Buy to let

Tax guide

UK tax relief on finance costs

April 2022

INTERACTIVE GUIDE →

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

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Executive summary

The full implications of the restriction to the deductibility of finance costs for individual landlords (introduced and phased in as of 6 April 2017) are now being felt by landlords. The full restriction has been in place since 6 April 2020 and will be keenly felt as people prepare and file self-assessment tax returns for the tax year ending 5 April 2021.

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.

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.

Many buy to let landlords have considered the use of a limited company as a holding structure for their property portfolio. A limited company is not currently subject to the same finance cost restrictions as an individual, and for many landlords UK corporation tax on rental profits can be favourable when compared to UK income tax. As such, in certain circumstances, the use of a company can alleviate some of the tax pressures faced by landlords as a result of legislative change. This is a complex area of taxation and professional advice is essential.

> **"Kent Reliance for Intermediaries has worked with EY on the tax aspects of this guide which has been created to aid broker knowledge."**

Further information about EY and the services they provide can be found on Page 23.

Roger Morris
Group Lending Engagement Director

A reminder of the previous rules

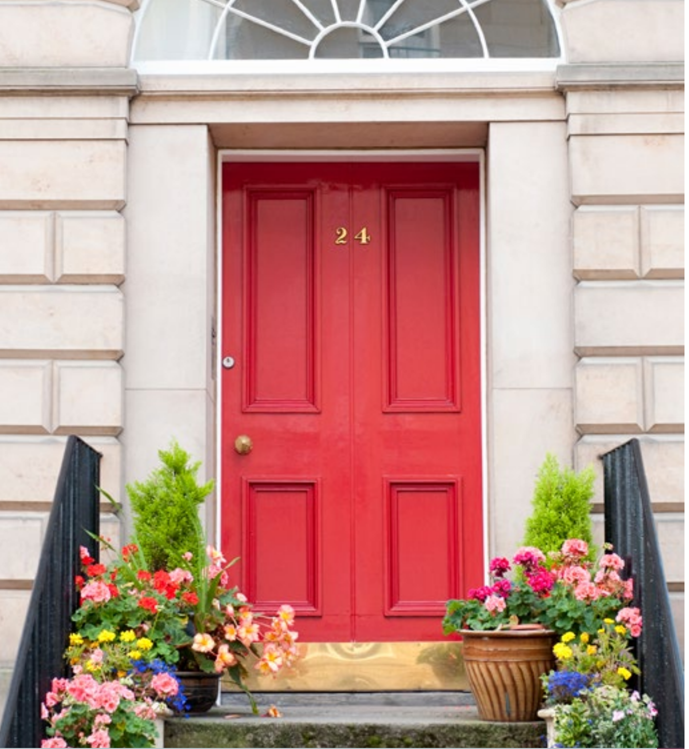
Prior to April 2017, the full amount of any finance costs incurred wholly and exclusively for the purpose of the rental business could be deducted from gross rental income to reduce taxable rental profits, including mortgage interest payments.

Accordingly, many buy to let investors 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.

Landlords were also able to claim other allowable deductions from rental income, such as rates, insurance, ground rents, repairs, renewals, management and professional fees and costs of services provided.



What are the *current rules?*

Individual landlords, general and limited liability partnerships, and trustees 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.

This has been replaced with a basic rate tax reduction from the individual/partner's income tax liability.

The effect of these changes on landlords' cashflows will only now be fully appreciated as individuals prepare self-assessment tax returns for the tax year ending 5 April 2021.

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

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

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

Some of the typical qualifying buy to let expenses include:

- **General maintenance and repair costs**
- **Water rates, council tax and gas and electricity**
- **Insurance costs**
- **Cost of services (e.g., ground rent)**
- **Agency and property management fees**

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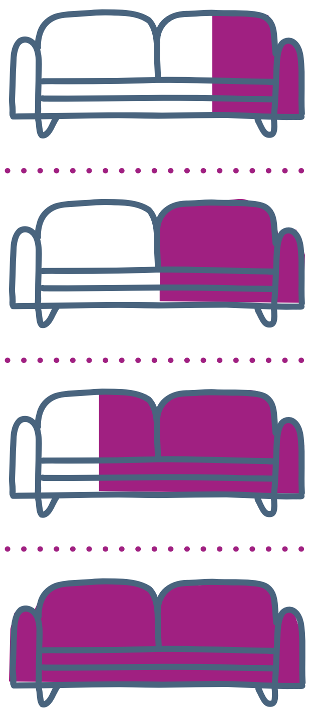
What are the *current rules?*

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 has been phased over four tax years to apply as follows:

Final cost reduction		*Basic* rate reduction
2017/18 TAX YEAR 75%		2017/18 TAX YEAR 25%
2018/19 TAX YEAR 50%		2018/19 TAX YEAR 50%
2019/20 TAX YEAR 25%		2019/20 TAX YEAR 75%
2020/21 NO DEDUCTION		2020/21 TAX YEAR 100%



Who are these *changes* affecting?

