# PROPERTY PLUS

MAY 2018

## INTRODUCTION

Welcome to the May edition of Property Plus, where we have sought to give you an insight into some of the most topical property issues we are discussing right now.

To start with, mortgage interest tax relief has been a hot topic since it was announced that a restriction would be phased in over a period of three years from April 2017. Alice Pearson considers how this impacts upon taxpayers who incur interest charges on loans to fund property businesses. As well as the more obvious tax liabilities to be faced, Alice also considers the knock-on effects of the restrictions. With examples illustrating the penal effects of this new measure, this is a must-read article for landlords who fund their property purchases and improvements through borrowings.

Following on from the squeeze landlords are feeling on their net income, many people are now considering acquiring their buy-to-let properties through a company. David Hadley compares the tax cost of corporate versus personal ownership, and asks the question of whether it is time to incorporate existing rental businesses. David provides clear examples which illustrate where the pros and cons of doing so lie, as well as useful narrative on the subject.

Cathy Corns recaps on what has already changed for non-resident corporate landlords since 2015 and looks ahead to what can be expected as new tax rules come into play over the next couple of years. Comparing the new regimes with those we are currently used to, Cathy details where consideration and advice may be needed.

Richard Collier looks at the VAT position for those who choose to rent out a property through Airbnb and similar agencies. Whilst such an arrangement may be entered into quite casually, owners should be aware of the VAT considerations, especially if the revenue from such a venture is likely to become significant, the property is owned by a person who is already making taxable supplies, or the property owner is non-UK resident.

Estate planning involving the UK family home is famously difficult and this valuable asset therefore tends to form a significant proportion of a person's Inheritance Tax (IHT) exposure. Lynsey Lord revisits the Residence Nil Rate Band which was introduced in April 2017 to help alleviate the IHT burden on homeowners. Lynsey reminds us of the main conditions and explores ways of maximising this opportunity.

Finally, pensions offer a tax-efficient structure for holding various investments, including property. Further to changes made to pension rules in April 2015, notable tax-efficient planning opportunities exist in this area. Michael Lapham looks at the opportunity and the detail, identifying the benefits which can be realised within an individual's lifetime and as part of UK IHT planning.

I hope you enjoy reading our articles and that they provide you with useful information, which you will find pertinent to your own circumstances. Whether you are seeking peace of mind, advice or action, and you think we may be able to assist, please do get in touch with me or one of my fellow contributors. We would be delighted to help you navigate the property ladder!

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# MORTGAGE INTEREST RELIEF RESTRICTION

**FROM 6 APRIL 2017, TAX RELIEF FOR FINANCE COSTS (INCLUDING MORTGAGE INTEREST) RELATING TO RESIDENTIAL PROPERTY BUSINESSES WAS RESTRICTED WITH THE CHANGES PHASED IN AS FOLLOWS:**

| Tax Year | % of costs deducted from profits | % of costs available as a basic rate tax reducer |
|---|---|---|
| 2017/18 | 75% | 25% |
| 2018/19 | 50% | 50% |
| 2019/20 | 25% | 75% |
| 2020/21 | - | 100% |

As a result, by 2020/21, these costs will no longer be an allowable deduction against rental income but instead a 20% income tax reduction will be given.

These rules only apply to individual landlords owning residential property and not to companies, commercial properties and furnished holiday lets.

**Example:** Philip (a 40% taxpayer) owns a buy-to-let property purchased with a mortgage. We can see the effect of this change by comparing Philip's tax position in 2016/17 with 2020/21:

| | 2016/17 (£) | 2020/21 (£) |
|---|---|---|
| Gross rents | 8,000 | 8,000 |
| Less: Repairs & other allowable expenses | (1,300) | (1,300) |
| | 6,700 | |
| Less: Interest paid | (2,700) | |
| Net rental profit | 4,000 | 6,700 |
| | | |
| Income tax @ 40% | 1,600 | 2,680 |
| Less: Interest relief (20% x 2,700) | | (540) |
| Net income tax | 1,600 | 2,140 |

As you will see, Phillip's tax liability has increased by £540 and the effective tax rate on the net rental profit has increased from 40% to 53.5%. Phillip only has relatively modest interest outgoings however and these changes are likely to significantly impact larger property businesses funded with debt.

