Taxcafe.co.uk Tax Guides

The Big Landlord Tax Increase

How to Beat the Cut in Mortgage Tax Relief

By Carl Bayley BSc FCA
and
Nick Braun PhD

Important Legal Notices:

Taxcafe®
Tax Guide - "The Big Landlord Tax Increase"

Published by:
Taxcafe UK Limited
67 Milton Road
Kirkcaldy KY1 1TL
Tel: (0044) 01592 560081
Email: team@taxcafe.co.uk

5th edition, April 2018

ISBN 978-1-911020-28-8

Copyright © Taxcafe UK Ltd and Carl Bayley. All rights reserved.

No part of this publication may be reproduced or transmitted in any form or by any means (electronically or mechanically, including photocopying, recording or storing it in any medium by electronic means) without the prior permission in writing of the publisher except in accordance with the provisions of the Copyright, Designs and Patents Act 1988 or under the terms of a licence issued by the Copyright Licensing Agency Ltd, Saffron House, 6-10 Kirby Street, London EC1N 8TS.

Warning: Any unauthorised reproduction or transmission of any part of this Tax Guide may result in criminal prosecution and a civil claim for damages.

Trademarks
Taxcafe® is a registered trademark of Taxcafe UK Limited. All other trademarks, names and logos in this tax guide may be trademarks of their respective owners.

Disclaimer
Before reading or relying on the content of this tax guide please read the disclaimer carefully.

TAX Cafe®

Pay Less Tax!

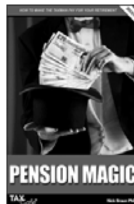
…with help from Taxcafe's unique tax guides

All products available online at

www.taxcafe.co.uk

Popular Taxcafe titles include:

- *How to Save Property Tax*
- *Using a Property Company to Save Tax*
- *How to Save Inheritance Tax*
- *Landlord Interest*
- *Salary versus Dividends*
- *Using a Company to Save Tax*
- *Small Business Tax Saving Tactics*
- *Keeping it Simple: Small Business Bookkeeping, Tax & VAT*
- *Tax Planning for Non-Residents & Non Doms*
- *Tax-Free Capital Gains*
- *Pension Magic*
- *Isle of Man Tax Saving Guide*
- *How to Save Tax*



About the Authors & Taxcafe

Carl Bayley is the author of a series of Taxcafe guides designed specifically for the layman. Carl's particular speciality is his ability to take the weird, complex and inexplicable world of taxation and set it out in the kind of clear, straightforward language that taxpayers themselves can understand. As he often says himself, "my job is to translate 'tax' into English".

In addition to being a recognised author, Carl has often spoken about taxation on radio and television, including the BBC's *It's Your Money* programme and the Jeremy Vine Show on Radio 2.

A chartered accountant by training, Carl is currently Chairman of the Tax Faculty of the Institute of Chartered Accountants in England and Wales and is also a member of the Institute's governing Council.

Nick Braun founded Taxcafe.co.uk in 1999, along with his partner, Aileen Smith. As the driving force behind the company, their aim is to provide affordable plain-English tax information to private individuals, investors, business owners and professional advisors.

Since then Taxcafe has become one of the best-known tax publishers in the UK and has won several business awards.

Nick has been involved in the tax publishing world since 1989 as a writer, editor and publisher. He holds a doctorate in economics from the University of Glasgow, where he was awarded the prestigious William Glen Scholarship and later became a Research Fellow. Prior to that, he graduated with distinction from the University of South Africa, the country's oldest university, earning the highest results in economics in the university's history.

Contents

Introduction 1

Chapter 1 The Tax Change in a Nutshell 5

Chapter 2 Why is the Government Targeting Landlords? 8

Chapter 3 Who is Affected? 11

Chapter 4 The Timetable 16

Chapter 5 The 20% Tax Reduction: How it Works 19

Chapter 6 How Much Tax Will You Pay? Case Studies 23

Chapter 7 How Much Will You Pay this Year (2018/19)? 32

Chapter 8 Scottish Landlords 38

Chapter 9 What if Interest Rates Increase Significantly? 41

Chapter 10 How to Beat the Tax Increase 44

Chapter 11 Increasing Rent to Cover Tax Bills 46

Chapter 12 Postponing Tax Deductible Expenses 48

Chapter 13 Increasing Tax Deductible Expenses 60

Chapter 14 Accelerating Finance Costs 67

Chapter 15 Pension Contributions 70

Chapter 16 Should You Reduce Your Buy-to-Let Mortgages? 77

Chapter 17 Selling Property 80

Chapter 18 Company Owners with Dividend Income 85

Chapter 19 Emigration 88

Chapter 20 Investing in Different Types of Property 91

Chapter 21 Alternative Investment Structures 94

Chapter 22 Transferring Property to Your Spouse or Partner 96

Chapter 23 Using a Company to Save Tax 104

Chapter 24 Getting Existing Property into a Company 119

Chapter 25 Using a Company: Mortgage Issues 129

Chapter 26 Other Ways to Save Tax by Using a Company 132

Chapter 27 The New Cash Basis for Landlords 137

Introduction

Back in 2015 former Chancellor of the Exchequer George Osborne dropped a huge tax bombshell on landlords.

