TOPIC 24

# Other mortgage products

**LEARNING OBJECTIVES**

In Topic 23 we looked at the most common mortgage products. The products we are going to outline in this topic are less widely used but it is important for an adviser to be aware of them – they may be precisely the products that a customer needs.

By the end of this topic, you should have an understanding of:

- foreign currency mortgages;
- sub-prime mortgages and mortgages for credit impaired borrowers;
- guarantee (guarantor) mortgages;
- Islamic home finance;
- mortgages for people who are building their own property (self-build);
- buy-to-let mortgages including the use of special purpose vehicles (SPVs).

**THINK ...**

The mortgage products in this topic may well be unfamiliar to you, even if you are currently working for a mortgage provider or have experience of buying your own home. We introduced the use of guarantees in Topic 11 and looked at buy-to-let mortgages from various perspectives (eg in Topics 2 and 3). In Topic 1 we outlined the role of sub-prime mortgages in triggering the 2007–09 financial crisis.

To focus your thoughts on some of the other areas in this topic:

- what impact do you think the rules on affordability and suitability might have had on the sub-prime lending sector?
- if you were lending to an individual who was building their own home, what precautions might you want to take?

TOPIC

# 24

## 24.1 How does a foreign currency mortgage work?

In simple terms, a foreign currency mortgage is one where the borrower's income is in a different currency from that applying to the mortgage. So, if an individual has a UK property with a sterling mortgage, but is paid in euros or US dollars, that mortgage would be a foreign currency mortgage. A Spanish mortgage used to fund a UK resident's holiday home in Spain would also be a foreign currency mortgage, unless the owner had sufficient income in euros to pay the mortgage.

Our focus in this study text will be on the use of foreign currency mortgages to buy UK property, which is very much a niche market.

Foreign currency mortgages secured on UK property were never mainstream products; a combination of high minimum loans, low loan-to-value limits, set-up costs and the potential risks meant they were only of interest to high-net-worth individuals with very large mortgages.

They were introduced when UK interest rates were very high compared with other countries, and were of potential benefit to those with very large mortgages who wanted the potential to reduce the monthly payments in return for taking a significant element of risk. Borrowers arranged mortgages in currencies allied to countries with much lower interest rates than the UK – most commonly Japan (yen) and Switzerland (Swiss franc). Now that rates in the UK, Europe, the USA and Japan are more closely aligned, such products are less attractive because, for most people, the savings may not be enough to justify the risks.

The key points relating to a foreign currency mortgage are as follows:

- The mortgage is arranged in a foreign currency and secured on a UK property.
- The capital owed is denoted in that currency.
- Each repayment is made in that currency – which means converting from sterling.
- The interest rate is determined by the rates applicable to that currency in the country in which it is used (eg if the currency is the yen, Japanese interest rates apply).
- There is usually a very high minimum loan – at least £250,000 in most cases.
- Loans are usually available on a repayment or interest-only basis.

**CALCULATING REPAYMENTS ON A FOREIGN CURRENCY MORTGAGE**

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To illustrate how a foreign currency mortgage works, we will look at an example denominated in Swiss francs (CHF).

Oscar borrows £250,000 in Swiss francs (CHF) on a repayment basis at an exchange rate of CHF1.45 to the pound.

The interest rate charged is 4 per cent; UK interest rates are 6.5 per cent.

This gives a debt of CHF362,500 (£250,000 x CHF1.45) and a monthly repayment of CHF1,932. This equates to £1,319 per month. A sterling mortgage for the same amount would cost £1,688 per month.

If the Swiss franc were to strengthen against the pound to CHF1.30, the debt owing would increase to £278,846 (CHF362,500 ÷ 1.30); the monthly sterling payment would rise to £1,486.

If the Swiss franc were to strengthen to CHF1.15, the monthly sterling payment would increase to £1,680 and the debt to £315,217.

Movement in the exchange rates has increased both the debt and the repayments, and the benefit of the lower interest rate has been eroded.

