



Finance (No. 2) Bill 2015 Clause 24: Relief for finance costs related to residential property businesses

ICAEW welcomes the opportunity to comment on the Finance Bill published on 15 July 2015.

This briefing of 7 September 2015 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

On 18 August 2015 and 24 August 2015 we attended meetings with HM Treasury and HMRC jointly with other professional bodies in which we were able to put forward some key comments and concerns and discuss aspects of the Finance Bill clauses

ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 144,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

Copyright © ICAEW 2015
All rights reserved.

This document may be reproduced without specific permission, in whole or part, free of charge and in any format or medium, subject to the conditions that:

- it is appropriately attributed, replicated accurately and is not used in a misleading context;
- the source of the extract or document is acknowledged and the title and ICAEW reference number are quoted.

Where third-party copyright material has been identified application for permission must be made to the copyright holder.

For more information, please contact ICAEW Tax Faculty: taxfac@icaew.com

icaew.com

WHAT THE CLAUSE IS INTENDED TO DO

Extract from Chancellor's speech

1. First, we will create a more level playing-field between those buying a home to let, and those who are buying a home to live in.
Buy-to-let landlords have a huge advantage in the market as they can offset their mortgage interest payments against their income, whereas homebuyers cannot.
And the better-off the landlord, the more tax relief they get.
For the wealthiest, every pound of mortgage interest costs they incur, they get 45p back from the taxpayer.
All this has contributed to the rapid growth in buy-to-let properties, which now account for over 15% of new mortgages, something the Bank of England warned us last week could pose a risk to our financial stability.
So we will act – but we will act in a proportionate and gradual way, because I know that many hardworking people who've saved and invested in property depend on the rental income they get.

General comments

2. The extract from the speech implies the measure is aimed at those landlords with a small portfolio of properties as an investment yet the title of the clause refers to "property businesses". Owners of a large portfolio, say 100 properties which is run as a full time business by the owner are included in the measure in the same way as say an investor buying one property to supplement their pension.
3. We appreciate that there is an inequality of treatment when tax relief is available where a loan is taken out to buy property to let when such relief is not available for the purchase of other investments, for example to purchase quoted shares. While this policy position has been the case for many years, it is reasonable for the Government to consider whether it is justified. . However there is a difference between a person buying one or two properties as an investment and a person buying a large portfolio run as a commercial business. A comparison can be made with tax relief on loan interest paid on a loan to buy shares: if the shares are, say, a quoted company then no tax relief is available on any interest paid but where a person buys shares in a family trading company they do receive tax relief on their loan interest paid.
4. The level playing field argument is specifically referenced to home owners not being able to claim tax relief on their mortgage interest, but the playing field is also skewed by the capital gains tax treatment; the home owner pays no capital gains tax on the sale of their home but a landlord pays capital gains tax at up to 28%.
5. The Chancellor introduced the change to "create a more level playing field" but as the measure does not apply to companies far from being level it leaves the playing field with a cliff edge in the middle.
6. Prior to 1998/99 interest paid on residential property lets was relieved as a charge on income; subsequently taxable rental income has been calculated in the same manner as income from a trade or a profession and interest has been deductible as a business expense. We can think of no other business where the cost of funding the capital of the business is not tax allowable.
7. It is a long established principle of taxation that expenses incurred wholly and exclusively for the purposes of the business are deductible when calculating the taxable profit. This proposal contravenes that principle and will result in proprietors of property businesses being liable to tax on an economic loss.
8. Interest paid for purchase of a residential property can only be offset against the rent received, if a rental loss is incurred the loss can only be carried forward, it cannot be set against general income so there is no question of tax relief for interest paid giving rise to a reduction in other taxable income.

9. The measure is extremely complex and will make it exceptionally difficult for taxpayers to self assess. The introduction over a four year period, whilst preferable to immediate withdrawal and the carry forward of “excess” interest will be very difficult to calculate and require extensive record keeping.

