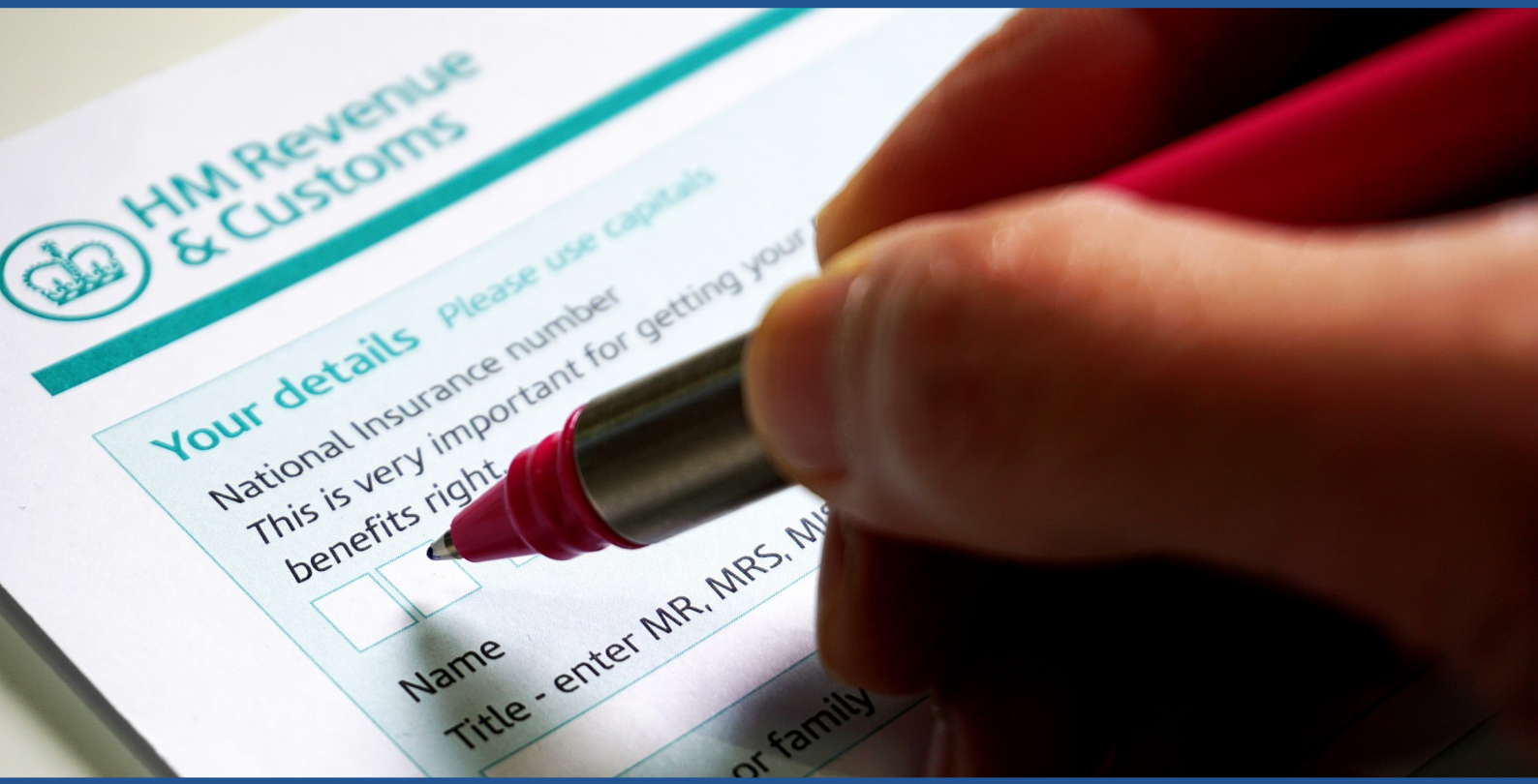
Mortgages for Business

INCOME TAX RELIEF CHANGES
FOR BUY TO LET LANDLORDS
TAX YEAR 2017/18



In this Guide

Section 24 explained
Calculating tax relief on finance costs
Impact of the changes to tax relief
Options for mitigating losses

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SEVEN TIMES
Business Moneyfacts® Award 2012-2018
Buy-to-Let Mortgage Broker of the Year

Before...