It is possible to insure against currency fluctuations, but this is expensive and will reduce savings. Some companies offer managed currency loans, where the debt is switched between currencies to gain advantage of better rates. These are still risky and cost a lot to run, again reducing the savings.

### 24.1.1 MCD requirements relating to foreign currency mortgages

The Mortgage Credit Directive includes requirements for foreign currency mortgages, which is defined in MCOB as:

a) denominated in a currency other than that in which the consumer receives the income or holds the assets from which the credit is to be repaid; or

b) denominated in a currency other than sterling.

Examples:

- A borrower lives in the UK and has a UK mortgage on a UK property but receives their income in euros from their German employer.
- A UK resident who is paid in sterling has a mortgage on their London property denominated in Swiss francs.

In such cases, the lender must include in the ESIS additional warnings about the potential impact of fluctuations in the exchange rate, particularly those that would have an adverse effect. Lenders are also required to put in place systems that provide consumer protection against such risks, such as allowing the borrower to convert the mortgage into another currency if the fluctuation exceeds a specified percentage, or capping the amount by which the consumer would be affected by the movement.

## 24.2 What is a sub-prime mortgage?

The mortgage market includes a number of specialist businesses that have created a niche in lending to, or arranging loans for, people who might not fit neatly into standard lending criteria, either because they do not have a track record of using credit or because they have suffered financial difficulty in the past. Those who have suffered credit problems in the past are referred to by the FCA as 'credit impaired' borrowers. The mortgages offered by sub-prime lenders reflect the increased risk taken, and interest rates are usually higher than those that apply to standard mortgages.

As lenders develop more expertise in underwriting sub-prime mortgages, the products have evolved to the extent that it is now possible to select from a range similar in structure to those in the general market. For example, it is possible to arrange sub-prime mortgages on a variable, tracker, fixed, capped or discount basis. The essential difference lies in the rate charged and the underwriting process. It may even be possible for borrowers with severe credit problems to arrange a sub-prime mortgage – at a price.

Many lenders and brokers now prefer to use the term 'near-prime' rather than sub-prime; MCOB requirements for more comprehensive assessment of affordability and a more responsible approach mean that they are more cautious in their approach to lending in this sector of the market.

The essential features that differentiate sub-prime mortgages from the mainstream are as follows:

- Borrowers with previous bad credit (credit impaired borrowers) can be accommodated. On occasion, those within weeks of having their home taken into possession have been able to arrange remortgages, although in the current market lenders are more cautious.
- Some lenders will include certain state benefits as part of assessable income.
- Interest rates are higher than those for prime borrowers. Many lenders set interest rates in broad bands depending on the credit history of the borrowers. For example, for those with one or two county court judgments (CCJs) against them, the rate might be 1–2 per cent higher than the prime rate; borrowers with more CCJs might be offered rates 2–3 per cent higher.

It is not unknown for fixed rates as high as 11 per cent to be offered to those with a very poor credit history.

- Maximum loan-to-value ratios may be lower than those for prime borrowers.
- Product fees tend to be higher than those for equivalent prime products. Early repayment charges can be considerably higher than on conventional mortgages and overhanging penalties are not unusual.

There may be rare occasions where a sub-prime mortgage could be suitable for a customer with a good credit record. MCOB rules allow this as long as the customer is not disadvantaged and the arrangement can be shown to be suitable and in their best interests.

## 24.3 What is a guarantor mortgage?

As property prices escalate, first-time buyers find it increasingly difficult to raise mortgages large enough to purchase a property. Typically they cannot raise a large enough deposit, or their income will not stretch to meet the repayments using the lender's standard affordability criteria. Many lenders have recognised this dilemma and have introduced 'guarantor mortgages'. A guarantor mortgage operates on the same principle as any other mortgage supported by a guarantee but the difference is that it is formally marketed as a specific product.

**CHECK YOUR UNDERSTANDING 1**

We looked at guarantors in Topic 11. Can you recall:

a) what a guarantor is?

b) the two bases on which a guarantee can be provided?