WHAT ICAEW IS CONCERNED ABOUT

10. We have compared the proposed legislation changes to our ten tenets as listed at Appendix 4 and found them to fail on several counts:
 - Some of the more complex areas like just and reasonable apportionment of interest for mixed use loans will be by guidance rather than statute
 - The calculated relief will not be certain, there will be scope for disagreement over the relief allowed
 - It will not be simple to understand
 - It will not be easy to calculate
 - The changes have not been subject to proper consultation
 - The measure is not fair and reasonable as the way the restriction is applied causes other reliefs to be lost and the resultant tax charge is far in excess of the restriction on the relief for the interest paid, see examples in Appendix 2
 - Denying a business tax relief on expenses wholly and exclusively for the purpose of the business is not fair and reasonable

Interaction with existing legislation

11. The provisions are retroactive as they impact transactions already undertaken. Taxpayers will have priced and borrowed according to the tax relief they expected and these borrowing decisions would by necessity have a long time line and many taxpayers will not be able to restructure their debt.
12. If the measure is enacted to include existing loans the lead in time is insufficient for most taxpayers to be able to unwind current borrowings and find alternative finance or to evict the tenant such that the property can be sold. The proposed changes to the tax treatment of the interest paid fundamentally change the economics of rental businesses and have the potential to distort the market.
13. Landlords will have to pay tax on real losses as those losses will become profits when the interest restriction is introduced, see example in Appendix 1.
14. The increase in taxable income as a result of the changes will have a significant impact on some taxpayers, the operation of the restriction on finance costs increases the income measurable for several income related reliefs, such as
 - Tax credits, with no real economic change in income the credit could be lost
 - Child benefit, again with no real economic change child benefit could be “lost” completely or be restricted
 - Loss of the £5,000 0% savings rate band
 - Personal allowance lost if the income without the benefit of the interest relief exceeds £100,000
 - Excess pension charge because the income without the benefit of the interest relief exceeds £150,000 causing allowable pension contributions to be reduced from £40,000

The impact of the change in legislation for many will not be simply a loss of tax relief at the higher rates of tax on the interest paid there will be additional amounts payable due to the loss of other unrelated reliefs, see Appendix 2.

There are two additional real life examples in Appendix 3.

Consistency with other policies

15. The proposals run contrary to other government policy, for example farmers who are encouraged to develop residential property to generate an income stream. Business property owners who were encouraged to develop unused space above their premises into residential accommodation using the Flat Conversion Allowance (available up until 2013) will now be denied full relief on the interest paid on their loans.
16. Recent legislation has been designed to discourage property ownership via limited companies but as the restriction on tax relief on interest does not apply to corporates it is likely that in future rental property purchase will be via limited companies and existing businesses will look to incorporate. This will reduce the tax take if the profits are not extracted. Existing property owning partnerships may be able to incorporate without incurring an SDLT charge so some existing businesses will change their structure to avoid the interest relief restriction.

Property businesses

17. Landed estates and social housing businesses with borrowings will be adversely affected by the changes given their large portfolios of properties.
18. We have been told that guidance will be issued on the just and reasonable calculation required when part of the loan will not be restricted and part will be. In general we believe taxation should be by statute and not by guidance, which can be changed overnight without reference to parliament. It is not clear how a just and reasonable calculation can be done where there is a mixed business of farming and residential lets with a fluctuating overdraft to fund the total business activities.
19. Property developers may also be caught by the legislation and have hugely complicated calculations to determine the disallowable interest as they often rent out properties short term whilst trying to find a buyer for property.

Miscellaneous

20. There will be considerable complexity for individuals in accounting for their rental income during the transition, where there are losses and restrictions in the amount relieved and where there is mixed use of premises commercial business and residential.
21. It is likely that landlords will increase their rents to compensate for the loss of tax relief and the number of rental properties may decrease.
22. The interest relief restriction will favour cash buyers who want to buy to let and may increase the competition even more at the lower end of the property price market, thereby increasing prices and hindering first time buyers.
23. It is disappointing there was no consultation prior to the inclusion of the measure in the Finance (No 2) Bill 2015; the draft legislation appears to have been rushed as it does not adequately cover the taxation of trustees and additional draft legislation is required.
24. Assuming that for trusts the restriction for the relief will apply in a similar manner there is a concern that trusts will become “insolvent” as they may not have alternative funds with which to pay a tax charge on the higher taxable income. Where the trustees of a discretionary trust have no other source of income, if they receive rent after expenses other than interest paid of £20,000, pay interest of £16,000 and have other trust management expenses of £1,000 they will have cash available of £3,000. In 2015/16 they would have a tax liability of some £1,500, in 2020/21 their tax liability will be in the order of £5,500 leaving the trustees with a deficit of over £2,500.
25. It is not clear if the restrictions will apply to finance obtained under Sharia law principles.

RECOMMENDATIONS

26. The restriction on tax relief on the interest paid would be fairer if it applied to new borrowings only.
27. If the measure is to apply to all borrowings, old and new, some of the complexity would be removed if instead of tapering in the restriction over a four year period with no relief at the higher rates of tax in 2020/21 full relief continued for three years with full restriction applied in year 2019/20 in order to equalise the anticipated tax take.
28. If the measure is to apply to large property rental businesses consideration be given to easing the path of those with substantial portfolios who need to incorporate to save their business. For example a one off SDLT special relief and confirmation that incorporation relief will apply under certain circumstances. Many of these businesses provide social housing and student accommodation and there would be a high social cost if the businesses had to be liquidated.