**Who is affected?**

This restriction impacts all taxpayers who incur finance costs in relation to their rental business and not just higher rate taxpayers. This is because basic rate taxpayers may find that, once the finance costs are disallowed, they are higher rate taxpayers. These changes can also increase the overall tax payable where the rental business is loss making. These complications are best illustrated in the next example.

**Example:** Theresa (normally a 20% taxpayer) receives business profits of £24,000 and annual rental income of £33,000. As the property has a large mortgage with annual interest of £35,000, the rental business is loss making. Her tax position for 2016/17 and 2020/21 will differ as follows:

| | 2016/17 (£) | 2020/21 (£) |
|---|---|---|
| Business profits | 24,000 | 24,000 |
| Rental income | 33,000 | 33,000 |
| | 57,000 | |
| Less: Interest paid | (33,000) | |
| Total income | 24,000 | 57,000 |
| Less: Personal Allowance | (11,000) | (11,000)* |
| Taxable income | 13,000 | 46,000 |
| | | |
| Income tax @ 20% | 2,600 | 6,400 |
| Income tax @ 40% | | 5,600 |
| | | 12,000 |
| Less: Interest relief (20% x 33,000) | | (6,600) |
| Net income tax | 2,600 | 5,400 |

*(*It is assumed that the 2016/17 tax bands and allowances will apply for 2020/21)*

As a result of the restriction, Theresa is now a higher rate taxpayer. Theresa's property letting business has made a loss of £2,000 but in 2020/21 she pays income tax of £2,800 in relation to this loss-making business! She will also lose most of her child benefit because her total income is over £50,000.

However, as her interest costs are greater than the letting income by £2,000, she will be able to carry forward a tax reduction of £400 (20% x £2,000) to set against a future income tax liability.

**Knock-on effects**

As interest is disallowed in the rental accounts, this increases overall taxable income. This could have a number of effects, such as pushing an individual into a higher rate of income tax and/or capital gains tax, reducing their personal allowance (if their income now exceeds £100,000), affecting their entitlement to child benefit (as illustrated above) and restricting the amount on which they can claim tax relief for pensions.

**Incorporation of rental business**

Highly leveraged landlords of residential properties are likely to be the worst affected by these changes. As this restriction only applies to individual landlords, some taxpayers are considering incorporating their property letting businesses, which is further driven by the fall in corporation tax to 17% by 2020.

However, there is scope for significant capital gains tax and SDLT charges to be triggered on incorporation, if relief is not available. There are also other considerations, such as the added administration and possibly higher rates of interest on company borrowings. Please refer to 'Residential properties – time to incorporate?' written by my colleague David Hadley, below.

**New acquisitions**

For new acquisitions, an appropriate ownership structure should be considered beforehand. Although there may be tax savings by holding property via a company where there is debt funding, the bigger picture needs to be considered, including profit extraction and long term exit planning. There is no 'one size fits all' solution and we therefore recommend you seek our advice prior to the acquisition.

IF YOU WOULD LIKE TO DISCUSS ANY OF THE ISSUES RAISED HERE, PLEASE GET IN TOUCH WITH ALICE PEARSON OR YOUR USUAL CONTACT AT MERCER & HOLE.

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# RESIDENTIAL PROPERTIES – TIME TO INCORPORATE?

MORTGAGE INTEREST RELIEF IS NOW BEING RESTRICTED FOR INDIVIDUALS HOLDING LOANS TO ACQUIRE RESIDENTIAL PROPERTIES FOR INVESTMENT PURPOSES. FROM 6 APRIL 2020 INCOME TAX RELIEF WILL BE LIMITED TO THE BASIC RATE OF INCOME TAX AT 20% ONLY FOR INTEREST ON BUY-TO-LET RESIDENTIAL PROPERTIES. THIS RESTRICTION IS ALREADY BEING PHASED IN AS MY COLLEAGUE ALICE PEARSON HAS MENTIONED IN THE PREVIOUS ARTICLE.

