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# Landlord Taxation & PRA Changes

## A Guide for Landlords

**Produced by Hollybeck Limited**
**Mortgage & Protection Advisers**
**E:** hello@hollybeckfinance.co.uk
**T:** 01332 416 470
**W:** hollybeckfinance.co.uk

## A Changing Tax Landscape

Landlords have been hit particularly hard recently by a raft of punitive tax measures and the government will continue to increase the pressure over the coming years. You need to be aware of the changes as they will directly affect the amount of tax you pay on your rental properties. Over the coming years they could seriously affect the profitability of your business.

On top of these tax changes landlords also need to prepare for the new PRA underwriting standards that will be introduced in October 2017. This overhaul is set to change the way lenders view landlords with 4 or more properties. These landlords will now be classed as 'portfolio landlords' and will need to meet more stringent requirements.

With all of this heaped upon them, landlords have a lot to think about and it may seem a little overwhelming. We've produced this guide to help you understand the changes and how the they may affect you. We also suggest some possible ways of minimising any negative effects and how to potentially increase the profitability of your rental properties despite the tax reforms.

## Removal of the 10% Wear & Tear Allowance

Historically landlords with furnished properties have been able to deduct a 10% wear and tear allowance from their rental income. This was intended to compensate for any furnishing that had to be replaced but in general it was available regardless of whether or not the landlord spent money on replacing furnishings.

This relief was scrapped as of April 2016. Landlords can now only claim relief where there has been actual expenditure on replacement furnishings. In essence, the removal of the wear and tear allowance has seen landlords of furnished properties paying more tax across the board.

## 3% Stamp Duty Surcharge

This is a particularly painful reform for any landlord wanting to add to their portfolio.

As of April 2016 if you purchase an additional property in the UK you will have to pay an extra 3% in stamp duty. This tax applies to purchases of any value even if it is below the normal SDLT threshold of £125,000. In other words, you pay it on the total purchase price. Here's a couple of examples to illustrate.

| **Example A: Charlie purchases an additional BTL property at £95,000** | |
|---|---|
| Old System | No SDLT pay |
| New System | Charlie pays SDLT on £95,000 at 3% (£2850) |

| **Example B: Claire purchases an additional BTL property at £245,000** | |
|---|---|
| Old System | Claire pays SDLT on £125,000 at 0%<br>Claire pays SDLT on the remaining £120,000 at 2%<br>Total SDLT = £2400 |
| New System | Claire pays SDLT on £125,000 at 3% = £3750<br>Claire pays SDLT on the remaining £120,000 at 5% = £6000<br>Total SDLT = £9750 |

It is clear that landlords pay significantly more tax under the new system and need to know their numbers now more than ever. This will ensure any potential new properties stack up in their overall portfolio and give them the return they need in the right timeframe.

## Reduction of Mortgage Interest Tax Relief

Another huge hammer-blow for landlords is the reduction of tax relief on BTL property financing. The impact of this blow will really start to become apparent as it is phased in over the coming years.

As of April 2017, you can no longer offset 100% of your mortgage interest when working out your profit. The amount you can offset will be reduced by 25% per year as the table below illustrates.

| Tax Year | Amount of Tax Relief |
|---|---|
| 2017/2018 | 75% |
| 2018/2019 | 50% |
| 2019/2020 | 25% |
| 2020/2021 | 0% |

Instead from April 2020, you will receive a tax credit for 20% of your property financing costs. If you are a higher rate tax payer this will make a big difference to the tax you will pay. Let's look at a couple of examples to illustrate what this could look like for a higher rate tax payer.

| Example A: Tom – mortgage interest equates to 60% of rental income | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Tax Year | Rental Income | Mortgage Interest | Tax Relief | HMRC calc. of Profits (Gross) | Actual Profits (Gross) | Tax Payable (40%) | Tax Credit (20%) | Actual Profits (Net) |
| 2016/2017 | £10,000 | £6000 | £6000 | £4000 | £4000 | £1600 | n/a | £2400 |
| 2020/2021 | £10,000 | £6000 | £0 | £10000 | £4000 | £4000 | £1200 | £2800 |

