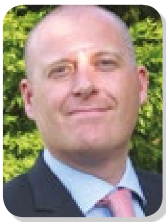
SHOULD I INCORPORATE MY BTL PORTFOLIO?



By specialist property accountant Stephen Fay FCA

Many property investors are considering the option of incorporating their buy-to-let (BTL) portfolio to avoid the mortgage interest relief restrictions starting from tax year 2018 – as these new tax relief restrictions don't apply to companies. However, there are tax and finance challenges, which make the decision not as straightforward as many landlords believe.

Why should I think about incorporating my BTL portfolio?

The new mortgage interest relief restrictions, starting from tax year 2018, will push many mortgaged portfolio landlords into the Higher Rate of tax, meaning tax is charged on pre-interest rental profits, with a flat 20% credit for mortgage costs deducted from the tax bill arising.

This can mean high rates (typically 60%-80%) of income tax for mortgaged portfolio landlords, which could make the entire rental business unviable – or, more likely, so much less profitable **AFTER** tax that many landlords will simply not be willing to deal with all the stresses and strains of running their portfolio.

By transferring the portfolio into a company, all mortgage interest would become fully tax deductible, and therefore in some circumstances incorporation can be a suitable strategy.

However, new dividends taxes from April 2017 mean that extracting income from a company is more expensive, so generally only larger portfolios will benefit from incorporation, and especially where personal income requirements from the company are modest (since extracting every penny of company profits would negate much of the benefit of incorporation).

Sounds great – what's the catch?

1. CORPORATE RE-FINANCING

Surprisingly, for most portfolio landlords, the biggest issue is the need to re-finance the portfolio within the company, as personal mortgage lenders will not allow the beneficial interest in a property to be transferred to a company without the mortgage being re-issued in the company's name.

For many landlords, this would mean re-financing off their attractive tracker mortgages (typically around 2%) onto company mortgages at around 4%. This would mean a significant increase in the landlord's main cost, which even if tax-deductible still means the incorporation option simply doesn't make overall financial sense. This is the most common reason why among our 1,000 or so property clients, only a handful are suitable for incorporation. In addition, each mortgage loan to value (LTV) would have to 'fit' the company lender's LTV criteria, or the property LTV would need to be lowered using the investor's own funds.

2. TAX CHALLENGES

Capital gains tax

The main tax challenge when transferring properties from an individual or a partnership into the company, is that CGT is payable at the point of transfer, as if a sale has taken place – this would cause a tax bill to arise that for many landlords would mean the incorporation isn't viable.

However, Incorporation Relief (via Section 162 of the Taxation of Chargeable Gains Act 1992) allows the capital gain to be 'rolled over' into the base cost of the company shares, meaning that CGT would not be payable on property transfer.

> *"It should be noted that joint ownership of property does NOT mean that a partnership exists"*

HMRC have historically challenged whether S162 Incorporation Relief applies to rental business transfers, however a 2013 case (Ramsey v HMRC UKUT 226) which HMRC lost has helped to establish the 'tests' a landlord would need to 'pass' so that S162 Incorporation Relief could be claimed:

- **The management of the properties must amount to a 'business', which means the owners must themselves be hands-on managers of the property portfolio, typically spending 20+ hours/week in doing so, and having no other significant occupation or income source**
- **The property business should be run to make a profit, have a 'substantial' turnover', and a degree of scale. Commercial practices must be in evidence (tenant management systems, banking arrangements, etc) and the business must be conducted using 'sound, recognised business principles'.**

Note that claiming S162 Incorporation relief is only possible when an entire business (portfolio) is incorporated, ie it is an 'all or nothing' tax relief, and so it isn't possible to transfer individual properties to a company and claim S162 Incorporation Relief.

SDLT

As well as CGT, SDLT would be payable when the properties are transferred to the company, as the landlord would be a 'connected party' with the company. This means that properties transfer to the company at market value, as per Section 53 of the Finance Act 2003, and ordinarily SDLT is due on the transfer value.

