Buy to let property owners

Changes to UK tax relief on finance costs

June 2020

For intermediaries only

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Contents

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Executive summary

Since 6 April 2017, restrictions to income tax relief available for finance costs have been significantly impacting landlords and the profitability of their portfolios. Tax relief is now restricted on finance costs including mortgage interest incurred in relation to loans used to acquire the property.

The restriction of relief in respect of finance costs incurred by individual landlords has had significant tax-cost implications for buy to let landlords as it's been gradually introduced in recent years. The introduction of the restriction on relief has had a material effect on the cash flow position of buy to let rental businesses and has led landlords to reconsider the way they choose to run their rental portfolio.

> "...restriction of relief has had a material effect on the cash flow position of buy to let rental businesses..."

Before any decisions are made by landlords, consideration needs to be given to areas such as income tax, corporation tax, stamp duty land tax (SDLT), inheritance tax and the annual tax on enveloped dwellings (ATED), as all of these could affect the tax efficiency of a property business.

We're working with Ernst & Young LLP to provide further detail on these key considerations.

Adrian Moloney
Group Sales Director
OneSavings Bank

Who will this affect?

The changes apply to individual landlords, partnerships and limited liability partnerships, and trustees or beneficiaries of trusts who incur finance costs in respect of UK and overseas residential property. The changes haven't affected landlords holding commercial property or properties that qualify as furnished holiday lettings. Importantly, the changes also didn't affect residential property owned through a company.

Whilst many buy to let owners have already been affected, due to the way the changes have been introduced gradually, the impact of the restriction may only just be being felt as tax reporting and payments catch up to the changes in legislation.

> "Buy to let owners need to understand how these changes have already affected their rental portfolio"

Buy to let owners need to understand:

- How these changes have already affected their rental portfolio
- How they will be impacted as of 6 April 2020 (as the phased introduction of the restriction is completed)
- What steps can be taken to mitigate their exposure to taxation

A reminder of the previous rules

Prior to April 2017, the full amount of finance costs, which were incurred wholly and exclusively for the purpose of the rental business, could be deducted from gross rental income to reduce taxable rental profits. This included mortgage interest payments, and many buy to let investors accordingly amassed significantly leveraged portfolios that naturally required substantial mortgage interest payments to maintain.

Under the old rules, mortgage interest charges could be set against the landlord's income tax exposure to provide relief. The deduction reduced the landlord's rental income that would be liable to income tax on property income.

Under the previous rules, landlords could also claim other allowable deductions from rental income, such as rates, insurance, ground rents, repairs, renewals, management and professional fees and costs of services provided.

"Under the previous rules, landlords could also claim other allowable deductions from rental income..."

What are the current rules?

> **“The changes are already having an effect...”**

Individual landlords, general partnerships and limited liability partnerships are no longer able to claim the full amount of their finance costs as a deduction from rental income to calculate the taxable rental profit. It’s been replaced with a basic rate tax reduction from the individual’s/partner’s income tax liability.

The changes are already having an effect as the restriction has been phased in since 6 April 2017, coming into effect in full on 6 April 2020.

As the effect of the changes will result in an increase in the tax liability for many landlords, those affected should consider the impact of these changes on the cash flow and profitability of their rental portfolio.

Some landlords may find that the tax they pay on their rental income has risen (or will rise) to in excess of 100% of their overall rental profit. This risk is particularly prominent for those with low yielding property. The restriction is being phased over four tax years to apply as follows:

Phased finance cost restriction

Tax year	Finance cost reduction	Basic rate reduction
2017/2018	75%	25%
2018/2019	50%	50%
2019/2020	25%	75%
2020/2021	NO DEDUCTION	100%

What are the new rules? - continued

The restriction of tax relief only applies to expenditure incurred on finance costs. Other expenditure incurred that qualifies for a deduction (repairs, for example), should not be affected.

Landlords should now be familiar with the changes to the wear and tear allowance that were implemented.

As a reminder, the wear and tear allowance has been replaced with a relief that enables residential landlords to deduct the costs they actually incur on replacing furnishings in the property.

It should be noted that not only companies are affected by these rules. Individuals, general partnerships and limited liability partnerships will all be impacted.

> "Landlords should now be familiar with the changes to the wear and tear allowance..."