He announced that tax relief on interest and other finance costs paid by residential landlords would be phased out over a period of four years. In its place landlords would receive a "20% tax reduction".

The tax relief cuts started on 6th April 2017 and from 6th April 2020 onwards residential landlords will not receive 40% or 45% tax relief on any of their interest payments. As a result, many will see the amount of Income Tax they pay each year rise by thousands of pounds.

The way the change has been designed also means that many landlords who were previously basic-rate taxpayers will end up paying tax at 40% and some landlords will face other tax stings including losing their child benefit and Income Tax personal allowance and paying tax at the 45% additional rate on some of their income.

In this guide we explain how the tax relief restriction operates and what you can do to protect yourself from a much bigger tax bill.

In Chapters 1 and 2 we provide a brief overview of the changes and explain why we think the Government is hammering landlords.

In Chapters 3 and 4 we look at which types of property investor and which types of finance costs are affected by the change and the timetable for its introduction.

In Chapter 5 we explain the complexities of the new 20% tax reduction and the circumstances in which it is restricted.

Chapters 6 and 7 contain case studies showing how different landlords are likely to be affected by the reduction in their tax relief – during the current 2018/19 tax year and ultimately in 2020/21 when the tax relief cut will be in full force. As you will see, some landlords will come away relatively unscathed, others will suffer a catastrophic drop in income.

Chapter 8 contains some extra information for Scottish landlords, now that their Income Tax rates are set by the Scottish Parliament.

In Chapter 9 we examine how the reduction in tax relief, coupled with further increases in interest rates, could wipe out some landlords' rental profits.

In Chapters 10 to 26 we turn to tax planning and explain how landlords can beat the tax increase by:

- Increasing the rent they charge
- Postponing tax deductible expenses
- Increasing tax deductible expenses (without suffering real economic loss)
- Accelerating finance costs
- Making pension contributions
- Reducing buy-to-let mortgages
- Selling properties
- Taking bigger dividends now (company owners)
- Emigrating
- Investing in other types of property
- Converting properties to a different use
- Using alternative investment structures
- Transferring properties to their spouses/partners
- Using a company (over 30 pages on this key issue)

Finally, in the last chapter we take a look at the new 'cash basis' for property businesses which could make it simpler for landlords to manage their tax affairs, although it also contains *another* potential sting in the tail for those with interest and other finance costs.

It's important to know about the cash basis because you will be forced to use it unless you actively opt out!

Scope of this Guide & Limitations

It is possible that further changes will be announced that affect some of the information contained in this guide.

Although the guide covers a fair amount of ground, it does not cover every possible scenario – that would be impossible without making it much longer and possibly much more difficult to digest.

Landlords come in many different shapes and sizes, so it is possible that some of the information contained in this guide will not be appropriate to your individual circumstances.

The main focus of this tax guide is *Income Tax* planning, i.e. how the reduction in tax relief for finance costs will affect the Income Tax paid by residential landlords and what they can do about it. Steps that you take to reduce one type of tax can have an adverse impact on your liability to pay other taxes.

There are also *non-tax* factors that have to be considered when taking action to reduce your tax bill. In some instances other considerations will outweigh any potential tax savings.

For all of these reasons it is vital that you obtain professional advice before taking any action based on information contained in this guide. The authors and Taxcafe UK Ltd cannot accept any responsibility for any loss which may arise as a consequence of any action taken, or any decision to refrain from taking action, as a result of reading this guide.

Scottish Taxpayers

The Scottish Parliament now has the power to set its own Income Tax rates and thresholds, although it cannot change the personal allowance or tax savings income or dividends. In Chapter 8 we explain the key differences and their impact on Scottish landlords.

Despite these differences, the vast majority of the information contained in this guide remains equally relevant to Scottish taxpayers. However, unless stated to the contrary, all examples, tables, calculations and illustrations are based on the assumption that the taxpayer concerned is not a Scottish taxpayer.

Landlords who are not Scottish taxpayers, but who invest in property in Scotland, are unaffected by Scottish Income Tax. They will, however, pay Land and Buildings Transaction Tax on property purchases in Scotland (instead of Stamp Duty Land Tax).

Welsh Taxpayers

The Welsh Assembly will have the power to set its own Income Tax rates from 6th April 2019. Again, the vast majority of the information contained in this guide will remain equally relevant to Welsh taxpayers once they are subject to different tax rates. Landlords who are not Welsh taxpayers, but who invest in property in Wales, will be unaffected by Welsh Income Tax rates. From 1st April 2018, however, they will pay Land Transaction Tax on property purchases in Wales (instead of Stamp Duty Land Tax).

