Buy-To-Let & the Implications for You

Issue 2

The MHA Construction & Real Estate team have worked together to provide a national outlook on the changes facing Buy-to-Let landlords. This is our second issue in our series of articles and information to help you better understand the changes that landlords now face.

Over the course of these issues we will be asking you to answer six questions to monitor the trends in the market place. Please take two minutes and share your views with us.

Take Part Now

Buy-to-Let and Brexit, an Uncertain Future?

June 23 saw the British public voting to leave the European Union; this caused some of the large house builders to consider slowing the pace of their construction programmes as well as revising their land buying policies in the face of an expected economic slowdown as the UK prepares to leave the EU.

Since the start of the implementation of the Chancellor's tax changes back in April 2016 we have seen some significant changes to the Buy-to-let (BTL) landscape. Add to that the uncertainty of a Brexit vote to the housing market and you can understand why mortgage lenders, as well as the house buying public have become very cautious.

In the first three months of 2016, Buy-to-let lending increased sharply with 48,800 loans approved and advanced as people rushed through their purchases in advance of the Government's 3% hike in stamp duty rates which came into force on 1 April 2016.

However, from the 1st April, the brakes were applied and the numbers tumbled. The Council of Mortgage Lenders recorded that there were just 4,200 Buy-to-let loans approved and advanced in April, rising only marginally in May by 200 to 4,400.

April 2017 will see the start of the implementation of the Chancellor's reduction to mortgage interest tax relief. While this will be phased in over the following four years we could expect to see this impact sooner on those landlords whose property portfolios are heavily geared and this could result in them having to pay tax on zero income or even on losses.

The National Landlords Association (NLA) believe that up to 500,000 properties will be sold in the next 12 months, followed by 100,000 properties a year thereafter.

Will the reduction in the number of new build properties be offset by the number of properties being released by landlords back into the housing market?

Who knows, but it is likely to have an impact on those people who rely on the professional landlord. With a potential reduction in the number of rental properties available, we could see an increase in rental income. If we then factor in the changes to mortgage interest tax relief and a reduction in the available profits for the landlord, we can almost guarantee to see an increase in rents across the UK.

Are you still considering property?

Many potential and existing landlords are still waiting for the dust to settle and that is the same defensive position that the mortgage market has taken. We have seen lenders re-write their underwriting criteria and ask for larger deposits (typically 25% to ensure that they are protected against a property crash), they have also increased the rates they apply when stress testing the rental income (this has moved from 125% @ 4.99% to 140% of a stressed interest rate of 5.99%), as well as limiting the amount of properties you can mortgage with an individual lender.

While some landlords are looking to leave the industry, the serious players are embracing these changes and moving towards the Limited Company route and the mortgage market continues to evolve to accommodate the demand with competitive rates, innovative products and a sensible approach to rental assessment.

Buy-to-Let Changes – Can we minimise the pain?

Restriction of tax relief on loan interest

By the 2020/21 tax year, loan interest will not be allowed as a deduction from profits. Instead, landlords will only be able to claim a tax reduction equal to 20% of the loan interest paid.

The change will be phased in starting from April 2017 as shown in the table below.

This could make a big difference to the amount of tax payable for higher rate tax payers, particularly where loan interest is high in comparison with rents received. Indeed, landlords who are currently basic rate taxpayers after deduction of loan interest from taxable profits could find that they actually have some tax to pay at higher rates once the changes are fully in force.

	2016/17	2017/18	2018/19	2019/20	2020/21
Proportion of interest allowed as a deduction	100%	75%	50%	25%	0%
Proportion of interest allowed as a 20% tax reduction	0%	25%	50%	75%	100%

Can anything be done to minimise the effect of the changes?

The best solution will depend on individual circumstances, but here are some suggestions:

Pay Down Debt

Currently, for a 40% taxpayer, the net of tax cost of interest on a 4% mortgage is just 2.4%, so you might choose to borrow rather than using your savings to fund a purchase. However, under the new rules, the net of tax cost will be 3.2%, so you may prefer to pay down the mortgage using savings to reduce the impact of the changes.

Sell Properties

If you have properties you know will be loss making after tax – you might consider selling them. Be aware that there could be capital gains tax to pay and that the reduced rates of capital gains tax announced in the 2016 budget do not apply to sales of Buy-to-let (BTL) properties, meaning that gains will still be taxed at 18% and 28%. The capital gains tax would reduce the funds available to reduce the debt on the remaining properties.