Finance costs explained

The definition of finance costs is broader than simply interest incurred on a mortgage. This includes incidental costs incurred in obtaining loan-finance, such as arrangement fees, refinancing fees and legal costs incurred.

> "The definition of finance costs is broader than simply interest incurred on a mortgage..."

It should also be noted that finance costs for these purposes aren't only restricted to costs incurred in relation to a mortgage or loan. They also include costs incurred in respect of loans used for the purpose of repairs and improvements.

Key implications for landlords

Generally, these changes have given rise to higher income tax liabilities for effected landlords. As a result of the reduction of allowable expenditure, taxable rental income has increased, resulting in an increase in their total taxable income.

For basic rate taxpayers the increased taxable rental income may have moved them into the higher rates of tax. An increase in taxable income could also affect other allowances and income assessed benefits, such as child benefit.

Landlords therefore need to consider the impact of increased tax liabilities on the cash flow and profitability of the rental business as, whilst the economic profit of the property may not have changed, it may have to fund a higher tax liability as the rules are phased in.

Landlords may consider transferring existing rental properties into a company or acquiring new property within a company. In spite of the changes having been introduced it's not too late to consider this structuring option in view of future rental profits although professional advice is crucial ahead of any affirmative action.

Landlords can stand to benefit from incorporating a portfolio; however, they must consider the implications across a range of different taxes, including:

- Capital gains tax
- Stamp duty land tax (SDLT)/land and buildings transaction tax
- Inheritance tax
- Income tax and corporation tax
- Annual tax on enveloped dwellings (ATED)

Capital gains tax

A transfer of property by a landlord into a company they control is a disposal at market value for capital gains tax (CGT) purposes. This means that when transferring ownership of their buy to let property into a company, a landlord could incur a tax charge of up to 28% on a property's market value (less any purchase costs) even where no cash changes hands.

The market value at the date of transfer will become the base cost of the property on any future sale. If a property is sold by the company in the future, any capital gain will be taxable at corporation tax rates.

Certain relief from capital gains tax on transfer of ownership may be available, and specialist advice should be sought in order to explore the availability of such relief. For example, gains can be wholly or partly deferred by "incorporation relief" where certain conditions are met, but this can be a complex area. Where incorporation relief is claimed, the deferred gain is rolled over and set against the base cost of the shares in the new company. Therefore, this gain will effectively be charged when the individual eventually sells the shares.

Incorporation relief could be available to both individual landlords and those owning property via a general partnership or LLP; however, it is a complex relief and is not available in all cases. Specialist advice should therefore be taken.

Non-UK resident landlords should be aware of their obligation to report any disposals of UK property to HMRC via a non-resident CGT return. Further information can be found in the subsequent section concerning non-resident landlords.

Please note that from 6 April 2020, many disposals of UK residential property (which are not an individual's main home) will need to be reported to HMRC within 30 days of the disposal. Landlords are therefore likely to have a tax reporting obligation when selling buy to let properties. Any capital gains tax due will need to be calculated and will also need to paid to HMRC within 30 days. Penalties will be charged for a failure to meet the deadline and interest will be payable on late paid tax.

NB: Where full private residence relief is available in respect of a disposal of a main home, there should be no reporting obligation or need to pay tax in respect of the disposal.

Stamp duty land tax (SDLT)/land and buildings transaction tax

Whether a buy to let property is purchased personally, via a company, or transferred to a company (including situations where no cash consideration is transferred), SDLT could be payable at rates of up to 15%. If, however, ownership is transferred to a company, this could potentially fall to 4% in certain circumstances where six or more residential properties are transferred as part of the same transaction.