As you can see, under the old tax regime Tom could automatically offset the £6000 he's paid in mortgage interest against his rental income. Once the new system is fully implemented he'll no longer be able to do this so HMRC will deem his pre-tax profits to be much higher. Ultimately it sees his net profits diminished by £400. Now, this example assumes a modest level of gearing – mortgage interest is 60% of rental income – but what if your financing costs are much higher in relation to your rental income? Well, it's a much gloomier picture as the next example shows.

| Example B: Sue – mortgage interest equates to 90% of rental income | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Tax Year | Rental Income | Mortgage Interest | Tax Relief | HMRC calc. of Profits (Gross) | Actual Profits (Gross) | Tax Payable (40%) | Tax Credit (20%) | Actual Profits (Net) |
| 2016/2017 | £10,000 | £9000 | £9000 | £1000 | £1000 | £400 | n/a | £600 |
| 2020/2021 | £10,000 | £9000 | £0 | £10,000 | £1000 | £4000 | £1800 | -£1200 |

In the above example Sue's profits are actually wiped out completely under the new system and her property actually becomes a liability, making a loss of £1200. HMRC offer her no relief and base their tax calculation on her total rental profits. It is clear that the mortgage interest she pays wipes out most of her profits and the tax credit she receives only partially compensates for the loss her inflated tax bill incurs.

| **Potential Changes to Your Tax Rate** |
| --- |
| If you are currently a basic rate tax payer it is possible that you may be tipped into higher rate tax payer status as a result of the increased rental income you will now be seen to receive. You are particularly at risk of this if your earnings from other employment are already towards the upper end of the basic rate tax payer bracket. It is estimated that 440,000 landlords will be affected in this way and is a major concern for many. |

## Portfolio Landlord Changes

The Prudential Regulation Authority (PRA) will bring in new underwriting standards as of 1st October 2017. These changes will affect portfolio landlords (any landlord who has an interest in 4 or more mortgaged buy-to-let properties). These new standards will require much greater scrutiny of landlords when they apply for a new mortgage. Instead of basing their decision to lend on the individual merits of the property requiring finance, lenders will now take a holistic view of your entire portfolio before agreeing a new mortgage. In essence, they will be looking for any potential problems such as under-performing properties that could cause issues in the future.

## What does this mean for you?

Requirements will vary between lenders and your mortgage broker will be able to guide you but essentially you will need to produce additional documentation when applying for any new lending. Here's what to expect.

| **Typical Documents Required from Portfolio Landlords** |
| --- |
| - Portfolio Schedule<br>- Business Plan<br>- Cashflow Forecast Statement<br>- Statement of Assets and Liabilities |

## How Could You Reduce the Impact?

Below are some ways that landlords are restructuring their businesses in order to better model their tax planning and reduce exposure moving forward.

### ***Reduce your Interest Rate***

It may make sense to remortgage your existing BTL's if it will reduce the interest you pay and your overall mortgage costs. This is something your mortgage adviser will help you determine.

***Going Limited***

Many landlords are opting to setup a limited company to hold their property, in order to reduce their exposure to the new tax laws. There are other costs involved if you go down this route and you will incur capital gains tax and stamp duty. It isn't the best path for everyone and your tax adviser or accountant will help you to decide if it is right for you.

***Transferring Property to Your Spouse***

For some landlords, it may be possible to reduce the amount of tax payable by transferring property into your spouses' name. Once again, professional tax planning that takes a holistic view is key here.

***Repurposing Your Existing Properties***

There is an increasing demand for houses of multiple occupation (HMOs) in some areas. There are additional legal considerations but it may be possible for you to convert existing properties into HMOs. Doing so can result in significantly more rental income and can be an effective way of mitigating the tax increases.

## Our Thoughts in Summary

There are clearly many changes afoot for landlords and you need to consider carefully how these changes will affect you.

One of the first things you should do is seek independent tax advice. Your accountant will talk you through how the changes will affect you now and in the future. They will also help you compare some of the options available and assist you in re-structuring accordingly. You should also sit down with your mortgage broker and review your current financing arrangements across your portfolio.

The new tax laws and PRA changes certainly aren't welcome news for landlords but it isn't a death knell. By educating yourself and understanding how the changes will affect you and your business you will be well positioned to take appropriate action. This will enable you to maintain a healthy, profitable property portfolio now and into the future.

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