PART 2 TAX PLANNING OPTIONS

The July 2015 Budget changes to mortgage interest relief will, for some landlords, create significantly higher tax bills. This article explains what tax-planning options are available, and the benefits and issues of each.

FIRSTLY, DON'T PANIC...

Landlords are currently able to offset all their finance interest against their rental profits, before calculating their rental profit and therefore tax bill. This will remain the case for the current 2016 and 2017 tax years. Many landlords have not yet filed their 2015 tax returns, and so will be filing 3 years of tax returns (year ended 5 April 2015, 5 April 2016, 5 April 2017) before the impact of the mortgage interest changes are seen.

This leaves almost two full tax years to plan for the mortgage interest relief 'new world', and even in the first tax year (2018) affected, the change is being phased in slowly i.e. this isn't a 'Big Bang' change.

So the message is … now is the time to plan, adjust your property plan, but knee-jerk reactions aren't required.

OPTIONS TO REDUCE THE IMPACT OF FORTHCOMING CHANGES TO MORTGAGE INTEREST RELIEF

First things first … please read the 'Part 1' of this 2-part article, and log onto our website to use our Mortgage Interest Relief Calculator, to check if you are likely to be affected by mortgage interest relief changes i.e. either:

1. **The changes push you – a Basic Rate taxpayer - into the Higher Rate band = so a 'medium' tax bill results (this is the category with the most people affected)**

Or,

2. **You are a Higher Rate taxpayer = so 'high' tax bill results**

OPTIONS:

1. PAY OFF HIGH-INTEREST MORTGAGE BORROWINGS

The mortgage interest relief changes only affect leveraged landlords i.e. those with borrowings used to fund their portfolio. So, paying off mortgages will increase profitability, and reduce the tax charge on the disallowed interest. Clearly it makes sense to target the highest-interest mortgages firstly, since £ for £ of repayment, this will affect the interest bill the most. Bear in mind that the new tax regime for leveraged landlords will make debt repayment hugely tax-efficient i.e. the tax benefit alone make this 'investment' worthwhile for many landlords.

2. RE-MORTGAGE HIGH-INTEREST MORTGAGE BORROWINGS TO A LOWER RATE

Now more than ever it is important to reduce property finance costs as much as possible. So, re-mortgage any property that isn't on the best possible deal. Bear in mind that 'finance costs' includes finance fees, so it makes no difference whether a high-fee-low-rate or a low-fee-high-rate mortgage deal is chosen.

> "The new rules don't apply to companies – therefore transferring property into a company allows the new rules to be side stepped completely"

3. CONSIDER SELLING PROPERTIES WITH HIGH MORTGAGE COSTS

Realistically, there is a limit to how much borrowings the average landlord can repay, and most portfolio landlords will mostly be on the best mortgages, or have mortgages on pre-credit crunch trackers that they may not want to re-finance. So, some hard decisions may need to be made – but extreme circumstances require extreme decisions.