The changes apply to individual landlords, partnerships (including 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 impact residential properties owned through a company, which continue to be able to benefit from finance cost deductions for the time being.

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.

> **"Landlords need to consider the impact of increased tax liabilities on the cash flow and profitability of their rental business."**

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.

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.

> **"Finance costs 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 affected 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. It 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 due to the change in the tax rules.

> **"Landlords may wish to consider transferring existing rental properties into a company or acquiring new property within a company."**

Despite the introduction of the changes 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.

The use of *limited companies*

There are a variety of options to consider when it comes to property ownership, and the attractiveness of different structures will change over time in conjunction with changes in law and an individual's circumstances.

One structure that can be considered, and that can be particularly useful as a property portfolio holding entity, is a private limited company - sometimes referred to as a family investment company. The ownership of a buy to let portfolio can be transferred to a limited company entity, and in some cases an existing property business can be "incorporated" into the company.

In this scenario, finance costs may be fully deducted so they are received by the company as taxable rental profits. These would no longer be subject to income tax (up to 45%) as trading income but would instead be subject to corporation tax (which is currently 19%, although will be increasing to 25% from April 2023). Additional tax will be due when the funds are extracted from the company; if transacted carefully this can be planned in a tax-efficient manner. Depending on an individual's specific circumstances, a limited company can allow for other tax, succession and practical advantages if set up with care.

Typically, the transfer will be a disposal for UK capital gains tax and SDLT, meaning that immediate "dry" tax charges will arise upon transfer, and these transactional taxes in particular can make the transfer to a limited company prohibitively expensive. Where certain conditions are met, relief may be available to extinguish/reduce capital gains tax. This is explored further in subsequent pages.

Further tax on profit extraction from the company to individuals can lead to double tax charges and careful planning of cash extraction should be considered. There are also increased administration costs associated with operating a company and there can also be complicated anti-avoidance provisions that need to be considered carefully so specialist advice should be taken.

Transferring a property portfolio to a company is a complex transaction from a tax perspective and can be costly. 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
- Annual tax on enveloped dwellings (ATED)
- Income tax and corporation tax
- Inheritance tax

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 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's a complex relief and is not available in all cases. Specialist advice should therefore be taken.

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Capital gains tax

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

Since 27 October 2021, many disposals of UK residential property (which are not an individual's main home) are required to be reported to HMRC within 60 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 paid to HMRC within 60 days. Penalties will be charged for a failure to meet the deadline and interest will be payable on late paid tax.

> **"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%.

The rates of SDLT can be as low as 0%-5% in certain "non-residential" transactions: this includes a situation in which 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 should be a consideration. 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 and don't apply to corporates or funds making significant investments in residential property. While we're unaware of any planned introduction of an exemption for large-scale investors, the existing provision under which the non-residential SDLT rates apply to purchases of 6 or more properties will continue to exist.

An example of the application of these rules is shown below to illustrate how significant a difference SDLT treatment can make. This example is based on a hypothetical scenario concerning six flats being transferred to a company for total consideration of £3,000,000.

	Residential SDLT rates	Commercial SDLT rates	Full relief on incorporation
Purchase price	£3,000,000	£3,000,000	£3,000,000
SDLT payable	£361,250	£139,500	£0
SDLT cost 'saving'	–	-£221,750	-£361,250