Refinance Lending

If you have a loan which covers both residential and commercial property, interest will need to be apportioned between the two sources so that relief on the residential portion is still restricted to 20%. If you refinance your borrowing and separate into two loans, with the level of gearing set at a higher level for the commercial property, the tax relief available will be maximised. Be aware that there could be one-off costs such as arrangement and legal fees.

Inter Spouse Transfers

If the new rules mean that one spouse will have to pay tax at 40% on rental profits, you might be able to save tax by transferring property to a basic rate tax paying spouse. There is no capital gains tax on inter spouse transfers so there would be no tax cost of the transfer.

Transfer Properties into a Company

The new rules on loan interest relief do not apply to companies, so loan interest will still be a deduction which reduces taxable profit. The rate of tax on that reduced profit will be just 20% because that is the current corporation tax rate (and it is set to reduce to as low as 17% by April 2020). Any tax beyond the 20% rate will only apply if you choose to extract some of the rental profit from the company. Be aware that if you need to extract all of the profits from the company, you will not pay much less tax overall than would have been payable as an individual. However, significant savings can be made if you do not need to distribute all of the profits from the company (as shown below). Be aware that there are increased accountancy costs of using a company, which will use up some of the savings, but if your plan is to retain profits within the company or reinvest in further property, using a company will save you money. However, the transfer of properties to a company is a disposal at market value so there could be capital gains tax to pay if the properties have increased in value since purchase.

Solutions:

1) Partial incorporation – only transfer properties standing at no gain

2) Incorporation relief

Tax Savings on Incorporation

Company Profit	Tax saving 2015/16 compared to sole trader	Tax saving 2016/17 compared to sole trader *
£100,000 Fully distributed	£4,737	£515
£100,000 £50,000 distributed	£8,253	£6,522

Due to changes to dividend taxation

Can you incorporate a property portfolio without incurring large tax charges?

The clearances confirm that no Stamp Duty Land Tax (SDLT) is payable if the ownership of the company mirrors the current ownership of the properties.

When starting this process of looking at incorporation for Buy-to-let (BTL) landlords who would be caught by the new rules, it was uncertain. However, our member firms have gone down the process of applying for non-statutory clearances from HMRC. The first letters helped us to understand more clearly what HMRC wanted to make their decision, but for the right cases clearance is being granted.

The clearances confirm that no Stamp Duty Land Tax (SDLT) is payable if the ownership of the company mirrors the current ownership of the properties. In addition, the separate Capital Gains Tax clearance confirms that incorporation relief can be claimed under Section 162 TCGA 1992 so any capital gain on the shares is held over into shares in the new company.

Activity Diary

What has proved to be a key point is the work carried out by the individuals. Where people use letting agents to do all of the work and the main activity is to file the monthly statements from the agent, relief is not likely to be given. The more that the individuals are actively involved in the letting of the properties, the more likely it is that clearance will be granted. You now need to include an activity diary for the individuals for one to two weeks showing the tasks that they undertake hour by hour in their property business.

Refinancing the Debt

Having obtained the clearances, there is then a need to refinance the debt on the properties.

There are three practical points on incorporation which are linked to each other.

The first is you will need a full set of accounts for the business, as it is the final accounts for the business that will determine the opening journal entries on incorporation of the company. The nominal value of the shares to be issued, including any share premium, will equal the closing net assets of the business. The base cost of the assets in the company for corporation tax will be the market value of those assets at the date of incorporation.

Secondly, the capital gain is only fully held over if the value of the shares to be issued is more than the gain on the assets. If the gain is more than the value of the shares, the excess gain continues to be taxable.

The final practical point is being able to determine the cost of the properties with certainty. For some individuals they may have spent considerable amounts on improving their properties over the years. Many landlords will have kept full records of this expenditure and the invoices for the work done; many others have not done so. Where such people want to incorporate their business into a limited company, if there is uncertainty about the amount of allowable expenditure and hence the capital gain, a landlord could find themselves in a situation where after HMRC challenge, the gain is shown to exceed net assets and so part of the gain would not be held over.

In conclusion, the use of non-statutory clearances provides certainty of tax treatment, and that the reliefs are being granted in appropriate cases. The clearance is not the end of the road but, if you deal with the practical issues of incorporation, you can achieve the aim of holding a property portfolio inside a limited company.

House Price Growth

The main contribution to the increase in UK house prices came from England, where house prices increased by 9.3% over the year to June 2016, with the average price in England now £229,000.

Wales saw house prices increase by 4.9% over the latest 12 months to stand at £145,000.

In Scotland, the average price increased by 4.6% over the year to stand at £143,000. The average price in Northern Ireland is currently £123,000.

