OPERATING A PROPERTY MANAGEMENT COMPANY EFFECTIVELY

By specialist property accountant **Stephen Fay FCA**

Many landlords own their property portfolio personally and operate a property management company (PMC) alongside. There are a variety of reasons why a PMC may be useful, and there are often (not always) tax advantages to be gained. However, as always, care must be taken to ensure that a PMC is operated properly so that in the event of an HMRC 'Enquiry', there are no issues that can be raised.

WHAT ARE SOME OF THE REASONS A 'PRIVATE LANDLORD' MIGHT OPERATE A PMC?

Most portfolio landlords run their rental business as just that – a business, which requires significant time and effort to manage, has cash flow challenges, creates personal business risk, and potentially high rewards.

The most common business structure in the UK – by a long way – is the limited company; however most mortgaged portfolio landlords did not build their portfolio in a company because of the vast difference in the availability and price of company versus personal buy-to-let (BTL) mortgages.

However, a private landlord may legitimately wish to operate a PMC alongside their personally-owned portfolio for any number of reasons, such as:

1. **To create a corporate, more professional 'front' to tenants and other stakeholders.**
2. **To gain access to property-related services and discounts that only companies can access.**
3. **To recognise that a rental business has both an investment (I) side and a management (M) side – which may be run by different people e.g. husband (I) / wife (M).**
4. **To create a separate business model (property management services) which could be sold or expanded in the future.**

WHAT ABOUT THE TAX BENEFITS OF USING A PMC?

If a Higher Rate taxpayer private landlord pays management fees to a PMC, the individual would save income tax at 40%, whereas the company would pay tax at 20% (2016 rate), meaning that there is a 20% tax saving to be made potentially. The funds then held in the company can be used to buy property within the company (and so avoid the new mortgage interest relief restrictions starting tax year 2018, **as well as** halving the income tax paid by the landlord on the value of the management fees).

Other benefits include the option to make larger pension contributions through the company than the landlord could himself make, and have the company pay for property training and similar expenses that are often not allowable for private landlords (for example, see HMRC BIM3566 – these rules do not apply to companies).

FURTHER TAX BENEFITS OF A PMC REGARDING MORTGAGE INTEREST RELIEF RESTRICTION

The new mortgage interest relief restrictions which start from tax year 2018 will increase the valuable tax benefits that a PMC can offer.

When finance costs are added back to initially calculate the taxable income of a private landlord, the 'excess' over the Higher Rate threshold is taxed at the Higher Rate, whereas interest tax relief is only given at the Basic Rate of tax.

By receiving a management charge into the rental accounts, the 'excess' is reduced. For example (assuming the £50k Higher Rate tax rate planned for 2010 is in place):

Jack makes rental profits of £50,000, after paying mortgage interest of £30,000. When the new mortgage interest relief restrictions are in place, Jack will pay income tax of £13,500.

Jill makes the same rental profits as Jack, but Jill operates a PMC, which makes a charge of £30,000 to Jill to cover all of its services. Jill's income tax bill is £1,500, and the PMC has a corporation tax bill of £6,000: meaning an overall saving of £6,000 (less PMC costs) as a result of Jill avoiding the new mortgage interest relief restrictions and Higher Rate income tax.

STAYING LEGITIMATE – ENSURING HMRC CANNOT CHALLENGE YOUR PMC

HMRC can now use the 'General Anti-Abuse Rule' (GAAR) to challenge any arrangement that is overtly mostly about tax-planning, rather than having any genuine commercial basis. As already explained, many landlords do have perfectly valid reasons in wishing to operate a PMC, albeit there are also some tax benefits in operating a PMC.

PMCs need to be managed effectively to avoid the risk of HMRC successfully challenging the basis for operating a PMC.

Therefore, the prudent landlord operating a PMC would ensure that:

1. **Payments for services are actually made during the year to the PMC:** HMRC are very focussed on whether payments are actually made, and when, and so it is important that payments of invoices are actually made, i.e. the PMC is not a sham paper exercise.

   Payment frequency should be as per normal commercial terms, e.g. 30 days. Note that, generally, for any business to include (accrue) into its accounts a cost that hasn't paid at its year-end, the payment must be made within nine months of its year-end (this applies to all businesses, large or small).

