Technical Connection

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THE TAXATION OF BUY-TO-LET PROPERTIES

The government's July Budget 2015 and the subsequent Finance Bill clauses make 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. Here we examine the implications of these changes.

(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 additional and higher 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*
HRT	*1,600*	*2,200*	*2,800*	*3,400*	*4,000*
Less BR 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 chid 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.

COMMENT

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 should not be taken just yet as the Finance Bill is not law and changes may be introduced because of the general uproar caused by these new measures.

DIVIDENDS AND MIXED/MULTI-ASSET FUNDS

The arrival of the personal savings allowance and dividend allowance in 2016/17 raises some interesting questions about the use of mixed funds (ie. funds which earn interest and dividends on their investments).

The rules for distributions from collective funds currently offer the opportunity to ‘convert’ interest into dividend income and vice versa for individual investors. Ignoring the complexities of property authorised investment funds (PAIFs) and tax-elected funds (TEFs):

- If the value of qualifying investments (broadly cash and interest-paying securities) exceeds 60% of total fund value then any distribution is classed as an interest payment and, for individual investors, 20% tax is currently deducted at source. This may change in 2016/17, when the personal savings allowance is introduced – the government is currently consulting on its options, which include making fund interest payments gross.

  At present, the situation is that any share dividends received by an interest-paying fund are effectively double taxed, although for funds held within an ISA or pension plan, the 20% tax is either not deducted or can be reclaimed by the plan manager.

- If the 60% qualifying investments threshold is not breached, then any distribution is classed as a dividend and interest received by the fund is subject to 20% corporation tax (matching basic rate). As the distribution is a dividend, it is made with a non-repayable 10% tax credit in 2015/16 (but not in subsequent years). This treatment renders such funds generally tax inefficient in terms of interest income for ISAs and pension funds (other than insured schemes, which benefit from the income streaming rules).

Now consider the situation in 2016/17:

- The personal savings allowance will make the first £1,000 of interest tax-free for basic rate taxpayers and the first £500 tax-free for higher rate taxpayers. The 350,000 (ish) additional rate taxpayers will receive no allowance.

- The dividend allowance will similarly mean no tax is payable on the first £5,000 of dividends, regardless of the investor’s marginal tax rate. However, once the allowance is exceeded, the tax rate will increase to 7.5% as compared to nil currently.

Assuming the “60% rule” is maintained, a fund that mixes interest and dividend income will mean that either one or other of the new allowances is used, but not both. This could be a drawback if the aim is to maximise the use of both allowances with the appropriate type of income. Separate fixed interest and equity funds, paying interest and dividends respectively, may make more tax planning sense.

Even so, a fund that changes interest into dividend income could be advantageous for a higher rate taxpayer with no or little personal savings allowance remaining or additional rate taxpayer, provided they have unused dividend allowance. In these circumstances the interest will only suffer 20% tax in the fund. However, once the dividend allowance is exceeded, the situation reverses: the effective tax rate on interest income becomes 46% for a higher rate taxpayer and 50.48% for an additional rate taxpayer:

	Higher Rate	**Additional Rate**
	£	**£**
Gross interest to fund	100.00	100.00
Corporation tax in fund @ 20%	(20.00)	(20.00)
Dividend distribution	80.00	80.00
Tax on dividend @ 32.5%/38.1%	(26.00)	(30.48)
Net interest income	54.00	49.52

A basic rate taxpayer exceeding their dividend allowance suffers an effective tax rate on interest of 26%.

A similar argument applies to mixed funds which transform dividend payments into interest distributions, although there is much less scope for planning here given the smaller personal savings allowance and the likelihood that the investor is already in receipt of some interest from savings/deposit accounts.

COMMENT

Multi-asset funds are increasingly popular, but often not enough thought is given to their distribution tax treatment. This will be harder to overlook from next April.

HMRC ACTION AGAINST “DOMESTIC” TAX AVOIDANCE

Much publicity has recently been given to Follower Notices (FNs), Accelerated Payment Notices (APNs) and Partnership Payment Notices (PPNs). All of these are intrinsic to HMRC’s strategy for getting tax from those who have adopted what, in its view, amount to aggressive tax avoidance schemes - without having to wait for the outcome of the relatively long-winded assessment and appeals process. This strategy is widely regarded as a bit of a game changer; and it's where a lot of the recent publicity in relation to tax avoidance has been focused, especially with the recent failure by some promoters of Film Schemes to have the APN/PPN process ruled invalid by judicial review.

