HOW TO USE FUNDS IN YOUR NON-PROPERTY COMPANY TO TAX-EFFICIENTLY FUND YOUR PROPERTY INVESTING...

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Most property investors have a 'day job' limited company – whether a contractor / consultant company or a more traditional business – which has excess cash that can't be extracted without incurring a tax charge of at least 25%. This article looks at how such funds can be used for property investing without incurring a tax charge.

THE SCENARIO

An investor operates a trading company, either a contractor-type company or a traditional trading business. The business would typically pay the owner a small (c£10,000) salary and a tax-free dividend totalling c£42,000 – this is the standard remuneration set-up for a company director-shareholder, as up to this level of extracted profits there is no personal income tax or National Insurance to pay. If there is a spouse / partner, the above c£42,000 profit extraction figure can be doubled.

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THE PROBLEM

Any dividends taken out of the trading company in excess of the above levels are taxed at 25% of the amount taken, meaning that the combination of company and personal tax paid is exactly 40% (after the dividend tax credit). Paying tax at 40% is of course highly unattractive and significantly reduces the benefits of having a company at all.

Therefore, for companies making significantly more profits than can be paid out by the usual c£42,000 per person small salary / dividend approach, there is the problem of having excess cash 'trapped' within the company that can't be extracted tax-efficiently for personal use (albeit, this is a nice problem to have!).

A SOLUTION – USING A SECOND COMPANY TO INVEST IN PROPERTY

Assuming that all expenses and claims to validly take profits from the trading company have been made, and there are no family members who can also receive income from the company, setting up a second company can enable profits from the 'day-job' company to be utilised for property investment, without extracting the funds personally and therefore without incurring Higher Rate income tax. The property company then buys property in its name, using the loaned funds for cash purchases, or taking a corporate mortgage.

This option has the following benefits:

1. Avoid higher rate income tax on the extracted funds

This is the primary reason for setting up the second company – a simple 'intercompany' loan is made from the trading company to the new property company. Interest does not need to be charged, and there is no set date by which the loan must be repaid (unlike a director's loan which must be repaid within nine months of year-end to avoid a 25% tax charge).

Since the funds are retained within a corporate environment, only 20% corporation tax has been paid on the original profits. In the trading company's accounts, the loan is simply a 'debtor', being an asset of the company, since at some stage the loan will be repaid. In the property company's accounts, the loan is simply a liability of the company.

2. Build wealth within a low-rate tax environment (20%)

Property rental profits will be taxed in the company, at 20%, and the balance is then available for reinvestment. This could mean either further property purchases, or switching to a repayment loan. Many investors who operate this model therefore have a property company which appreciates in value each year, but which is not for day-to-day spending – this is an investment company for long term wealth accumulation (albeit at some stage in the future, usually when the investor 'retires' from their trading company work, the investor then starts to draw income from the company).

3. Enable Entrepreneurs Relief to still be claimed if the day-job company is sold or closed

Owners of a trading company can claim Entrepreneurs Relief (ER) when the company is either sold or closed down, meaning a tax rate of just 10% when the business is sold or ceases. However, having 'significant' investment property in the company (meaning >20% of the company value / income) can mean an ER claim is blocked – which could potentially mean the tax rate on sale / closure of the trading company is 28% rather than 10%.

4. No negative VAT issues caused

If the trading company is VAT-registered, there are several potential VAT issues that arise. For example, if the trading company is on the VAT Flat Rate Scheme (FRS), as the vast majority of contractor companies are, then the residential rent is included in the FRS calculation, i.e. VAT is payable on residential rent, whereas normally residential rent is exempt from VAT. And, for non-FRS companies, the residential rent included in the accounts will reduce the amount of VAT that can be reclaimed by the trading company (via the 'partial exemption' rules). Therefore, mixing residential rent in with a VAT-registered trading company rarely makes sense.

5. Enable corporate lending by using a property-only company

Most corporate lenders will only lend to companies whose only activity is property investment. This means that most lenders would not lend to a trading company to buy residential property, which therefore severely limits the leverage benefits that borrowing to buy property affords.

BUT, IF I CAN'T USE THE MONEY IN THE PROPERTY COMPANY NOW, WHAT'S THE POINT OF THIS?

Using a property company in this way enables trading company profits to be invested into property without incurring the 25% income tax charge that would be payable if the funds were extracted and then used to buy property personally. So, get out of the mindset about 'my money' versus 'the company's money', and think of the company (and its properties) as just part of your overall wealth.

In later life you may choose to start taking income from the company, usually when the day-job trading company is sold or closed, or the owner retires. Or, the property company can be gifted in a slow, piecemeal way to children, or the shares gifted into trust for future generations

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SUMMARY

Using a second property company to invest 'excess' profits from a 'day-job' trading company can mean Higher Rate income tax is avoided, and so the cumulative benefit over time of only ever paying 20% tax can become significant. This is really only a strategy for those company owners who year on year find themselves in a position of having significant cash in a company that they can't extract tax-efficiently. Although there are clearly costs and hassle factors to consider, we have many clients who have a second property company which is their main asset base, and so investors should be aware of this option, given its potentially powerful boost to long-term property wealth.