In most aspects the mortgage is the same as any other mortgage product: it may offer fixed or variable rates in line with standard products, and repayment or interest-only options. The key details are as follows:

- The product will allow higher lending than a standard mortgage.
- The applicants are responsible for the debt in the first instance, but if they fail to meet the interest or capital payments as required, the guarantor becomes responsible for some or all of the debt, depending on whether the guarantee is on a full or limited liability basis.
- The lender will need evidence that the guarantor can afford their own commitments as well as the payments on the guarantor mortgage. Some lenders will take a charge over the guarantor's property to secure the lending.

- As with all loan guarantees, the lender will require the guarantor to seek independent legal advice to ensure they understand the implications of what they are taking on.

Guarantor mortgages tend to be short-term arrangements, and the lender would be looking for evidence that the borrower(s) would be able to maintain the mortgage independently in the relatively near future, perhaps within three to four years.

**PROVIDING ADDITIONAL SECURITY VIA ASSIGNED SAVINGS**

Rather than take a conventional guarantee, some lenders offer a different approach to prospective guarantors who perhaps do not want to take too much of a risk. A number of lenders have launched schemes designed to allow family members to provide security – outside of the legal definition of a guarantor – to help others secure a larger mortgage than they could otherwise. The general principles are as follows.

- Family members usually provide security by placing cash equal to a set percentage of the purchase price (typically 10 per cent) in a savings account with, and assigned to, the lender.
- The borrower can then arrange a repayment mortgage of between 95 and 100 per cent of the purchase price, depending on whether they are able to provide a deposit.
- The savings account is locked to the lender for a minimum period – typically three to five years – and earns interest.
- As long as the mortgage account has been conducted satisfactorily, the savings are released at the end of the agreed period, the guarantee is cancelled and the mortgage continues as normal.
- If there are problems with the mortgage account during the initial period, the lender has the security to make up any deficit or can extend the lock-in period.
- By the end of the lock-in period, the borrower will have repaid enough of the mortgage to bring the loan closer to (or within) the lender's normal limits, and the lending risk will have reduced to acceptable levels.

Another offering from some lenders is the joint borrower, sole proprietor scheme, as covered in section 11.2.

> **TECHNICAL TERM**
>
> Where a third party's savings are assigned to guarantee a loan, this is known as a surety.

## 24.4 What is Islamic home finance?

Muslims wishing to buy property are faced with a religious dilemma because Sharia principles and law forbids the payment or receipt of interest. This is because one party would gain at the expense of another without regard to the value of the goods traded – a concept that conflicts with the Islamic principle of equality. Islamic law does allow the sharing of risk and profit.

Islamic home finance (sometimes inaccurately called Sharia or Islamic mortgages) is based on Islamic finance principles and has been developed to allow Muslims to raise the finance to buy property without compromising religious principles.

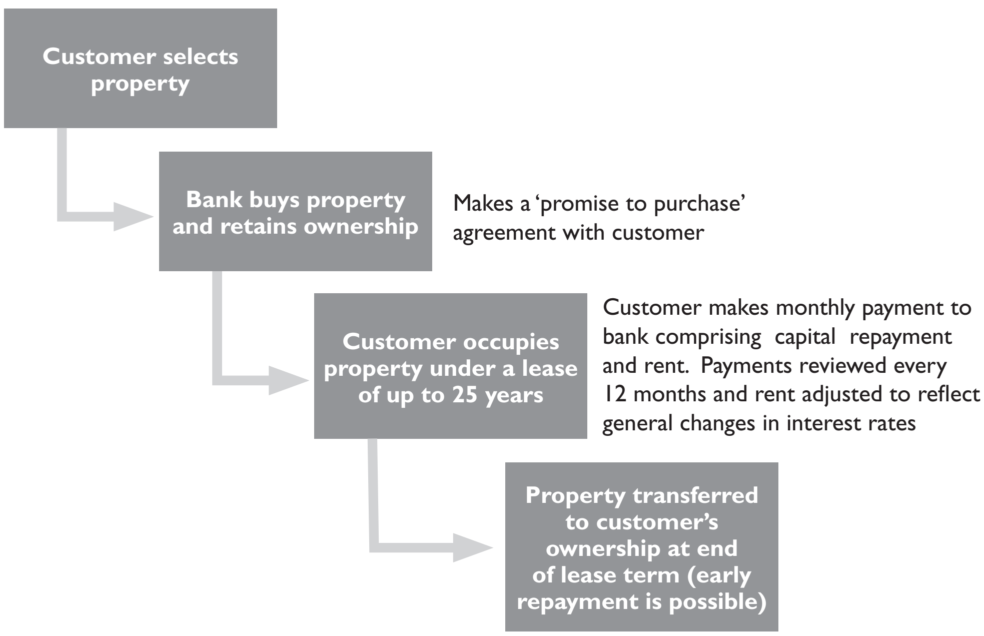
There are two types of arrangement available:

- *Ijara* – which follows the acceptable principle of leasing;
- *Murabaha* – which follows the acceptable principle of co-ownership.

### 24.4.1 *Ijara* method

The *Ijara* (lease to own) method is a type of home purchase plan whereby the bank buys the client's selected property. The method is summarised in Figure 24.1.

**FIGURE 24.1 *IJARA* METHOD OF HOME PURCHASE**

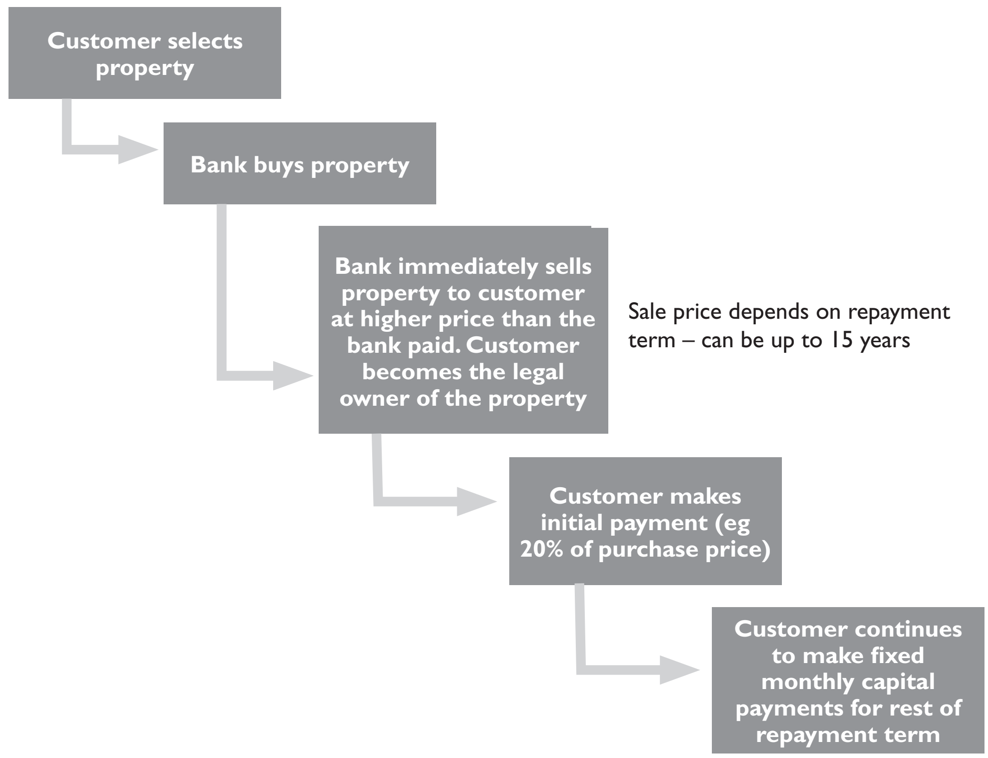


Under Sharia principles, the rent is seen as a fair price for using the property and so there is no conflict of principle. The bank makes its profit from the rent paid over the term. In comparison with a conventional mortgage, the *Ijara* method is more expensive – the monthly payments tend to be higher.