For this reason many people are considering acquiring their buy-to-let properties through a company. This is best illustrated with an example:

Samira owns a number of residential buy-to-let properties. The net profits before interest are £100,000. The annual interest on her borrowings is £25,000. She pays income tax at 40%. Her tax liability for 2020/21 is as follows:

| | Owned personally (£) | Owned through company (£) |
|---|---|---|
| Net rents | 100,000 | 100,000 |
| Less: interest paid | (25,000) | (25,000) |
| | 75,000 | 75,000 |
| Corporation tax @17% | - | (12,750) |
| | 75,000 | 62,250 |
| Income tax on dividend @32.5% | - | 20,231 |
| Income tax on £100,000 of rents @40% | 40,000 | - |
| Less: interest relief (20% x 25,000) | (5,000) | - |
| Total tax | 35,000 | 20,231 |
| | | |
| Net income | 40,000 | 42,019 |

The illustration assumes that the company distributes all of its income by way of dividend.

It may be that Samira does not need to distribute all of the company's income to her but retain some in the company for re-investment. In that case she shelters some of the profit from income tax and as a result there is a further benefit of holding the properties in the company.

A further potential benefit of holding the properties through a company is that when the company sells a residential investment property it usually pays corporation tax on the gain at corporation tax rates. The current corporation tax rate is 19% and is due to reduce to 17% in 2020. In addition, in calculating the gain the cost of the property is indexed for inflation (indexation allowance) but only up to 1 January 2018. This contrasts with an individual, such as Samira, who pays Capital Gains Tax (CGT) at the higher rate of 28% (18% for basic rate taxpayers) on the disposal of a residential property held as an investment and is not entitled to any indexation allowance. However, if the company sells the property the funds from the disposal will then be in the company. If Samira wishes to withdraw the funds from the company rather than re-invest the proceeds there will then be a further tax charge on the payment of the dividend.

**Example:** Samira owns a number of residential buy-to-let properties. She sells one of the properties in 2018/19 and realises a gain of £100,000. She pays income tax on dividends at 32.5%. Her tax liability is as follows:

| | **Owned personally (£)** | **Owned through company (£)** |
|---|---|---|
| Taxable gain | 100,000 | 100,000 |
| Less: CGT annual exemption | (11,700) | - |
| | 88,300 | 100,000 |
| CGT @ 28% | (24,724) | - |
| Corporation tax @19% | - | (19,000) |
| Gain after tax | 75,276 | 81,000 |
| Less: Income tax on dividend of £81,000 @32.5% | - | (26,325) |
| | | |
| Net income | 75,276 | 54,675 |

The illustration assumes Samira has no other gains in the year. Thus, if she reinvests all of her proceeds she saves £5,724 of tax by holding the property in the company. However, if she distributes all of the profits as a dividend she is in isolation £20,601 worse off holding the property in the company.

Samira also needs to be aware that there are some potential tax charges on incorporation. If and when she transfers her properties to the company there is a potential taxable chargeable gain on her. The gain is on the market value of the properties on the date of the transfer less what she originally paid for them and the rate of tax is 28% (18% for basic rate taxpayers).

## "THE RESTRICTION ON TAX RELIEF FOR MORTGAGE INTEREST IS CAUSING PEOPLE TO CONSIDER USING A COMPANY TO OWN UK RESIDENTIAL LET PROPERTIES"

Samira may qualify for incorporation relief in which case no CGT charge arises and the gain is effectively deferred. Incorporation relief is available if she transfers the whole of her property business and all of its assets (except for cash) to her new company in exchange for the issue of shares to her by the new company. However, HMRC generally will not accept that the passive holding of a few property investments represents a business and the activity needs to be more substantial to constitute a business.

In addition, on the transfer of the properties to the company, Stamp Duty Land Tax (SDLT) will be payable on the market value of the properties. A possible way around this is for Samira to transfer the properties firstly to either a partnership or a Limited Liability Partnership. This then operates as the property business for a few years and it can then usually, based on current legislation, transfer the properties to a company without SDLT. This solution may not work for Samira as she owns all of her properties herself but may work if say she owns the properties jointly with her husband.

IF YOU WOULD LIKE TO DISCUSS ANY OF THE ASPECTS RAISED IN THIS ARTICLE IN MORE DEPTH, PLEASE CONTACT DAVID HADLEY OR YOUR USUAL MERCER & HOLE CONTACT.

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# TAX CHANGES FOR NON-RESIDENT CORPORATE LANDLORDS

**THE UK TAX LANDSCAPE HAS CHANGED DRAMATICALLY FOR COMPANIES OWNING AND LETTING PROPERTY IN THE UK.**

Historically, any rental income received, net of costs, was charged to income tax but capital gains were excluded from the charge.