Way back in July 2015, George Osborne, then Chancellor of the Exchequer, announced his intention to create a more level playing-field between those buying a home to let, and those buying a home to live in.

He said that buy to let landlords had a huge advantage over homebuyers because they could offset their mortgage interest payments against their income, whereas homeowners could not.

He said that the better-off the landlord, the more tax relief they got.

The Chancellor believed that this situation had led to the rapid growth of buy to let which, if left unchecked, could pose a risk to the financial stability of the British economy.

The leveller came in the form of legislation…

Section 24 of the Finance (No. 2) Act 2015, which received Royal Assent on 18 November 2015, gradually reduces a landlord's ability to offset finance costs—including mortgage interest—against rental profits before calculating the amount of tax payable to HM Revenue & Customs.

This change would make most but not all landlords financially worse off…

After...

On 6th April 2017 we entered the 2017/18 tax year and thus began the first phase of the implementation of Section 24 of the Finance Act which alters the way landlords work out their taxable property profit.

When landlords come to file their income tax return for the 2017/18 tax year—probably in January 2019—they will only be able to deduct 75% of their finance costs from the taxable property profits.

The remaining 25% will be replaced with a basic rate (currently 20%) relief tax deduction. This means that some landlords, especially higher and additional rate tax payers, will pay more tax, (some basic rate tax payers could also be negatively affected). Then they will continue to pay more tax each year as the new rules are tapered in, such that by 2020/21 finance costs will not be deductible at all and the basic rate deductible will be applied to all finance costs.

Let's be clear; the finance costs we mean include—crucially—interest on buy to let mortgages, but also loans to buy furnishings and overdrafts, plus the fees and costs incurred when getting or repaying these mortgages and loans.

The first, tapering phase of the new system ends on 5th April 2018, and the actual effects will be felt in landlords' pockets when they file their tax return and pay the tax due—usually before 31st January 2019. In fact, the tax changes could tip some landlords into the next tax bracket, or even from profit to loss. Landlords who have traditionally been basic rate tax payers shouldn't assume they won't be affected.

FINANCE COSTS

Interest on:

- Mortgages
- Loans (inc loans to buy furniture)
- Overdrafts

Other costs:

- Alternative finance returns
- Fees
- Incidental costs for getting or repaying mortgages & loans
- Discounts, premiums & disguised interest

Are you affected?

YES?

If you, as an individual, let residential property you will be affected if:

- You live in the UK and the property you let is in the UK or overseas
- You do not live in the UK and the property you let is in the UK
- Either of the above applies to you and you let property in partnership
- You are a trustee or beneficiary of a trust liable for Income Tax on the property profits

So what?

If any of the above four bullet points apply to you, the following pages will explain how you could be affected and what you should consider doing about it.

NO?

You won't be affected if:

