Landlord & home owner's tax planning road map 2016-17

What are your choices as the 6 April 2016 tax changes start to bite?

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Introduction

Chancellor George Osborne rather rashly committed to no increases in VAT, income tax and National Insurance during the five-year term of the present government when he presented his summer budget speech 2015. Having nailed his foot to the floor, he has subsequently devised increasingly diverse tax changes to plug the continuing shortfall in tax revenues, and balance his books. Add to this the uncertainty following the Brexit vote and it looks as if landlords will bear more than their fair share of tax increases this year. 33333333333

This guide will take you through various aspects of a property business and highlight the tax and other changes that landlords and multiple property owners will face due to legislation already disclosed by the Finance Bill 2016, or otherwise working its way through the legislative process. Landlords, especially those who have borrowed heavily to grow their property portfolio, may be faced with hard choices in the coming years. Business building strategy and tax planning in this sector needs to be refocussed so that longer term planning goals can be redrawn with a modicum of confidence.

Throughout this guide you will see three icons. They point to areas of relevance for three distinct types of property investor:

The buy-to-let landlord

The furnished holiday lets landlord

Home owners with more than one property

The title for each section of the guide will display one or more of these icons.

Each section of the guide will cover the areas set out in the index that follows. Within each section the taxes that need to be considered and some of the planning options that you may want to consider are discussed.

Please note that this publication is not an alternative to a face to face consultation with a professional advisor. We have used reasonable care and skill in assembling the information in this document. Advice implied in the text cannot be tailored to all personal circumstances or particular situations. There may also be factors relevant to your particular circumstances which fall outside the scope of some or all of the strategies highlighted. Accordingly, the material provided on this document does not constitute personal advice. You should not rely solely on this material to make (or refrain from making) any decision or take (or refrain from taking) any action. If, after reading

this guide, you need clarification regarding any of the issues raised, please call; see the contact details printed on the guide cover page.

Purchasing property

Stamp Duty Land Tax and Land & Buildings Transaction Tax

One of the major, recent changes that will affect buyers of additional residential property, whether to let or use as a second home, is the introduction of higher rates of Stamp Duty Land Tax (SDLT) – applies in England, Wales and Northern Ireland – and, Land & Buildings Transaction Tax (LBTT) – applies in Scotland.

From 1 April 2016, the new rates of SDLT for additional residential property purchases are:

Purchase price banding	Higher SDLT rates from 1 April 2016
Up to £40,000	0%
£0 to £125,000	3%*
£125,001 to £250,000	5%
£250,001 to £925,000	8%
£925,001 to £1,500,000	13%
Over £1,500,000	15%

*SDLT rates apply to the nominated bandings apart from properties purchased over £40,000 and up to £125,000 which will pay 3% on the total purchase price included in the £0 to £125,000 banding.

For example, the SDLT payable for the purchase of a residential property subject to the higher rates for £300,000, May 2016, would be £14,000. This is made up as: 3% on the first £125,000, 5% on the next £125,000, and 8% on the next £50,000. This is considerably higher than the SDLT payable for similar properties prior to 1 April 2016.

In Scotland, the LBTT legislation has been amended in a similar way. Usefully, the additional LBTT charge is referred to as the Additional Dwelling Supplement (ADS).

The ADS is calculated as 3% of the purchase price for relevant transactions.

What property purchases are subject to these higher rates of SDLT?

Essentially, when an individual buys more than one residential property they will have to pay the higher rates of SDLT. This can create unexpected results. For example:

- If Jane decided to purchase her first buy-to-let property, and she was living in rented accommodation (didn't own any other residential property) she would not have to pay the higher rates of SDLT.

- If John decided to sell his home, but due to a slow market he was unable to sell before the purchase of the replacement property, then the higher SDLT rates would apply to the replacement home. As long as the existing home is sold within 3 years of the replacement purchase then the additional SDLT can be reclaimed.
- The higher rates will not apply to purchases of property under £40,000 or purchases of caravans, mobile homes and houseboats.
- If John and Jane were married, they would be treated as a single unit for SDLT purposes. Accordingly, John would be liable for the higher rates if he bought a residential property and Jane already owned one.
- Parents helping their children with a property purchase will need to take care when organising the legalities. If they buy a home for children to live in, or buy in joint names with their children, the higher rates of SDLT will apply.