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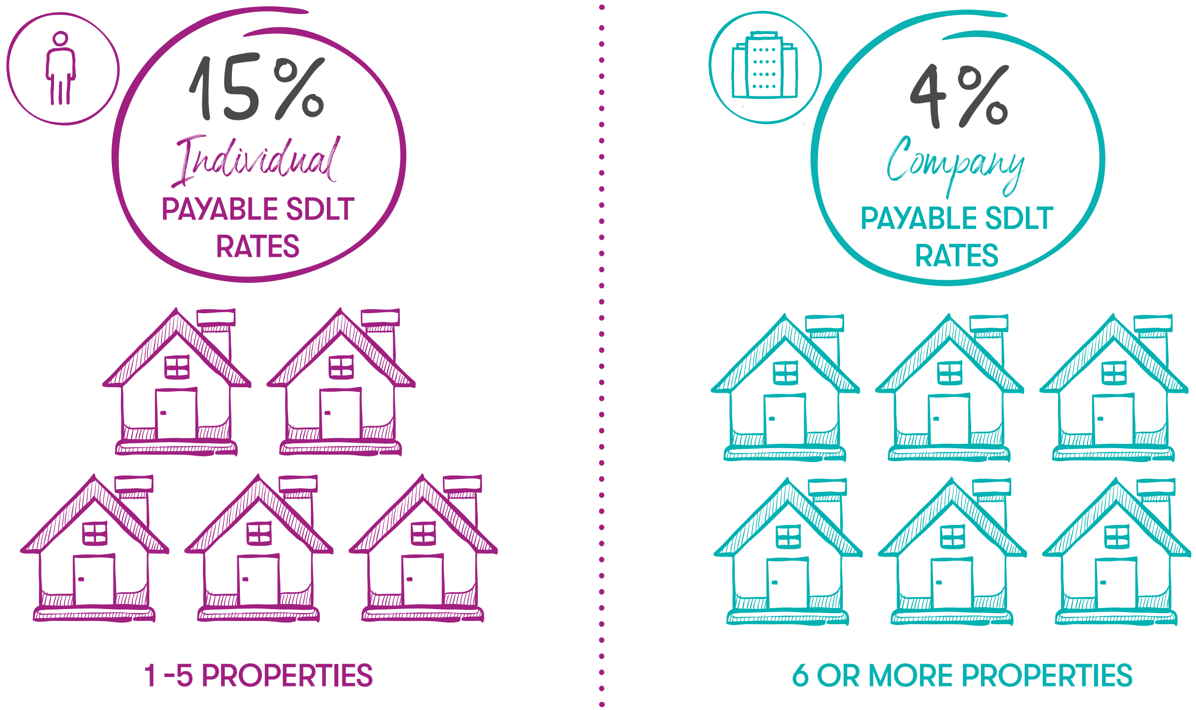
Stamp duty land tax (SDLT) land and buildings transaction tax

Where a number of properties are being transferred, Multiple Dwellings Relief (MDR) may be available where reduced rates or full relief are not. MDR applies relief based on taking an average value of each property transferred, often reducing exposure to SDLT at the higher rates/bands. Since April 2021, a 2% SDLT surcharge is required for non-UK residents purchasing UK property.



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, face a risk that investment activity might affect availability of the relief.

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

> **"Shares in a property development company may qualify for business property relief."**

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% (albeit rising to 25% in April 2023), will be due on profits rather than income tax of 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 (up to 38.1% in 2021-22 and 39.35% from 2022-23) meaning that both taxation for the company and individual must be considered when assessing costs associated with operating this way.

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. Specialist advice should therefore be taken.

> **"Corporation tax, which is currently 19% (albeit rising to 25% in April 2023), will be due on profits rather than income tax of up to 45%."**

Annual tax on enveloped dwellings (ATED)

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

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.

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

Intercompany loans

Intercompany loans can sometimes be used as a means of funding a deposit required for a limited company.

Consider the following example: an individual operating a cash-rich trading company may wish to diversify and purchase a buy to let property, however they may not wish to purchase the property as an individual, or within their trading company. There are a number of reasons why this may be the case:

1. The cash available to fund the purchase (i.e., the deposit amount) is currently held within the trading company as undistributed trading profits; extracting this profit will incur tax charges.
2. Holding investment assets could prejudice the "trading" status of the company in the eyes of HMRC.
3. Potentially restricted access to mortgage financing when applying through a trading company with a trading company SIC code.
4. Holding property in a corporate entity, and obtaining a mortgage against the property, can allow for them to deduct payments of interest when computing the tax liability on rental profits; this is no longer possible for individual landlords.

Accordingly, an individual shareholder may set up a separate limited company entity, and as these companies are owned by a common majority shareholder they'll be connected for certain tax purposes, facilitating intercompany loans.

Having acquired some financing to purchase a property the new entity can then seek to enter into a mortgage arrangement for further financing.

The borrowing/lending parties should carefully consider any arrangements put in place, including recommended terms regarding repayment, interest rates and tax reporting as this is a complex area of taxation and shouldn't be entered into without taking professional advice.

"An individual shareholder may set up a separate limited company entity, and as these companies are owned by a common majority shareholder they'll be connected for certain tax purposes, facilitating intercompany loans."

Joint tenants vs tenants in common

When looking at joint property ownership it's important to distinguish between the types of legal ownership between two parties: joint tenants and tenants in common.

