Extracting equity from your portfolio tax-efficiently

By specialist property accountant Stephen Fay ACA

Residential property investors suffer a harsh capital gains tax regime and so selling properties that have increased significantly in value often results in a tax bill that is just too hard to take!

As an alternative, investors may instead choose to borrow against their assets –as a sale hasn't occurred there is no CGT to pay. This article looks at how landlords can access their equity tax-efficiently using a borrowing rather than selling strategy.

Withdrawing 'capital introduced' into your property rental business

Generally, property investors use debt finance (AKA 'other people's money') to buy property. However as lenders generally require a 20-30% deposit from the investor's own funds, this means that the investor's own cash needs to be tied up in a purchase – and that usually restricts portfolio growth unless an infinite supply of deposit cash is available!

Most lenders require that the initial deposit funds come from the investor's 'own resources' (meaning, the lender doesn't want the investor to borrow the deposit funds). However, investors are free to replace the original equity (deposit) with further debt finance, and receive tax relief on all the interest up to the limit of the 'capital introduced'.

Example: An investor buys a property for £100k, financed by a mortgage of £80k, and £20k cash deposit. The 'capital introduced' is therefore £100k, and the investor could potentially replace the £20k of equity in the rental business with £20k of further borrowings (from any source) and substitute the loan for the equity in the rental accounts.

The rental business (albeit just 1 property in this example for ease of illustration) would therefore be 100% debt-financed via a £80k mortgage and a £20k loan – and ALL of the interest charged is allowable against the rental profits.

The poker analogy …

Readers who play poker may be familiar with the strategy of 'taking your cash off the table'. The poker player starts off with a pot of cash, and 'invests' the cash into each play, hopefully making gains along the way.

However, in order to protect precious cash reserves, the shrewd poker player will take their original capital 'off the table' as they accumulate winnings, to protect against a loss of their original capital. Future plays are then funded using the winnings from the first few plays, and even if those funds are lost, the player can revert back to their original capital. This simple risk management technique can also be used by property investors.

In exactly the same way, the shrewd property investor will put their deposit cash into a deal, but then look to re-finance that cash back out as soon as possible. A portfolio fully-funded by debt finance is perfectly legitimate and possible, provided that the portfolio income (yield) is sufficient to pay the interest charged.

Another key advantage to this strategy is that effectively the portfolio is fully-funded by external lenders and so by investing the cash reserves with a different bank (to prevent a lender seizing cash to repay borrowings), the investor is in full control of their business borrowings. The investor can always choose to repay some debt, to increase cashflow and profits – or may decide not to.

The boring bit…

The example above is very simple of course – one property, one mortgage, one loan. In reality, investors typically grow their portfolio by remortgaging their properties and so the capital introduced and borrowings position can become increasingly complex over the years. Remortgages, further advances, repayment mortgages, loans, credit cards etc all serve to 'muddy the waters'.

Therefore, to ensure that you can prove the value of the capital introduced into your portfolio, good records need to be maintained.

Our largest client (in terms of properties) has over 200 properties and capital introduced of £15m. The investor has borrowings with over 20 different lenders, and has had in excess of 500 mortgages, credit cards, personal and business loans, store cards, further advances, and other finance facilities! HMRC could disallow a large portion of the interest paid without a properly-maintained capital account, given the complexity of the portfolio financing.

Visit our website for a **FREE 'Capital Account Tracker'** tool to enable you to precisely measure the capital introduced to your portfolio, and so get full tax relief on all borrowings (whether secured or unsecured).

What do HMRC have to say about extracting equity from a property portfolio?

The concept of withdrawing capital from a business and replacing it with debt finance is not unique to property, although clearly it is most relevant to 'asset businesses'.

Note that only capital introduced **originally** can be extracted tax-free – this means up to the purchase price plus capital purchase costs. However, beyond this, as long as the borrowed funds are used to invest in property, interest on the additional funds would also be allowable.

HMRC have also helpfully clarified their position in their own manual (reference – BIM45700) and summarise the position well: "A proprietor of a business may withdraw the profits of the business **and the capital they have introduced to the business**".

CGT and IHT impact of withdrawing equity…

The strategy of 'gearing up' a portfolio to extract equity also helps in terms of CGT and IHT planning.

CGT: Clearly, if no sale has occurred then CGT is not relevant. Given how few CGT reliefs are available to residential investors (as opposed to properties used in a trading business), there is a real disincentive to selling a property that is standing at a significant capital gain.

Another issue is that the transfer of a property to – typically – a child by a parent is a CGT event and so taxable – but there are no sale proceeds!

Whereas, if cash is remortgaged out of a property and gifted to the child, as cash itself is not subject to CGT, there is no taxable transfer and so no CGT due.

IHT: By borrowing against property and either spending the funds or gifting the funds to family, the net estate value (assets less liabilities) is reduced, and so any IHT exposure is also reduced. The gift is a 'Potentially Exempt Transfer' and as long as the donor does not die within 7 years of the gift, the gifted funds are excluded from the estate value.

To summarise … and caution!

Borrowing out equity can be very tax-efficient from an income tax, capital gains tax, and inheritance tax view. However, investors **MUST** ensure that there is adequate cashflow and rental yield to fund the interest payable, and of course must also be comfortable with significant borrowings later in life. For those investors with good yields, and good debt and property management skills, extracting capital from a portfolio can make a huge difference to the main taxes that landlords can be hit with.

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