APPENDIX 1

Tax payable by a landlord who either breaks even or makes a loss on his rental income

The following figures are based on a real life taxpayer in partnership with two others running a student housing business.

It is assumed that the personal allowance is £12,000, the basic rate band is £31,000 and other rates and allowance as now. The position pre and post the interest relief restriction is compared for when the business makes a loss and when it breaks even.

	Rental loss incurred		Break even	
	Pre s.272A	Post s.272A	Pre s.272A	Post s.272A
Gross rent	180,000	180,000	228,000	228,000
Expenses	<u>95,500</u>	<u>95,500</u>	<u>79,000</u>	<u>79,000</u>
Rent	84,500	84,500	149,000	149,000
Interest	152,000	152,000	149,000	149,000
Net rental income/deficit	- 67,500	- 67,500	-	-
Other income	<u>10,000</u>	<u>10,000</u>	<u>10,000</u>	<u>10,000</u>
Actual income/deficit	<u>- 57,500</u>	<u>- 57,500</u>	<u>10,000</u>	<u>10,000</u>
Tax due on income of	-	94,500	-	159,000
Tax before relief	-	26,800	-	57,850
Interest for relief restricted to	N/A	84,500	N/A	149,000
Relief for interest	N/A	16,900	N/A	29,800
Tax actually payable	<u>-</u>	<u>9,900</u>	<u>-</u>	<u>28,050</u>

This illustrates how tax will be payable on an economic loss.

APPENDIX 2

The following examples illustrate the effect of the interest relief restriction on other tax reliefs

It is assumed that the personal allowance is £12,000, the basic rate band is £31,000 and other rates and allowance as now.

The method proposed to restrict the tax relief, s.272A ITA 2007, is to deny relief altogether on the relevant proportion of the finance costs in calculating the profits of the property business for income tax purposes. A credit is then given for the interest under s.274A ITA 2007.

The amount of relief for the finance costs per s.274A(3) is the lower of the finance costs disallowed and the profits of the property business (L) at the basic rate of tax (BR). This is subject to s.274A(4), which reduces the credit if 'gross finance-costs relief' (GFCR - defined in S274A(6)(b) as the total relief available for finance cost before restriction), is more than the individual's 'adjusted total income' for the year, (ATI - defined in S.274A(6)(a) as total income for the year less savings and dividend income and personal allowances). Where this additional restriction applies the relief is calculated as $\frac{ATI}{GFCR} \times (BR \times L)$.

Example 1

Income

	Pre s.272A	Post s.272A
	£	£
Interest	5,000	5,000
Rents before finance costs	18,000	18,000
Finance costs	6,000	
Personal allowance	12,000	12,000
Taxable	5,000	11,000
Tax payable	0	2,200
Adjusted total income		6,000
Credit under S.274A		1,200
Net liability		1,000

The extra liability is 20% of £5,000, which is the 0% savings band lost as a result of S.272A.

Example 2

Income

	Pre s.272A	Post s.272A
	£	£
Interest	5,000	5,000
Rents before finance costs	16,000	16,000
Finance costs	6,000	
Personal allowance	12,000	12,000
Taxable	3,000	9,000
Tax payable	0	1,600
Adjusted total income		4,000
Credit under S.274A*		800
Net liability		800

*As ATI (£21,000 - £5,000 - £12,000) is less than GFCR (£6,000) the credit is $4000/6000 \times 20\%$ of £6,000 = £800

The extra liability is 20% of £4,000, which is the part of the 0% savings band lost as a result of S.272A.

Example 3

Income

	Pre s.272A	Post s.272A
	£	£
Salary	10,000	10,000
Interest	5,000	5,000
Rents before finance costs	18,000	18,000
Finance costs	6,000	
Personal allowance	12,000	12,000
Taxable	15,000	21,000
Tax payable	3,000	4,200
Adjusted total income		16,000
Credit under S.274A		1,200
Net liability		3,000

In these circumstances s.272A has no effect because the individual is only getting 20% relief on his finance costs

Example 4

Income

	Pre s.272A	Post s.272A
	£	£
Salary	80,000	80,000
Rents before finance costs	70,000	70,000
Finance costs	50,000	
Personal allowance	12,000	0
Taxable	88,000	150,000
Tax payable	29,000	53,800
Adjusted total income		150,000
Credit under S.274A		10,000
Net liability		43,800

The extra tax liability of £14,800 represents 20% of the £50,000 finance costs plus 40% of the lost £12,000 personal allowance.