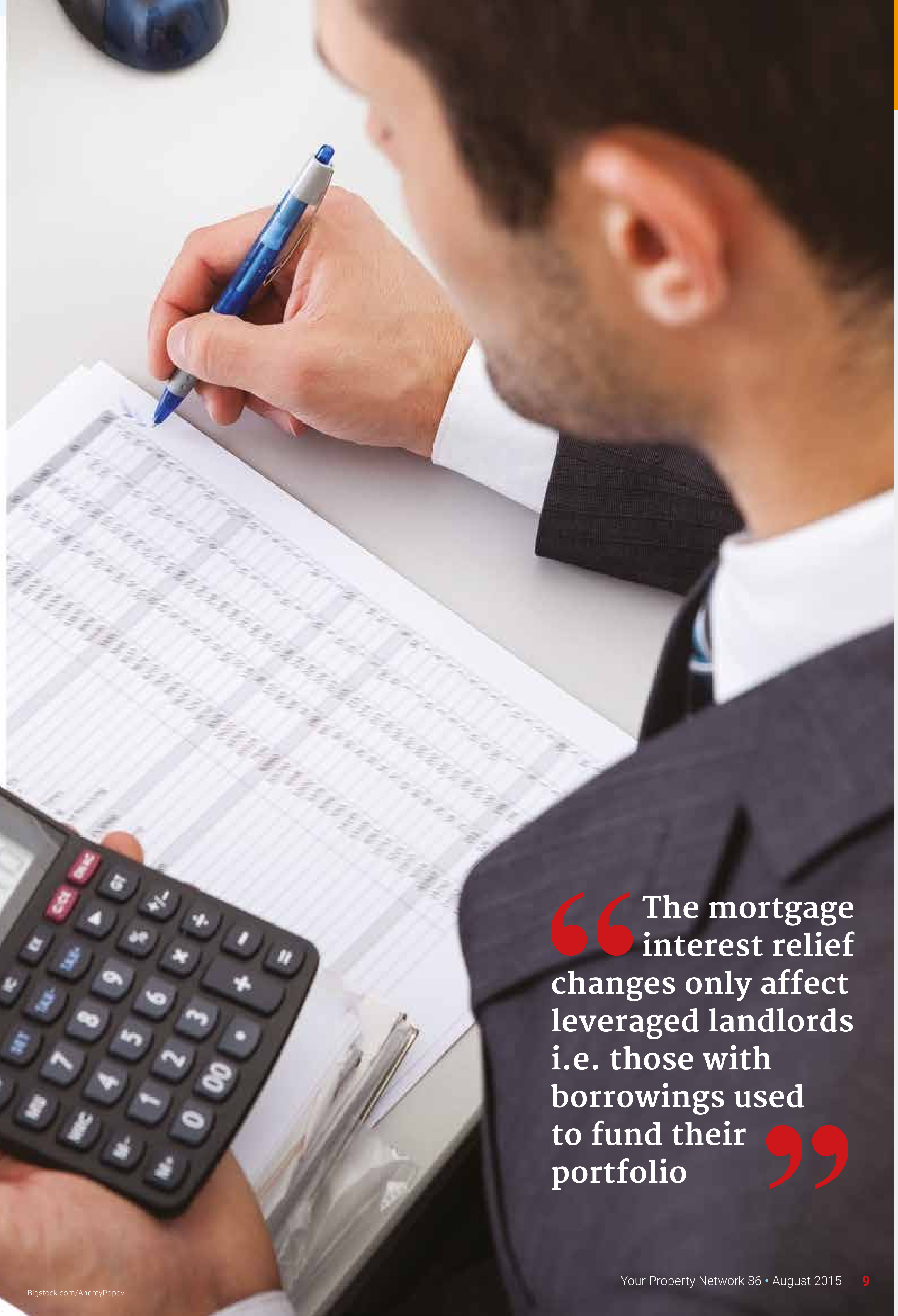
4. REDUCE PERSONAL PROFITS VIA A MANAGEMENT COMPANY

A company can be used to charge a management fee to a private landlord for management services (which can include the usual range of letting agent services, but also 'refurb management', accounts services, arranging insurance etc, in order to increase the total fee charged). This is a simple and cost-effective company set-up, in practical terms, as long as total fees in a 12-month period are below the VAT threshold (currently £82k). Alternatively a lease arrangement can be implemented, whereby properties are leased to a company and then sublet (subject to no lender objections).

Note that using a company in this way needs careful set-up and operation in order not to fall foul of HMRC's General Anti Avoidance Rules (GAAR).

