Buy to Let property owners

Changes to UK Tax Relief on Finance Costs

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Contents

Click to go to section

Executive summary

In the Summer Budget on 8 July 2015, the UK Government announced a proposal to restrict the income tax relief available for finance costs incurred by an individual or trustee who is in receipt of rental income from residential property. Tax relief will be restricted on finance costs, such as mortgage interest incurred in relation to loans used to acquire the property.

Although these changes will apply from 6 April 2017, these could have significant tax cost implications for Buy to Let landlords and could change the way they choose to run their 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 Annual Tax on Enveloped Dwellings (ATED), as all of these could affect the tax efficiency of a property business. We are working with Ernst & Young LLP to provide further detail on these key considerations.

> “...could have significant tax cost implications...”

Who will this affect?

The changes apply to individual landlords, partnerships and limited liability partnerships who incur finance costs in respect of UK and overseas residential property. The changes will not affect landlords holding commercial property or properties which qualify as furnished holiday lettings. Importantly, the changes also do not affect residential property owned through a company.

> “...many Buy to Let owners will be affected and need to understand how these changes will impact them...”

Therefore, many Buy to Let owners will be affected and need to understand how these changes will impact them. Similarly those who are considering investing in Buy to Let property should be aware of the changes as this could have a significant bearing on how they structure their investments.

Changes **WILL APPLY** to:	Changes **WILL NOT APPLY** to:
Individual landlords	Landlords holding only commercial property
Partnerships	Residential property owners
LLP Limited liability partnerships Who incur finance costs in respect of UK and overseas residential property	

A reminder of the current rules

The full amount of finance costs, which are incurred wholly and exclusively for the purpose of the rental business, can be deducted from gross rental income to reduce taxable rental profits. This deduction therefore reduces the landlord's rental income liable to Income Tax on property income.

Under current rules, landlords may 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.

"This deduction therefore reduces the landlord's rental income liable to Income Tax on property income."

What are the new rules?

> ...proposed changes will apply from 6 April 2017...

Individual landlords will no longer be able to claim finance costs as a deduction from rental income to calculate the taxable rental profit. It will be replaced with a basic rate tax reduction from the individual's Income Tax liability.

The proposed changes will apply from 6 April 2017 but will be phased in over four tax years so that the full impact of the change will not apply until 6 April 2020. However, as the effect of these changes will result in an increase in the tax liability for many landlords, those affected should start considering the impact of these changes on the cash flow and profitability of their business now.

Some landlords may find that the tax they pay on their rental income may rise to in excess of 100% of their overall rental profit. This is particularly applicable to those with low yielding property. The restriction will apply as follows:

2017/18	Allowable deduction restricted to 75% of finance costs – basic rate deduction on the remaining 25%.
2018/19	Allowable deduction restricted to 50% of finance costs - basic rate deduction on the remaining 50%.
2019/20	Deduction restricted to 25% of finance costs – basic rate deduction on the remaining 75%.
2020/21	No deduction for finance costs – basic rate deduction on finance costs incurred.

Apply from
6 April 2017

Full impact from
6 April 2020

The proposed restriction of tax relief will only apply to expenditure incurred on finance costs. Other expenditure incurred which qualifies for a deduction, for example on repairs, should not be affected.

However, landlords should be aware of the proposed changes to the wear and tear allowance. Currently a deduction of 10% is available when calculating the profits of a property business if a wear and tear election is made, however no other relief is available in respect of the expenditure incurred on the furniture, furnishings and equipment.

The Government has announced that from April 2016 the wear and tear allowance will be replaced with a relief that enables residential landlords to deduct the costs they actually incur on replacing furnishings in the property.

Finance costs explained

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

> “Costs incurred in attempting to obtain finance can also be claimed regardless of whether finance is actually obtained.”

It should also be noted that finance costs for these purposes are not 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 will give rise to higher Income Tax liabilities for affected landlords. As a result of the reduction of allowable expenditure, their taxable rental income will increase, resulting in an increase in their total taxable income.

For basic rate taxpayers the increased taxable rental income may move 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 will therefore need to consider the impact of any increased tax liability on the cash flow and profitability of the rental business, as whilst the economic profit of the property may not change it may have to fund a higher tax liability.

As these changes start to apply from 6 April 2017, this gives landlords an opportunity to assess the implications of the changes and consider any action they may wish to take.

Landlords may consider transferring existing rental properties into a company or acquiring new property within a company. Before doing so, landlords will need to 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 & corporation tax
- Annual Tax on Enveloped Dwellings (ATED)

Capital gains tax P.10

Stamp duty land tax (SDLT)/land and buildings transaction tax P.11

Inheritance tax P.12

Income tax & corporation tax P.13

Annual Tax on Enveloped Dwellings (ATED) P.14

Click the icons to find out more

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 will incur a tax charge of up to 28% on its market value (less any purchase costs).

