The choice of property holding vehicle

A common theme in our recent discussions with clients is that "a company is always best" when considering how to structure the ownership of rental properties. Indeed, there are many advisors who are, not without reason, currently promoting this point of view. However, as with all areas of tax and asset protection, there is no one size fits all approach to structuring property ownership and what is appropriate for an individual's initial acquisitions may not be appropriate as their investment portfolio grows or their personal circumstances change.

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So how did this view come about?

Finance Act 2015 introduced new legislation which restricted the amount of relief given for mortgage interest suffered on rental properties. Amongst property circles, this is commonly known as a "section 24 restriction".

The effect of the restriction was phased in over four years, with the effect that from 2021/22 relief for mortgage interest was, broadly, restricted to the basic rate (i.e. 20% of the mortgage interest suffered during the tax year). The restrictions do not apply to serviced accommodation, holiday lets or to rental properties owned by a company.

For a higher rate or additional rate taxpayer (broadly, those earning over £50,000

or £150,000) this has created an increased tax burden as they suffer tax at 40 or 45%, but now only receive relief for mortgage interest at 20%. Basic rate taxpayers on the cusp of the higher rate threshold have also suffered in consequence of these changes, as mortgage interest is no longer deducted when calculating their taxable rental income which has caused some individuals to jump into the higher rate band, despite have the same net cash position in respect of rental income.

It is this restriction that has, in the main, driven the rush to transfer existing properties to a limited company or to acquire new properties under a limited company. Although there are other good reasons why this structure may be appropriate, such as to facilitate inheritance tax planning or for asset protection purposes.

So which is best?

The short answer is “neither, it depends entirely on each person’s circumstances”. In more detail:

At first glance many regard the choice of a company as an obvious one, on the basis that:

- Individuals pay tax at 20, 40 or 45% on rental income but only get relief for mortgage interest at a rate of 20%; and
- Companies pay tax at 19% on rental income (for now) and receive a full deduction for mortgage interest.

However, to view matters on this basis only is at best reductive. The actual decision, and level of tax borne, will depend on several factors, including:

- Whether the rental profits are required for lifestyle or reinvestment;
- The level of gearing on the property;
- Whether future inheritance tax or present asset protection planning is desired; and
- How the purchase will be funded.

Lifestyle or reinvestment?

It is clear to all that a company pays a lower rate of tax on its income than an individual, however if the owners of the company (i.e. the shareholders) wish to

draw the net profits for lifestyle they will most likely do so as a dividend. The receipt of dividends by an individual are subject to income tax at 0/7.5/32.8/38.1% depending on their level of income. Therefore, there is an effective double charge to tax.

For example, consider a rental business with £24,000 of gross rents and £12,000 of mortgage interest payments. If they the properties were owned by the individual (and that individual had no other sources of income) the income tax borne would be £nil. If the properties were instead owned by a company, the corporation tax would be £2,280. Under these circumstances the taxpayer would be £2,280 worse off if the property was owned by a company.

If instead the rents were £90,000 with £45,000 of mortgage interest, the income tax borne by the individual (assuming they have no other income) would be £14,500. If they were owned by a company the corporation tax would be £8,550 but a further £1,641 of income tax would be incurred if they were to withdraw all of the profits. Conversely, if that taxpayer had, say, £50,000 of other income the total corporation tax and income tax borne on the profits drawn would exceed the income tax arising if the property was held in their own name.

Gearing

A higher or additional rate taxpayer with little or no borrowing will not suffer any material impact in consequence of these changes. A basic rate taxpayer, who is not on the cusp of the higher rate, is highly unlikely to be impacted either.

However, if the higher rate taxpayer chose to hold the rental property under a company and then draw all of the profits to meet lifestyle they would suffer corporation tax at 19% and income tax at 32.5% or 38.1% on any drawings from the company. Clearly if they intent to reinvest the profits in further properties the company model would be better, but if they need the net income for lifestyle the company model of ownership would effectively increase the higher rate taxpayer's taxation on rental income from 40% to 55%.

IHT planning/Asset Protection

It is far easier to transfer shares in a company to one's intended heirs than small portions of an interest in UK land. It is also possible, in some circumstances, to transfer the right to future growth in a company – thus freezing the value of the

asset in the taxpayer’s estate.

Equally holding property in a company ring-fences the shareholders other assets from the claims of creditors of that company (assuming there is no intent to defraud the company’s customers or creditors). However, in most instances lenders will insist on a personal guarantee – thus eroding the benefits of this structure for new property investment companies.

Funding of the purchase

The source of funds will also impact the decision of holding vehicle. For example, where an existing trading company has surplus funds for investment, it may be more appropriate to create a corporate group to facilitate the investment.

Where an individual is putting down a significant deposit, it may be more appropriate to use a company as these funds could be drawn back tax free.

Other structures

It should also be remembered, that it is possible to operate a property business under a formal partnership. This is often seen as a precursor to incorporation, but in and of itself offers a considerable degree of flexibility in respect of the allocation of partnership profits and may be preferable where spouses with differing levels of income (say where one is a higher rate taxpayer and the other has little or no income) intend to invest in property.

Making a decision

It is clear that, as with all tax planning, the choice of the most appropriate holding vehicle will depend upon each individual’s current circumstances and future intentions. It is therefore important to seek informed advice at the outset of your property journey.

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Article Key Points Title Executive Summary

Article Key Points Content

- A company is not always the most “tax effective” structure to hold property;
- The choice of holding vehicle should be determined with reference to several factors, including:
    - Whether the rental profits are required for lifestyle or reinvestment;
    - The level of gearing on the property;
    - Whether future inheritance tax or present asset protection planning is desired; and
    - How the purchase will be funded

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