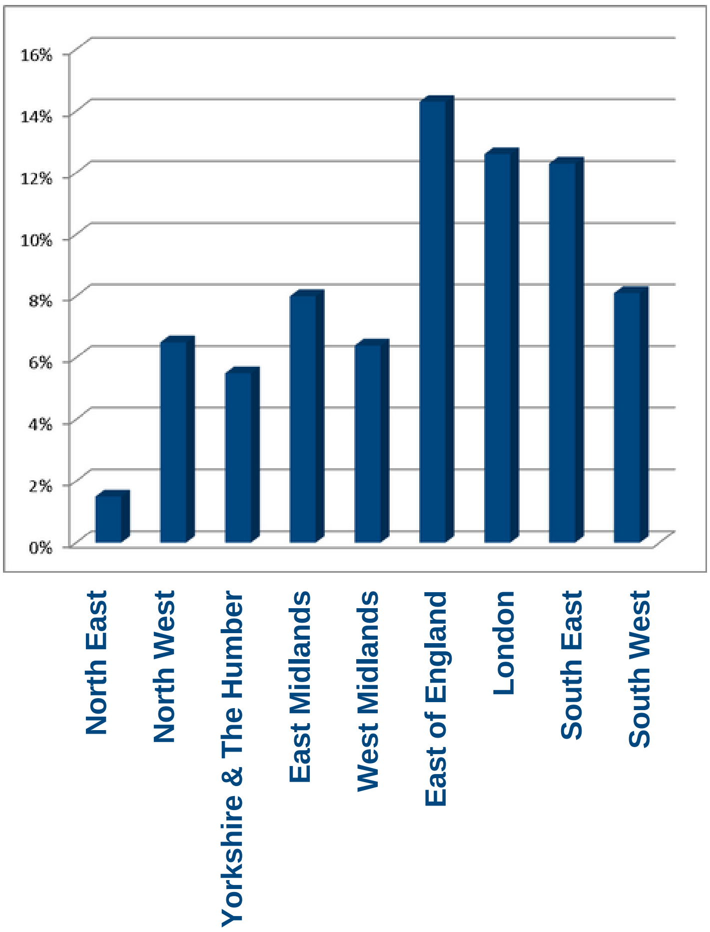
House prices increased by 9.3% over the year to June 2016

London

On a regional basis, London continues to be the region with the highest average house price at £472,000, followed by the South East and the East of England, which stand at £309,000 and £270,000 respectively. The lowest average price continues to be in the North East at £124,000.

House Price Change

This chart shows the 12 month change in house price growth/decline from June 2015 to June 2016. It is based on mortgage data and was taken from the ONS website.



In the Regions

The East of England replaces London as the region which showed the highest annual growth, with prices increasing by 14.3% in the year to June 2016. Growth in London remains high at 12.6%, followed by the South East with a 12.3% annual growth. The lowest annual growth was in the North East, where prices increased by 1.5% over the year.

Overall the average UK house price has continued to rise in each month for the first half of 2016 and has risen from £204,919 at the start of the year to £213,927 by the end of June.

Of course there are regional variations but there does not yet seem to have been any statistically significant impact on house prices by the recently announced tax changes. Growth has slowed in London in particular and it looks as though the uncertainty leading up to the Brexit vote may have an effect on the June figures for some London Boroughs. In other areas there were local variations with places such as Aberdeen seeing annual declines in prices for other reasons.

As the vote wasn't until 23 June we will have to wait and see whether any longer term impact will apply and it will certainly be hard to separate whether this is due to the mortgage interest allowability changes coming in at April 2017 or due to the uncertainty over the precise nature of Brexit. Hopefully things will become clearer over the coming months, both for the terms of Brexit and in respect of its effect and those of the tax changes on house prices.

MHA Firms

MHA is a UK wide association of progressive and respected accountancy and business advisory firms. Each MHA member firm offers a broad range of services including accountancy, tax and corporate finance as well as sector specialisms.

We are the UK members of the international network, Baker Tilly International. Through our membership of Baker Tilly International we are able to provide premier accounting, assurance, tax and specialist business advice worldwide, drawing on internationally recognised industry and service line experts in 141 countries.

Collectively we have

50 offices across the UK

Services

- Accounting and Financial Reporting: including advice and support with the conversion to new UK GAAP and advising on changes affecting the property sector.
- External Audit: audits tailored to mitigate risks affecting the property sector.
- Internal Audit, Control Reviews and Finance Function Effectiveness Reviews.
- Fund raising for property transactions.
- Advice on complicated property transactions and suitable structures, including joint ventures and special purpose vehicles.
- VAT advice on property transactions, including election to tax.
- Advice on high value residential property, including Annual Tax on Enveloped Dwellings.
- Stamp Duty Land Tax and, in Scotland, Land and Buildings Transaction Tax.
- Structures to minimise taxation on development and investment profits.
- Enhanced capital allowances claims.