Just to be clear, though, the APN process does not deny the right to appeal against an assessment, just that if you have an APN issued then the tax "at risk" will "rest" with HMRC pending the outcome of the appeal as opposed to with the taxpayer. The HMRC rationale for this is that "it's only fair" and "goes with the territory" that you have to accept if you enter into a scheme that has a DOTAS reference number. Of course, the recent proposals (and draft regulations) to expand the number of schemes for which DOTAS reference numbers can be issued is a really important part of this strategy to increase the number of potential APN-generating transactions that are in the hopper – so to speak.

The ability to "get tax in" on account and ahead of the appeals process being considered has understandably been seen as highly newsworthy. This is especially so as a number of relatively rich and relatively famous people have been affected.

But, despite all of this interest in advance payments, it's important that financial planners (and their clients) do not lose sight of the much bigger picture in relation to the relentless HMRC fight against what it sees as unacceptable, aggressive tax avoidance. "Avoidance and legal interpretation" does, after all, contribute around 24% of the tax gap of £35bn.

A really good reference point is the government Policy Paper, "Tackling Tax Evasion and Avoidance". It has a very strong focus on evasion and especially offshore (being a strong contributor to the tax gap); but it also sets out a very clear and multi-faceted strategy to combat domestic tax avoidance. Yes, it was issued under the previous coalition government, but it was issued in March this year and its contents remain, as far as we know, in principle, very much part of the policy of this current government.

In the section of the paper on "Domestic Avoidance" HMRC states that over a relatively short period the government has transformed the way avoidance is tackled. Rather than just acting to block individual abuses, the government's radical approach has altered the underlying economics of avoidance by accelerating the payment of disputed tax and stemmed the supply side by acting against the highest-risk tactics of avoidance promoters. These actions have been a significant leap forward but more can be done.

In the coalition (pre-election) Budget 2015, the government announced it would introduce a range of new measures for those who persistently enter into tax avoidance schemes which HMRC defeats. Avoidance is the preserve of a small, persistent minority. The measures the government has taken to date are working to reduce that minority. Amongst those that remain, there are some who avoid again and again, often using more than one scheme each year, knowing that some will fail but hoping that one will not.

The government also announced that it is asking the regulatory bodies who police professional standards to take on a greater lead and responsibility in setting and enforcing clear professional standards around the facilitation and promotion of avoidance to protect the reputation of the tax and accountancy profession and to act for the greater public good.

COMMENT

No one can be in any doubt regarding the level of official commitment to stamping out what is thought to be aggressive avoidance.

EXCESSIVE WITHDRAWALS FROM A DONOR'S BANK ACCOUNT ARE SUFFICIENT EVIDENCE OF AN ATTORNEY'S DISHONESTY

The Court of Appeal (Criminal Division) has held that, where a general deficiency in a donor's funds can be attributed to withdrawals made by an attorney acting under a lasting power of attorney (LPA), this will be sufficient evidence to prosecute the attorney for abuse of their position in accordance with section 4 of the Fraud Act 2006.

The case in point - *R* v *TJC* (2015 EWCA Crim 1276) - involved an appeal against a decision of the Crown Court not to proceed with the prosecution of a LPA attorney because there was no evidence of specific fraudulent transactions. Instead, the case had been based on a broad-spectrum evidence of withdrawals from the donor's accounts by the attorney that had seemed unreasonably high given the needs of the donor.

The Court of Appeal determined that it would be acceptable to present an amended argument that the total value of the withdrawals made by the attorney, when set against the reasonable costs that would have been incurred over specific periods in providing for the donor, showed that the attorney could not have been acting honestly.

COMMENT

This case is a reminder that, in extreme cases, the investigation team at the Office of the Public Guardian may refer suspected financial abuse by attorneys to the police. It also shows that it may not be necessary to match withdrawals of specific amounts from the donor's funds against specific expenditure for a prosecution for financial abuse to succeed.

TRUSTEE INVESTMENT OPPORTUNITY

In this article we provide a reminder of the factors trustees should take into account when investing trust funds.

The investment of trust funds is one of the most difficult duties for trustees. They have to take account of numerous factors before deciding how trust assets should be invested. So how do trustees decide what to invest in so as to deliver a suitable outcome for the beneficiaries? As a starting point trustees should look at the express powers given to them under the terms of the trust. In addition, trustees should be aware of their statutory powers and duties and how these may differ depending on the capacity in which they act. For example, a professional trustee is expected to exercise a higher standard of care than a lay trustee.

You should also be aware that as well as the express powers in the trust, trustees in England and Wales are governed by the statutory powers created by Trustee Act 2000. These statutory powers give most trustees wide investment powers to invest trust assets and are in addition to any express powers contained within the trust – but subject to any restriction or exclusion imposed by the trust instrument. For most trusts (subject to specifically stated exclusions) this means that most retail investment solutions - notably collective investments and investment bonds - will be "within scope/permissible " in principle.