The position on residential property changed in 2015. Any gains on such properties are now chargeable to UK tax. Additionally, there is a requirement to notify HMRC of any sale within 30 days of the conveyance, with penalties for late returns.

Looking forward, from April 2019, any gains on UK land and/or property are expected to fall within the charge to UK tax.

Then HMRC are consulting on proposals that, from 6 April 2020, non-resident corporate landlords will come into the corporation tax, rather than income tax, regime. This has a number of implications:

- The companies, including those already known to HMRC through registration under the non-resident landlord scheme, are likely to need to re-register with HMRC for corporation tax. They will also need to re-file details of their tax agents, as automatic carry-over of the income tax authorisation is not envisaged.
- The change to corporation tax will be on 6 April 2020, immediately following the end of the income tax year 2019/20. The income tax property business will be deemed to end on 5 April 2020. A final income tax return is needed for 2019/20; and a 'new' corporation tax business and accounting period will be deemed to commence on 6 April 2020.

  If the corporate landlord has a different financial year end (which is likely) this may lead to overlap between 'real' and deemed tax basis periods.

  It seems probable that capital allowance values, if any, will just carry over, although this is not yet confirmed.
- Any unused income tax property losses will be carried forward as a new category of income tax loss 'income tax property losses'. This will be available to offset against post-2020 property business profits only.

  Corporation tax relief for management expenses will be available to non-resident corporate landlords. However, if the company carries on other activities, for example, if it owns non-UK properties or subsidiaries, relief will only be given for expenses directly linked to its UK property business.

Currently, non-resident landlords can claim relief for interest as an expense in working out income tax profits. The only limits on deductibility are the 'wholly and exclusively' condition and transfer pricing rules. From April 2020, the position will be very different:

- Firstly, financing costs will no longer be deductible as property business expenses but under the loan relationship regime.
- Secondly, landlords will need to consider the provisions that could limit deductibility of financing costs; the connected company and unallowable purpose tests will need to be considered as well as, in some cases, the rules on 'hybrid' arrangements. Finally, the distribution rules will be relevant to payments made by non-resident companies.
- Non-resident corporate landlords will also need to consider the new corporate interest restrictions. Broadly speaking, these limit tax relief for finance costs to a percentage of taxable profits, potentially as low as 30%, subject to a capped £2m interest capacity which may help to avoid restriction. However, the £2m is a group (not a company) limit.
- Finally, non-resident corporate landlords, therefore, face a much heavier compliance burden under corporate tax. Some, particularly those with high leverage and/or significant shareholder debt, may find that some of their finance costs are no longer deductible.

**IF YOU WOULD LIKE TO DISCUSS THE CHANGES IN RELATION TO YOUR CIRCUMSTANCES, PLEASE GET IN TOUCH WITH CATHY CORNS OR YOUR USUAL CONTACT AT MERCER & HOLE.**

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# AIRBNB – VAT

**THE CHALLENGES OF VAT ARE EVER PRESENT. A RELATIVELY SIMPLE IDEA SUCH AS RENTING OUT A PROPERTY ON A TEMPORARY BASIS TO VISITORS WOULD SEEM QUITE INNOCUOUS, BUT IF THE RENTAL TURNOVER BECOMES SIGNIFICANT IT COULD LEAD TO VAT REGISTRATION AND ASSOCIATED CONSIDERATIONS.**

The income from property that qualifies as UK holiday accommodation will be standard rated for VAT. This assumes that the property is not let out on a long term residential basis, but rather as short term, furnished sleeping accommodation, held out for visitors. Care is needed when applying the rules as there are exceptions (e.g. longer stays).

The typical example of a UK property let to visitors under an Airbnb (or similar) arrangement would probably qualify. There are some contractual issues to clarify in terms of billing; does the property owner supply to an organisation in return for a standard fee, or to the individuals that use the property? Understanding this can assist with invoicing and also VAT recovery on costs (e.g. admin costs, payment handling fees etc from the central organisation).

VAT applies once the property provider has VAT registered, which is compulsory where taxable turnover exceeds £85,000. However, there are separate rules for 'non-established' providers of VATable supplies where no registration threshold applies, following the decision in Schmelz, which concerned the rental of foreign-owned property. Those in such a position should consider their obligations carefully.

