The Positive Cashflow Vs Taxable Profit Enigma

What it is and how to benefit from it

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A typical property investor will show positive portfolio cashflow from day #1, yet have income tax losses that mean no income tax is due. How can this be?

This article looks at the typical investor's cashflow and tax position during the various stages of their portfolio lifecycle.

What is the 'enigma', exactly?

Most property investors follow the same financial pattern as they build and maintain a property portfolio.

Typically, in the early years of portfolio growth, tax losses will be generated, despite positive cashflow. It often puzzles investors why they have cash in the bank yet a loss on their tax return – here's why…

Simply, the total of the various allowances, expenses, reliefs and claims possible in the early growth stage 'outpaces' the positive cashflow which would otherwise be taxable.

There are three distinct portfolio stages with different cashflow vs taxable profit characteristics:

Stage 1 - Portfolio Build

Generate tax losses + reasonably positive cashflow

This is the stage where investors 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**
- Finance costs: **Arrangement fees are debited direct to the mortgage account, yet are fully deductible when incurred. So, a typical 2.5% fee on a £100k mortgage (£2,500) will be deducted from rental profits – but has no effect on cashflow as the fee is added to the loan. Then there are survey fees, broker fees, TT fees etc – all are deductible**
- Pre-let refurb: **most properties need some TLC and these costs are often mostly revenue expenses and so fully deductible against rental profit – sometimes hefty sums**
- Letting set-ups costs: **lettings fees, EPCs, consent to lets (etc) – all upfront costs and deductible**

In addition, many investors finance these costs using capital or borrowings, rather than income, meaning that their accounts show all the expenses but little income and hence a loss.

It is therefore important to have a good cashflow forecast so that you can plan with your tax adviser when the portfolio will **first** produce taxable profits.

For an investor planning to build a portfolio over (say) 3 years, it may very well be year #4-5 before any tax is due – which means that tax rates, using a company, ownership structures etc are not going to be of major concern (exception – if capital allowances are claimable).

Although there is no tax due at this stage, your tax adviser should be greedily wringing out every last drop of tax allowances from your portfolio – to maximise the tax loss (which, for many companies is literally capitalised as an asset, since the ability to earn tax-free income has a value).

Stage 2 – Portfolio Maintaining

Use up tax losses + very positive cashflow

Once the portfolio has been built, the steady stream of finance / refurb / letting costs stops, and the portfolio moves into a steady-state and far more profitable position.

All properties will now be showing a full-year of income (hopefully as close to 100% occupancy as possible), plus most investors get a better feel for market rents, and may even start charging for check-ins, credit checks etc – it all helps!

The initial major refurb has been completed, and (fingers crossed!) there are now years of relatively maintenance-free letting ahead. Again, there is often a learning curve too – investors learn what repairs should really cost, which repairs the tenant is responsible for, how to refurb for lower future costs etc.

The interest-only mortgage ticks away and the initial fees have already been absorbed so it's now just a case of paying the monthly mortgage.

This is the stage where the tax losses built up during the portfolio build phase are utilised. It is the stage where cashflow is strong, yet there are no tax bills due to the accumulated losses. However, one day the losses will run out.

Stage 3 – Portfolio Super-Profits

Tax losses used up, tax bills looming + super-profits

This is the stage that some investors are 'lucky' enough to reach – they have to start paying some tax!

Typically, an investor is now very experienced as a landlord, with 95-100% occupancy and a good handle on charging the right rents and selecting the right tenants.

Tradesmen are often sourced very cheaply, and treated well, and the investor knows exactly 'how far' to refurb a property, and often does deals with tenants to reduce call-outs and repair bills. The investor is more savvy and watches costs more closely.

Mortgages may have dropped off the initial fixed rate onto a better follow-on rate, and some capital repayment may have occurred. The investor has learned not to remortgage too often as the costs of 5+ remortgages over a typical 25-year mortgage are often not justified – getting good long-term value is better.

In later years, the effects of inflation on the value of the original (by now quite old) mortgage are evident, and lenders offer lower rates due to the substantial equity in the portfolio.

Good tax-planning is key at this stage, since any losses have been used. This means that ownership structure, marginal tax rates, the use of a lease or management company, a thorough expense review, identifying capital allowances, and possibly more adventurous options are to be proactively considered.

Summary

Most property portfolio finances follow a similar pattern: tax losses and modest positive cashflow during the portfolio build stage.

Then, rapidly improving cashflow once the growth has stopped, the portfolio moves into a steady-state, and the initial tax losses are then used up.

Finally, the successful investor will start to generate substantial profits, and having used up the initial tax losses, requires a new tax strategy to ensure that HM Government don't receive more than necessary.

A good property tax accountant will understand where you are in the portfolio lifecycle, and what tax-planning options are suitable and cost-effective to maximise the tax loss or minimise the tax burden.