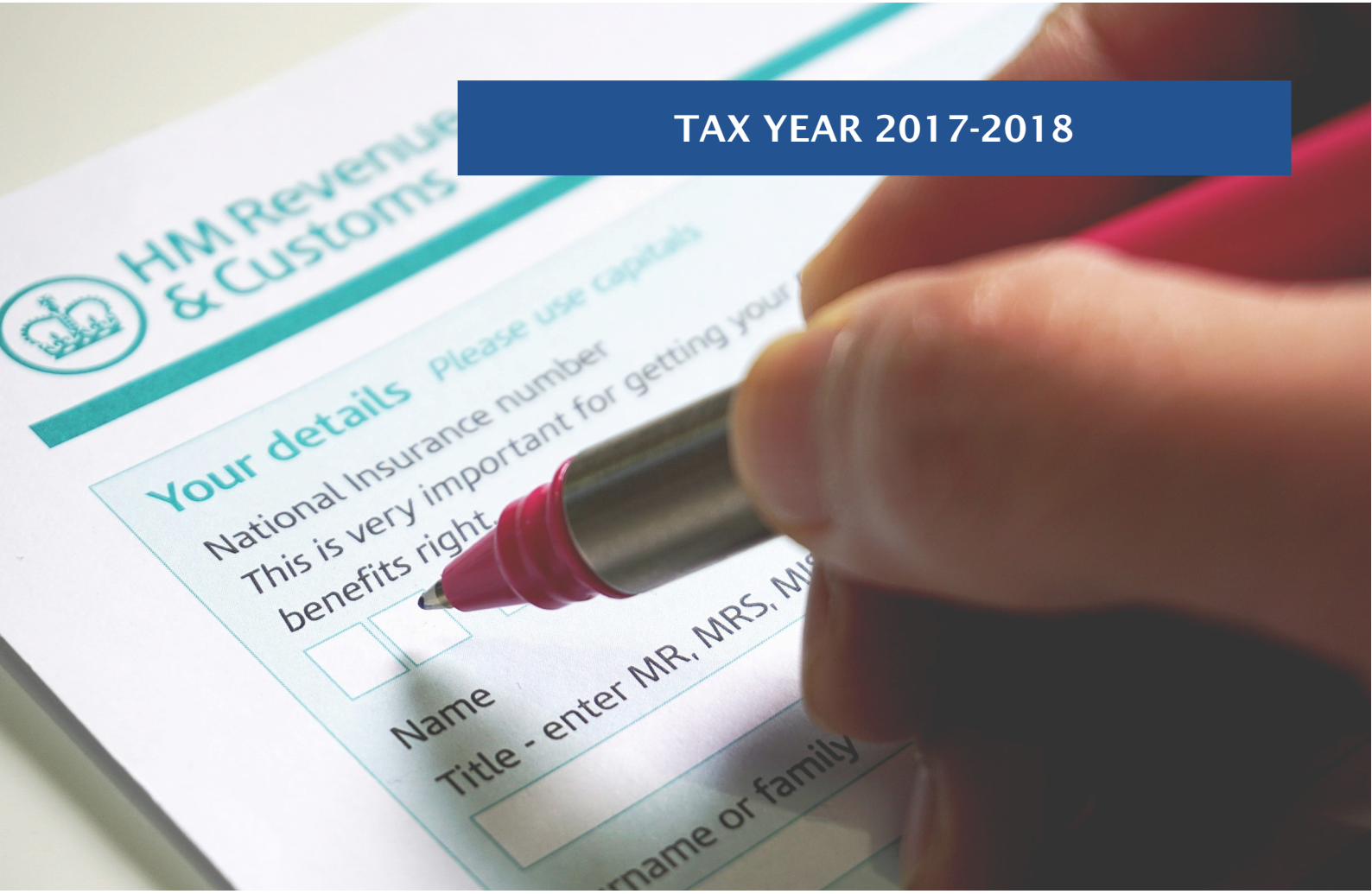
- The property is owned by a UK resident company (and not by you personally)
- The property is owned by a non-UK resident company
- Your property is a furnished holiday let

So what?

If any of the above three bullet points apply to you, you can expect to receive tax relief as usual.

IMPORTANT

This information is for guidance only. For clarity please ask a qualified accountant or contact HM Revenue & Customs.