What about property purchases in Scotland?

The LBTT legislation largely mirrors the SDLT regulations but there are exceptions. For example, the ADS can be reduced if multiple dwelling are purchased together. Also the ability to claw back ADS on the purchase of a replacement main residence, before the existing residence is sold, has to be completed within 18 months, rather than the 3 years if SDLT applies.

What about companies, do they pay the higher rate of SDLT or ADS?

Yes, they do! In fact, when the higher charges were first mooted, it was hinted that significant corporate investors would be exempted from the extra stamp duty, but this is not to be the case. Companies are even required to pay the higher rates of SDLT when acquiring their first residential property.

PLANNING NOTE: Take advice on the SDLT/LBTT/ADS implications of your property acquisition before completing your purchase. What was previously a reasonably straight forward tax is now increasingly complex. The 3% surcharge is intended to dampen demand for buy-to-let properties and second homes. It is a cost you need to quantify before signing on the dotted line.

Financing property acquisitions

One of the most challenging and surprising announcements in recent budgets was the proposed reduction in income tax relief for the cost of mortgage and loan interest to buy property or any other asset used in a property rental business.

The changes are due to start 6 April 2017 and will be fully implemented by 5 April 2020.

In a nut-shell, interest relief will gradually be restricted so that from 6 April 2020 landlords will only be able to claim income tax relief on these payments at basic rate, currently 20%. This will have a significant negative impact on the cash flow of property businesses run by individuals, who up to 5 April 2017, will have enjoyed tax relief at their highest rate of income tax on interest payments.

There is also a nasty twist in the way in which the legislation making these changes will apply and landlords who have borrowed heavily to grow their property portfolio will face potentially, crippling increasing in their tax payments. This is how the changes will work.

Loan and mortgage interest charges will no longer be treated as a business expense, instead a 20% tax credit, based on the interest paid, will be deducted from any income tax due. Because the loan interest is no longer a business expense a landlord's profits from his property business could increase dramatically depending on the amount of mortgages and loans the landlord has taken out. In fact, the landlord may find that they become higher rate or additional rate taxpayers. An example will clarify this point:

Sohail has a number of rental properties that will bring in rents of £200,000 for 2016-17. His annual interest charges to purchase these properties is £160,000. He is therefore taxed on net property income profits of £40,000 for 2016-17. If this was his total income his income tax liability for 2016-17 would be £5,800 as a basic rate tax payer. Sohail's take home pay, after tax is therefore £34,200 (£40,000 - £5,800).

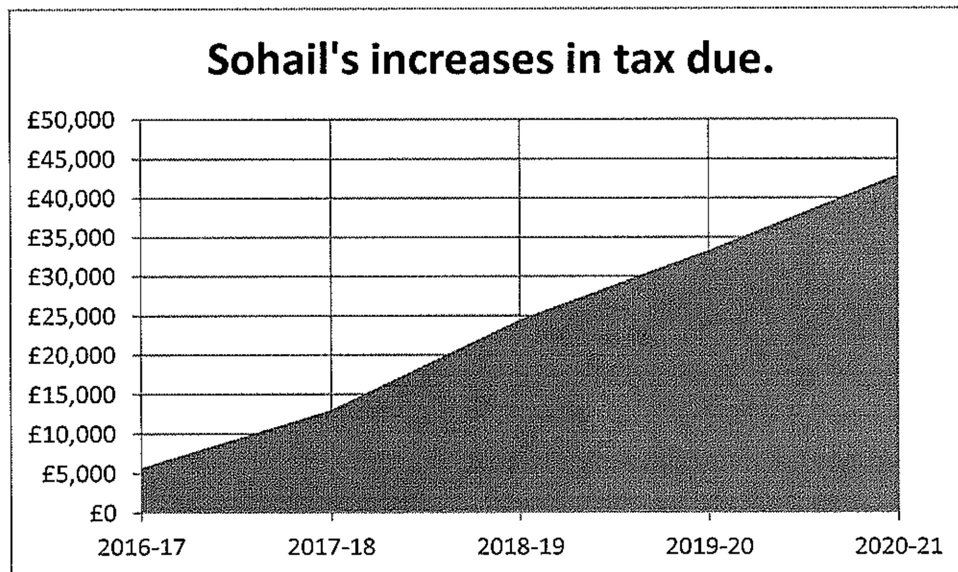
If Sohail's property rents and interest charges remained the same for the next four years, in the tax year 2020-21, with no increase in rents, a reasonable estimate of his income tax payable would be a massive £43,000! This would totally eliminate his annual earnings of £40,000 and he would have to fund both the deficit of £3,000 and his living expenses from savings or by increasing his income from other sources.

