December 2015

The Taxation of Buy to Let Properties

The Autumn Statement included a proposal for an additional 3% SDLT charge on post 31 March 2016 purchases of residential property not used as a main residence. This was yet another "tax blow" to the already beleaguered "buy-to-let" sector. But in addition to this increase to front-end costs let's not forget that changes to the wear and tear allowance and substantial changes to the way buy-to-let investors will be taxed in the future if they have a mortgage and are higher/additional rate taxpayers are in the pipeline. In this article we examine the implications of these changes which are important to those of your clients with buy-to-let investments.

(1) Wear and tear allowance

Currently, a landlord of a furnished property can offset 10% of the rental income as a wear and tear allowance for keeping furnishings in a fit and proper state irrespective of the actual costs incurred. From 6 April 2016, such an allowance will only be given on expenditure actually incurred in maintaining the furnishings.

(2) Tax relief on mortgage interest

Currently, in determining taxable income, a landlord can deduct qualifying interest against rental income. In this respect qualifying interest will be interest paid on loans taken to buy or improve the property. This means that the landlord will obtain tax relief at the top rate of tax paid – be that basic rate, higher rate or additional rate.

The government proposes to phase out tax relief, starting from 2017/18, at the higher and additional rates over a period of four years so that in 2020/21 tax relief will only be available at the basic rate. The phase out of higher/additional rate tax relief will be at 25% per year. Also from 2017/18 basic rate tax relief will be given by way of a credit for deduction against any higher/additional rate tax payable.

An example should help make this clear.

Joe is a higher rate taxpayer and enjoys a rental income of £10,000 per annum from his buy-to-let property. He has a mortgage used to buy the property on which he pays £6,000 interest per annum.

His position as regards the taxation of the rental income over the four years from 2017/18 will be as follows:

	2015/16 and 2016/17	2017/18	2018/19	2019/20	2020/21
	£	£	£	£	£
Rent	*10,000*	*10,000*	*10,000*	*10,000*	*10,000*
Interest	*6,000*	*4,500*	*3,000*	*1,500*	*-*
	4,000	*5,500*	*7,000*	*8,500*	*10,000*
Higher rate tax	*1,600*	*2,200*	*2,800*	*3,400*	*4,000*
Less basic rate credit	*-*	*300*	*600*	*900*	*1,200*
Net tax	*-*	*1,900*	*2,200*	*2,500*	*2,800*
Net receipt	*2,400*	*2,100*	*1,800*	*1,500*	*1,200*

The proposed rules will therefore have a profound impact on landlords who

- have a mortgage in respect of that buy-to-let property and
- are higher/additional rate taxpayers

The tax changes could also have the effect of moving some basic rate taxpaying landlords into higher rate tax and so care should be exercised.

One of the important changes in the new tax approach is that mortgage interest will no longer be deducted from rental income to determine taxable income – instead basic rate tax relief will be given by way of a credit against other tax payable on the buy-to-let. This means that the level of taxable income that a landlord has will increase. This, in turn, may, directly or indirectly, affect entitlement to allowances, such as child benefit (by way of the high income child benefit tax charge), personal allowances, annual allowances for pension plans and whether chargeable event gains suffer higher rate tax or not. For example, in Joe's case, his taxable income from the buy-to-let will have moved from £4,000 in 2016/17 to £10,000 in 2020/21. This may well have significant other tax repercussions.

Any person contemplating setting up a buy-to-let business in the future may prefer to run the business inside a company structure.

The company would still be entitled to full tax relief on the mortgage interest and net profits would only currently suffer corporation tax at 20% - reducing to 19% in financial year 2017 and 18% in financial year 2020. Profits could be extracted from the company by way of dividend payments which would not attract National Insurance. Also, the first £5,000 of the dividend payment will, from 6 April 2016, be tax free assuming the allowance has not been used elsewhere. Of course, there are other issues with the corporate ownership route – not least the extra formalities involved and the possibility of double tax on

capital gains on the sale of the property ie. once in the company with a subsequent net capital gain reflected in the value of the shares.