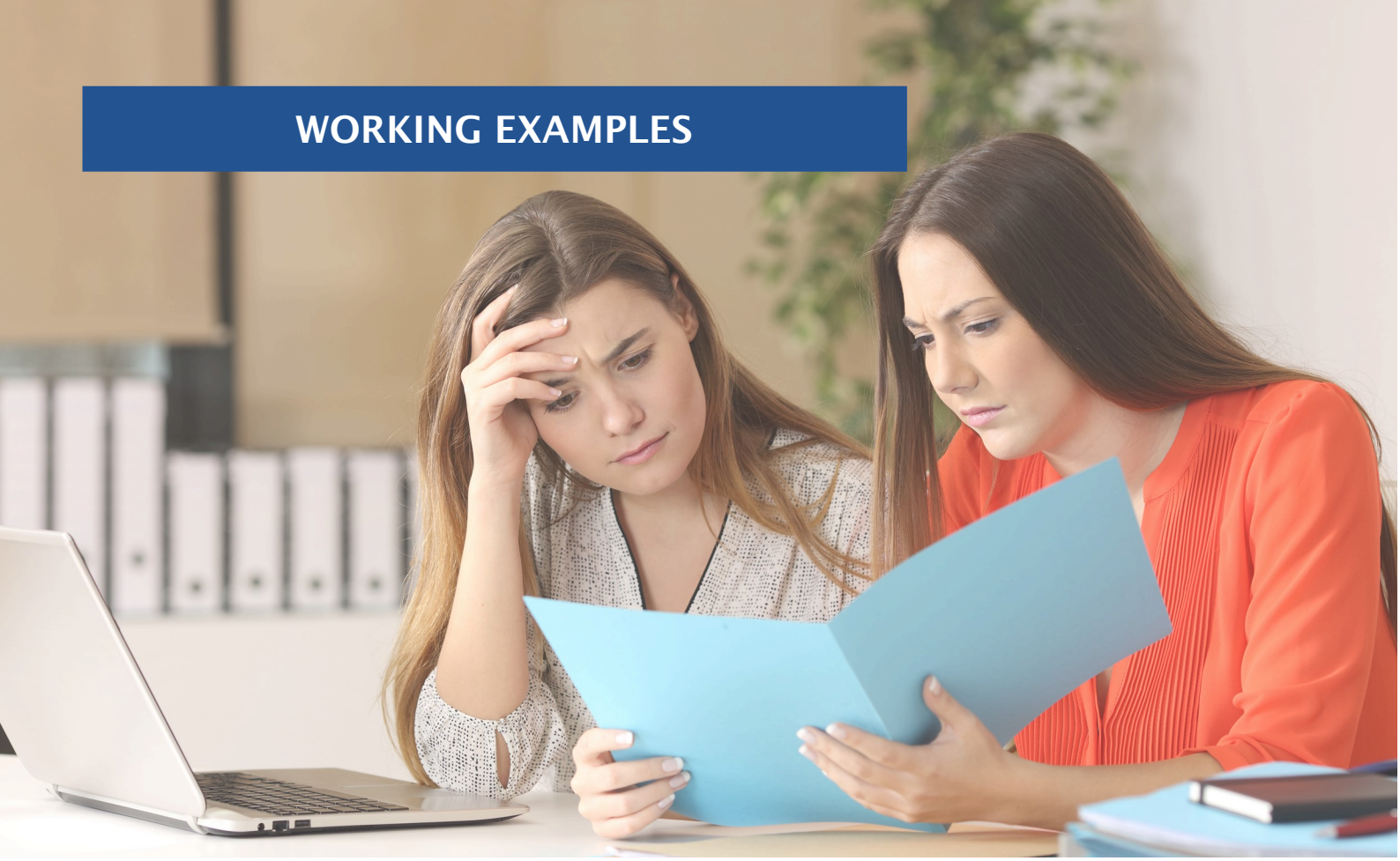
2017/18 tax year

The first year of transition.

This means that affected residential landlords will only be able to deduct 75% of their finance costs from their rental income. The remaining 25% will be due a reduction at the basic rate of tax, currently 20%.

Take a look on the next few pages for examples of how this works for landlords in both the basic and higher rate tax brackets.

Tax Year	Percentage of finance costs deductible from rental income	Percentage of basic rate tax reduction
2017-2018	75%	25%
2018-2019	50%	50%
2019-2020	25%	75%
2020-2021	0%	100%



How it works

Using extremely simplified examples, let's consider how the changes to relief affect landlords in both the basic and higher rate tax bands.

Finance costs relate solely to buy to let mortgage interest—other possible finance costs have not been included in the examples.

The examples on the following pages assume that the current tax rates and bands will continue to apply in future years, although do bear in mind that these could change.

Changes announced in respect of 2018/19 have been ignored for simplicity.

INCOME TAX RATES & BANDS 2017/18

Band	Taxable Income	Tax Rate
Personal allowance	Up to £11,500	0%
Basic rate	£11,501 to £45,000	20%
Higher rate	£45,000 to £150,000*	40%
Additional rate	Over £150,000	45%

*Personal allowance tapers by £1 for every £2 earned over £100k

Scenario 1

BASIC TAX RATE LANDLORD

Ash is a landlord with just one residential investment property.