The Trustee Act 2000 also imposes a statutory duty on trustees to exercise reasonable care and skill when considering investment matters though. With this duty comes a requirement to ensure that trust funds are invested in a suitable manner, with appropriate diversification and on the basis of proper advice. It is also essential for trustees to review the investments of the trust fund on a regular basis.

The need to obtain advice

In exercising their power of investment or when reviewing investments, trustees should obtain proper advice before proceeding. Exceptionally, trustees need not obtain advice if they reasonably conclude that it is unnecessary or inappropriate to do so. This exception will normally apply where the value of the trust fund is small or where the trustees are sufficiently qualified to give advice themselves.

'Proper advice', in this context, is the advice of a person reasonably believed by the trustees to be appropriately qualified by their ability and practical experience of financial and other matters relating to the proposed investment.

Where individuals are acting as trustees in the course of a business or profession, they are treated as having such special knowledge or experience that might be reasonable to expect of a person in that kind of business or profession. Importantly, this means that solicitors or accountants who act as trustees in a professional capacity will be subject to a greater standard of care than, say, family members.

This requirement for trustees to seek "proper advice" is excellent news for financial advisers and offers a very good opportunity to collaborate with other professionals, e.g solicitors and accountants, who are often the "gatekeepers" to trustee investment funds.

Regular reviews, trust suitability and tax considerations

The regular review of the trust investments should take account of both investment returns and the objectives of the trust. Trustees must give consideration to the size of the trust fund, the way in which trust investments will be taxed and the nature, needs and tax positions of the beneficiaries. It will be advisable to make changes in the assets held where appropriate.

Where investment advice is sought, it is common for a suitability report to be completed when carrying out a trust review. A suitability report will enable the trustees to identify whether existing allocations meet the current objectives of the trust.

The report can also cover other aspects, such as how the current assets are taxed, and comment on the current diversification strategy. This is of particular importance as trustees are required to diversify, where possible. It can also provide an overall summary of the current position of the trust.

Case law has, in the past, implied that trustees who do not carry out regular reviews could be held liable. The leading case of Nestle -v- National Westminster Bank Plc [1994] 1 All ER 118 was decided by the Court of Appeal in favour of the trustee bank. Whilst the Court decided that the bank had misunderstood the scope of its investment powers, and had therefore breached its duty both to undertake regular reviews of the investments and to diversify out of the limited range of equities, the appellant (Miss Nestle, the trust beneficiary) needed to establish causation. It was for the appellant to prove on the balance of probabilities: -

(i) that if the bank had regularly reviewed the investments and had understood its investment powers, it would, as a prudent trustee, have diversified the portfolio; and

(ii) that the notional diversified portfolio would have been worth more than the actual portfolio. This was a matter of expert evidence and the appellant was unable to discharge the burden of proof. So, based on the facts, the appellant lost.

As part of the Court of Appeal's judgement Staughton LJ held there was no breach of trust. Despite this the trust company fell 'woefully short of maintaining the real value of the fund, let alone matching the average increase in price of ordinary shares'. The trust company had not acted 'conscientiously, fairly and carefully' and there was 'not much for the bank to be proud of in its administration of the… trust'.

Finally, taxation and administration costs should be taken into account prior to investing the trust fund. Regard should be given to optimising the tax position of the trustees and the beneficiaries. For example, it may be possible to reclaim tax deducted at source for a non-taxpaying beneficiary on any savings income. With a single premium bond investment the benefits include the 5% tax-deferred withdrawal facility, the ability to switch funds without any tax liability and the fact that it may be possible to assign a bond/segments to a beneficiary who is a low rate taxpayer pre encashment rather than having the trustees encash the investment when the gain may be assessed at a higher rate on the trustees or the settlor - depending on the circumstances.

There are also the new dividend tax changes (to take effect from 6 April 2016) to take into account. It seems reasonable to assume (although we await the draft legislation) that trustees will be liable to tax on dividends at the highest rate of 38.1% and with no £5,000 dividend allowance.

COMMENT

This article will hopefully serve as a helpful reminder of the factors to consider when investing trust funds and perhaps, equally important, remind financial advisers of the opportunity that trustee investment offers for collaboration with other professionals.

The referred-to imminent dividend tax changes will offer a valid reason (arguably a requirement) for a comprehensive review of trustee investments.

INCOME WITHDRAWAL RATE FOR OCTOBER 2015

The appropriate gilt yield, used to determine the 'relevant annuity rate' from HMRC's tables for an adult member commencing income withdrawals (or reaching an income withdrawal review date), in October 2015 is 2.25%.