Why, in the above example, is there such a large increase in Sohail's income tax payable even though his actual earnings after interest charges remain the same?

The main factor is the disallowance of his annual £160,000 interest charges as a business expense in 2020-21, and the restriction in income tax relief to 20% of the interest paid. In effect, Sohail's annual, taxable income becomes £200,000. As a direct result of this increase in income the following income tax changes occur:

- Significant parts of this £200,000 are taxable at 40% and 45% income tax rates.
- As Sohail's income exceeds £100,000 by a sufficient margin, he will no longer be able to claim a personal income tax allowance.

The following graph shows how Sohail's income tax increases over the transitional period.



An added sting in the tail for Sohail and his family is the loss of the child benefit that they claim for two school age children. When one of the parent's income exceeds £60,000, they are no longer eligible to claim.

The restriction of income tax relief will apply to individuals:

- Who let residential property in the UK or elsewhere, and
- Who are claiming a deduction for financing costs (see below for list of costs included) from April 2017, and
- Who, from April 2017, pay income tax on their property income at the higher (40%) or additional (45%) rate.

It will not apply to:

- Financing costs for purchase of furnished holiday lets or commercial property,
- Property businesses subject to corporation tax - owned by companies, or
- Individuals who pay tax on their property income at basic rate only.

Between now and the 6 April 2020 relief will be tapered as follows:

2017-18	The deduction of allowable finance costs will be restricted to 75%, with 25% being available as a basic rate income tax deduction.
2018-19	The deduction of allowable finance costs will be restricted to 50%, with 50% being available as a basic rate income tax deduction.
2019-20	The deduction of allowable finance costs will be restricted to 25%, with 75% being available as a basic rate income tax deduction.

Note: taxpayers that remain basic rate taxpayers after this change will suffer no change in their income tax position.

Finance costs include: mortgage interest, interest on loans to buy furnishings or other assets used in the property business. The definition also includes the fees incurred when taking out or repaying mortgages or loans.

Landlords have until April 2017 to consider the effects of this measure on their property businesses, and in particular the impact on their tax payments. Please contact us if you would like to explore your planning options in more detail.

PLANNING NOTE: The restrictions outlined in this section of our guide start to apply from April 2017. This does mean that landlords who have committed to high levels of borrowing in order to build their property business should start to consider their options now. We recommend an initial fact find and a calculation of the progressive effects of the changes as soon as possible so that alternative strategies can be examined in good time.

Tax and replacement furniture

The abolition of the wear and tear allowance

The government have replaced the wear and tear allowance (WTA) with a new replacement furniture relief from April 2016.

Up to 5 April 2016, landlords of fully furnished property could claim an annual deduction based on 10% of their rents to compensate them for periodic replacement of furnishings. This deduction was given even if no actual expenditure occurred. If actual expenditure was higher than the 10% WTA no additional relief was given.

As WTA was based on rents received, landlords where property values (and therefore rents) were higher, would have received an unfair advantage, as the amount of relief they could claim was inflated even though actual replacement expenditure would be the same across the UK.

This measure only affects landlords of fully furnished property. Owners of holiday let property are also unaffected as the WTA was not available to these businesses.

The new replacement furniture relief (RFR)

From 6 April 2016, landlords of fully, partly or unfurnished residential property can claim for the actual cost of replacing furnishings. The new RFR is not available to furnished holiday lets businesses.

Replacement items available for RFR include:

- Moveable furniture or furnishings, such as beds or suites,
- Televisions,
- Fridges or freezers,
- Carpets and floor coverings,
- Curtains,
- Linen,
- Crockery or cutlery,
- Beds and other furniture.