However, where the transferor is a partnership, SDLT can be avoided by the specific provisions within Schedule 15 of the Finance Act 2003, which permit the SDLT-free transfer of property to the connected company.

Note that a 'partnership' can be either a 'simple' partnership or an LLP (Limited Liability Partnership) – most investors who incorporate their portfolio will choose a simple partnership so that they can avoid having to file their portfolio rental accounts on the public record with Companies House, as LLPs have to ('simple' partnerships do not have to file public accounts, and the tax treatment of both is the same).

However, it should be noted that joint ownership of property does **NOT** necessarily mean that a partnership exists. The following are features of a 'genuine' property partnership:

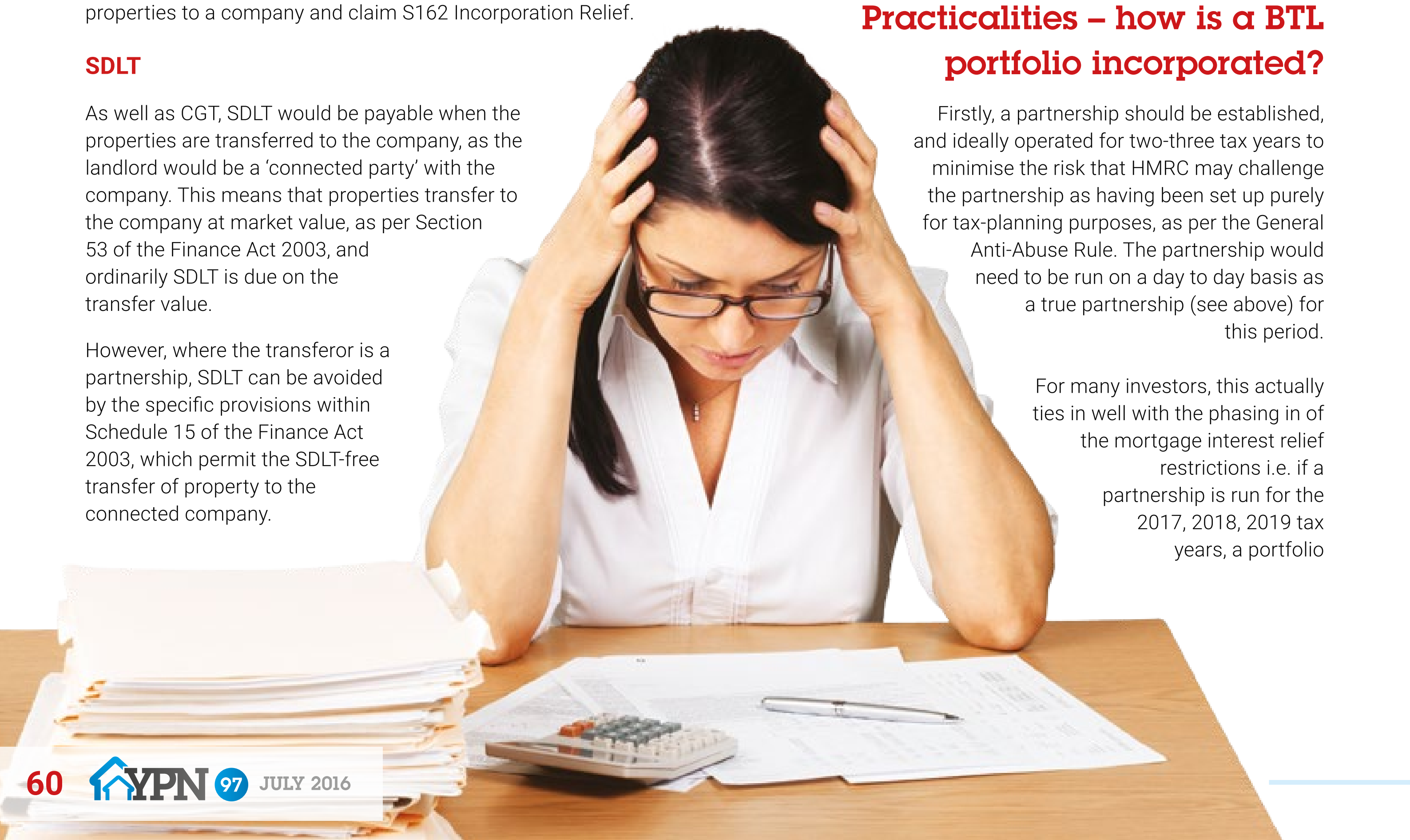
- **It should go without saying, but a 'partnership' must – by definition – include at least TWO individuals, who must EACH own some property within the partnership, each file tax returns, each want to incorporate the portfolio eventually into a company**
- **A signed partnership agreement exists, which sets out how the partnership profits are to be apportioned**
- **The partnership must be a genuine business with a profit motive, and with each partner actively involved on a day to day basis. This means that, just as with the CGT point above, a 'business' must be operated, which means a high degree of commercial organisation, a website and similar evidence of a 'real' business, that the portfolio is the main source of business activity and income of the partners, etc**