If you require any further information or advice regarding these topics, then please feel free to contact your local MHA member firm contact.

MHA Member Firm Offices

@mha_uk

Broomfield & Alexander
www.broomfield.co.uk
Cardiff (Head office)
Ty Derw
Lime Tree Court
Cardiff Gate International Business Park
Cardiff
CF23 8AB
Tel: 02920 549939

Additional offices: Newport & Swansea

Larking Gowen
www.larking-gowen.co.uk
Norwich (Head office)
King Street House
15 Upper King Street
Norwich
NR3 1RB
Tel: 01603 624181

Additional offices: Bungay, Colchester, Cromer, Dereham, Diss, Fakenham, Holt & Ipswich

Monahans
www.monahans.co.uk
Swindon (Head office)
38-42 Newport Street
Swindon
Wilts
SN1 3DR
Tel: 01793 818300

Additional offices: Bath, Chippenham, Frome, Glastonbury & Trowbridge

Carpenter Box
www.carpenterbox.com
Worthing (Head office)
Amelia House
Crescent Road
Worthing, BN11 1QR
Tel: 01903 234 094

Additional offices: Gatwick

Henderson Loggie
www.hlca.co.uk
Dundee (Head office)
The Vision Building
20 Greenmarket
Dundee
DD1 4QB
Tel: 01382 200 055

Additional offices: Aberdeen, Edinburgh & Glasgow

MHA MacIntyre Hudson
www.macintyrehudson.co.uk
London City
New Bridge Street House
30-34 New Bridge Street
London EC4V 6BJ
Tel: 020 7429 4100

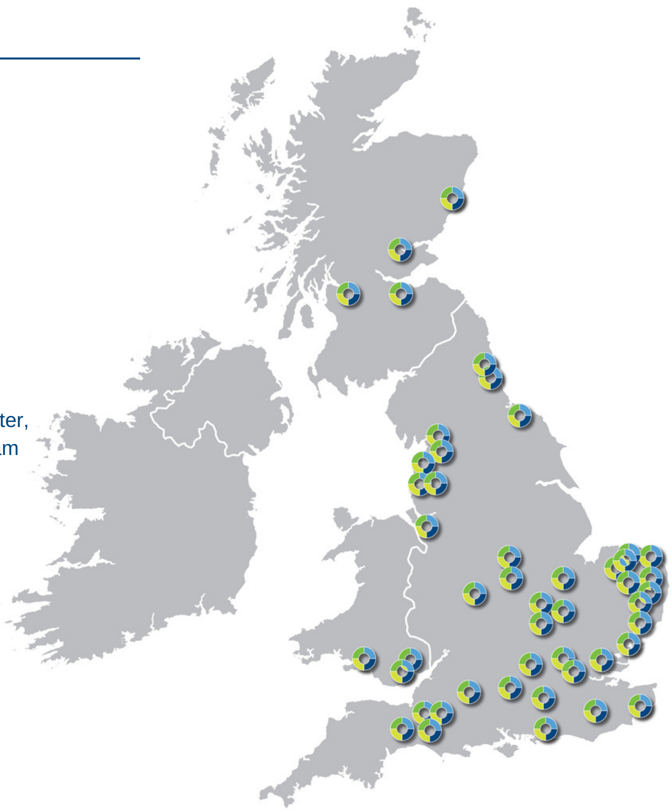
Additional Offices: Bedford, Birmingham, Canterbury, Chelmsford, Folkestone, High Wycombe, Leicester, Maidstone, Milton Keynes, Northampton, North London, Peterborough & Reading

Moore and Smalley
www.mooreandsmalley.co.uk
Preston (Head Office)
Richard House
9 Winckley Square
Preston
Lancashire
PR1 3HP
Tel: 01772 821021

Additional offices: Blackpool, Kendal, Kirkby Lonsdale, Lancaster, Liverpool, Manchester, Nottingham & Southport

Tait Walker
www.taitwalker.co.uk
Newcastle (Head office)
Bulman House
Regent Centre
Gosforth
Newcastle Upon Tyne
NE3 3LS
Tel: 0191 285 0321

Additional offices: Northumberland & Tees Valley



An independent member of BAKER TILLY INTERNATIONAL