As far as existing higher/additional rate tax buy-to-let investors with mortgage interest are concerned, they will now need to consider their position. Possible planning action would include:-

- repaying the mortgage if funds are available or
- the transfer of the property to a low taxpaying spouse/civil partner.

ACTION

The changes need to be seriously considered by those who have buy-to-let property (especially those with a high loan to value ratio) and those thinking about this type of investment. The changes will mean for many that greater focus needs to be given to the capital growth qualities of the investment to justify an acceptable return. Investors (and would-be investors) should be reminded of this and, of course, the danger of over concentrating investment on a single asset class. The power of diversification should always be borne in mind when designing an investment strategy.

PENSIONS - THE TAXATION OF DEATH BENEFITS

Some further changes in relation to this important benefit have been confirmed.

(i) Payments to individuals

The rules on the taxation of lump sum death benefits from DC/money purchase schemes is set to change from 6 April 2016.

Currently, all lump sum death benefits paid on the death of a member/beneficiary aged 75 or over are taxed at 45%. From 6 April 2016, payments made to an individual(s) will be taxed, under PAYE, as if they were the beneficiary's income – which could, of course, give rise to a tax liability at a rate lower than 45%.

The provisions apply to payments made after 5 April 2016. Therefore, if a death occurs before 6 April 2016 and it is desired to make a lump sum payment to an individual whose tax rate on the benefit is likely to be lower than 45%, it may pay to wait until after 5 April 2016.

(ii) Payments to trusts

Where the member dies at age 75 or over, lump sum death benefits paid to trusts (eg so called "By-Pass" trusts) after 5 April 2016 will continue to be taxed at 45%.

However, the Finance (No.2) Act 2015 introduces new subsection (8) to section 206 Finance Act 2004.

This new provision basically states that

- where a lump sum death benefit (deducted and paid over to HMRC by the Scheme Administrator) suffers income tax at 45%;

- that lump sum benefit is paid to a trustee; and
- a payment of any of that lump sum is made out of the trust to an individual

then

(a) the amount received by the individual plus

(b) so much of the tax on the lump sum that is attributable to the amount

will be taxed as income of the beneficiary for income tax purposes.

But the beneficiary may claim to deduct that much of the tax (presumed to be the tax in (b)) from the income tax on the beneficiary's total income in that year ie the tax year in which they receive the capital payment from the trust.

This change will be of particular benefit in those cases where a lump sum death benefit is paid to a by-pass trust on a member's death at age 75 or over and a 45% tax charge applies. When a payment of this benefit is made to a beneficiary at a later date, an appropriate credit can be given to the beneficiary in respect of the tax paid when the trustees received the cash. However, it's important to keep in mind that

(i) where tax is deducted (@ 45% from the payment made to the by-pass trust a substantially lower sum will be invested for the beneficiary

(ii) the tax credit on payment can only be used against the beneficiary's other income tax due in the year of receipt. There is no carry forward of any unused amount.

ACTION

Whether, how and where to pay death benefits is an important, multi-faceted decision that will absolutely require advice from practising specialists before taking action involving what could be substantial sums.

TAX AVOIDANCE AND EVASION

Tax avoidance and evasion are favourite areas for Budget/Autumn Statement change. This year's Autumn Statement was no exception. Closing the 'tax gap' (the difference between what HMRC should receive in tax if the legislation were applied as it was intended and what it actually receives) remains a key objective.

So here is a selection of what has been referenced in this year's Autumn Statement. Many of these areas for action have been known (at least) since the Summer Budget. Where the measure will be included in legislation in the Finance Bill 2016, we reference this by an asterisk.

*A new criminal offence for tax evasion – The government will introduce a new criminal offence that removes the need to prove intent for the most serious cases of failing to declare offshore income and gains. There has been a lot of consultation and refinement to these provisions which now offer a little more protection from prosecution than when they were first proposed.

