Using a company to shield rental profits from 40% income tax

By specialist property accountant Stephen Fay ACA

The Bank of England base rate has now been at 0.5% for around three years, and many property investors are reaching the end of any rental losses they may have built up. This often means that profits are taxed at 40% as rental profits are added to any other income.

So, it's vital that investors look at options to avoid this exposure – and appreciate that using a company can help to 'shield' profits from Higher Rate income tax.

Why is Higher Rate income tax an issue?

Fortunately, rental profits are not subject to National Insurance. This means that, £ for £, property investors have an inherent advantage over employed & self-employed people in that the same £100 of rental profit will be subject to around a third less tax than £100 of employment income – due to NI not being due.

However, rental profits are added to other income and any income over £42,475 is taxed at 40% up to £150k (50% thereafter). To add insult to injury, the Personal Allowance is also withdrawn at £100k income, meaning a tax rate of over 60% between £100k-£113k!

Paying tax on income at a rate of 40% acts as a huge drag on general wealth accumulation – wealthy people generally avoid this at all costs – it's how they become wealthy!

The Small Companies rate for Corporation Tax is 20% - whereas Higher Rate income is 40%. This enables tax on profits to be halved by using a company.

For investors that own their properties personally (the vast majority), there are two options to enable rental profits to be accounted for in a company

Option A – 'management' company

Setting up a management company allows a percentage of rental profits to be invoiced by the company, and so reduces profits for the investor personally.

For example, with monthly rents of £5k, the company would invoice £1k (20%) of rents each month, thereby shifting £1k of profit (£12k per annum) of profits into the company. As many investors are making a net profit of 20% or so, this shifts all profits into the company and 'zeros' the investors personal profits.

Option B – 'lease' company

For investors that are making rental profits of substantially more than 20% of rents, individual properties can instead be leased from the investor, to the company. The company then sub-leases the property onto the end-tenant.

Typically, the lease payment would be for the value of monthly mortgage payment, and possibly some maintenance costs, depending on the portfolio finances.

This enables the company to account for the full value of rental income, and pay the investor a fixed monthly amount which produces a zero or small personal rental profit.

Keeping on the right side of HMRC …

HMRC has wide-ranging powers to reverse any artificial arrangements that are pure tax avoidance and have no commercial basis. Therefore, it is important to ensure that there is a sound commercial basis for any set-up that an investor might have. Also, the underlying contracts, arrangements and banking must actually be operated – tax-planning is not a 'paper exercise'. Some investors are complacent about ensuring that their affairs are arranged professionally, and so are vulnerable to attack from HMRC.

Extracting profits from a company

There is no such thing as a free lunch! For profits to be extracted from the company without an additional tax charge, the investor must be a Basic Rate taxpayer. Higher Rate taxpayers pay a 25% charge on the profit they take out of a company.

For Higher Rate tax-payers, extracting profits immediately without paying further tax is not, therefore, going to be possible. Therefore, there are several options:

1. Have a Basic Rate taxpayer spouse or family member as the company shareholder and pay dividends out to him/her. Bear in mind – the shareholder must actually work in the business and do more than 'nominal' work for it, in order to benefit from it

2. Allow profits to be rolled up in the lower-tax company environment for later extraction when interest rates rise & personal profits subside down to normal levels & the investor reverts to becoming a Basic Rate taxpayer

3. Buy property within the company (possibly using a limited company mortgage), and so avoid the need to extract profits at all. Some investors like their affairs to be 'clean and simple' but often as tax matters begin to play a larger part in their business thinking, having more complex affairs is the price of a lower tax burden.

In summary ...

Using a management or lease company is a useful way of transferring profits out of a personally-held portfolio into a company, and so having those profits taxed at 20% rather than 40% or more.

Proper planning and commercial arrangements must be in place to ensure that the set-up complies with HMRC tax anti-avoidance legislation. And, the extraction of profits – if extraction is necessary – must be planned carefully to avoid a double tax charge.

Remember, only ever paying 20% income tax on business profits has a dramatic effect on wealth accumulation and is standard tax-planning for wealthy clients – after all, that's how they become wealthy!

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