

# TAX AND YOUR PROPERTY COMPANY

## When Will I Need to Plan for My First Tax Bill?

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*Most property investment (rental) companies will generate positive early cash flow but may not have a Corporation Tax bill for several years. This article looks at how a new property investment company's cash flow and tax position change during its lifetime.*

### I'm a new property company owner – when will tax become payable?

Many new 'property investment company' (PIC) structures follow a familiar route in terms of their early-years financials, as the property portfolio is built up.

The early years of the company's life are the 'portfolio growth' years, during which time tax losses are generated, often despite positive rental cash flow.

While welcome, this can be puzzling ...



### Stage 1 Growing the portfolio

#### GENERATION OF TAX LOSSES + NEGATIVE CASH FLOW

This is the early point in the company's life, where a company could generate often substantial tax losses.

The reasons for this are usually a combination of the following:

- ▶ **Lower year #1 rent:** A property bought mid-year won't generate a full year of income, whereas in year #2 onwards, hopefully the property is in a 'steady state' and generating a full year's income.
- ▶ **Finance fees:** Mortgage arrangement fees are usually added to the mortgage balance, but these are fully deductible when incurred. So, a typical 3% fee on a £150k mortgage (£4,500) would be deducted from company profits; however, there is no effect on cash flow as the fee was added to the mortgage. There are also survey fees, broker fees, TT fees, etc., so the 'acquisition year' for a mortgaged property can be an expensive one!
- ▶ **Pre-let refurb:** Many properties will need some repairs and maintenance to bring the property's condition up to a modern letting standard. These costs are usually mostly 'revenue' expenses and so deductible against rental income, which can mean a net rental loss in the acquisition year for a newly acquired property.
- ▶ **Letting set-up costs:** Lettings fees (more these days as agents can't charge tenants!), EPCs, gas and electrical certificates, consent to let (etc.) – all these are upfront costs and deductible.

For a typical property rental company building a portfolio over (say) three to five years, it may very well be years five to seven before any Corporation Tax is due – which of course allows more net funds for expansion.

Although no tax may be due at this early stage, your tax adviser should still ensure that the tax loss is maximised each year to defer the point at which tax starts to become payable.



## Stage 2

Portfolio 'steady state'  
+ no tax payable

### UTILISING EARLY-YEARS TAX LOSSES + POSITIVE CASH FLOW

After a company's property portfolio has been built up to the target size, the steady stream of finance / refurb / letting costs stops, and the portfolio moves into a 'steady state', and usually far more profitable position.

If all properties have been refurbished and let out, each should be showing a full year of income (hopefully as close to 100% occupancy as possible). The initial major refurb has been completed, and (fingers crossed!) there are now years of relatively maintenance-free rental income ahead.

Also, most property investors – whether private landlords or directors of a company – simply become better at the business of being a landlord and will get a better feel for market rents, be better at getting good value quotes, have an improved financial position to get better mortgage rates, etc.

The initial mortgage set-up costs have already been expensed, so it's now just a case of paying the monthly mortgage and other costs (insurance, utilities, etc.), and renting the property to earn a good steady income.

This stage is where the early-years tax losses, incurred as the property portfolio was built up, are utilised. Cash flow should be positive, and so there is no tax bill due to the accumulated losses from the earlier years. However, one day the losses will run out...

## Stage 3

Portfolio 'steady state'  
+ tax becomes payable

### TAX LOSSES NOW FULLY UTILISED... TAX BECOMES PAYABLE!

This is the 'mature' stage for a property rental company – the company is now in a steady state, with properties that have been owned and let for several years achieving good rental incomes with a predictable cost base. Typically, the company is managed by a now-experienced director, with high rental occupancy the norm.

Repairs, insurance, mortgages... all the costs of running the company are monitored and managed, and the director knows how far to go (and when) during property refurbishments and is generally more 'savvy'. Good rental incomes combined with good cost control feed through to better overall profit levels.

Some capital growth may have occurred and/or mortgage debt been repaid (or refurbishments 'forcing' up property values), meaning a lower LTV (loan-to-value) and better mortgage rates are possible. Lenders often offer their best rates at 60-65% LTV, so there can be a real benefit in achieving a lower LTV than was the case on first acquiring a property, as the whole of the mortgage balance benefits from the lower mortgage rate. The director may have opted not to remortgage too often, as the cost of remortgages over the years can frequently be prohibitive.

In later years, the effects of inflation on the value of the original (by now quite old) mortgage debt effectively 'inflate away' the present value of the debt. Property is a special asset class in that it is relatively easy to leverage property assets and so substantially increase the 'cash on cash return', i.e. the company's financial profit compared to the amount of the director's cash invested.

## Summary

Most property investment / rental companies' financial performance follows a similar pattern:

1. Tax losses + modest positive cash flow during the portfolio building stage.
2. Rapidly improving cash flow once portfolio growth has stopped, as the portfolio moves into a steady state, but no tax due as initial tax losses are being utilised.
3. Substantial profits in the 'mature' phase of the company's life, with tax losses from early years now utilised, and Corporation Tax payable annually, nine months after the company's year-end.