TAX CHANGES AFFECTING LANDLORDS

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Content

This guide is based on our understanding of current taxation law and HM Revenue and Customs practice, which may change in the future. The content of this article is not, nor is it intended to constitute, investment, tax or legal advice.

Introduction

Following on from the changes announced in the Summer Budget of 2015, this article looks at the changes affecting Landlords who own property in a personal capacity, rather than through a corporate structure or partnership. And I'm afraid it's bad news.

The Chancellor announced that the amount of income tax relief landlords can get on residential property finance costs (such as mortgage interest) will be restricted to the basic rate of tax. However, these changes will be imposed on individual landlords only, and they will not affect investment properties acquired by, and held in, a company.

The changes will start to have an impact from the 2017/18 tax year, but transitional arrangements mean that the full force of the changes will not be implemented until the 2020/21 tax year.

Finance costs changes

CHANGES

The changes imposed will apply to:

- Individuals who let residential properties (unless the property is a furnished holiday letting) and incur finance costs such as mortgage interest
- Companies acting in fiduciary or representative capacity, and incur finance costs.

The changes are:

- A restriction preventing the deduction of finance costs arising from 'dwelling related loans'
- The introduction of a 'tax reducer', limiting the relief to the basic rate of tax
- Changes to be phased in from 2017/18 over a 4 year period.

Currently when calculating taxable profits, all finance costs (such as mortgage interest) are allowable deductions. When the new legislation comes into force, this will no longer be the case, with the effect of increasing your taxable profits and as a consequence tax payable.

In place of the allowable finance costs, a tax reducer will be introduced. This is a fundamental shift as it acts as a reduction to the amount of tax payable rather than as a reduction in taxable profits.

The tax reducer is calculated at the basic rate of tax, of the disallowed finance costs. The basic rate of tax is currently at 20%.

How the tax reducer will work:

- The basic tax rate will be applied to the smaller of:
    - The finance costs disallowed when calculating rental profits, or
    - The rental profits of the year (net of any brought forward losses)
- The maximum tax reduction an individual can receive will be restricted to an amount equal to the individual's general income, ignoring personal allowances. In other words a

refund is not available
    - General income is defined as all income except interest and dividends
- Any proportion of the tax reducer that is unavailable due to the general income restriction can be carried forward and added to future amounts eligible for relief
- The same will be extended to individuals taking out loans to invest in a partnership that then uses money for residential property purposes.

BASIC EXAMPLE

To show the effect of the changes an example has been shown below, based on the following assumptions:

- Gross rental income of £50,000 per annum
- Finance costs are £25,000 per annum
- The individual is a higher rate tax payer

	Current Legislation	New Legislation
Gross rental income	£50,000	£50,000
Finance costs (allowable)	(£25,000)	-
Rental profits	**£25,000**	**£50,000**
Tax @ 40%	£10,000	£20,000
Tax reducer		
(£25,000 x 20%)		(£5,000)
Net tax	£10,000	£15,000

PHASING IN

This new legislation is a significant shift from the current position and will result in the increase of tax payable for these landlords. Consequently, to allow landlords time to adjust the governments are phasing the changes over a 4 year period, starting from the 2017/18 tax year.

The phasing period will limit the reduction in the allowable finance costs by 25% per annum. As the tax reducer is calculated as a function of the disallowed finance costs there is a 25% annual increase to the size of the tax reducer. This is shown in the table below:

Tax year	Proportion of finance costs allowable	Tax reducer percentage of finance costs used
2017/18	75%	25%
2018/19	50%	50%
2019/20	25%	75%
2020/21	0%	100%

Examples

EXAMPLE 1

An example based on an individual who works full time and a property investor/landlord on a part-time / ‘hobby’ basis.

- Gross rental income of £50,000 per annum
- Non-finance costs are £10,000 per annum
- Finance costs are £25,000 per annum
- Salary income of £70,000

The following is shown in the table below:

- The 2016/17 tax year shows the current legislation
- From 2017/18, the allowable finance costs are reduced by 25% per year. From 2020/21 this will continue to be nil. Please note all non-finance costs are allowable
- As the individual is a higher rate tax payer, rental profits are taxable at 40%
- From 2017/18 the tax reducer has been increased by 25% per year. From 2020/21 this will continue to be 100%. The tax reducer has been calculated at the basic rate of tax, which is currently 20%
- As this individuals income starts to rise above £100,000, they will start to lose their personal allowance by £1 for every £2. This is legislation that is currently in place.

Please note I have kept the 2016/17 tax rates throughout, for comparable illustrations.

	2016/17	2017/18	2018/19	2019/20	2020/21
Gross rental income	£50,000	£50,000	£50,000	£50,000	£50,000
Non-finance costs	(£10,000)	(£10,000)	(£10,000)	(£10,000)	(£10,000)
Finance costs (allowable)	(£25,000)	(£18,750)	(£12,500)	(£6,250)	-
Rental profits	£15,000	£21,250	£27,500	£33,750	£40,000
Tax @ 40%	£6,000	£8,500	£11,000	£13,500	£16,000
Tax reducer					
(£25,000 x 20%) x 25%		(£1,250)			
(£25,000 x 20%) x 50%			(£2,500)		
(£25,000 x 20%) x 75%				(£3,750)	
(£25,000 x 20%) x 100%					(£5,000)
Reduction in P.A over £100k					
(£3,750 x ½) x 20%				£375	
(£10,000 x ½) x 20%					£1,000
Tax payable	£6,000	£7,250	£8,500	£10,125	£12,000
Effective tax rate	40%	48%	57%	68%	80%

The result of the changes in legislation will double this individuals tax payable by 2020/21, resulting in an effective tax rate of 80%.

