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Reforms put pressure on buy-to-let landlords

The lure of property

Given the strength of house prices in recent decades it is easy to understand why the lure of property as an investment – or buy-to-let remains strong. Many of Britain's estimated 1.4 million landlords[1] have profited handsomely in recent years, with strong tenant demand enabling them to push up rents.

The radical pension changes introduced earlier this year, offering savers greater flexibility, have provoked even more interest in buy-to-let investment. Since April 2015, savers aged 55 and over have been able to spend, save or invest their pension pots as they please. This has led to speculation that people will exploit the 'pension freedoms' by cashing in their pots to buy more property – counting on the rental income to fund their retirement.

With 22% of those planning to use the new flexibilities to invest in property and 18% saying they will rely on income from buy-to-let[2] it makes sense to take a closer look at the pros and cons of using property to support your lifestyle in retirement.

Buy-to-let as an investment

Sweeping changes introduced in April have given you more choice over how you use your pension savings once you reach the age of 55. One of the key reforms enables you to take your entire pension as cash, subject to tax, if you so wish. Alternatively, you can withdraw an income or one-off lump sums whenever you like. Previously, when people felt forced into buying an annuity, they had much less control.

Ever since the reforms were announced by the chancellor in his 2014 Budget there has been interest in how the new flexibilities will be used: especially whether savers will be tempted to take money from their pension to invest in buy-to-let to fund their retirement.

The new freedom to cash in large lump sums, or even your whole pot, means that as an option buying property with your pension appears to be much more achievable. There is definitely scope to do this as part of a balanced retirement plan. However, anyone considering taking the plunge needs to carefully weigh up the advantages and disadvantages.

Pros

It can be profitable

There is a good reason why more than a million people have invested in buy-to-let – investment properties can generate a good income while also offering the potential of capital growth.

Strong tenant demand has pushed up rents to record levels in some areas[3], powered by a shortage of housing and the low level of lending to first-time buyers struggling to get on the property ladder. Gross rental yields, the rent received before letting costs as a percentage of the property's purchase price, are around 5%, according to the industry trade body The Association of Residential Letting Agents[4]. Nationally, house prices have risen three-fold in the past 25 years[5].

That sounds impressive, but it is worth noting that total returns from the FTSE All-Share Index have outperformed property over that period.

Borrowing can boost returns

In recent years, low borrowing costs have increased theappeal of property as an investment. Even in areas where house prices have risen strongly, cheap mortgage rates have helped to keep property affordable. The National Landlords Association estimates that those who have used a mortgage to purchase their buy-to-let property spend just 28% of their rental income meeting repayments[6]. Borrowing magnifies the returns on your cash as property prices rise.

You can touch it

People feel they understand property because it is a physical asset. Unlike a company share or a bond you can see it and touch it and it is familiar. Low savings rates and periods of stock market volatility add to the perception that investment in property is 'as safe as houses'.

Tax benefits

Renting out a property is treated as a commercial enterprise for tax purposes. Generous tax reliefs on rental property have provided another incentive to save. You can currently claim tax relief on items such as wear and tear and mortgage interest. However, a word of warning: these tax benefits will become substantially less generous from next April, as we explain below.

Cons

It may be less profitable than you think

You should not underestimate the expenses associated with buy-to-let, which can be substantial. Recent research by specialist buy-to-let business Platinum Property Partners indicated that nearly one-in-eight landlords fail to consider costs when calculating the profitability of their property portfolio[7].

Costs to consider include solicitors' fees, mortgage application fees, stamp duty, letting agents' fees, service charges, insurance andmaintenanceexpenses.

There is also tax to factor into your sums. Rents are taxed as income, selling a property will likely trigger capital gains tax and passing a property onto your children could result in an inheritance tax bill. Tax bills are going to soar for some landlords in the next five years, due to imminent tax changes that are explained below.

All of these costs mean that the yield you actually receive from your property may be much less than you hoped. Once costs are taken into account net yields average 4.9%, according to The Association of Residential Lettings Agents[8]. However, net yields in prime Central London are as low as 2%[9].