He pays £9k each year in buy to let mortgage interest.

The property generates £17k pa in rent.

He also works full-time earning an annual salary of £25,000.

Impact: Neutral

BASIC RATE TAX PAYING LANDLORD	TAX YEAR & POSITION				
SCENARIO 1: ASH	2016/17	2017/18	2018/19	2019/20	2020/21
Salary	£25,000	£25,000	£25,000	£25,000	£25,000
Gross rental income	£17,000	£17,000	£17,000	£17,000	£17,000
Less deductible mortgage interest	(£9,000)	(£6,750)	(£4,500)	(£2,250)	£0
Less letting costs	(£2,000)	(£2,000)	(£2,000)	(£2,000)	(£2,000)
Total taxable income	**£31,000**	**£33,250**	**£35,500**	**£37,750**	**£40,000**
Personal allowance	(£11,500)	(£11,500)	£11,500	£11,500	(£11,500)
Total taxable income	**£19,500**	**£21,750**	**£24,000**	**£26,250**	**£28,500**
Basic rate tax (20%)	£3,900	£4,350	£4,800	£5,250	£5,700
Less finance costs (20%)	N/A	(£450)	(£900)	(£1,350)	(£1,800)
Total tax payable	**£3,900**	**£3,900**	**£3,900**	**£3,900**	**£3,900**
Net Income After Tax	**£27,100**	**£27,100**	**£27,100**	**£27,100**	**£27,100**

BASIC RATE EXAMPLE

Scenario 2

BASIC TAX RATE LANDLORD

Laura is a landlord with a couple of residential investment properties.

She pays £15k each year in buy to let mortgage interest.

The properties generate £25k pa in rent.

She also works full time earning an annual salary of £38,500.

Impact: Negative

BASIC RATE TAX PAYING LANDLORD	TAX YEAR & POSITION				
SCENARIO 2: LAURA	2016/17	2017/18	2018/19	2019/20	2020/21
Salary	£38,500	£38,500	£38,500	£38,500	£38,500
Gross rental income	£25,000	£25,000	£25,000	£25,000	£25,000
Less deductible mortgage interest	(£15,000)	(£11,250)	(£7,500)	(£3,750)	(£0)
Less letting costs	(£4,000)	(£4,000)	(£4,000)	(£4,000)	(£4,000)
Taxable rental profit	**£6,000**	**£9,750**	**£13,500**	**£17,250**	**£21,000**
Total taxable income	**£44,500**	**£48,250**	**£52,000**	**£55,750**	**£59,500**
Personal allowance	(£11,500)	(£11,500)	(£11,500)	(£11,500)	(£11,500)
Total taxable Income	**£33,000**	**£36,750**	**£40,500**	**£42,250**	**£48,000**
Basic rate tax (20%)	£6,600	£6,700	£6,700	£6,700	£6,700
Higher rate tax (40%)	-	£1,300	£2,800	£4,300	£5,800
Less finance costs (20%)	N/A	(£750)	(£1,500)	(£2,250)	(£3,000)
Total tax payable	**£6,600**	**£7,250**	**£8,000**	**£8,750**	**£9,500**
Net Income After Tax	**£37,900**	**£37,250**	**£36,500**	**£35,750**	**£35,000**

Scenario 3

HIGHER TAX RATE LANDLORD

Pauline is a full-time landlord who owns 15 residential investment properties.