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. However, certain reliefs 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 reliefs.

Non-UK resident landlords should be aware of their obligation to report any disposals of property to HMRC via a non-resident CGT return.

“Non-UK resident landlords should be aware of their obligation to report any disposals of property to HMRC via a non-resident CGT return.”

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, SDLT could be payable at rates of up to 12%. If however ownership is transferred to a company, this could fall to 4% where six or more residential properties are transferred as part of the same transaction.

If the properties are owned by a partnership, certain reliefs from SDLT on transfer of ownership may be available.

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, from 1 April 2016.

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

The government will consult on the changes to SDLT rates, including on whether an exemption for corporates and funds owning more than 15 residential properties is appropriate.

“...stamp duty land tax could be payable at rates of up to 12%...”

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.

Transferring ownership of a property business to a company could be an opportunity for an individual to reduce their estate for inheritance tax purposes, as it could allow for easier gifting of portions of the business to future generations. Landlords should therefore seek specialist advice in order to explore the options available to them.

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 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 inheritance tax purposes."

Income tax & corporation tax

If a landlord 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 (currently 20% but falling to 18% by 2020) 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). Landlords should therefore weigh up whether it would be more tax efficient to hold their properties personally or via a company.

“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 2015, companies owning properties worth more than £1m are now subject to an annual charge. From 1 April 2016, companies owning properties worth more than £500,000 will also be within the ATED regime.

The ATED charge includes SDLT of 15% on acquisition (already effective for properties worth more than £500,000) and a CGT charge on disposal.

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.

"From 1 April 2016, companies owning properties worth more than £500,000 will also be within the ATED regime."

Action points

New landlords

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

Existing landlords

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.

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

Examples

A

In 2020/21 an individual landlord owns a Buy to Let property worth £350,000, annual rents of £17,400, expenditure of £1,200 and finance costs of £10,000. He also has a salary of £45,000.

Under current rules his tax position would be as follows:

Direct ownership

Income		17,400
Expenditure		(1,200)
Finance costs		(10,000)
		6,200
6,200	@40%	2,480
		2,480
Tax due on rental profits		2,480
Cash position		6,200
Income tax		(2,480)
Net cash		3,720

Company ownership

Income		17,400
Expenditure		(1,200)
Finance costs		(10,000)
		6,200
6,200	@20%	1,240
Tax due on rental profits		1,240
Dividend paid of 4,960	@25%	1,240
Total tax due		2,480
Gross profit		6,200
Corporate tax		(1,240)
Company net profit		4,960
Dividend paid		(4,960)
Company net cash		0
Dividend received		4,960
Income tax on dividend		(1,240)
Individual net profit		3,720

Examples - continued

When the new rules are introduced the tax he will pay personally compared with if he owned the properties via a company is as follows:

Direct ownership

Income		17,400
Expenditure		(1,200)
		16,200
16,200	@40%	6,480
		6,480
Less: Basic rate deduction		(2,000)
Tax due on rental profits		4,480

Company ownership

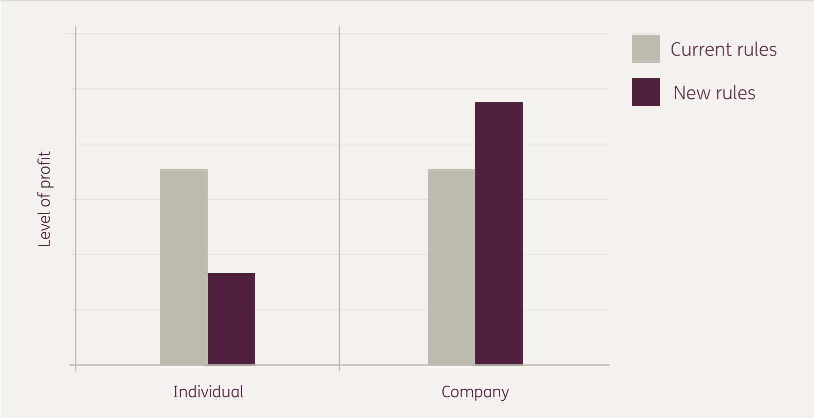
Income		17,400
Expenditure		(1,200)
Finance costs		(10,000)
		6,200
6,200	@18%	1,116
Tax due on rental profits		1,116
Dividend paid (5,084 - allowance)	@32.5%	27
Total tax due		1,143

His cash position would therefore be:

Gross profit	16,200
Finance costs	(10,000)
Income tax	4,480
Net cash	1,720

Gross profit	6,200
Corporate tax	(1,116)
Company net profit	5,084
Dividend paid	(5,084)
Company net cash	0
Dividend received	5,084
Income tax on dividend	(27)
Individual net cash	5,057

The following graph illustrates the impact of the law changes on profits for the landlord in the above illustration:



Examples - continued

B

In 2020/21 an individual landlord owns four Buy to Let properties worth £1.8m, annual rents of £72,000, expenditure of £4,000 and finance costs of £50,400. He also has a salary of £60,000.

