When Will My New Property Investment Company have to Start Paying Tax?

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A typical new property investment company will show positive early cashflow, but may not have a tax bill for several years. How can this be? This article looks at how a new property investment company's cashflow and tax position changes during its life.

I've recently formed a new property investment company – when is tax normally payable?

A typical new 'property investment company' (PIC) will follow a well-trodden path in terms of its financial performance as a property portfolio is built up. Usually, the early years of the company's life involve growing a portfolio, during which time tax losses are generated, often despite positive rental cashflow.

It often puzzles investors why their PIC may have cash in the bank yet not have a tax bill. The reason is usually because the company doesn't have a full year of income in its first year of ownership of a property, plus will have tax-deductible expenses (eg repairs), that means each property acquired will make a loss in the first year of ownership.

There are three distinct stages that a PIC will typically go through during its life, with different cashflow vs taxable profit characteristics:

Stage 1

Portfolio expansion

Generate tax losses + modest positive cashflow

This is the early point in the company's lifecycle, where a PIC could generate often substantial tax losses. The reason for this is a mix 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 2% fee on a £100,000 mortgage (£2,000) would be deducted from company profits. However, there is no effect on cashflow as the PIC hasn't had to pay cash for the fee. And, add survey fees, broker fees, TT fees etc into the mix, and the acquisition year for a mortgaged property can be an expensive one.
- **Pre-let refurb:** Most properties will need some repairs and maintenance to bring the property's condition up to letting standard. These costs are usually mostly revenue expenses and so fully deductible against rental profit.
- **Letting set-ups costs:** lettings fees, EPCs, consent to lets (etc) – all upfront costs and deductible.

For a typical PIC building a rental portfolio over (say) three-five years, it may very well be year #5-7 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

Utilise early-years tax losses + good positive cashflow

Once the 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.

All properties bought have been refurbished and let, and 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.

And, most property investors – whether private landlords or directors of a PIC – 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 interest-only mortgage ticks away and the initial fees 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. Cashflow should be strong, yet there are no tax bills due to the accumulated losses. However, one day the losses will run out …

Stage 3

Portfolio 'Steady State' + tax becomes payable

Tax losses now utilised, tax becomes payable

This is the 'maturity' stage for a property rental business – the company is now in a mature state with properties that have been owned and let for many years, achieving good rental incomes with predictable costs, and an overall satisfactory rental profit. Typically, the PIC is managed by a now-experienced director, with 95-100% rental occupancy and an acceptable cost base.

Repairs, insurance, mortgages … all the costs of running the PIC are carefully monitored, the director knows how far to go (and when) during property refurbishments, and is generally more savvy. Good rental levels combined with good cost control feeds 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 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 has learned not to remortgage too often as the costs of remortgages over the years is often prohibitive.

And, in later years, the effects of inflation on the value of the original (by now quite old) mortgage debt effectively 'inflates 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', ie the company's financial profit compared to the amount of the director's cash invested.

Summary

Most property investment companies' (PICs) financial performance follows a similar pattern:

- **Tax losses and modest positive cashflow during the portfolio building stage.**
- **Rapidly improving cashflow once portfolio growth has stopped, as the portfolio moves into a 'steady state', but no tax due as initial tax losses are utilised.**
- **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.**

At the time of writing, the rate of corporation tax is 19%. However, at the March 2021 Budget, the Chancellor announced that the rate will increase to 25% from 1st April 2023. The new tax rate will apply to companies with profits >£250,000 per year, and there will be no change for companies with profits <£50,000 per year. Companies with taxable profits between these thresholds will be subject to a 'marginal rate', which acts to gradually phase in the tax increase … more to follow on the details of this, and tax-planning options.

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