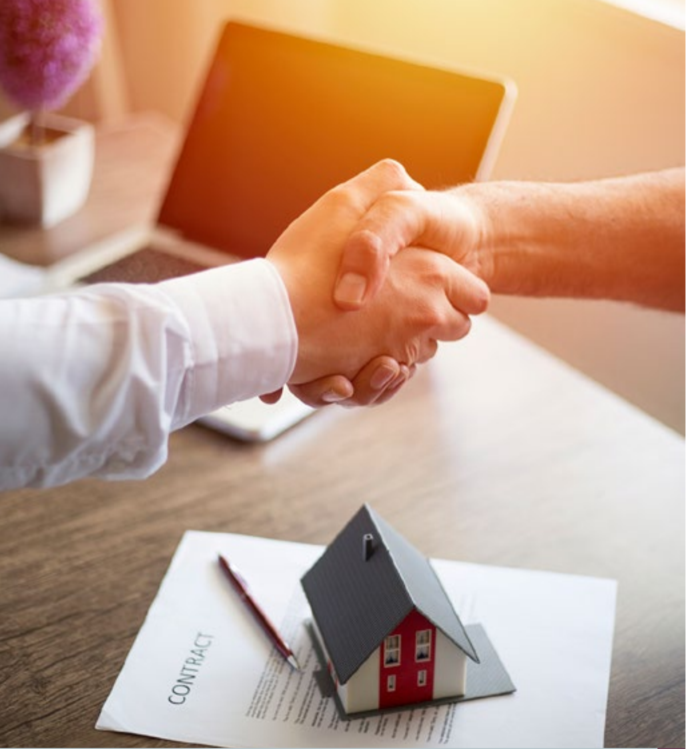
Joint tenancy is where each party shares 100% ownership of the property irrespective of the size of the contribution made. Owners are seen to be equally liable for expenses and equally entitled to profits, unless they're unconnected parties and arrangements have been made to vary economic interests. A key feature of joint ownership is that if one of the joint tenants dies the property will automatically pass to the surviving joint tenant, preventing property being left to other beneficiaries in their will.

On the other hand, under tenants in common each purchaser can each independently own a specific percentage share that when combined totals 100%.

The respective shares in the property don't need to be equal in size and each individual is able to pass their respective share onto their beneficiaries in their will. Moreover, each owner is only exposed to UK taxation on their respective percentage share of profits and only responsible for that portion of costs.

The type of legal ownership can be simply varied within 60 days of purchase, however thereafter the process to change ownership is more complex. Careful consideration needs to be given to UK tax on transfer, notably CGT and SDLT.

"A key feature of joint ownership is that if one of the joint tenants dies the property will automatically pass to the surviving joint tenant, preventing property being left to other beneficiaries in their will."



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 considered.

Existing landlords

Prior to transfer, existing buy to let landlords should seek advice around the implications of transferring their existing 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.

Reporting obligations

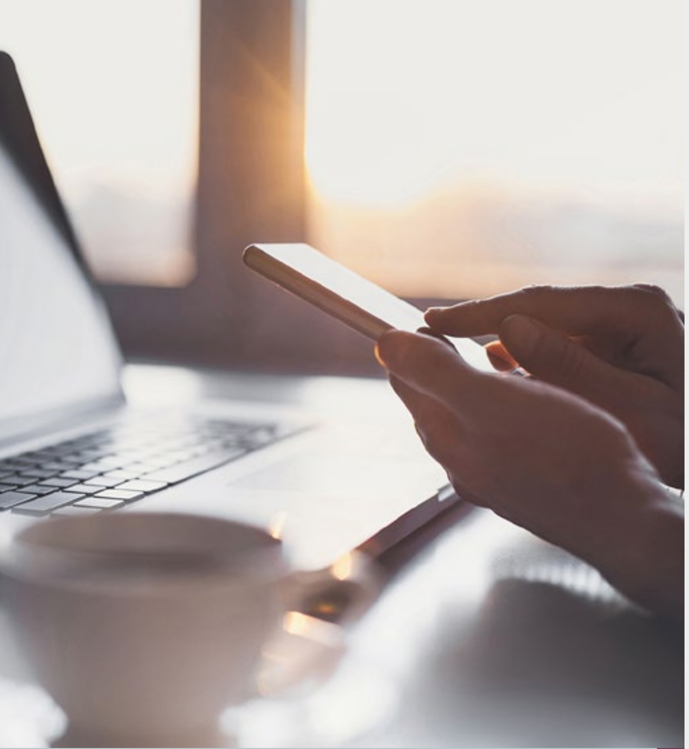
Both new and existing landlords should consider their reporting obligations when exploring the use of a corporate structure as filing statutory accounts and corporation tax returns can be an arduous process.

This guide is primarily focused on tax matters concerning UK residents, however 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.

> **"Buy to let landlords should seek tax advice around the implications of transferring to a company structure."**



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Contact us

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