Tenant problems

There will be intermittent periods when your property is between tenants, with no rent coming in. Maintenance, redecoration or refurbishment may also lead to void periods. The average length of a tenancy is 18 months and the average void between tenancies is twoweeks[10].

Even with the assistance of a letting agent, landlords have a lot of responsibilities like ensuring the safety of the property. Most landlords will tell you that tenants are trustworthy and decent, but dealing with just one problem tenant can be an ordeal. Some 29% of buy-to-let landlords have had tenants with financial or other problems and 21% have had tenants in rental arrears[11].

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Accessing your investment

Property is an 'illiquid' asset. It does not offer ready access to your money should you decide that buy-to let is not for you and you want to sell. Selling a property can take many months, or longer if market conditions are not in your favour.

Being overexposed

You should always aim to use your money in the most tax-efficient way. That means making use of your entire portfolio of investments and savings, including pensions, ISAs, stocks and shares – and buy-to-let property if you so wish. The key is to make sure that risk is well balanced and that your investments are properly diversified.

When the office for National Statistics last ran the numbers it found that around 37% of the nation's wealth is already tied up in property[12]. That means that if you purchase a buy-to-let you may be heavily exposed to property and being overexposed to a single sector is risky.

Do you really want to continue to work?

You may be relaxed about running a buy-to-let investment in your 50s or your 60s but if you are buying it to fund your retirement ask yourself whether you will be as content, later in life, to deal with the hassles that landlords can face. If you want to make all or part of your living from buy-to-let it is probably best to view it as a job – not a hobby that pays.

"With recent house price growth and a rental boom, many of Britain's retirees think buy-to-let is the way out of their retirement conundrum. Many don't consider the risks of buying a highly illiquid asset. Void periods, hidden costs and the perils of being a landlord at the age of 80 are just some of the issues with buy-to-let. If you've given up work, do you really want to begin a new career as a property manager?"

Nick Fitzgerald, Head of Financial Planning at Brewin Dolphin

Understanding the longer-term risks

Rising interest rates

Borrowing to purchase an investment property adds risk. Mortgage rates are near all-time lows and even though they are not predicted to rise very fast even a small uplift could eat into your profits. The repayments on a £100,000 interest-only mortgage, with a 15-year term, will jump by nearly £1,000 a year – £999.96 to be precise – for every one percentage point increase inrates[13].

Nor can you count on being able to switch to a cheaper mortgage when rates start to rise. Lenders are more rigorous than ever about lending money, so it may not be as easy to borrow money moving forwards compared to the past.

You cannot count on property price rises…

Relying on capital growth being as strong as in the past is risky. The ratio of house prices to earnings, an indicator of property affordability, is above its long-term average[14]. On this gauge property is overvalued, meaning house prices are vulnerable to a slowdown or correction.

There are fears that the tax cuts announced in the summer Budget could encourage many landlords to sell up. Some will find that their buy-to-let business is barely profitable, or even loss-making, when the changes are fully implemented in 2020. A flood of properties onto the market by landlords desperate to sell could trigger house price falls. If there is a rush to sell, the Bank of England is worried that buy-to-let lending could pose a risk to financial stability[15].

… or rent increases

Rents tend to rise and fall in line with disposable income. With inflation low and wages rising after years of stagnation there is scope for rents to move higher. However, you should not take the ability to raise rates for granted – even though demand from tenants is high in some areas landlords cannot simply name their price.

Tax threats

Cashing in yourpensions

While the ability to withdraw all of a pension pot at once might sound attractive, only 25% of a pension fund is tax free. Anything above that amount is taxed as income. So if you have a pension pot of £500,000, £125,000 of that can be taken tax free but the other £375,000 will be taxed. You need to take care as taking more than the 25% tax-free amount could push you into a higher tax bracket, resulting in an unnecessarily steep bill.

Prepare yourself for major reforms

Some important changes to the tax reliefs available to landlords were made in the July Budget. The bottom line is that from April next year the reliefs available will be less generous, potentially making buy-to-let less profitable as an investment. Some landlords will find that their buy-to-let business is no longer financially viable as they will suffer a cash loss after tax.