*New civil penalties for offshore tax evaders – The government will increase civil penalties for deliberate offshore tax evasion, including the introduction of a new penalty linked to the value of the asset on which tax was evaded and increased public naming of tax evaders.

*New civil penalties for those who enable offshore evasion – The government will introduce civil penalties for those who enable offshore tax evasion, including public naming of those who have enabled the evasion.

A new criminal offence for corporates failing to prevent tax evasion – The government will introduce a new criminal offence for corporates which fail to prevent their agents from criminally facilitating tax evasion by an individual or entity.

An additional requirement to correct past offshore tax non-compliance – The government will consult on an additional requirement for individuals to correct any past offshore non-compliance with new penalties for failure to do so.

Cash and the hidden economy – HMRC has published a call for evidence to seek a better understanding of what implications the trend away from cash has for tax compliance, and in particular evasion and the hidden economy.

*Serial avoiders – The government will introduce tough new measures for those who persistently enter into tax avoidance schemes that are defeated by HMRC. These include a special reporting requirement and a surcharge on those whose latest return is inaccurate due to use of a defeated scheme, the names of such avoiders being published and, for those who persistently abuse reliefs, restrictions on them accessing certain tax reliefs for a period. The government is also widening the Promoters of Tax Avoidance Schemes (POTAS) regime, by bringing in promoters whose schemes are regularly defeated by HMRC.

*General Anti-Abuse Rule (GAAR) – The government will introduce a new penalty of 60% of tax due to be charged in all cases successfully tackled by the GAAR. The government will also make small changes to the way the GAAR works to improve its ability to tackle marketed avoidance schemes.

*Company distributions – The government will publish a consultation on the rules concerning company distributions later in the year. The government will also amend the Transactions in Securities rules and introduce a Targeted Anti-Avoidance Rule in order to prevent opportunities for income to be converted to capital in order to gain a tax advantage.

Disguised remuneration – The government intends to take action against those who have used or continue to use disguised remuneration schemes and who have not yet paid their fair share of tax. The government will also consider legislating in a future Finance Bill to close down any further new schemes intended to avoid tax on earned income, where necessary, with effect from 25 November 2015.

*Related party rules: partnerships and transfers of intangible assets – The government will amend the intangible fixed asset rules to clarify the tax treatment on transfers of assets to partnerships. This change has immediate effect. It will ensure that partnerships cannot be used in arrangements that seek to obtain a tax relief for their corporate members in a way that is contrary to the intention of the regime. The

government will also consider a review of the intangible assets regime as part of the Business Tax Roadmap.

*Taxation of asset managers' performance-based rewards – The government will introduce legislation to determine when performance awards received by asset managers will be taxed as income or capital gains. An award will be subject to income tax, unless the underlying fund undertakes long-term investment activity.

*Tools to encourage voluntary compliance and special measures to tackle the highest risk businesses – At Summer Budget 2015, the government announced new measures to improve large business tax compliance, with a consultation over the summer to refine the detail of the measures. Following consultation, the government will legislate to introduce:

- a new requirement that large businesses publish their tax strategies as they relate to or affect UK taxation
- a special measures regime to tackle businesses that persistently engage in aggressive tax planning
- a framework for cooperative compliance

Capital gains tax entrepreneurs' relief: contrived structures – The government will consider bringing forward legislation to amend the changes made by Finance Act 2015 to entrepreneurs' relief, in order to support businesses by ensuring that the relief is available on certain genuine commercial transactions.

ACTION:

So, more evidence (as if any were needed) that HMRC is not in any way backing off from its (largely publicly supported) crusade against aggressive tax avoidance and evasion.

Its multi-faceted strategy (comprising targeted anti-avoidance rules, the GAAR, legislation, 'naming and shaming', DOTAS and Accelerated Payments) continues to pay dividends.

As we have said before, we have, for some time now, seen the effective end of any meaningful market in aggressive tax avoidance which must be seen as good news for most financial planners. We repeat, "Boring is the new exciting" when it comes to tax and financial planning. We are, of course, happy to discuss any of the many "tried and tested" (non-aggressive) ways to legitimately reduce tax in relation to investments, pensions and insurance products.