Under current rules his tax position would be as follows:

Direct ownership

Income		72,000
Expenditure		(4,000)
Finance costs		(50,400)
		17,600
17,600	@40%	7,040
		7,040
Tax due on rental profits		7,040
Cash position		17,600
Income tax		(7,040)
Net cash		10,560

Company ownership

Income		72,000
Expenditure		(4,000)
Finance costs		(50,400)
		17,600
17,600	@20%	3,520
Tax due on rental profits		3,520
Dividend paid of 14,080	@25%	3,520
Total tax due		7,040
Gross profit		17,600
Corporate tax		(3,520)
Company net profit		14,080
Dividend paid		(14,080)
Company net cash		0
Dividend received		14,080
Income tax on dividend		(3,520)
Individual net profit		10,560

Examples - continued

When the new rules are introduced the tax he will pay personally compared with if he owned the properties via a company is as follows:

Direct ownership

Income		72,000
Expenditure		(4,000)
		68,000
68,000	*@40%*	27,200
		27,200
Less: Basic rate deduction		(10,080)
Tax due on rental profits		17,120

Company ownership

Income		72,000
Expenditure		(4,000)
Finance costs		(50,400)
		17,600
17,600	*@18%*	3,168
Tax due on rental profits		3,168
Dividend paid (14,432 - allowance)	*@32.5%*	3,065
Total tax due		6,233

His cash position would therefore be:

Gross profit	68,000
Finance costs	(50,400)
Income tax	17,120
Net cash	480

Gross profit	17,600
Corporate tax	(3,168)
Company net profit	14,432
Dividend paid	(14,432)
Company net cash	0
Dividend received	14,432
Income tax on dividend	(3,065)
Individual net cash	11,367

Examples - continued

C

In 2020/21 an individual landlord has a Buy to Let property portfolio worth £5.4m, receiving annual rents of £189,000, expenditure of £7,500 and finance costs of £129,600. He has no other income.

Under current rules his tax position would be as follows:

Direct ownership

Income		189,000
Expenditure		(7,500)
Finance costs		(129,600)
		51,900
Less: personal allowance		(10,600)
		41,300
31,785	@20%	6,357
9,515	@40%	3,806
		10,163
Tax due on rental profits		10,163
Cash position		51,900
Income tax		(10,163)
Net cash		41,737

Company ownership

Income		189,000
Expenditure		(7,500)
Finance costs		(129,600)
		51,900
51,900	@20%	10,380
Tax due on rental profits		10,380
Dividend taxable at higher rate 3,748	@25%	937
Total tax due		11,317
Gross profit		51,900
Corporate tax		(10,380)
Company net profit		41,520
Dividend paid		(41,520)
Company net cash		0
Dividend received		41,520
Income tax on dividend		(937*)
Individual net profit		40,583

*Taxable balance covered by personal allowance and 10% national tax credit.

Examples - continued

When the new rules are introduced the tax he will pay personally compared with if he owned the properties via a company is as follows:

Direct ownership

Income		189,000
Expenditure		(7,500)
		181,500
31,785	@20%	6,357
118,215	@40%	47,286
31,500	@45%	14,175
		67,818
Less: Basic rate deduction		(25,920)
Tax due on rental profits		41,898

Company ownership

Income		189,000
Expenditure		(7,500)
Finance costs		(129,600)
		51,900
51,900	@18%	9,342
Tax due on rental profits		9,342
Dividend paid (42,558 - allowances)	@7.5%	2,021
Total tax due		11,363

His cash position would therefore be:

Gross profit	181,500
Finance costs	(129,600)
Income tax	41,898
Net cash	10,002

Gross profit	51,900
Corporate tax	(9,342)
Company net profit	42,558
Dividend paid	(42,558)
Company net cash	0
Dividend received	42,558
Income tax on dividend	(2,021)
Individual net cash	40,537

Whilst the examples above show a better position overall where a company is used, consideration must be given to the key implications for landlords outlined in this factsheet and advice should be taken.

The above illustrations are based on the position in 2020/21 when the changes to law will have been fully phased in and the 10% tax credit for dividends will have been replaced by an annual £5,000 tax free dividend allowance. The dividend tax rates in the examples are based on the effective rate of tax after allowances and tax credits.

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