Accruals versus Cash

As we will see in Chapter 27, the new 'cash basis' has become the 'default' method for landlords to calculate their tax liabilities from 2017/18 onwards. However, despite this, we believe that most landlords will generally prefer to continue using the traditional accounting method under generally accepted accounting principles ('GAAP'), also sometimes known as the 'accruals basis', and will therefore opt out of the 'cash basis'.

We will look at the advantages and disadvantages of the 'cash basis' in Chapter 27 and, in particular, its impact on the restrictions in tax relief for interest and finance costs. Throughout the rest of this guide, however, we will assume that landlords continue to use the traditional 'accruals basis'. Hence, unless stated to the contrary, all examples, tables, calculations and illustrations are based on the assumption that the taxpayer concerned is accounting for their rental income under GAAP.

Spouses and Partners

Please note that any references to a 'spouse' throughout this guide mean a legally married spouse or a registered civil partner. Unmarried partners are generally subject to a different tax treatment for most purposes.

Chapter 1

The Tax Change in a Nutshell

Before 2017/18

Before 2017/18, landlords could generally claim ALL their mortgage interest as a tax deductible business expense.

So if you had £20,000 of rental income, £10,000 of mortgage interest and, to keep things simple, no other expenses, your taxable rental profit would have been £10,000.

As a higher-rate taxpayer you would have paid 40% tax (£4,000) and as a basic-rate taxpayer you would have paid 20% tax (£2,000).

2017/18 and Beyond

Starting with the previous 2017/18 tax year, the mortgage interest tax deduction is being phased out over a period of four years (see Chapter 4 for the timetable).

In its place landlords receive a basic-rate "tax reduction". Essentially what this means is an amount equal to 20% of your interest costs will be deducted from your final tax bill. Higher-rate taxpayers have always enjoyed 40% tax relief on their finance costs, so their tax relief is being halved.

For example, if when the interest deduction is fully phased out you have £20,000 of rental income and £10,000 of mortgage interest you will have a taxable rental profit of **£20,000**, not £10,000.

If you are a higher-rate taxpayer you will pay 40% tax on this profit (£8,000) and if you're a basic-rate taxpayer you'll pay 20% tax (£4,000). You'll then be given a "tax reduction" equal to 20% of your interest costs which in this case is £2,000 (£10,000 x 20%).

So if you're a basic-rate taxpayer you'll still pay £2,000 tax overall and will be unaffected by the change. If you're a higher-rate taxpayer you'll pay £6,000 tax overall – an increase of £2,000.

In a Nutshell

If you're a basic-rate taxpayer you will not have to pay more tax.

If you're a higher-rate taxpayer you can make a rough and ready estimate of how much extra tax you'll pay in 2020/21 and future tax years by multiplying your total finance costs by 20%.

This is because instead of getting 40% tax relief on your finance costs you will only get 20% in the future – a 20% cut in tax relief.

Thus, if your total finance costs are £10,000, your tax bill will eventually increase by £2,000 (£10,000 x 20%).

It's important to stress that here we are comparing 2020/21 tax bills with pre 6th April 2017 tax bills (i.e. before the interest relief restriction started to bite).

But it's Not Always that Simple

Because you will eventually be unable to deduct any of your interest costs from your rental income, your total taxable income could increase significantly.

This means you could end up in a higher tax bracket.

Thus some landlords who have previously always been basic-rate taxpayers could end up as higher-rate taxpayers. As a result they could end up paying 40% tax instead of 20%.

In addition some landlords could see their income go over other key tax thresholds (e.g. £100,000 where the personal allowance is withdrawn or £150,000 where the additional rate of tax is payable).

In Chapter 6 we'll take a look at some case studies showing how different landlords are likely to be affected by the time the tax change has been rolled out fully in 2020/21.

What about the Current 2018/19 Tax Year?

If you're a higher-rate taxpayer this year you can make a very rough estimate of how much extra tax you'll pay because of the tax change by multiplying your total finance costs by 10%.

You are a higher-rate taxpayer this year if your taxable income is more than £46,350 (£43,430 in Scotland).

If you are still a basic-rate taxpayer this year, despite the fact that half your interest costs are no longer tax deductible, you will have no extra tax to pay.

Note, here we are comparing 2018/19 tax bills with pre 6th April 2017 tax bills (i.e. before the interest relief restriction started to bite).

Once again it's important to stress that these rough and ready estimates cannot be relied on by all taxpayers. If you end up in a higher tax bracket because half your interest is no longer tax deductible, you could face a higher tax bill.

In Chapter 7 we'll take a look at some case studies showing how different landlords are likely to be affected this year.

If you have enjoyed reading the first few pages of this publication, please

CLICK HERE

to add it to your shopping cart at

£26.95

+ FAST & FREE POSTAGE

You will also receive a FREE PDF copy so you can read the entire book just seconds after placing your order!