> "VAT APPLIES ONCE THE PROPERTY PROVIDER HAS VAT REGISTERED, WHICH IS COMPULSORY WHERE TAXABLE TURNOVER EXCEEDS £85,000."

It is possible to register before breaching the £85,000 limit, on a voluntary basis, but the cost-benefit analysis of price increases should be measured against VAT recovery potential. By not charging VAT, the property provider has a competitive advantage over hotel chains, but in the case of well situated city properties, adding VAT may not be overly disadvantageous for bookings.

VAT registration applies to the provider, i.e. the owner of the property. In the case of an individual, this registration will render not just their property income, but all potentially taxable income subject to VAT, which could be onerous. By the same token, all such personal income counts towards the VAT registration threshold, so starting to let out a property could tip an individual over the threshold.

For larger Airbnb type operations, involving multiple properties, it may therefore be preferable (for VAT) to own the properties in a separate entity such as a company or even a partnership. Multiple tax and legal considerations apply to transferring property ownership, but for VAT registration purposes at least, a partnership route might be a more viable option than transferring to a separate corporate entity.

> "FOR LARGER AIRBNB TYPE OPERATIONS, INVOLVING MULTIPLE PROPERTIES, IT MAY THEREFORE BE PREFERABLE (FOR VAT) TO OWN THE PROPERTIES IN A SEPARATE ENTITY SUCH AS A COMPANY OR EVEN A PARTNERSHIP."

A simple decision to generate additional income from an existing asset may not always be the straightforward option it appears. Sensible up-front structuring and advice can mitigate potential downsides.

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# RESIDENCE NIL RATE BAND

The Residence Nil Rate Band (RNRB) became one year old on 6 April 2018 and £25,000 greater in value. In two years' time it will have reached its maximum value of £175,000 giving some individuals a £500,000 inheritance exemption (£1,000,000 for married couples) when added to the current nil rate band. In this article we recap how this additional exemption operates and how to maximise its benefit.

**Qualifying conditions**

1. Estate threshold: The chargeable estate must be valued at £2 million or less, before taking into account any reliefs or exemptions, to obtain the full RNRB. Where an estate exceeds £2 million in value, the RNRB is tapered away and £1 of RNRB is lost for every £2 the estate exceeds £2 million.
2. Qualifying residential interest: The deceased's estate must contain a home which they occupied at some stage during their life but not necessarily on their death. This condition is further extended by the downsizing provisions which enables an estate to qualify if the deceased owned a home but sold, gifted or downsized it prior to their death (but after 8 July 2015).
3. Closely inherited: The home must have been left to a lineal descendant of the deceased (child, grandchild, step-child, adopted child and fostered child and their spouses).

**Amount of relief**

The amount of relief will be the lower of:

1. The value of the home, or share thereof, which is closely inherited. Note that any outstanding mortgage reduces the value here.
2. The maximum RNRB that is available when the person died.

Like the nil rate band, any unused RNRB is transferable between married couples and civil partners and the unused percentage can be claimed against the estate of the surviving spouse at the rate on the second death. Therefore if the surviving spouse inherits the whole of the estate (or even just the home), the full RNRB will be available on the second death.

**Downsizing provisions "the downsize addition"**

In HMRC's own words "the downsizing rules are complicated" and executors who are dealing with a claim may need to seek professional advice. Broadly the provision will enable an estate which did not hold a qualifying interest at the date of death (because it was sold, gifted or downsized) to benefit from the exemption as long as there are other assets in the estate equal to the value of former property.

**Example:** In August 2015 John downsizes from a £400,000 property to a flat worth £100,000. In May 2020 he passes away with an estate worth £600,000 which includes his flat worth £150,000. The RNRB is £175,000 in 2020/21 and as long as John leaves his flat and £25,000 of other assets to lineal descendants his estate will benefit from the full RNRB of £175,000

Another hurdle the executors will face is locating information on a former home and it is therefore extremely important that good records are kept in the individual's lifetime to help the executors claim the relief. Keeping your tax adviser informed is good practice and will ensure there is paperwork available for the executors.

