2023/24

PROPERTY COMPANY V PROPERTY TRUST

Sarah Bradford

taxinsider
PROPERTY

Contents

About Sarah Bradford 4

1. About this guide 5

2. Holding an investment property 5

2.1 Unincorporated property business 5
2.2 Property partnerships....7
2.3 Property company 7
2.4 Property trust 8

3. Property companies 9

3.1 Popularity of property companies 9
3.2 Setting up a property company.... 10
3.3 Tax overview 13
3.4 Incorporating an existing property business....13
3.5 Operating through a property company from the outset.... 16
3.6 Tax on rental profits.... 16
3.7 Losses 19
3.8 Treatment of gains and losses on disposal.... 19
3.9 Extracting profits from the property company....20
3.10 Annual tax on enveloped dwellings (ATED) 24
3.11 Property management companies....25
3.12 Advantages and disadvantages of operating as a property company....26

4. Property trusts 27

4.1 Nature of a trust 28
4.2 Types of trust 28
4.3 Requirement to register a trust....29
4.4 Tax implications of putting a property into trust 31
4.5 Tax treatment of rental income 33
4.6 Interest relief restriction.... 35
4.7 Capital gains tax on disposal of property by the trust..36
4.8 Inheritance tax considerations 36
4.9 Advantages and disadvantages of using property trusts.... 38

5 Final considerations....39

'Property Company v Property Trust' first published October 2022, second edition October 2023.

Copyright
The right of Sarah Bradford and Tax Insider Ltd to be identified as the authors of this guide.

© 2023 Tax Insider Ltd

Disclaimer
This 'Tax Insider' guide is produced for general guidance only, and professional advice should be sought before any decision is made. Individual circumstances can vary and therefore no responsibility can be accepted by the contributors or the publisher, Tax Insider Ltd, for any action taken, or any decision made to refrain from action, by any readers of this guide. All rights reserved. No part of this guide may be reproduced or transmitted in any form or by any means. To the fullest extent permitted by law, the contributors and Tax Insider Ltd do not accept liability for any direct, indirect, special, consequential or other losses or damages of whatsoever kind arising from using this guide.

About Sarah Bradford

Sarah Bradford BA (Hons) FCA CTA (Fellow) is a director of Writetax Ltd, a company providing technical writing services on tax and National Insurance.

Sarah writes widely on tax and National Insurance. She contributes regularly to:

- Business Tax Insider;
- Property Tax Insider;
- Tax Insider Professional;
- Tax-Efficient Ways to Extract Cash from Your Company;
- IR35 – Tax Tips for Contractors;
- How To Maximise Deductions For Business Expenses;
- Tax-Efficient Business Exit Strategies; *and*
- Cash Basis for Landlords.

1 About this guide

This guide looks at two options for holding property – in a limited company or in a trust. In each case, consideration is given to the associated tax implications that may arise.

When looking at property, there are a number of different taxes to consider and a number of scenarios which may give rise to a tax liability.

- On initial purchase of the property, a liability to stamp duty land tax (SDLT) (or land and buildings transaction tax (LBTT) in Scotland or land transaction tax (LTT) in Wales) may arise.
- Where a property which is already owned in a personal capacity is transferred into a limited company or a trust, there is a disposal for capital gains tax purposes which may trigger a capital gains tax charge.
- If the property is transferred into a discretionary trust, there may be a lifetime charge to inheritance tax.
- In the event that the property in question is let out, there will be rental income to consider, on which tax will be payable.
- If the property is eventually sold, a tax liability will arise if a gain is made on disposal. If the property is held by a company, the charge will be to corporation tax and if the property is held in trust, the charge will be to capital gains tax.
- Where a high value residential property is held in a company, the annual tax on enveloped dwellings will also need to be considered. However, there are exemptions if the property is let out and certain conditions are met.

The liability and nature of the taxes and the rates that apply will depend on how the property is held. This report looks at the various 'tax events' that may arise where a property is held in a limited company and where a property is held in trust.

2 Holding an investment property

Property is viewed as a good investment, and one which generally appreciates in value over time. Where the property is let out, whether as a residential or commercial let or as a holiday let, it will also generate a source of income.

There are various ways in which an investment property can be held. The way that a property is held will dictate what taxes are payable.

2.1 Unincorporated property business

The simplest way to hold an investment property is to hold it in a personal capacity. Under the property tax rules, all properties held in the same capacity by the same person or persons form part of the same rental business. For example, if a person owns two UK buy-to-let properties and

three UK furnished holiday lets, they will have two property businesses – one for the buy-to-lets and one for the furnished holiday lets – and will need to calculate the profits of each separately. A distinction is also made between UK properties and overseas properties, and where a person owns both UK and overseas properties, they will have both a UK property business and an overseas property business.

On the initial purchase of the property, a liability to SDLT (or, as appropriate, LBTT or LTT) will arise if the consideration exceeds the relevant threshold. Where the landlord already owns one residential property, the purchase of second and subsequent residential properties will attract the SDLT/LBTT/LTT supplement.

The cash basis is the default basis of accounts preparation for unincorporated landlords with rental income of £150,000 or less. Where the rental income exceeds this, or if one of the other cash basis conditions is not met, the accounts must be prepared using the accruals basis. A landlord who is eligible for the cash basis can also elect to prepare accounts on the accruals basis if this is preferred or advantageous.