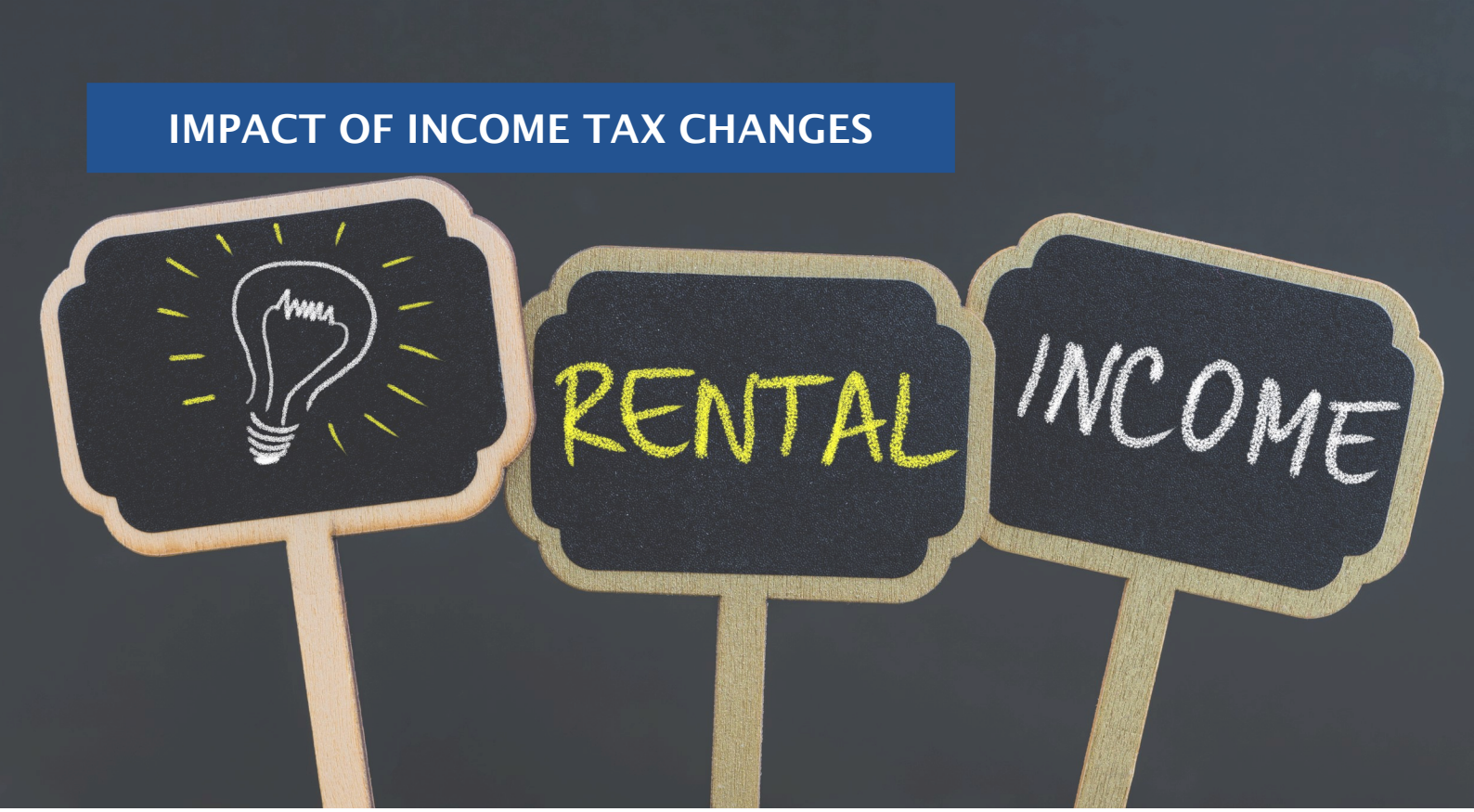
She pays £67.5k each year in buy to let mortgage interest.

The properties generate £150k pa in rent.

NB: Her personal allowance reduces by £1 for every £2 that her income exceeds £100k.

Impact: Negative

HIGER RATE TAX PAYING LANDLORD	TAX YEAR & POSITION				
SCENARIO 3: PAULINE	2016/17	2017/18	2018/19	2019/20	2020/21
Salary	-	-	-	-	-
Gross rental income	£150,000	£150,000	£150,000	£150,000	£150,000
Less deductible mortgage interest	(£67,500)	(£50,625)	(£33,750)	(£16,875)	-
Less letting costs	(£30,000)	(£30,000)	(£30,000)	(£30,000)	(£30,000)
Actual rental profit	**£52,500**	**£52,500**	**£52,500**	**£52,500**	**£52,500**
Total taxable Profit	**£52,500**	**£69,375**	**£86,250**	**£103,125**	**£120,000**
Personal allowance	(£11,500)	(£11,500)	(£11,500)	(£9,937)	(£1,500)
Total taxable income	**£41,000**	**£57,875**	**£74,750**	**£93,188**	**£118,500**
Basic rate tax (20%)	£6,700	£6,700	£6,700	£6,700	£6,700
Higher rate tax (40%)	£3,000	£9,750	£16,500	£23,875	£34,000
Less finance costs (20%)	-	(£3,375)	(£6,750)	(£10,125)	(£13,500)
Total Tax Payable	**£9,700**	**£13,075**	**£16,450**	**£20,450**	**£27,200**
Net Income After Tax	**£42,800**	**£39,425**	**£36,050**	**£32,050**	**£25,300**