Fixtures that are part of the building and would not normally be removed if the owner sold the building would not qualify for the RFR. These fixtures include:

- Baths,
- Washbasins,
- Toilets,
- Boilers,

- Fitted kitchen units.

Additional considerations:

- The new relief only applies to replacement costs. The initial cost of furnishing a property is not included.
- The RFR is based on the replacement cost less any proceeds from the sale of the replaced item.
- Any improvement cost is excluded from RFR. For example, if a washing machine was replaced by a washer/dryer that cost £600, only the replacement cost of a similar washing machine, say £400, would be allowed.

PLANNING NOTE: Record keeping could be an issue when claiming this relief. Landlords should take care to record all replacement purchases and be able to demonstrate that there was no improvement value in the replacement cost. They should also record the sales of any replaced assets.

Incorporated property businesses

At first glance, there are compelling reasons for incorporating a property business. For example:

- Profits are taxed at corporation tax (CT) rates, presently 20%. The highest income tax rate is 45% - the highest marginal income tax rate can reach 60% if the landlord's property and other income exceed £100,000.
- Capital gains on sales of property owned by a company are taxed at 20% whereas individuals are still be taxed at 28% on similar gains.
- Consequently, higher amounts of after-tax profits can be retained in a company to fund portfolio growth, other investment opportunities, or debt reduction.
- There are declared decreases in CT rates to 19% in April 2017 and to 17% April 2020. There are no present government plans to decrease income tax rates.
- The draconian reductions in higher rate income tax relief for finance costs do not apply to companies. Finance charges continue to be a business expense for corporation tax purposes.

These simplistic comparisons are quickly swept aside if the landlord, the company owner, decides to withdraw funds from the company. Then we need to consider in what form the shareholder/director takes these funds. More about this later in this section.

Readers may remember, if they read the section on financing property transactions, that the gradual loss of higher rate tax relief for financing costs (mortgage interest etc.) – especially for landlords who have not incorporated their property business - can quickly shift earnings into the higher rates for income tax purposes.

This is the major difference between being taxed as an individual or earning your property income inside a limited company. Incorporated businesses <u>only</u> pay CT at 20% on all the property business profits; there are no further taxes to pay as long as the after tax profits are retained in the business. Landlords who own their rental properties personally are taxed at progressively higher rates of income tax even if they don't spend the after tax earnings.

So what happens if the shareholder/director of a property company runs the property business as their day-job and they need to withdraw their tax-paid income to pay their personal bills?

The most utilised method of extracting profits from a company is to take a salary or dividends, or a combination of the two. Generally speaking, director shareholders tend to take lower salaries – to avoid NIC costs – and the balance as dividends. This policy is still effective even with the advent of the new dividend allowance and the associated income tax charges for dividends in excess of £5,000 per year.

The number crunching, to determine if incorporation is going to prove an effective tax strategy for your property business, depends on a number of variables, some of which are beyond the scope of this guide. However, to whet your appetite, we have listed below some of the considerations that need to be taken into account if you want to transfer your present residential property business to a limited company:

Tax considerations – incorporating a property business

Capital gains tax (CGT)

- Property transferred to a company by an individual is a disposal for CGT purposes. The property is deemed to be transferred at market value.
- There are reliefs that can be claimed as part of the transfer process that will defer any CGT payable, but it is by no means certain that all landlords will qualify for these reliefs.
- Neither entrepreneurs' relief nor hold-over gifts relief is available for CGT purposes if it can be argued that a property rental activity is an investment activity and not a trade. This will be an inherent risk for most landlords that own residential property for rent outside a formal business structure.

SDLT – transactions in England, Wales and Northern Ireland

- Residential property transferred to a company by an individual is a chargeable acquisition for SDLT purposes. SDLT will be charged at the higher rates if the market value of the property exceeds the SDLT threshold.
- The SDLT charge will not apply if the transfer is made by a partnership.
- There are possibilities to reduce the SDLT charge if multiple properties are transferred to a limited company.

LBTT – transactions in Scotland

- LBTT will be chargeable if a residential property is transferred to a company and the seller (an individual) is connected to the buying company. In most cases LBTT will be charged based on the market value of the property transferred.
- In addition to LBTT the Additional Dwelling supplement of 3% will apply.
- There are reliefs from this charge that are similar to those quoted above for SDLT.