The profit or loss is computed separately for each property rental business. The calculation is at business level rather than for each individual property. In this way, a loss on one property is automatically relieved against a profit made on another property within the same property business.

The profits of the property business are charged to income tax at the landlord's marginal rate. The rental profits form part of the landlord's total taxable income, on which their tax liability is computed. If the landlord lets residential property other than as a furnished holiday let, relief for any interest and finance costs is given as a basic-rate tax reduction, rather than as a deduction in computing the taxable profits of the property business.

If a gain is made on the disposal of the property, a liability to capital gains tax may arise. This will be the case if the landlord's net gains for the year, less any allowable losses set against the gain, exceed the annual exempt amount. Residential gains must be reported to HMRC within 60 days and a payment on account of the capital gains tax must be made within the same timescale.

Changes to the tax rules in recent years have reduced the attractiveness of holding investment property in a personal capacity. In particular, changes to the mechanism for relieving interest on finance costs, which moved from relief by deduction (allowing relief at the landlord's marginal rate) to relief at 20% of the interest and finance costs as a tax reduction, have prompted many landlords to consider other property holding structures. Changes to lettings relief and the need to pay and report residential gains within 60 days have also decreased the attractiveness of holding property as an individual.

2.2 Property partnerships

Property may also be held in a partnership. This can be advantageous where property is jointly owned as it provides greater flexibility for allocating profits and losses than where jointly owned property is held outside a partnership, particularly if the joint owners are spouses or civil partners.

A traditional partnership is transparent for tax purposes, and the individual partners are liable for income tax on their share of the profits. Where an individual partner also owns property outside the partnership in an individual capacity, they will have two separate property businesses – one for their share of the partnership profits and one for the rental properties owned in an individual capacity. If a gain arises when the property is sold, each partner is liable for capital gains tax (subject to the gain being sheltered by the annual exempt amount and any allowable losses) on their share of the gain.

Property can also be held in a limited liability partnership (LLP); in certain circumstances, this can generate tax advantages. An LLP is something of a hybrid between a company and a traditional partnership. Like a limited company, it offers the advantage of limited liability and, like a traditional partnership, it provides the flexibility to agree on how to share profits between the partners. As with a traditional partnership, an LLP is transparent for tax purposes, with each partner being taxed personally on their share of the profits and liable to capital gains tax on their share of any gain on disposal. However, unlike a traditional partnership, an LLP can hold property in its own right and properties transferred to the LLP are held on trust by it.

2.3 Property company

In recent years, holding a property in a limited company has become popular. This is due in part to the restriction for interest and finance costs that applies in relation to residential property held by an unincorporated property business. The restriction does not apply where residential property is held in a limited company, and any associated interest and finance costs can be deducted in full when computing the taxable profit.

Since 1 April 2023, the rate at which a company pays corporation tax on its profits depends on the level of those profits. Where a company has profits below the lower profits limit (set at £50,000 for a company with no associates), the small profits rate applies. This is set at 19% for the financial year 2023 which runs from 1 April 2023 to 31 March 2024. At the other end of the scale, where a company has profits in excess of the upper limit (set at £250,000 for a company with no associates), corporation tax is charged at the main rate of 25%. If the profits of the company fall between the two limits, the effective rate will be between 19% and 25%; corporation tax is calculated at the main rate of 25%, as reduced by marginal relief.

The tax payable by a property company on the profits of the property

business may be less than that payable by an unincorporated property business. The small profits rate of 19% is less than the basic rate of income tax, and the highest corporation tax rate applying from 1 April 2023 at 25% is significantly lower than the higher and additional rates of income tax. However, this will depend on the company's profits and its effective rate of corporation tax and on the landlord's marginal rate of tax. In addition, unlike an individual, a company does not have the equivalent of a personal allowance, so tax is payable from the first £1 of profit.

Companies also pay corporation tax on chargeable gains. If the landlord is a higher or additional-rate taxpayer, the corporation tax rate payable by the company on chargeable gains will be lower than the rate of capital gains tax payable on a residential property gain where income and gains exceed the basic-rate band (set at £37,700 for 2023/24) is payable at the rate of 28%. This again can make operating through a property company attractive. However, unlike an individual, a company does not have an annual exempt amount. Further, if the landlord's income and gains fall within the basic-rate band, they will only pay capital gains tax at the rate of 18% on a residential property gain – this is lower than the rate at which a company will pay corporation tax on those gains.

However, the story does not end there. If the profits are to be used outside the company, they will need to be extracted, and this may give rise to additional tax and, potentially, National Insurance liabilities. When assessing whether it is beneficial to operate through a property company, this must be borne in mind.

The tax implications of holding an investment property in a limited company are discussed in detail in section 3.

2.4 Property trust

Putting a property into trust can be beneficial, particularly from an inheritance tax perspective as the property will fall outside the settlor's estate.

The tax consequences of putting a property in trust will depend on the type of trust that is used. There may also be tax implications when the property is put into the trust, and when it is transferred to the beneficiaries.

Where the property is let, tax will be payable on any rental income received by the trust. When this is distributed to the beneficiaries, the beneficiaries will be taxed on the income that they receive but will receive credit for that already paid by the trust. This may give rise to a repayment.

A tax charge may also arise on the settlor when the property is settled as the settlor will be deemed to have disposed of the property at market value. This may trigger a chargeable gain. However, in certain circumstances it may be possible to hold over the gain, delaying the point at which the tax must be paid.

Property trusts are considered in detail in section 4. While the main focus