**Maximising the RNRB**

*Lifetime gifting*

When testing the £2million threshold, gifts made in the last 7 years are not taken into account. This means gifts could be made the day before the date of death and would result in the estate being reduced for RNRB purposes. However before any "deathbed planning" is carried out care needs to be taken to consider whether any other tax liability is triggered on such a gift. A gift of assets other than cash could give rise to capital gains tax for example.

*Review of the Will*

Unless the property is held as joint tenants it will devolve via the Will. For those with simple Wills, ideally the property will devolve to the surviving spouse to preserve the RNRB. Those with flexible Wills (leaving assets on discretionary trust with a side letter of wishes) should ensure their properties are held as tenants in common so that the property devolves via the Will.

We remain advocates of flexible Wills in certain circumstances as they can provide protection for the beneficiary against care home fees, second marriages, bankruptcy proceedings etc. They also enable the executors to divide an estate in a way that is right taking into account the tax rules on death and, if required, make alterations within two years of death to secure the RNRB.

*Here today gone tomorrow?*

With tax changing regularly we cannot complete this article without mentioning the review which the office of tax simplification is carrying out in relation to inheritance tax. It remains to be seen whether the RNRB will survive any overhaul or whether we will finally get the £1million nil rate band which was initially promised.

IF YOU WOULD LIKE TO REVIEW YOUR ELIGIBILITY FOR THE RNRB OR EXPLORE YOUR ESTATE PLANNING OPTIONS, PLEASE GET IN TOUCH WITH LYNSEY LORD OR YOUR USUAL CONTACT AT MERCER & HOLE.

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# PENSIONS, PROPERTY AND INHERITANCE TAX

The Inheritance Tax (IHT) advantages available to non-UK domiciliaries have been curtailed by extending the scope of IHT to include all UK residential property regardless of the ownership structure in place. It is therefore an opportune time to remind or familiarise oneself with the tax efficiencies offered by contributing to a UK registered pension and the advantages of holding assets, which may still include commercial property, within them.

Ultimately pensions are merely a tax-efficient structure capable of holding various investments. Qualifying contributions made into a pension receive tax relief, any growth in the value of the assets are tax-free whilst held within the pension wrapper and typically 25% of withdrawals are tax-free.

Whilst the tax treatment of pensions outlined above are often understood, the fact that they are not included in the value of an individual's estate upon death is still often overlooked. Any potential future tax does, however, depend upon the age of the individual at their date of death and the way in which beneficiaries make withdrawals.

The following applies to defined contribution pensions, such as personal pensions or self-invested arrangements, such as SIPPs (Self-Invested Personal Pensions) and SSASs (Small Self-Administered Schemes). Since April 2015, if an individual dies before their 75th birthday, whatever is left in their pension can be paid, whether it be as a lump sum or regular or ad-hoc withdrawals, to the nominated beneficiaries tax-free. If death occurs at or after age 75 those payments will be taxable at the recipient's marginal rate of income tax. In addition, beneficiaries no longer have to be spouses or financial dependents and pensions can now potentially be cascaded down the generations.

These changes have led to significant planning opportunities, particularly where pensions hold property.

Given the substantial costs of purchasing a property this will not be an option for everyone. However, previously accrued pension policies could be consolidated into one arrangement from which the purchase could then take place. In addition, self-invested pensions can borrow up to 50% of their net value to help fund a desired purchase and a number of individuals' pensions can potentially be grouped together in order to amass sufficient funds.

There are often misconceptions surrounding pensions which typically concern issues such as restrictions in the types of assets that can be held within a pension. In fact there are very few restrictions, in terms of permissible investments that a pension can hold. The big restriction is residential property, and this should be borne in mind when considering the contents of this article.

In addition to the above, the pensions Annual and Lifetime Allowances impact appropriate contribution levels and pension fund sizes which need to be taken into consideration both now and in the future.

Those points aside, pensions remain a very tax-efficient way of holding commercial property throughout an individual's lifetime whilst also preventing it from becoming subject to the UK IHT net on death. At the same time the appropriateness of the investment, along with the investor's personal circumstances and objectives, need to be considered as usual.

IF YOU WOULD LIKE TO DISCUSS ANY OF THE ISSUES RAISED HERE, PLEASE GET IN TOUCH WITH MICHAEL LAPHAM OR YOUR USUAL CONTACT AT MERCER & HOLE.

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