Impact on landlords

The examples demonstrate that unless a landlord is well within the basic rate tax band, like Ash, the overall impact is financially negative.

Ash is not adversely affected by the tapering relief and she won't be affected when the tax changes are fully implemented in 2020/21.

But for **Laura**, who was a basic rate tax payer in 2016/17, the changes mean she is tipped into the higher rate band and she may not even realise it. Financially she will be worse off this tax year by £650.

By 2020/21 she will be paying £2,900 more in tax - that's £2,900 less net income.

Pauline is affected even worse. Over the next five years her tax bill will rise (and her net income will reduce) by a whopping £17,500.

Essentially, the more mortgage interest an individual landlord pays, the greater the adverse impact on their tax position.

But it doesn't stop there—the knock-on effect is that when landlords realise they will be negatively impacted, they will have to re-evaluate their entire residential property investment strategy.

What to do?

Clearly it is imperative that landlords understand exactly how the changes affect them both now and in the future.

But what can landlords do about it?

Get professional advice—sooner rather than later!

We recommend that landlords take proper tax and financial advice as soon as possible from a qualified, preferably specialist, property accountant.

The sooner landlords understand the implications, the sooner they can decide how to proceed.

In particular they will need to decide:

- Whether to remain in the buy to let sector
- What do to with their existing properties
- How to buy any future rental properties.

Making a decision

Do nothing?

Landlords who choose to do nothing will be obliged to pay any additional tax which may be due.

Last December (2017), in a survey conducted by Mortgages for Business, more than 42% of landlords surveyed said that they would neither sell nor buy any rental properties for at least the next six months—presumably giving them more time to seek clarification on how they might be affected and to consider their options.

Sell up?

Should landlords sell their entire portfolios and leave the sector completely?

Possibly. Only they can decide based on the professional advice they are given.

Sell some properties?

Should landlords sell off a certain number of properties in order to lessen the negative impact of the tax changes?

Possibly. Again, only they can decide based on the professional advice they are given.

Only landlords themselves can make these decisions. According to the MFB survey only 14% of landlords said they were considering selling some or all of their properties as a consequence of the changes to income tax relief.

Transfer some properties to a spouse?

For some, this is a tax efficient route which deserves investigation.

Again, landlords should take professional advice.

Incorporate?

Should landlords stop running their portfolios personally and start using limited companies instead?

Possibly. Only they can decide based upon the professional advice they are given and going down this route is not cost or tax-free.

However, many landlords have started using limited companies through which to operate their portfolios because the new relief restrictions do not apply to corporate entities which pay corporation tax rather than income tax. This means that they can continue to deduct mortgage interest and other finance costs from their rental income.

Currently, the main rate of corporation tax is set at 19% until the year starting April 2020 when it will reduce to 17% for all profits (except ring-fenced profits).

The fact that the corporation tax rate is lower than income tax is an added bonus for landlords, although there will be additional tax to pay when profit is taken out of the company.

Also when applying for a buy to let mortgage, limited companies can borrow more than individuals because the interest coverage ratio (ICR) calculation which lenders use is less onerous.

Whilst incorporation is on the rise by landlords, research shows that it is being used most widely as a vehicle in which to make new acquisitions.

SPV Ltd Companies

Special Purpose Vehicles are used solely for holding and letting property. Lenders prefer these to trading companies as they are easier to underwrite.

Trading Ltd Companies

Corporate structures for trading businesses. Fewer buy to let lenders offer mortgages to these corporates because the business as well as the portfolio has to be underwritten.

Incorporate what?

Are other landlords using Ltd companies?