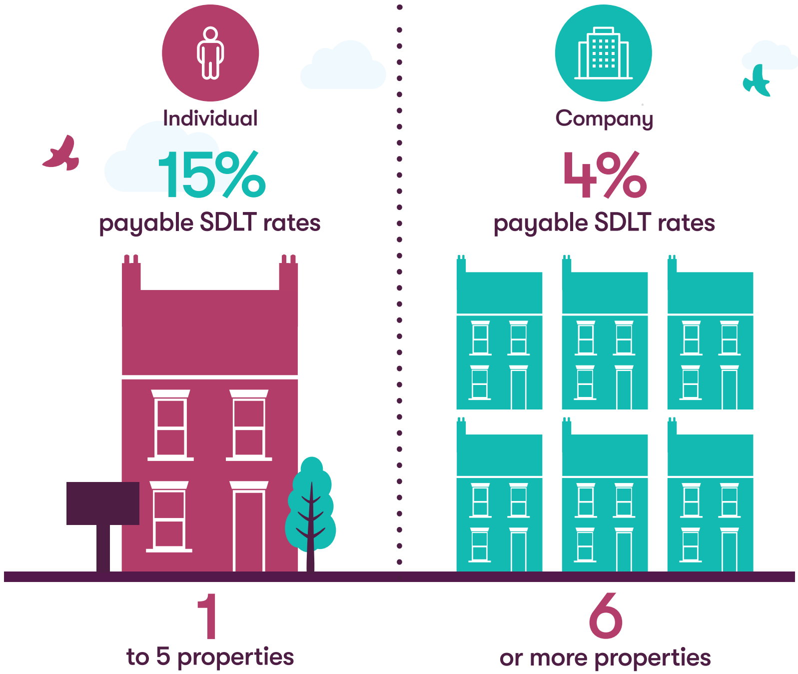
If the properties are owned by a partnership, certain complex alternative provisions in relation to SDLT on transfer of ownership may be in point. For example, where a landlord owns properties via a partnership, in certain circumstances there are special provisions which could allow a transfer to a company to take place free of stamp taxes. However, these provisions are complex and specialist advice must be taken as relief is not guaranteed.

Higher rates of SDLT will be charged on purchases of additional residential properties (above £40,000), such as buy to let properties and second homes.

The higher rates will be 3% above the current SDLT rates. The higher rates do not apply to corporates or funds making significant investments in residential property.

The Government has decided against introducing an exemption for large scale investors. However, it's understood that the existing provision under which the non-residential SDLT rates will apply to purchases of six or more dwellings in a single transaction will continue to apply.

The Chancellor of the Exchequer announced in his budget on 11 March 2020 the Government's intention to introduce a 2% SDLT surcharge for non-UK residents purchasing UK property. At the time of writing, it's understood that this will apply from April 2021.



Inheritance tax

Where a property business is transferred into a company, the value of the shares in that company will form part of the individual's estate, rather than the value of the underlying properties.

Shares in a residential property investment company are within the scope of inheritance tax, whereas shares in a property development company may qualify for 'business property relief'. Individuals who have property companies with a mixed purpose, carrying out both investment and development activities, are under a risk that investment activity might affect availability of the relief. Advice should be sought on how to manage this risk.

Individuals should therefore seek advice around whether the value of their estate can be reduced for inheritance tax purposes.

"Transferring ownership of a property business to a company could be an opportunity for an individual to reduce their estate for UK inheritance tax purposes"

Income tax and corporation tax

If an individual landlord or partnership transfers the ownership of their properties into a company, the rates at which they will pay tax on their rental profits will change.

Corporation tax, which is currently 19%, will be due on profits rather than income tax (up to 45%). If the landlord wants to take cash out of the company, an additional layer of tax will be due on any dividends paid out of the company (up to 38.1% based on rates applying from April 2016) meaning that both taxation for the company and individual must be considered when assessing costs associated with operating via a company.

Additional income and corporation tax rules apply to non-UK resident landlords outlined in the subsequent section.

Landlords and partnerships should therefore weigh up whether it would be more tax efficient to hold their properties personally or via a company, factoring in the two layers of taxation pertaining to both the company and the individual.

> “...landlords should therefore weigh up whether it would be more tax efficient to hold their properties personally or via a company...”

Annual tax on enveloped dwellings (ATED)

ATED is an annual tax payable by companies that own UK residential property (a dwelling) valued above a certain amount. It was initially introduced for properties valued at in excess of £2m.

Since 1 April 2017, companies owning properties worth more than £500,000 have been subject to an annual tax charge.

However, specific exemptions to the ATED charges apply, including where the properties are let to unrelated third parties on a commercial basis. Where an exemption from ATED applies, the ATED form must be filed annually and the exemption claimed. ATED does not apply to individuals, trusts or partnerships. Broadly the same exemptions can also apply to the enhanced 15% SDLT charge faced by companies, referred to earlier.

As of 6 April 2019, ATED related CGT, which applied to post April 2013 capital gains on UK residential property to the extent that they related to property that has been liable to ATED, has been abolished.