THE TRANSFER OF ISA BENEFITS TO A SURVIVING SPOUSE/CIVIL PARTNER UPON DEATH

Background

In the 2014 Autumn Statement it was announced that the ISA rules would be amended to provide for the surviving spouse or civil partner of a deceased ISA saver to receive an additional ISA allowance up to the value of the deceased saver's ISA at the time of their death. In addition, the additional ISA allowance would not count against the surviving spouse's/civil partner's annual ISA allowance.

In accordance with proposals originally announced in the 2014 Autumn Statement, the government made regulations giving an additional ISA allowance to the surviving spouse or civil partner of a deceased ISA

saver from 6 April 2015 - Individual Savings Account (Amendment No. 2) Regulations 2015 (SI 2015/869)). At the same time HMRC also updated its draft guidance for ISA managers. The regulations provide more flexibility than the draft regulations published in January 2015.

In what follows we refer to the additional allowance as the "additional allowance subscription" and the use of the word "spouse" includes civil partner.

Who is eligible to make an additional allowance subscription?

The surviving spouse of an ISA saver who died on or after 3 December 2014. At the time of death the deceased ISA saver and the surviving spouse must have been living together as defined in section 1101 of the Income Tax Act 2007. The additional allowance subscription is not available in respect of a deceased's Junior ISA.

The subscription limit

The amount of the additional allowance subscription(s) cannot exceed the total value of all of the ISAs owned by the deceased at the date of their death.

The subscription rules

An additional allowance subscription can be made in cash or in specie (called non-cash assets).

(a) General

ISA managers can choose whether to accept subscriptions from a surviving spouse using the additional allowance and also choose whether to allow a surviving spouse to make a subscription using the additional allowance in instalments or to insist on a single payment. A manager who insists on a single payment must make clear to the surviving spouse that if that payment is less than the maximum additional allowance available, the rest of the allowance will be lost.

(b) Cash subscription

In this situation, on death, the ISA will come to an end (as it does currently) by the deceased's personal representatives taking the cash from a cash ISA, or arranging for the assets in a stocks and shares ISA to be liquidated or assigned to a beneficiary of the deceased's estate.

Once this occurs the surviving spouse can make an additional subscription up to an amount not exceeding the value of the deceased's ISA(s) at the date of their death. The surviving spouse can make this additional subscription irrespective of who inherits the proceeds of the ISA. For example, the whole of the deceased's estate could pass to a charity but because the deceased's ISA has terminated their surviving spouse can make an additional allowance subscription within the permitted time limits – see below. A subscription may also be made when there is an in specie subscription (see (c) below) and the value of the non-cash assets at subscription is less than their value at death.

A surviving spouse can use the additional allowance to subscribe cash to one or more accounts with an ISA manager other than the deceased's manager (provided the new manager agrees to accept responsibility for monitoring the additional permitted subscription).

A surviving spouse can also make cash subscriptions up to the value of the deceased's stocks and shares ISAs as an alternative to subscribing non-cash assets (for example, if they do not inherit the non-cash assets from the deceased).

(c) In specie subscription

An ordinary subscription to an ISA must be made in cash. This is subject to one exception for shares awarded under certain share option schemes. In contrast, an additional allowance subscription can be in cash (see (b) above) or in specie (called "non-cash assets").

Where the amount subscribed is made up of non-cash assets then the following conditions apply:

(i) The non-cash assets subscribed were in an ISA held by the deceased at death;

(ii) The non-cash assets subscribed were inherited by the surviving spouse from the deceased. The regulations make it clear that the word "inherited" includes inherited under a will trust or as a result of a deed of variation; and

(iii) Title to the non-cash assets at the point of subscription has been vested since the account manager was notified of the deceased's death in the account manager ie the non-cash assets have remained in the deceased's ISA and have not been transferred out to the surviving spouse.
This means that a subscription of inherited non-cash assets must be made with the deceased's ISA manager. A transfer in specie to a new manager could be authorised by HMRC in circumstances outside of the surviving spouse's control, eg where the old manager makes a bulk transfer of assets to a new manager or where the old manager is no longer open for new business.
The non-cash assets that can fund an additional allowance subscription are mainly those investments that qualify for inclusion in a stocks and shares component apart from cash.

