“One of the main benefits of interest-only mortgages is the taxation position... allowing you to offset the interest proportion as a business expense against the rental income”

Mortgage monitor

Experienced UK and overseas mortgage broker **Tony Taylor** offers his expert advice

I hope you enjoyed the article in the last edition of the magazine; it certainly provoked a response from a lot of landlords who were struggling to get their buy to lets to stack up. In this edition we are going to take a look at the thorny issue of Interest-Only Mortgages, the benefits and disadvantages and cover a few Tax Tips for Landlords.

Normally, unless you have loads of cash, you will have to finance your UK or overseas property investment with a mortgage. I covered in my last article the effective use of debt as leverage and the benefits of using other people’s money to invest with. Apart from all the styles of mortgage, e.g. Fixed, Capped, Variable, and of course the now much spoken about ‘Cracker Jacker Tracker’ (the so true to life Nationwide advert), essentially there are two ways to take out your mortgage – interest only and capital repayment. Let’s look at both of these in detail.

Interest-only mortgages do what it says on the tin. You only pay back the interest to the lender (at whatever rate this may be), and you don’t pay back any of the capital. You may pay back capital via a regular overpayment, or occasional lump sums if the mortgage conditions allow, or it may be a flexible-type mortgage. Generally, however, if clients want to overpay they will take out a repayment mortgage. So, a simple example would be:

- £100,000 mortgage at an interest rate of 5% will give you a monthly payment of:
- £100,000 at 5% = 5,000
  £5,000 ÷ 12 months
  £416 per month

If this mortgage is on a fixed rate then this payment will be constant.

At the end of the mortgage term you will still owe the same amount as when you started the mortgage, so the amount will need to be refinanced or paid off by a separate repayment vehicle, a cash acquisition or, normally, the sale of the property.

A capital repayment mortgage is a more complex beast. Of course, here you are paying interest at the mortgage lender’s rate on a monthly basis; however, with this loan you elect a period of time (traditionally 25 years) in which you will pay off the capital sum. The shorter the term of the mortgage, the higher your repayments will be. Every month you pay the interest back to the lender plus a portion of capital depending on the term. Every month, as you pay back a little bit of the capital, the loan reduces and the next month your interest bill will be a little less. This compounds up over the term so in the early years you pay off very little capital but in the years leading up to the end of the mortgage most of your payments are made up of capital repayment.

So that is all very interesting but how does that relate to property investment, I hear you say.

First of all, let’s look at cashflow:

We will assume that you own one property. The way house prices are today, coupled with the fact that most investors want to take out as big a mortgage as possible on their property, it is getting harder and harder to get a deal to ‘wash its face’, i.e. be at a neutral cashflow position with the mortgage, landlord’s insurance and possibly agents’ fees to equal the rent payable. So one of the first advantages of having an interest-only mortgage is quite simply that your payments are smaller. This helps with cashflow and should assist you in not having to subsidise the deal.

As you buy more and more properties, this benefit increases dramatically as the rental profits from each unit can subsidise any other properties that are empty. On properly geared deals with an interest-only mortgage, the rent from three properties should cover the mortgage payments on four properties, thus giving you a little bit of a safety margin. If these were repayment mortgages, you would probably still have to subsidise the mortgages. Really, interest-only mortgages just help the property investor buy more property with a lower total monthly outlay, thus minimising the potential chance of getting into financial difficulties when voids occur.

If the investor is only ever intending to buy one or two properties for long-term investment and potential pension income, then of course these properties should be on capital repayment mortgages so the loans will be paid off by the target retirement age, thus allowing the investor to receive the rents in full without having to pay out mortgages. However, if the intention is to maybe own ten properties then there are different exit strategies that can be employed to minimise the risk of ending up in retirement with huge amounts of debt to service. I will look at portfolio exit strategies in the next edition of the Jet-to-Let Magazine.

