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Incorporation of a property business



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We are a forward-looking firm with an emphasis on innovation, new technology and finding pioneering ways to give our clients the best possible service.

Our Norfolk-based firm is led by ten partners who are some of the most high-profile and well-respected experts in their fields locally, supported by a talented team of over ninety staff.

We have a well-earned reputation for building excellent relationships with clients and the wider business community. That has always been, and continues to be our number one priority.

With significant changes to the taxation of residential property, landlords are considering alternatives to holding properties in their personal names, not least via a Limited Company.

This factsheet briefly covers the significant changes to allowable finance costs and then, in more detail, the tax implications of incorporating a property business.

Our 'Buy to Let Property Tax' factsheet summarises the changes in taxation of residential buy-to-lets.

Finance costs restriction - who this has impacted the most

Landlords with a highly geared property portfolio are likely to have been most impacted by the changes in taxation. For some, the changes that were introduced from 6 April 2017 will make their current property portfolio structure unsustainable.

From 2020/21, landlords can no longer deduct finance costs from their property income; instead they now receive a basic rate reduction to their income tax liability.

The following is an example of a married couple receiving no income other than from their rental business:

	2016/17 £	2020/21 onwards £
Gross rents	380,000	380,000
Allowable expenses (excl finance costs)	(100,000)	(100,000)
Finance costs inc mortgage interest	(200,000)	
Net rental profit	80,000	280,000
Personal allowances	(22,000)	Nil
Taxable income	58,000	280,000
Basic rate tax @ 20% (first £32,000 each)	11,600	12,800
Higher rate tax @ 40%		86,400
		99,200
Less interest relief at 20% of £200,000		(40,000)
Net tax liability	11,600	59,200
Effective tax rate on actual rental profit	14.5%	74%

In the above scenario, the married couple will pay an additional £47,600 in income tax every year.

Whilst each individual's tax position differs, the above goes some way in quantifying the potential tax implications of the forthcoming changes.

Limited companies

There is currently no proposal for the finance relief restriction to apply to companies and so those with a highly geared property business may consider transferring their business to a limited company.

Whilst there are costs associated with running a limited company, for those that are impacted by the finance costs restriction, these are likely to be small in comparison to the potential longer term savings.

For many, the main deterrent is that the transfer of the property business into a limited company may involve paying significant one off transfer costs including Capital Gains Tax (CGT) and Stamp Duty Land Tax (SDLT).

A potential solution to these unwanted costs is Incorporation Relief.

Incorporation Relief

Capital Gains Tax (CGT)

Incorporation is the process of transferring the property portfolio into a limited company.

The implications of incorporation are far reaching but include:

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- + The individual disposes of their entire property business at market value to the company and the individual is liable to CGT;
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- + In exchange for the properties, the company will issue shares to the individual;
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- + The restrictions on tax relief for finance costs, including mortgage interest, will not affect property held in the company;
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- + The company will pay corporation tax on the rental profits at:
 - + Currently 19%;
 - + From 1 April 2023; Companies with profits of £50,000 or less will continue to be taxed at the 19% small companies rate. A 26.5% marginal rate will be introduced for profits between £50,000 and £250,000. Businesses with profits of £250,000 or greater will be taxed at the main rate of 25%;
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- + Profits need to be extracted unless the cash is to remain within the company, say, for reinvestment;
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- + As the purchaser, the company is liable to pay SDLT; and
-
- + The properties will be re-registered in the name of the company.
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If a property business exists, Incorporation Relief may be available to defer the gains against the base cost of the shares in the newly incorporated company.

For incorporation relief to be available, a substantive property business must exist. There is no legislative definition of a substantive property business, however, case law provides guidance and indicates that to qualify there must be a reasonable amount of time spent on property related activities.

In this case the husband and wife spent about 20 hours per week attending to their 10 properties: ensuring rent was paid on time, forwarding post to prior tenants, arranging insurance and compliance with fire regulations. This was enough to convince the courts that a 'property business' existed and incorporation relief was available.

Stamp Duty Land Tax (SDLT)

In the majority of cases SDLT will be payable by the purchasing company based on the market value of the property portfolio at the time of incorporation.

It may be possible to reduce the SDLT exposure via a Multiple Dwellings Relief (MDR) claim or application of the commercial rates.

MDR can apply to the purchase of two or more dwellings in a single transaction, or in a series of linked transactions. The relief works by calculating the SDLT based on an average value of the dwellings. There is a minimum 1% SDLT charge, and the 3% surcharge is still applicable on residential purchases.

It may be advisable to apply commercial rates of SDLT where six or more residential properties are bought in a single transaction. The 3% SDLT surcharge would not apply in these circumstances.

Other considerations

Tax is likely to be a driving factor for many of those affected, however those transferring their properties into a limited company need to consider other costs including:

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- + Finance: early discussion with the current lenders is essential as arrangement fees could apply and favourable current mortgage terms may not be matched;
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- + One off legal fee for transferring the titles; and
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- + One off fee for a valuation of the property portfolio on incorporation.
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This is a brief summary, for further information contact our experts:



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