5. TRANSFER EXISTING PROPERTY INTO A COMPANY

The new rules don't apply to companies – therefore transferring property into a company allows the new rules to be side-stepped completely. However, transferring property into a company potentially results in a CGT charge, plus SDLT, i.e. the transfer is treated for tax purposes like as a 'market value' sale (albeit, 'market value' can mean a range of values).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> "The mortgage interest relief changes only affect leveraged landlords i.e. those with borrowings used to fund their portfolio"

For Northern landlords / properties, this may not be an issue as no significant CGT may result (bear in mind the £11k per person (two spouses?) CGT Annual Exemption), and many Northern properties are valued at £125k or less. However for some landlords (Southern?) sat on large capital gains, it may not be a viable option to pay CGT and SDLT on a transfer into a company.

Finally, transferring beneficial interest in a personally-owned property into a company may be against the mortgage provider's terms: of course if this is the case then the mortgage may need to be repaid and re-financed within the company. However this is a lender issue, not a tax issue.

Note that the transfer of a property into a company can result in a large credit on the directors loan account which can then be subsequently drawn out from company profits tax-free.

> "The new mortgage interest relief restrictions don't start to apply until tax year 2018, and even then are phasing in over 4 tax years"

6. TRANSFER PROPERTY OWNERSHIP TO BASIC-RATE TAXPAYERS

Mortgage interest relief is still available at 20% to all landlords – which means that for Basic Rate taxpayers, there is no change to their tax position. Typically, a spousal transfer would be the first option, but it may be viable to transfer property ownership to family or trusted friends, subject to CGT / SDLT considerations (see option 4).

BUT! Note, that 'Basic Rate taxpayers' means those who even with the full finance interest added back, their total 'new income' is within the £50k Basic Rate band (as at tax year 2021).

7. MAKE PENSION & GIFT AID CHARITY CONTRIBUTIONS

Making pension contributions increases the Basic Rate tax band, by 10/8 of the amount paid e.g. a £4k cash pension contribution increases the Basic Rate band by £5k. This means that £5k more of mortgage interest can be claimed at the Higher Rate of tax – meaning pension contributions are even more tax-efficient. However, note that for landlords with only rental income, the maximum gross pension is £3,600 per year (landlords with earned income will be able to contribute more).

Gift Aid charity payments also extend the Basic Rate band just like pension payments do.

8. CLAIM EVERY ALLOWANCE / RELIEF /EXPENSE POSSIBLE

Now, more than ever, it is vital that every possible property allowance / relief / claim is made, to reduce taxable rental income, so that the maximum amount of 'headroom' is allowed. We find some clients become complacent about maintaining records of expenditure – the new tax consequence of this will change that behaviour, I suspect!

9. SPEND SOME MONEY ON REPAIRS TO LOWER TAXABLE RENTAL PROFITS

When it comes to property repairs, there is a fine line between 'money well spent' and 'over the top'. However, for landlords who are not **ALREADY** Higher Rate taxpayers, spending money on repairs could mean staying out of the punitive Higher Rate tax band. Assuming that such repairs don't amount to capital (i.e. not extensions / structural changes, or repairs that are a substantial improvement on the prior position), then there is 40% tax relief available **PLUS** avoidance of the punitive 'interest addback' that means a further 20% tax charge on interest payable.

10. CONSIDER YOUR DAY-JOB – LATERAL THINKING

If remaining in your day-job means you are a Higher Rate taxpayer and subject to a 20% tax charge on your finance interest above the £50k Basic Rate band, at least consider whether you might be better off without the day job… and, bear in mind that the proposed changes only fully hit in 5-6 years time, so there is plenty of time to plan.

In other words, rather than thinking that your property portfolio is causing you additional tax as a result of the mortgage interest relief changes, thinking laterally, could it be that by giving up the day job, the whole of the Basic Rate band becomes available and so the day job is the "problem"?

SUMMARY…

The new mortgage interest relief restrictions don't start to apply until tax year 2018, and even then are phasing in over 4 tax years. This means there is time for landlords to plan how they will deal with the new regime – the most likely scenario will be a combination of using a company, selling some properties, pay down mortgages, and spending money on repairs and pension / Gift Aid contributions… plus good tax advice, of course!

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