Increasingly! In December 2017, 46% of landlords surveyed by Mortgages for Business, held at least one property in a corporate structure, up from 42% in May 2017 and 32% in November 2016.

The number of buy to let mortgage transactions made by companies has also grown. Before the tax changes were announced only 18% of buy to let mortgage transactions placed through Mortgages for Business, were made by landlords using limited companies (for both purchases and remortgages).

By Q4 2017 this figure had grown to nearly 75% for purchases although the majority of these were for additional property acquisitions.

Can landlords transfer property they own personally into a limited company?

Generally speaking no! The transaction must be treated as a sale at market value.

This means incurring not only the costs of sale—including remortgaging—but also the sale itself creates a taxable event which means that landlords will usually have to pay:

- **Capital Gains Tax** personally on the sale.
- **Stamp Duty** which will be payable by the company including the 3% surcharge—even on the company's first purchase.

In certain circumstances the CGT can be "rolled over" into the shares in the limited company, and incorporation of a property owning partnership may be exempt from Stamp Duty. As with all these things, landlords should check their specific circumstances with an accountant or solicitor.

At Mortgages for Business we have helped many landlords who have chosen to sell their personally owned properties to their limited company. From a buy to let borrowing perspective, the transaction is treated as 'linked', i.e. both the vendor and the buyer are related.

Ltd Company BTL

The good news is, most of the lenders which offer buy to let mortgages to limited companies, will consider linked transactions.

However, the very cheapest buy to let rates on the market are only available from lenders which lend solely to individuals.

Using Ltd companies to buy more rental property

Most landlords who have chosen to incorporate have done so in order to expand their portfolios.

This is a strategy which seems to be growing in popularity and lenders are responding to meet demand.

Buy to let lending to Ltd companies

At the end of 2017, around 44% of buy to let lenders were offering mortgages to limited companies—mostly SPVs.

From a product perspective, of the 1,600 or so buy to let mortgages available to landlords, nearly a quarter were available to limited companies. Contrary to popular belief rate the rates available to corporates are not more expensive than those available to individuals; for the most part, they are the same.

Next steps

Before making any decision landlords should take advice—from HMRC, accountants, solicitors and brokers—to ensure they understand the implications of the tax relief changes for their personal circumstances, and to be able to make a decision on how to proceed.

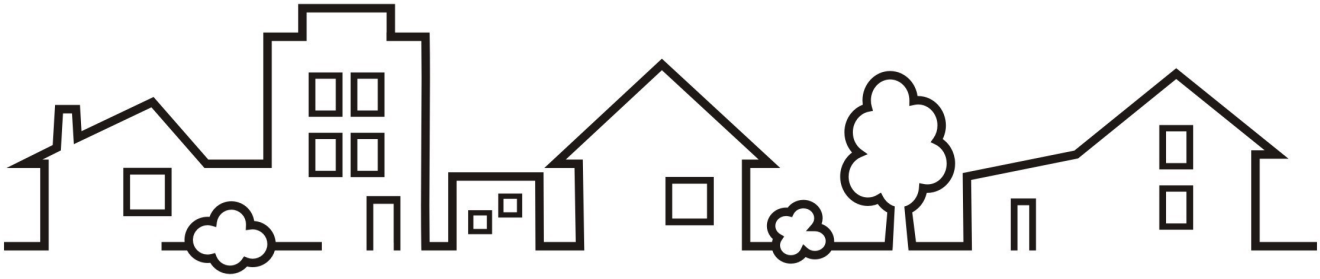
Need a Ltd Co buy to let mortgage?

Having taken advice, if you would like to explore borrowing options using a limited company please get in touch.

>> Call 0345 345 6788

>> Email us

>> Request a call back



Further Research

We publish a variety of papers designed to help landlords, businesses and home-buyers make informed property investment decisions.

For more information

Please visit the **News & Insight** section of our website for more information about the impact of both tax and regulatory changes to buy to let landlords.

ANY PROPERTY USED AS SECURITY, WHICH MAY INCLUDE YOUR HOME, MAY BE REPOSSESSED IF YOU DO NOT KEEP UP REPAYMENTS ON YOUR MORTGAGE.

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Mortgages for Business