Example 5

The example illustrates the effect of the high income child benefit charge on a person claiming for three children, the child benefit is clawed back where at least one parent has income over £50,000 until it is all clawed back once income reaches £60,000.

Income

	Pre s.272A	Post s.272A
	£	£
Salary	40,000	40,000
Rents before finance costs	20,000	20,000
Finance costs	10,000	
Personal allowance	12,000	12,000
Taxable	38,000	48,000
Tax payable	9,000	13,000
Adjusted total income		48,000
Credit under S.274A		2,000
Child benefit charge		2,549
Net liability		13,549

The extra liability of £4,549 represents 20% of the £20,000 finance costs plus the high income child benefit charge.

Example 6

This shows the effect on the annual (pension) allowance, assuming the investor has used his allowance in previous years, so has a maximum of £40,000 available in 2020/21.

Income

	Pre s.272A	Post s.272A
	£	£
Salary	130,000	130,000
Excess pension input		20,000
Employer's pension contribution	30,000	
Rents before finance costs	60,000	60,000
Finance costs	30,000	
Personal allowance	0	0
Taxable	160,000	210,000
Tax payable	58,300	80,800
Adjusted income		210,000
Credit under S.274A		6,000
Net liability		74,800

The extra £16,500 tax payable represents 25% of the £30,000 finance costs and 45% of the lost £20,000 pension allowance.

APPENDIX 3

The following are real life examples showing the difference in the tax payable before and after the change to the relief for finance costs.

Example 1 – single buy to let

Jo is a teacher and is 49 years old; he is a 40% taxpayer. He has purchased a buy to let property as an investment. As he has owned the property for some time, the outstanding debt on the property is relatively low. Here is the effect of the change:

	2016-17	2020-21
Gross rents	7,200	7,200
Repairs and other tax deductible costs	1,000	1,000
Interest on mortgage	<u>2,500</u>	=
Net rental profit	<u>3,700</u>	<u>6,200</u>
Tax at 40%	£1,480	£2,480
Less interest relief at 20% on £2,500		<u>500</u>
Net tax liability on rental income	<u>£1,480</u>	<u>£1,980</u>
Tax Increase		£500
Effective rate on “real” rental profit	40%	53.5%

If Jo decided to increase his borrowings to allow him to buy a second buy to let, he would see his tax rate rise still further, as his interest costs will be higher initially, and his net return lower.

Example 2 – substantial property portfolio

John and Julie are married and together run a sizeable rental property business. They have not run this through a limited company due to the difficulty in obtaining finance for purchases with limited company status.

	2016-17	2020-21
Gross rents	600,000	600,000
Repairs and other tax deductible costs	200,000	200,000
Interest on mortgage	<u>350,000</u>	=
Net rental profit	<u>50,000</u>	<u>400,000</u>
Personal allowances (x2)	<u>22,000</u>	-
Taxable income	<u>28,000</u>	<u>400,000</u>
Basic rate tax (2 taxpayers)	5,600	12,800
Tax at 40%	-	94,400
Tax at 45%	-	<u>45,000</u>
		152,200
Less interest relief at 20% on £350,000	-	<u>70,000</u>
Net tax liability on rental income	<u>£5,600</u>	<u>£82,200</u>
Tax Increase		£76,600
Effective rate on “real” rental profit	11.2%	164.4%

Although John and Julie spend at least 35 hours a week on the business (and their cash return is modest) that is because they have ploughed most of their profits back into building up the portfolio, and taken risks to allow them to grow their business. Their current business structure is now unsustainable.

Example 3 – increase in interest rates

Finally we return to Jo, who has presently got borrowings of £50,000 on his property which has a current market value of £160,000. His interest rate is 5%. If his interest rate was to rise to 10% he would see the following change:

	2016-17	2020-21
Gross rents	7,200	7,200
Repairs and other tax deductible costs	1,000	1,000
Interest on mortgage	<u>5,000</u>	<u>-</u>
Net rental profit	<u>1,200</u>	<u>6,200</u>
Tax at 40%	£480	£2,480
Less interest relief at 20% on £5,000		<u>1,000</u>
Net tax liability on rental income	<u>£480</u>	<u>£1,480</u>
Tax Increase		£1,000
Effective rate on “real” rental profit	40%	123.3%

APPENDIX 4

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.
4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see via <http://www.icaew.com/en/about-icaew/what-we-do/technical-releases/tax>).