PLANNING NOTE: The incorporation of a residential property business should never be undertaken without discussing the CGT and stamp duty on-costs with a professional advisor. There are a number of bear-traps waiting to snare the unwary landlord.

Home owners

Stamp duty changes

Home owners, whether or not they have a property business, may be affected by the SDLT/LBTT changes mentioned at the beginning of this guide. All residential property buyers who purchase a second or subsequent property after 1 April 2016 will need to consider the additional 3% SDLT or LBTT (ADS) charge.

Indeed, there are circumstances where these additional charges will apply even if you replace your main residence. This can occur if you complete on the purchase of your new home before you complete the sale of your present home. If you subsequently sell the first property, then you can apply to have the 3% additional SDLT or LBTT repaid. But beware the time limits. They are:

- If SDLT applies the subsequent sale must be made within 3 years of the replacement property purchase.
- If LBTT applies the subsequent sale must be made within 18 months of the replacement property purchase.

An increase in the rent-a-room allowance

From 6 April 2016 the tax-free allowance increased from £4,250 to £7,500. This means you can earn up to £7,500 from renting rooms in your home without paying income tax on the rents received.

Second home owners

Home owners with more than property – for example a main residence and a holiday home for personal use – will need to consider CGT chargeable when they sell the second property.

There is still limited scope to mitigate CGT liabilities on the sale of a second home. This involves changing elections with HMRC that assert which of your properties is your principal private residence for CGT purposes. Recent changes in legislation have reduced the savings available from this "flipping" strategy.

PLANNING NOTE: As can be seen from these short notes, ownership of private residences

is by no means a tax-free zone. If you are considering the purchase or sale of a second home you may be advised to take advice on the CGT and stamp duty consequences.

Furnished holiday let (FHL) owners

For tax purposes, the ownership and letting of residential property that qualify as FHLs, are treated as a trade. Contrast this with the longer term lets of residential property that are not considered to be a trade.

Why is this distinction important?

As we have already set out thus far in this booklet, residential property letting is generally considered to be an investment activity by HMRC. Because of this judgement, many valuable tax reliefs are denied to landlords that fall into this category.

Accordingly, if you can re-jig your letting so that it does qualify as an FHL for tax purposes, then all of the CGT, IHT and income tax reliefs applicable to trading activities can be claimed. The most valuable is probably Entrepreneurs' relief. This can reduce CGT on qualifying disposals to 10% of the chargeable gain.

A quick summary of some of the tax benefits follows:

- You can claim CGT reliefs for traders including: Business Asset Rollover Relief, Entrepreneurs' Relief, relief for gifts of business assets and relief for loans to traders.
- You can claim plant and machinery capital allowances for expenditure on items such as furniture, equipment and fixtures.
- Any profits you make from your FHL trade counts as earnings for pension purposes.

Also, the 3% stamp duty (SDLT and LBTT) supplement for purchases of second homes, and the changes to the tax treatment of finance charges, do not apply to FHL property businesses.

What are the qualifying conditions for FHL benefits? They are:

- At present, before we formally leave the EU, your FHL property must be in the UK, the European Economic Area (including Iceland, Liechtenstein and Norway), and
- be furnished: should be sufficiently furnished to provide normal accommodation and be available for use when rented.

Additionally, FHL property must pass a three-part occupancy test:

1. The sum of all longer term lets of more than 31 days cannot exceed 155 days during a year.
2. The property must be available to let for at least 210 days in a year – these qualifying days should not include days that the landlord uses the property.
3. The property must be commercially let for at least 105 days a year. Days when friends or relatives of the landlord are staying at zero or reduced rates should not be included.

VAT: As FHL rents are classified as trading income, they are potentially subject to VAT. If total FHL rents received exceeded the current £83,000 VAT registration threshold, landlords would be obliged to register and add 20% VAT to their rents.

This may also drag an FHL landlord's rental income into VAT (even if the £83,000 limit is not breached) if the landlord already has a VAT registered business in his or her own name.

PLANNING NOTE: As long as the above rules are followed, the conversion of a furnished property business into a furnished holiday let business hinges on the adherence to the above conditions. The tax benefits are significant so it is well worth brainstorming, but note the VAT complication...