The above cannot be over-stated – HMRC do NOT regard the mere joint ownership of letting property as a business, and so if the degree of business activity is not seen to be significant, the transfer of property from the partnership to the company will not be free of CGT or SDLT. There must be clear evidence of such business activity and partner involvement if the incorporation is to be successful.

Practicalities – how is a BTL portfolio incorporated?

Firstly, a partnership should be established, and ideally operated for two-three tax years to minimise the risk that HMRC may challenge the partnership as having been set up purely for tax-planning purposes, as per the General Anti-Abuse Rule. The partnership would need to be run on a day to day basis as a true partnership (see above) for this period.

For many investors, this actually ties in well with the phasing in of the mortgage interest relief restrictions i.e. if a partnership is run for the 2017, 2018, 2019 tax years, a portfolio



incorporation could then take place in 2020, just as the worst of the mortgage interest relief restrictions begins.

Secondly, establish a new 'SPV' (Special Purpose Vehicle) company just prior to the incorporation so that the company's Tax Reference can be obtained and company bank account put in place, in good time ahead of the property transfer.

Thirdly, establish the market value for all properties and arrange the new mortgages in the company's name, ready for a transfer of title from individual name to company name. Obviously, care needs to be taken to manage the tenant aspect of the transition in terms of new bank details, ASTs, deposit schemes, etc.

