

Buy To Let & the Implications for You

Issue 1

The MHA Construction & Real Estate team have worked together to provide a national outlook on the changes facing Buy to Let landlords. Over the course of the next 12 months, we will bring you a series of articles and information to help you better understand the changes that landlords now face.

Taking the Heat out of the Buy To Let Kitchen

A number of measures were announced in the July 2015 Budget by George Osborne and David Cameron as part of their 'one nation' government to reward hard working people and to ensure they can enjoy the benefits of home ownership. Some of these measures were focussed on increasing the supply of residential stock, including the unlocking of public land for development and changes to planning rules for SME builders.

These measures should help to increase the supply of homes over the medium to long term. However, it was the announcements of tax changes, due to take effect almost immediately and over the short term that have caused both controversy and delight; the former for landlords and individuals attempting to purchase a second home, and the latter for those trying to get on to the housing ladder to provide a home for their families.



The main budget announcements affecting the residential property market were:

- the increase of stamp duty by 3% for the purchase of a second home from April 2016;
- the removal of the 10% wear and tear allowance from April 2016;
- the restriction of tax relief on interest for buy to let landlords being phased in from April 2017;
- the reporting and payment of capital gains tax on a disposal within 30 days. This acceleration of the tax payable will apply from April 2019.

We will monitor the effects on the residential property market as the new changes take effect and issue a series of commentaries and tax planning strategies that may help to mitigate tax. For now, the market is being predominantly directed by the increase in the stamp duty payable from April 2016...

Stamp Duty Land Tax

The new rule changes to Stamp Duty Land Tax affect those individuals that are buying a second **residential** property. Corporate bodies buying residential property will either be subject to these additional rates or a more penal rate of 15% if the property is over £500,000 and is not used for a qualifying purpose. This penal charge was introduced to prevent abuse of the stamp duty rules by enveloping 'expensive' dwellings within companies and then selling the company rather than the property itself.

An additional 3% tax is now being charged to individuals purchasing a second residential property regardless of them being a property magnate with an extended history of purchasing such properties for the rental incomes, or a family that just happens to be moving home and are having to purchase the second home before selling the first.

As expected the market reacted to this additional charge with volatile pricing and a large rise in the volume of property transactions in February and March 2016.

House prices increased by 2.2% in March 2016 alone and were then reported to have fallen by 0.8% in April 2016.

The number of property transactions in March 2016 was 165,480, an increase of 48,550 compared to February 2016, and was the highest number of properties transacted in a single month since records began in April 2005.

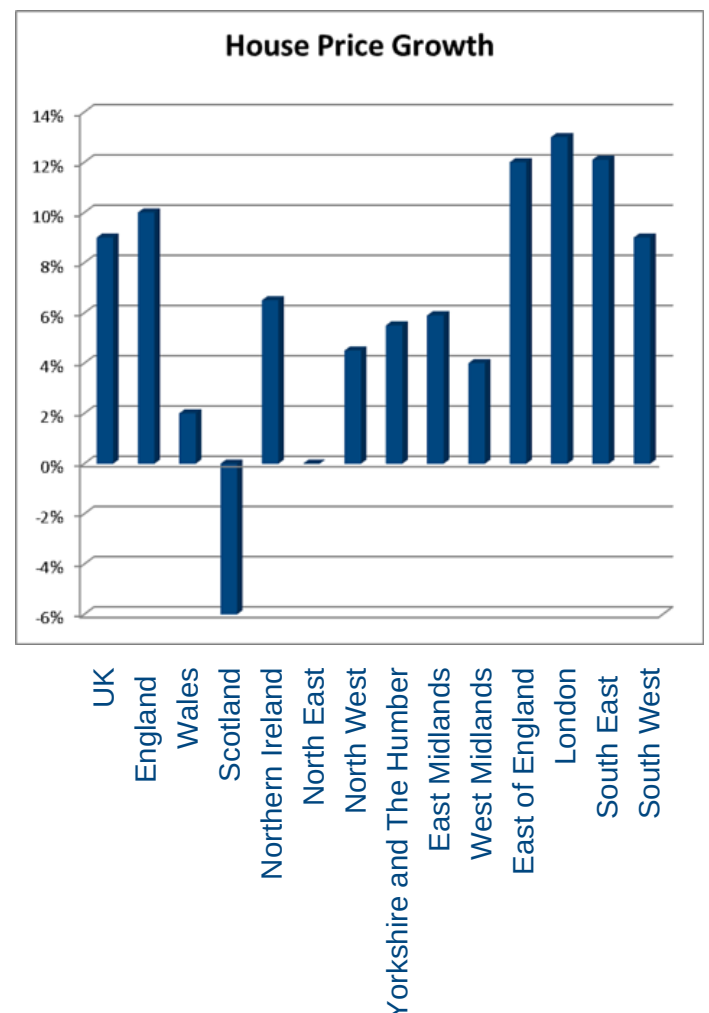
A number of individuals that were moving home in the spring were quite rightly confused by the new stamp duty rules due to the implementation of the policy appearing quite rushed. Would they suffer a permanent 3% additional tax charge? Would there be a mechanism to reclaim the additional stamp duty once paid, if they sold the original home shortly afterwards?