Tightening of rules on annual 'wear and tear' allowance

At present, landlords can claim 10% tax relief each year on their rental income from furnished accommodation to cover 'wear and tear', whether improvements to furnishings are made or not. From next April landlords will only be able to claim a deduction for the costs they actually incur if they replace furnishings.

Reduction of tax relief on buy-to-let mortgage interest

Restrictions on the tax relief landlords can claim on mortgage interest will be an even bigger blow for many landlords. Currently, property investors can claim this relief at their marginal rate – if they are a higher-rate taxpayer this is 40% and if they are an additional-rate taxpayer this is 45%. From April 2017, a reduction in the level of tax relief will be phased in over four years, eventually restricting relief to the basic rate of income tax of 20% for all landlords from 2020.

Some buy-to-let businesses, especially those already on the margin of profitability, will no longer be financially viable as they will suffer a cash loss after tax. Higher-rate taxpayers who own buy-to let properties on which there is a large mortgage will suffer most. Landlords who do not have a mortgage will be unaffected.

Even basic rate payers need to take care, as the changes may push them into the higher-rate tax bracket landing them with bigger bills. The National Landlords Association estimates that around 130,000 buy-to-let landlords who are higher-rate taxpayers will be affected by this change at a total cost of around £700 million per year[16].

How profits could turn to a loss

- A landlord has a gross rental income of £10,000 with an 80% loan-to-value mortgage worth £160,000
- He or she pays mortgage interest of £8,000 a year, leaving a gross profit of £2,000
- Currently a higher-rate taxpayer would pay £800 in tax on this amount i.e. 40% of £2,000
- The £8,000 mortgage bill is added to the £800 tax bill to give total expenses of £8,800, leaving £1,200 of profit for the landlord
- However, from 2020, their tax bill will be charged on the full £10,000 (40% of £10,000 equals £4,000) less a 20% tax credit on the mortgage interest, totalling £1,600 (20% of £8,000 is £1,600), leaving a payable tax bill of £2,400
- Add that to the mortgage interest costs of £8,000 and the result is total expenses of £10,400, which translates to a £400 loss.

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Conclusion

Aspiring landlords should carefully weigh up all the pros and cons before committing their money to bricks and mortar. Buy-to-let property can play an important part in an investment portfolio and a central role in retirement planning. However, you must ensure that your portfolio is properly diversified to reduce risk. That means investing in a spread of investments including ISAs, pensions, stocks and shares, and property – commercial or residential – if you so wish.

Talking to one of our Independent Financial Advisers can help you to look at the full range of options there are for building a strong foundation for your retirement.

If you would like to discuss any of the issues raised in this article with one of our Independent Financial Advisers, please call 01273 208813 or email info@iepfinancial.co.uk

The value of investments can fall and you may get back less than you invested. Past performance is not a guide to future performance. No investment is suitable in all cases and if you have any doubts as to an investment's suitability then you should contact us for independent advice. Any tax allowances or thresholds mentioned are based on personal circumstances and current legislation, which are subject to change.

The information contained in this document is believed to be reliable and accurate, but without further investigation cannot be warranted as to accuracy or completeness.

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References

[1]National Landlords Association. [2]YouGov survey on behalf of Brewin Dolphin: 515 respondents with investable assets of £100k+, of which 455 have a pension. [3]LSL Buy-to-Let Index, September 2015. [4]The Association of Residential Letting Agents Buy-To-Let Reviews 2014, Fourth Quarter. [5]Halifax House Price Index, September 1990 – September 2015. [6]National Landlords Association. [7]Platinum Property Partners, UK landlords are failing to take running costs into account when measuring buy-to-let return, 28 April 2015. [8]The Association of Residential Letting Agents Buy-To-Let Reviews 2014, Fourth Quarter. [9]Knight Frank London Residential Review Winter 2015. [10]The Association of Residential Letting Agents Private Rented Sector Report, September 2015. [11]The Association of Residential Letting Agents UK Buy-to-Let: An Overview for Landlords. [12]Office for National Statistics Total Wealth, Wealth in Great Britain 2010-12, 15 May 2014. [13]John Charcol Mortgage Repayment Calculator. [14]Nationwide House Price Index, October 2015. [15]Bank of England Inflation Report, August 2015. [16]National Landlords Association.