EXAMPLE 2

An example based on a husband and wife, who are property investors/landlords full time, who hold a sizeable portfolio with high mortgage interest costs.

- Gross rental income £450,000 per annum
- Non-finance costs are £120,000 per annum
- Finance costs are £250,000 per annum
- No other income.

The following is shown in the table below:

- The 2016/17 tax year shows the current legislation
- From 2017/18, the allowable finance costs are reduced by 25% per year. From 2020/21 this will continue to be nil. Please note all non-finance costs are allowable
- Rental profits are split between the husband and wife equally
- Personal allowances are provided. This is then reduced by £1 for every £2, when the individual profits rise above £100,000, until the personal allowance is lost

- Taxation has been applied using the current rates for 2016/17. These are to provide a comparative, and the rates in 2020/21 are expected to be different from those in 2016/17
- From 2017/18 the tax reducer has been increased by 25% per year. From 2020/21 this will continue to be 100%. The tax reducer has been calculated at the basic rate of tax, which is currently 20%
- Multiplied the tax payable by 2 to get the total tax payable for the couple.

Please note I have kept the 2016/17 tax rates throughout, for comparable illustrations.

	2016/17	2017/18	2018/19	2019/20	2020/21
Gross rental income	£450,000	£450,000	£450,000	£450,000	£450,000
Non-finance costs	(£120,000)	(£120,000)	(£120,000)	(£120,000)	(£120,000)
Finance costs (allowable)	(£250,000)	(£187,500)	(£125,000)	(£62,500)	-
Rental profits	**£80,000**	**£142,500**	**£205,000**	**£267,500**	**£330,000**
Profit split each (/2)	**£40,000**	**£71,250**	**£102,500**	**£133,750**	**£165,000**
Personal Allowance	(£11,000)	(£11,000)	(£11,000)	(£11,000)	(£11,000)
Lost P.A over £100k x ½			£1,250	£11,000	£11,000
Taxable profits each	**£29,000**	**£60,250**	**£92,750**	**£133,750**	**£165,000**
Taxation					
Basic rate @ 20%	£5,800	£6,400	£6,650	£8,600	£8,600
Higher rate @ 40%		£11,300	£23,800	£36,300	£42,800
Additional rate @ 45%					£6,750
Net tax	**£5,800**	**£17,700**	**£30,450**	**£44,900**	**£58,150**
Net tax for the couple (x 2)	£11,600	£35,400	£60,900	£89,800	£116,300
Tax reducer		(£12,500)	(£25,000)	(£37,500)	(£50,000)
Tax payable for the couple	**£11,600**	**£22,900**	**£35,900**	**£52,300**	**£66,300**
Effective tax rate	29%	57%	90%	131%	166%

In this example, once the legislation is in force and the transitional arrangements completed, the tax payable will be £66,300 on what is actually only £40,000 of profits.

Depending on the couples' circumstance, it is possible that by the time they get to 2020/21 one, or even more of their investment properties may be required to be sold in order to meet the increased tax liabilities. However, selling properties may expose them to further issues. Capital

Gains Tax will be payable on gains above the current Capital Gains Tax allowance (currently £11,100 for the 2015/16 tax year).

Individual v Company

TRANSFERING INVESTMENT PROPERTIES TO A COMPANY

Most people will naturally think that transferring all their properties into a company will reduce their tax liability, and they would be right. Whilst it would reduce their income tax liability, transferring an investment property from an individual to a company would result in a sale from the individual to the company. This will mean the individual will have to pay Capital Gains (CG) tax and the company will be subject to Stamp Duty Land Tax (SDLT). Furthermore, the government have put in place legislation preventing individuals claiming such claims as incorporating relief and entrepreneurs' relief, however, it is still unclear how tough they will be on such claims.

Clearly an understanding and a calculation of the tax consequences need to be undertaken to ascertain the best course of action. Understandably it is not possible to consider all possible scenarios within this article.

If you have any questions or would like to work through your particular circumstances or scenario then I'd be happy to discuss these with you. Please see my contact details at the end of this article.

TAXATION UNDER A COMPANY

To provide a comparison between the tax payable by an individual and that payable by a property holding company I have taken Example 2 above and shown the taxation (with the new dividend reforms that come into action in April 2016). Again, I have used the 2016/17 tax rates for comparable reasons throughout.

	Ltd
Gross rental income	£450,000
Non-finance expenses	(£120,000)
Finance costs (allowable)	(£250,000)
Joint salary	(£21,200)
Company NIC @ 13.8%	(£2,926)
Taxable profits	£55,874
Corporation Taxation @ 19%	£11,175
Available for distribution	£44,699
Split distribution as dividends	£22,350
Dividends taxable @ 7.5%	£1,676
Tax payable	
Company NIC	£2,926
Corporation tax	£11,175
Dividend tax (x 2)	£3,352
Total tax payable	£17,453

Before the dividend reform, the taxation for an individual would have been slightly advantageous, and with the additional administration burden that a company brings with it, many investors may have opted to buy investment properties within their own names.

Going forward the tax payable is clearly beneficial to purchase property within a property holding company, however, the position is far less clear-cut when looking at whether to hold existing properties as an individual, or to purchase them through a company.

Getting advice

GET ADVICE EARLY

As with all complex tax issues, particularly where there are significant numbers of possible scenarios and permutations, it is important the right advise is sought and have the appropriate calculations undertaken, before any changes are implemented.

As the examples I have used show the legislative changes are going to result in more tax being paid, a full understanding of the implications on your overall income levels is clearly critical.

Contacts

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