Landlords are also asking what can be done to avoid suffering the 3% charge in the future. Would this charge be applied if they move a property portfolio into a company to avoid future tax disincentives? Over the course of these publications, we will address these questions and more.

Those landlords that have suffered the additional stamp duty charge have been noted as attempting to pass on the increase in their 'cost' by increasing rents rather than pulling out of the market.

If this is the case, Cameron and Osbourne's attempt to temper the residential market may be a policy fail and have the effect of those hard workers that already cannot afford to buy a home, starting to be priced out of the rental market too.

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



Tax Changes Affecting Landlords and How to Reduce Tax

Changes to tax relief on finance costs

Currently, individuals receiving rental income from residential properties can offset finance costs incurred in full against the rental incomes received. This results in reduced property profits that are subject to tax. These rules are broadly aligned with other businesses and self-employed individuals who are able to claim business costs against business incomes.

Tax relief for finance costs on residential properties will start being restricted to landlords; this is a significant shift from the rules that apply to other businesses. Furthermore, the mechanics of how tax relief on finance costs on residential rental properties is obtained is also changing, which may have further financial consequences for the taxpayer.

The restricted tax relief will be phased in from April 2017 and by 2020/21 landlords will only be able to claim basic rate tax relief on the financed costs incurred. Finance costs typically include mortgage interest, but also include interest on loans to buy furnishings and bank arrangement fees and charges.

**Restricted
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from**



How the new rules will work

Deductions of finance costs from property income will be restricted to:

- 75% for 2017 to 2018
- 50% for 2018 to 2019
- 25% for 2019 to 2020
- 0% for 2020 to 2021

Individuals will be able to claim a basic rate tax reduction from their income tax liability on the portion of finance costs not deducted in calculating the profit. In practice this tax reduction will be calculated as 20% of the lower of the:

- finance costs not deducted from income in the tax year (25% for 2017 to 2018, 50% for 2018 to 2019, 75% for 2019 to 2020 and 100% thereafter);
- profits of the property business in the year;
- total income (excluding savings income and dividend income) that exceeds the personal allowance and blind person's allowance in the tax year.

Any excess finance costs may be carried forward to following years if the tax reduction has been limited to 20% of the profits of the property business in the tax year.



Example: A landlord paying tax at the additional rate (45%) with rental income of £25,000 and mortgage interest of £20,000

| Current Rules: | |
|--------------------------|-----------|
| Rental income: | £25,000 |
| Mortgage interest: | (£20,000) |
| Tax liability @ 45%: | (£2,250) |
| Rental profit after tax: | £2,750 |

| New Rules: | |
|------------------------|-----------|
| Rental income: | £25,000 |
| Mortgage interest: | (£20,000) |
| Tax liability @ 45%: | (£7,250)* |
| Rental loss after tax: | (£2,250) |

*The tax relief under the new rules is calculated at 45% of the rental income (£11,250) less tax relief on the interest payments at only 20% (£4,000).

Other financial consequences

The new rules also change the reporting of rental profits within the constitution of what is regarded as an individual's income.

Before April 2017, profits from rental income, being rents received less interest and other property expenses, will be reported as income.

After April 2017, rental income before the deduction of finance costs will be regarded as an individual's income.

This change will result in the reporting of an increase to the individual's income, which may give rise to an increased High Income Child Benefit Tax (HICTB) charge and additional Child Maintenance costs. It may also push the taxpayer into a higher tax bracket whereby the personal allowance available will be restricted or it may push the taxpayer from the higher rate 40% tax bracket into the additional 45% tax bracket.

Example: The effect of the new rules on a taxpayer receiving child benefit on two children with rental income of £25,000 and mortgage interest of £20,000

| Current Rules: | |
|---|---------|
| Rental profit: (after deduction of interest) | £5,000 |
| Employment income: | £40,000 |
| Total income: | £45,000 |
| HICTB charge: | £NIL |

| New Rules: | |
|---|---------|
| Rental income: (before deduction of interest) | £25,000 |
| Employment income: | £40,000 |
| Total income: | £65,000 |
| HICTB charge: (Based on 2015/16 child benefit rates) | £1,823 |

Potential solutions

As the new rules only affect residential properties, if you have a mixture of residential and non-residential properties in your property portfolio, you may wish to consider moving borrowing away from the residential properties and borrow instead on the non-residential properties. You will then be able to obtain full tax relief on the finance costs incurred. However, the change in borrowing may result in mortgage early redemption penalties and further bank arrangement fees, which you will need to consider and take into account.

Alternatively, with careful exploration, incorporation may be advantageous with the rental properties being transferred into a corporate shell paying corporation tax at 18%.

Careful consideration will need to be given to potentially significant stamp duty land tax (SDLT) and capital gains tax (CGT) charges, which may arise as a result of the transfers, but also how to efficiently extract the profits from the company.

MHA Firms

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Collectively we have

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However, recent case law indicates that it may be possible for incorporation relief to be claimed, allowing the capital gain arising from the transfer to the company to be deferred until the properties are onward sold by the company. This may only be possible where there is a strong argument that the properties are being actively managed and specific tax advice should be obtained before implementing this strategy.

The SDLT charge arising may also be reduced by claiming multiple dwellings relief where appropriate. This will have the effect of the rate of SDLT to be averaged down to the market value of each dwelling within a property.

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

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.
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