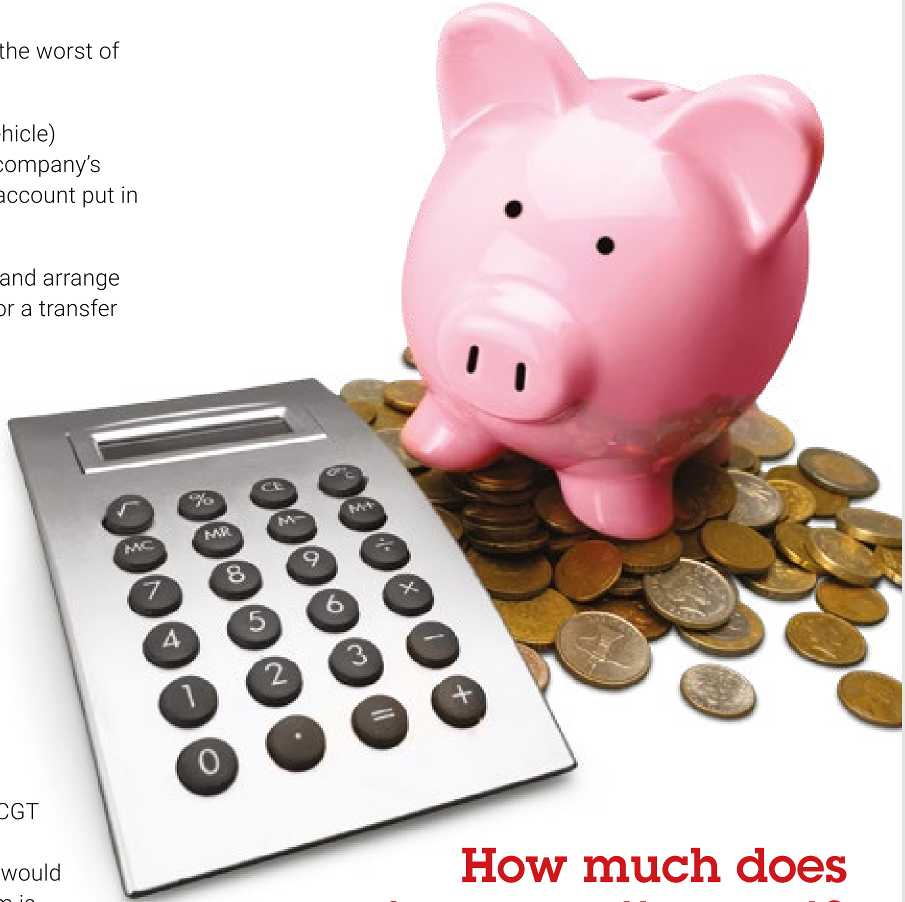
Finally, draw up the final partnership accounts (called 'cessation' accounts), plus tax return, and notify HMRC of the closure of the partnership. At the appropriate time, draw up the first year of company accounts and tax returns, which includes the properties acquired by the company, dealing with the 'base cost' of the properties and company shares, and of course deal with the company rental accounts in the usual way.

In marginal cases, it is possible to request a 'pre-clearance' from HMRC regarding the SDLT and CGT position on the incorporation of the partnership. This is not necessary in most cases as the position would normally be clear-cut, and in any case the tax system is one of 'self-assessment', and of course HMRC won't provide any advice or support as such.

When would incorporation NOT be generally advisable?

There are several typical scenarios where incorporation is usually not possible or advisable:

1. **Where there are cheaper and easier alternatives which get the investor, after considering all costs and the 'hassle factor', largely to where they would be on incorporation, eg selling off some properties, using a management or lease company, sharing property ownership with a spouse, buying additional properties within a company but leaving the existing portfolio personally-owned**
2. **Where the sheer re-financing cost (and cash required to pay down any mortgages to 'fit' the lender's LTVs) for transferring a portfolio into a company isn't justified compared to the tax saved.**
3. **Where a portfolio is too small, or insufficiently profitable, or where the owner has a 'day-job' or significant non-property income, such that 'passing' the partnership and company 'tests' to enable the avoidance of CGT and SDLT is unlikely – this would mean potentially huge CGT and SDLT bills.**
4. **Where an investor doesn't have a large personal portfolio and can easily simply switch to buying future properties within a company.**



How much does an incorporation cost?

Typically, an incorporation can cost around £3,000 initially, which would include a full review and financial assessment, advice on operating the partnership prior to incorporation, partnership tax return / advice, and assisting with the incorporation process itself. Ongoing costs are of course increased as companies cost more to deal with than personally-held rental portfolios, generally, and there are more tax-related issues to manage.

"Incorporation involves considerable costs and a degree of tax risk"

We have completed several incorporations (even prior to the July 2015 Budget) and are able to deal with client incorporations (please note – we don't deal with incorporations as a one-off service to non-clients) – although it has to be said that it is rare for an incorporation to be the best option.

Summary

Incorporating a personally-held BTL portfolio is a 'big bang' potential solution to the mortgage interest relief restrictions, which for some landlords will cause a major increase in their tax exposure. However, incorporation involves considerable costs and a degree of tax risk, and in many cases there are cheaper and easier solutions that can be used to achieve largely the same result. As always, professional advice from experienced advisers with a track record of dealing with property investors is essential.