Should I use a Company when Investing in Property?
By James Bailey

The question I am most often asked as a tax consultant is probably "Should I use a company when investing in property?" This question needs some background and does not make good written sense to stand on its own. Unfortunately, there is no simple answer because so much depends on your circumstances and your plans for the future.

Rates of Tax
Let's start with the basics. A company pays corporation tax at 19% on its profits up to £300,000. Above that level, the rate of tax goes up on a sliding scale, but the maximum a company will pay on all its profits is 30%.This sounds excellent when compared to income tax at 22% up to income of £33,300 per year and 40% above that, but the problem is that the money is still in the company, and there will be further tax to pay when it is taken out for the shareholders' use.

"The Corporate Veil"
This is an expression used by the courts to describe the relationship between a company and its shareholders, though for some reason it always reminds me of exotic dancers!

The point is that a company is a separate legal person from its shareholders and its employees, it pays its own tax on its profits and gains, it can be sued for its debts, and it is the legal owner of the money it makes. If the shareholders want to take money out of the company, getting it through the corporate veil will usually create a tax charge.

Getting the Cash Out
Broadly, there are five ways you can extract cash from your company. Starting with the most obvious, they are:

- **Wages, salaries, and bonuses**
- **Dividends**
- **Benefits in kind**
- **Loans**
- **Liquidations or share sales**

Wages, salaries, and bonuses
Generally speaking, this is the most expensive way to extract cash from a company, because both you and the company will have to pay National Insurance Contributions. For 2006/07, yours will be at 11% up to a salary of £33,540, and 1% thereafter. The company will pay employer's contributions of 12.8%, with no upper limit.

If the company is your only source of employment, however, don't forget that no National Insurance is due on wages of less than £97 per week. In these circumstances, it makes sense to pay yourself (and any other shareholder or family member who genuinely works for the business) this much per week. Because the company can claim the cost of your salary as an expense against its profits chargeable to

corporation tax, there will be a saving of just over £958 (£97 times 52 weeks = £5,044. £5,044 reduction in company's profit (taxed at 19%) saves £958.36p) as a result of paying a salary just below the NIC threshold. The income tax payable on the salary is neither here nor there, because if you were trading as an individual you would still have had to pay that.

Dividends
If a company "distributes" its profits to shareholders by paying dividends, it cannot get a deduction from its taxable profits for doing so, so the sums are rather different.

Because dividends are paid out of profits already charged to corporation tax, they come with a "tax credit" that can be offset against any income tax due from the shareholder who receives the dividend. The arithmetic is complicated, but basically what happens is:

If the company pays a dividend in cash (say, £900), you have to add one ninth (£100) to it to arrive at the taxable amount, so in this case you are treated as receiving £1,000 of taxable income, which includes a "tax credit" of £100.

If you do not pay tax at the higher rate, the tax credit is enough to cover the income tax due, so you do not need to pay any further tax.

If you are a higher rate taxpayer, you will pay income tax at the "dividend rate" of 32.5% on your dividend of £1,000, giving a tax bill of £325. From this you can deduct the tax credit of £100, so you have to pay a further £225 in income tax.

It's much simpler to look at it this way – a higher rate taxpayer will pay income tax of £225 on a dividend of £900 cash – that's 25%.

Benefits in kind (cars, holidays, TVs, etc)
These used to be a good way to extract value from your company, because generally speaking, no National Insurance Contributions were due on benefits that were not in the form of cash, but the company could still deduct the cost from its profits.

Unfortunately, the rules are now much tighter, and as a general rule, the company will have to pay NIC on the value of any benefits in kind it provides, so there is no real point in serious "BIK" planning.

There are a few benefits that are tax free, and thus worth considering. Some common examples are:

- Childcare (up to £55 per week, and subject to various conditions)
- Car parking at the workplace
- Mobile phones (only one per employee, thanks to this year's Budget!)
- Staff parties up to a cost of £150 per head per year

Loans
There is some quite complex planning that can be done here.

First of all, when setting up a company, it is often wise to lend it the money it needs to get started, rather than putting this in by subscribing for shares, because the company can repay that loan in the future with no income tax charge on the lender.

The other side of the coin is if the company lends money to you. Generally speaking this is unwise, because the company itself has to pay a form of "deposit" to the taxman, of 25% of the amount loaned – this is repayable when the loan is repaid.
If the company lends more than £5,000 to you, you will be charged to income tax on the difference between the interest on the loan you pay to the company, and the "official rate" of interest (currently 5%) – so if you have an interest free loan of £5,001 for a year, you will pay income tax on £250, meaning £100 tax for a higher rate taxpayer.

That may sound rather a good deal, but beware – there are Company Law problems to consider.

More sophisticated planning involves the company lending money and then writing off the loan – but this is an area where you **must** have specialist advice to avoid getting into serious trouble with both the taxman and Company Law.

Sales and Liquidations

If you sell your company to someone else, you are selling them the shares in the company. If you liquidate your company, the shares cease to exist, and you become the owner of the company's assets.

In either case, you will realise a capital gain, based on the difference between the cost of your shares and the price you get for them, or the value of the company's assets in the case of liquidation.

Capital gains are taxed as if they were income, but there are some reliefs that will reduce the taxable amount. The first £8,800 of your capital gains for the tax year 2006/07 is exempt from tax – this "annual exempt amount" increases each year.

There is also "taper relief", depending on how long you have owned your shares, and on whether the company was a "trading company" or not.

In the case of a trading company, the capital gain is reduced by half if you have owned the shares for one year and by 75% if you have owned the shares for two years.

Putting this together with the "annual exempt amount" means that you could realise a gain of £35,200 on your shares in a trading company, and if you had owned them for two years you would pay no tax - £35,200 reduced by 75% is £8,800.

For other companies, taper relief does not start until you have owned the shares for three years, and then it only reduces the gain by 5% for each year, until it reaches its maximum reduction of 40% after you have owned your shares for ten years.

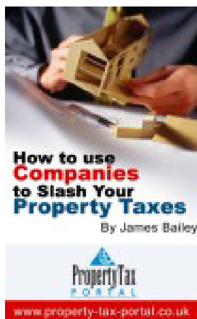
The definition of a "trading company" is a strict one, and unfortunately, a property investment company is not a "trading company". Property development companies

(which buy or build properties for resale), or property management companies (which do not own property, but deal with the collection of rents, repairs, finding tenants, and so on) can be trading companies, however, so there are planning possibilities for them.

So, should I use a company or not?
There is no simple answer, and I hope this article has helped explain why, but here are two general guidelines:

- If you do not expect to be paying income tax at the higher rate, there is probably little tax advantage in using a company – the difference between 19% corporation tax and 22% income tax will probably not justify the cost of running the company.

- If you expect to pay tax at the higher rate, and you intend to reinvest some of your profits to grow your business rather than taking them all for your personal use, you may well be better off by using a company – the 19% rate of corporation tax is a real advantage if the profits are to be retained in the company rather than taken out using one of the methods described above.



About the Author
James Bailey (CTA) is author of the newly released guide – 'How to Use Companies to Slash Your Property Taxes', which is available through the Property Tax Portal.

To learn more about his guide click here.