company tax free.

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There are also more opportunities available for inheritance tax planning with ownership of shares in the company, should you look to pass the investment portfolio to the next generation, if applicable, and when appropriate. You may also consider issuing differing classes of shares for different shareholders e.g., growth or freezer shares, alphabet shares, etc. Although there is no business relief on shares held in property companies, you could make a gift of your shares (subject to CGT) and they will fall out of your estate for IHT purposes if you survive 7 years of making the gift.

Any gains on disposal of property within a company would be taxed at 19%, which again will be reduced to 17% by 2020. If the properties are sold by the company, any gain will also be reduced by indexation allowance, which is not available if held in a personal capacity. However, an individual gets an annual CGT exemption.

If you wanted to extract the funds out of the company from the sale of the property, you would be subject to tax either by way of dividends at the applicable dividend rates or by liquidating the company. This would equate to double taxation being corporation tax paid by the company and income tax/ capital gains tax payable by you the shareholder. It may therefore not be beneficial to hold the property within the company, if funds are required to be extracted within the short term.

If you as the shareholder sold the shares of the company, you would be taxed on the gain on the shares at 20%, as opposed to 28% if the property was owned personally.

Please note that the annual compliance costs of running a company will need to be factored in to any incorporation decision as the company will need to file accounts with Companies House and also file a corporation tax return with HMRC. Should you wish Gerald Edelman to incorporate and act for your company along with the provision of advice on planning opportunities from the outset, please do contact us further.

Conclusion

- Existing portfolio – We recommend that you incorporate assuming that your current structure meets the conditions in order to mitigate CGT & SDLT:
  i) It is a business i.e. satisfies principles in the Ramsey v HMRC (2013);
  ii) Consider incorporation costs e.g., refinancing costs, etc.;
  iii) Form genuine property partnership;
  iv) Obtain HMRC non-statutory clearance for incorporation relief;
  v) Incorporate after a period of at least 3 years trading as a partnership.

- Future acquisitions – acquired into company based on analysis set out in option 2 above under "**further purchases of BTL properties**"

Our report has been prepared based on the information provided to us and on current UK tax legislation.

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