“Since 1 April 2017, companies owning properties worth more than £500,000 have been subject to an annual tax charge”

An update for non-resident landlords

Whilst the use of a company as a holding structure can provide tax efficiencies, it's important to keep in mind how this may impact filing requirements. In spite of not being UK resident, non-resident individuals who own UK property still have a host of reporting requirements in respect of their UK property interests. These rules too have undergone changes in recent years and the rules will differ based on whether properties are held directly or through an entity such as a company.

"In spite of not being UK resident, non-resident individuals who own UK property still have a host of reporting requirements in respect of their UK property interests"

Non-resident CGT (NRCGT):

A non-UK resident person needs to inform HMRC within 30 days if they have disposed of UK land or property (residential or commercial) via a NRCGT or Corporation tax (CT) return depending on the ownership structure. A reporting obligation may also arise where a non-UK resident person disposes of shares/an interest in a 'property rich entity'.
An NRCGT return (for individuals) must be submitted within 30 days of conveyancing for all UK land and property disposals by non-UK residents — even if there is a loss, no tax to pay, or the individual is registered for self-assessment. If tax is due this may also be payable within 30 days of conveyancing.

From 6 April 2019, all non-UK resident companies disposing of UK property will be subject to corporation tax (19%) on disposal, and be required to register for CT and report as part of a UK CT return, as well as submitting tagged (iXBRL) accounts.

From 6 April 2019 the scope of non-resident CGT has been expanded and now also includes commercial properties and disposals of shares in property rich companies, not just UK residential property.

An update for non-resident landlords - continued

Income tax:
Rental income from UK properties is taxable in the UK regardless of whether the owner is UK resident. Generally, where a letting agent acts for a non-resident landlord, they are mandated to withhold basic rate tax from rental income, which will be paid to HMRC (the non-resident landlord, or 'NRL', scheme). The letting agent isn't able to account for tax-deductible expenses that may be incurred as a landlord, and as such, paying tax in this manner can result in additional tax being paid.

An application may be made to HMRC such that the landlord may receive rental income gross. The landlord will still have a UK filing/tax obligation in respect of the UK rental income received, which can be met through the submission of a UK self-assessment return (allowing tax-deductible expenses and annual allowances to be utilised).

From 6 April 2020, the NRL scheme for companies will be moving into the CT regime, which will require the company to register for CT and submit annual CT returns to report rental income.

In addition, from April 2020, non-UK resident companies will be subject to UK corporation tax (rather than income tax) on rental income profits.

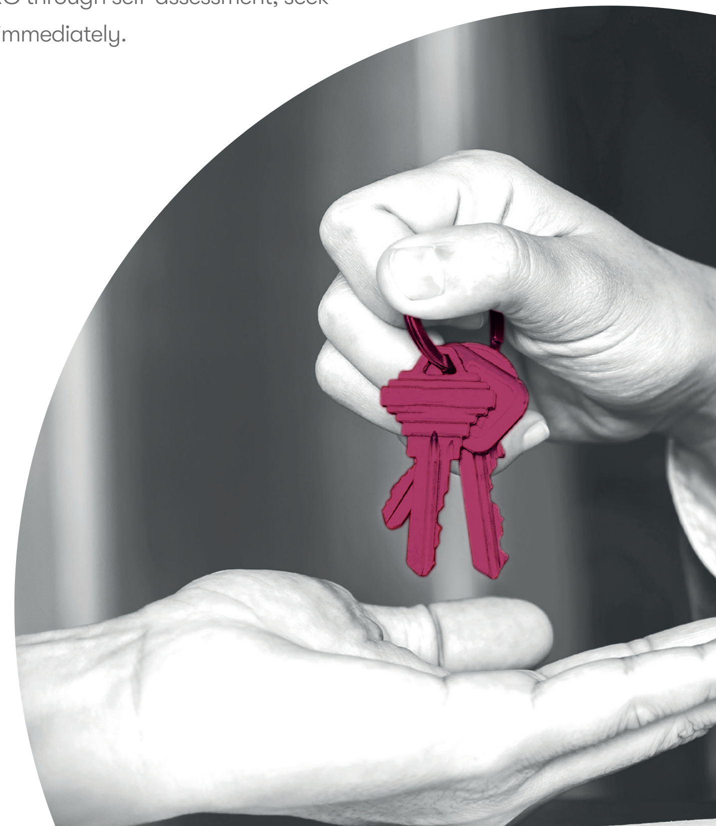
Action points

New landlords should seek specialist advice before purchasing property in order to ascertain whether it's more beneficial from a tax perspective, for example, to purchase via a company or directly, with all relevant taxes are considered.