When a non-cash asset subscription is made the amount of the subscription is equal to the value of the asset at the date of subscription. Because of this rule, the net result is that an in specie transfer will never be a simple movement of holdings from old to new ISA, unless the value at the date of death is matched by the value at the date of the surviving spouse's subscription:

- If values rise after death, then some of the former ISA holdings effectively become non-transferable (in ISA terms);

- If values fall between death and subscription it will be possible for the surviving spouse to make a full in specie transfer and a top-up cash subscription.

Income arising from the deceased's ISA, eg dividends, will not be transferable, although it may be possible to use it to fund a top up subscription if investment values fall post-death.

One drawback of making an in specie transfer is that the income/gains of the ISA would be taxable during the administration period following the individual's death. To counter this drawback the Finance Bill 2016 contains a provision whereby the ISA savings of a deceased person will continue to benefit from tax advantages during the administration of their estate. This measure will be introduced following technical consultation with ISA providers.

The "permitted" period

A subscription funded by non-cash assets must be made within a period which runs for 180 days 'beginning with distribution to S (ie the surviving spouse/civil partner) by the deceased's estate of those

assets'. The distribution for this purpose is treated as occurring on the later of 6 April 2015 and the actual date of distribution.

Any other subscription – which basically means cash – must be made within 3 years from the deceased's date of death or within the 180 day period following completion of the administration of the deceased's estate if this date is later. If the deceased died on or after 3 December 2014 but before 6 April 2015 they will be treated as dying on 6 April 2015.

Making an additional subscription

An individual who wishes to make an additional subscription will be required to provide certain information and give certain declarations to the provider such as the deceased's full name and the deceased's NINO, or confirmation they did not have one.

Declaration

An additional allowance subscription will not be regarded as an additional subscription which counts against the surviving spouse's subscription provided satisfactory declarations are given by the surviving spouse as follows:-

- he or she is the surviving spouse of the deceased and that the couple were living together at the time of the deceased's death;

- the subscription is an additional permitted subscription; and

- the subscription is being made within the permitted time limits (see above). The permitted time limits for this purpose are modified where the deceased died between 3 December 2014 and 5 April 2015.

ACTION

There are many investors whose ISA portfolio represents a significant proportion of their overall invested assets. Especially older investors will be interested to know how these new rules work and how they should be factored into planning. We would be happy to discuss the estate planning aspects of ISAs with you taking full account of these new rules.

INHERITANCE TAX - THE TAX TREATMENT OF PENSION SCHEME DRAWDOWN FUNDS ON DEATH

As announced in the Autumn Statement the government has introduced backdated legislation in the Finance Bill 2016 to ensure that an inheritance tax charge (under the "omission to exercise a right" provisions in section 3(3) IHTA 1984) will not arise where a pension scheme member dies with undrawn funds that had been designated to drawdown. Without this change (though HMRC has stated that it had never had cause (or, it seems, desire) to apply section 3(3) IHTA 1984 in this context) such designated funds would not have benefited from the exemption applying to 'available but as yet uncrystallised funds of members age 55 and over'. The change is backdated to apply to all deaths occurring on or after 6 April 2011.

ACTION

This is a recurring piece of legislative "tidying up". Pensions are, of course, largely an "IHT- free zone". But there are exceptions, especially in relation to "one-off" transactions (or pension transfers) when the member is in serious ill health, knew they were in serious ill health when they made the contributions and died within 2 years of making the contributions.

The rules are arcane but they exist. We'd be happy to give you the "low down" on where we are now in relation to pension death benefits and IHT. Save for these exceptions, it's a pretty attractive picture.

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