2. **The company has the 'look and feel' of a normal commercial entity:** a website, business cards, dedicated phone number, letterheads, business email addresses, corporate memberships (e.g. NLA), all serve to make the PMC look and feel like a genuine business, operated in the way that any letting agent / property management company would be.

3. **Fees and charges are at normal commercial rates:** generally, fees and charges should be made in the normal range at which such services are offered by local similar businesses, e.g. it would be strange – and therefore open to HMRC challenge – for a letting agent to charge 50% of the gross rent to cover its services, no matter how good that service was, since this is clearly well above what a reasonable rate might be.

4. **The company has several customers:** while it is often the case that any business may be reliant on one or a small number of initial customers initially, over time one would expect that the number of customers a business might serve would increase. This helps to defend against HMRC attack that the PMC is in place solely to benefit the private landlord. So, managing at least some other landlords' properties would be helpful if at all possible.

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WHAT KIND OF SERVICES COULD A PMC CHARGE FOR, AND AT WHAT RATES?

Most PMCs charge a management fee as a % of the gross rent – this will differ according to the local market, and of course depends on the quality of service and number of services that the PMC may make, e.g. budget no-frills vs all-in option. Charges may be made for a wide variety of services:

- **General management: 5%-20% of gross rent**
- **Tenant find: around 0.5-1.0 month's rent**
- **Inventory: £200-£500 each**
- **Review of legal compliance: tenancy deposits / gas safety / EPC / HMO licenses / other as part of on-boarding service: £200-£500/property**
- **Provision of bespoke AST and similar documentation: £200-£500/landlord**
- **Managing S8 and S21 evictions, court attendance, etc.: £300-£800/case**
- **Liaison with utilities, councils, EHO: £75/hour**
- **Refurb management / sourcing tradesmen and materials: £500-£5,000 (depending on complexity and costs involved).**

HOW DO I SET UP MY PMC?

As usual, take advice from your tax accountant about the specific set-up of your PMC (year-end, directors, shareholders, etc.). In terms of the day to day financial management of the PMC, there are two options:

***Option 1** – The Easy Way*

All rents, mortgages and repairs (etc.) are managed through the private landlord's bank account (i.e. non-company account). Each month, or possibly quarter, the private landlord pays the PMC for the management and other services provided, via a simple online bank transfer. A simple invoice is raised, and this is income to the PMC, and a cost to the private landlord. Note that tenants continue to pay their rent directly to the private landlord, and so there is no disruption to rental income, or any requirements to ask tenants to change their payment arrangements (which can be a significant extra task).

***Option 2** – The Harder Way*

Payment arrangements with tenants are changed, with tenants then being asked to pay the PMC, and the PMC deducting its fees, and sending on the net rent to the private landlord. This obviously creates two sets of transactions – firstly rent paid into the PMC, and then rent paid out from the PMC – which causes extra accounts work, but more importantly will require tenants to be contacted and asked to change their payment arrangement. As many landlords know, this change may not go smoothly! Overall, option 1 is the simpler method, however either are perfectly acceptable as far as tax compliance is concerned.

PMC AND CORPORATE BTL LENDERS

Ideally, for private landlords wishing to buy residential property in a company, they would be able to use their PMC to do so. However, some lenders will only lend to an SPV company (Special Purpose Vehicle), i.e. a company that ONLY rents property and has no other income. Advice should be sought from specific lenders / brokers to check that a lender is happy to lend to a PMC (otherwise an entirely separate SPV company may be required for company ownership of rental property).

A NOTE ON VAT

VAT is only chargeable on PMC fees and charges once total PMC income (excluding rent, which is the landlord's income) exceeds £82,000 (2016 threshold) in a given 12-month period. This is typically well below what an average small PMC has as income and so such small PMCs have no need to register for VAT.

SUMMARY

Operating a property management company is quite common for many landlords, and can offer some valuable tax benefits. However as with arrangements, commercial necessity and rationale should be the main reason that a PMC is operated, with any tax benefits being a secondary consideration. And, a PMC should be operated in the correct way to mitigate the risk of HMRC challenge.