Existing landlords
Prior to transfer, existing buy to let landlords should seek advice around the implications of transferring their existing buy to let properties into a company. They should be aware of how this will change the taxation of rental profits, tax charges that could arise as part of the transfer, potential ATED charges, and the impact on their estate for inheritance tax purposes.

Compliance obligations
Both new and existing landlords should consider their compliance obligations when exploring the use of a corporate structure as filing statutory accounts and corporation tax returns can be an arduous process. The flyer is primarily focused on tax matters concerning UK residents. However, as outlined above, non-UK residents should also be aware of their UK tax obligations.

If you're concerned you may have an obligation to report your income to HMRC through self-assessment, seek professional advice immediately.



The content of this note does not constitute tax advice.
Formal advice should be sought prior to any planning being undertaken.

Example

A

In 2020/2021 an individual landlord owns a buy to let property worth £350,000, annual rents of £17,400, expenditure of £5,900 and finance costs of £9,700. The landlord also has a salary of £45,000.

Under current rules, the landlord's tax position would be as follows:

Direct ownership		
Income	17,400	
Expenditure	-5,900	
Gross profit		11,500
Income tax: 11,500 @40%	4,600	
Basic rate reduction: 9,700 @20%	-1,940	
Tax due on rental profits		-2,660
Finance cost		-9,700
Individual's net cash		-860

Company ownership		
Income	17,400	
Expenditure	-5,900	
Gross profit		11,500
Finance cost		-9,700
Corporation tax: 1,800 @19%	342	
Tax due on rental profits		-342
Post-tax profit (paid out as dividend)		1,458
Tax payable on dividend @32.5%	0	
Individual's net cash		1,458

***We've assumed no other dividends will be paid out in our example.**

Example

B

In 2020/2021 an individual landlord owns four buy to let properties worth £1.8m, annual rents of £72,000, expenditure of £24,500 and finance costs of £40,000. The landlord also has a salary of £60,000.

Under current rules, the landlord's tax position would be as follows:

Direct ownership		
Income	72,000	
Expenditure	-24,500	
Gross profit		47,500
Income tax: 11,500 @40%	19,000	
Basic rate reduction: 9,700 @20%	-8,000	
Tax due on rental profits		-11,000
Finance cost		-40,000
Individual's net cash		-3,500

Company ownership		
Income	72,000	
Expenditure	-24,500	
Gross profit		47,500
Finance cost		-40,000
Corporation tax: 7,500 @19%	1,425	
Tax due on rental profits		-1,425
Post-tax profit (paid out as dividend)		6,075
Tax payable on dividend @32.5%	1,324	
Income tax on dividend		-1,324
Individual's net cash		4,751

Example

C

In 2020/2021 an individual landlord has a buy to let property portfolio worth £5.4m; receiving annual rents of £189,000, expenditure of £64,250 and finance costs of £105,000. The landlord has no other income.

Under current rules, the landlord's tax position would be as follows:

Direct ownership		
Income	189,000	
Expenditure	-64,250	
Gross profit		124,750
Income tax: 50,000 @20%	10,000	
Income tax: 75,750 @40%	29,900	
Basic rate reduction: 105,000 @20%	-21,000	
Tax due on rental profits		-18,900
Finance cost		-105,000
Individual's net cash		850

Company ownership		
Income	189,000	
Expenditure	-64,250	
Gross profit		124,750
Finance cost		-105,000
Corporation tax: 19,750 @19%	3,753	
Tax due on rental profits		-3,753
Post-tax profit (paid out as dividend)		15,998
Tax payable on dividend @7.5%	1,050	
Income tax on dividend		-1,050
Individual's net cash		14,948

***We've assumed no other dividends will be paid out in our example.**

The above illustrations are based on the position in 2020/21 when the changes to law will have been fully phased in. An annual tax-free allowance for dividends is currently £2,000 (as off 6 April 2018). The dividend rates in the examples are based on the effective rate of tax after allowances and tax credits.

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