One of the main benefits of interest-only mortgages is the taxation position. HM Revenue & Customs will allow you to offset the interest proportion of your mortgage as a business expense against the rental income. If you have an interest-only mortgage, the debt remains the same throughout the term so the monthly payment is always fully offset against the income. However, if you have a capital repayment mortgage, every year that you have the loan, the interest portion will reduce as you pay the capital back. So, conversely, as you have less interest outstanding, you have less expense and hence, in theory, will make more profit and pay more tax. Over a 25-year period the extra tax that you may pay could mount up to be at least a deposit on another property. Taking into account the magic of compounding, I would always say that you are better off:

- Having smaller mortgage payments at the start of your Buy to Let career, to minimise the risk involved in expanding the portfolio.
- Paying as little tax as possible to enable you to re-invest that extra money in refurbishment, maintenance and further property deposits.

There is always a risk with interest-only mortgages, but of course there is always a risk that you might not be able to make the payments on a capital repayment mortgage. In fact, life is just one big risk, isn’t it, as the health and safety mafia will no doubt tell you? Most of my clients will always want to take interest-only mortgages as they feel that it is less risky in the long run.

Also in this article, as we have talked about the tax benefits of interest-only mortgages, I would like to give you some property investment tax tips. I would like to point out that I am not an accountant and you should discuss any of these concepts with your own auditor to see if they apply in your situation.

- If you remortgage your existing residential or business property to fund the deposit, the whole purchase price, improvements, or any money otherwise spent for the purpose of the property business, the interest portion of this loan is fully allowable as an expense within the property business. This works on the basis of apportionment, i.e. if Tony has a mortgage of £100,000 on his own home, and he borrows £25,000 of the equity to fund a Buy to Let deposit, his mortgage balance would now be £125,000; therefore Tony could claim 25/125ths of his mortgage interest as a business expense.
- I think most of you are well aware that the sale of your main residence is exempt from Capital Gains Tax. This is because of the principle private residence exemption. This applies to each individual, married couple or civil partnership, and the exemption covers the whole of the period in which the property was their main residence, but more importantly their last three years of ownership. In practice, this means that Harry and Harriet could each have their own private residence when they were single, they could then buy a property together and rent out their existing properties (this would be called a double Let to Buy). If they kept these properties for three years and then sold them they would pay no Capital Gains Tax on the profit if the properties had increased in value.
- Capital Expense and Revenue Expense. This is quite simple and really depends whether you are going to keep a house for long-term investment or rent it on a short-term basis and then sell on. If, for instance, the property needs a new kitchen, if you were going to sell the property on you would claim this kitchen refurbishment as a capital expense as then this could be offset against a potential Capital Gains Tax bill, and you should refurbish the kitchen before you let the property out. When you dispose of the property you can then offset this and reduce your Capital Gains Tax bill. However, if the property is a long-term rental you would refurbish the kitchen after the property is let and claim the cost as a revenue expense. This would then be offset against the rental income, thus reducing your income tax bill.
- The use of Partnerships. If a couple decide to start a property business it is always better to put the properties in joint names to be able to maximise each individual’s Capital Gains Tax annual allowance on a future disposal. However, rather than being a sole trader or a limited company, if you run the property business as a partnership it doesn’t really matter whether the properties are in joint names or single names. The main saving of having a partnership is that you can decide to allocate the partnership profits in unequal proportions to each partner. For example, if Harry and Harriet have a property business producing a gross profit of £10,000 per year and Harry’s income from his main occupation puts him very close to the 40% tax bracket, the partnership can decide to allocate all of the profit to Harriet, who is a basic rate taxpayer and thus would be taxed at 20% rather than 40%, saving 20%. Obviously, the larger the profit, the larger the saving. If the couple had formed a limited company, they would have to allocate the profits as dividends in equal proportions to the shareholders (this does simplify the issue as there may be different shareholdings). Most experts only recommend that you run a property rental business as a limited company if you have in excess of 20 units. For trading or development businesses, a limited company would normally be the way to go.

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I hope you have enjoyed my thoughts in this edition. If you have any queries please do not hesitate to contact me on 08000 277 336. In the next edition of the Jet-to-Let Magazine I will discuss some concepts for building a portfolio, as well as some exit strategies.

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