### 24.4.2 *Murabaha* method

The *Murabaha* method is outlined in Figure 24.2. The *Murabaha* arrangement is less popular than the *Ijara* approach as it is more expensive overall and less flexible in terms of early repayment. Note that properties purchased under 'Right-to-Buy' schemes cannot qualify.

**FIGURE 24.2 *MURABAHA* METHOD OF HOME PURCHASE**



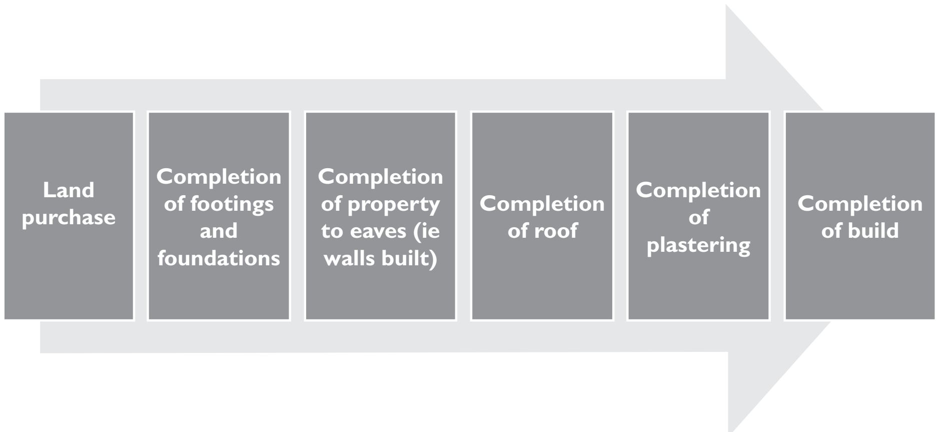

**SDLT AND ISLAMIC HOME FINANCE**

With both the *Ijara* and *Murabaha* methods, stamp duty land tax is paid once, when the property is initially purchased by the lender.

## 24.5 How does a mortgage for a self-build project differ from a standard mortgage?

A limited number of lenders provide finance for people wishing to build or supervise the building of a property, generically termed self-build mortgages. The self-build mortgage allows the borrower to purchase the land and finance the construction as well, with funds released at key completion stages of the build process, ie stage payments in arrears. Lenders generally release the initial funding on purchase of the land (see Figure 24.3). They usually require an inspection to confirm that each stage has been completed satisfactorily.

**FIGURE 24.3 TYPICAL COMPLETION STAGES TRIGGERING RELEASE OF FUNDS**




The lending criteria vary between lenders, but a typical arrangement would offer self-build finance for up to 75–85 per cent of the initial land costs and 75–85 per cent of either the total building costs or the final value, released in tranches at specified stages of the build. Arrears stage payments require the self-builder to have the resources to pay for the work first before receiving the mortgage tranches.

Some lenders consider advancing funds at the start of each significant phase, known as advance stage payments. This is better for those on a tight budget, but the risk to the lender is higher than for stage payments in arrears, so higher interest rates tend to be standard.

Some lenders insist on the applicant paying for an insurance policy that protects the lender if the self-builder cannot complete the project. It covers the lender for repossessing the property, completing the work and then selling it.

## 24.6 What is a buy-to-let mortgage?

A buy-to-let mortgage is designed to enable an individual to finance a property for letting rather than for owner occupation. Consequently, most buy-to-let

(BTL) mortgages are not regulated by the FCA and are outside the scope of MCOB. The exception is when it meets the criteria for a regulated consumer buy-to-let (CBTL) mortgage, a new category of BTL mortgage, which was described in Topic 2.

### 24.6.1 Consumer buy-to-let mortgages

Consumer buy to let (CBTL) mortgages are expected to represent a very small part of the overall BTL market. Lenders are required to treat CBTL borrowers in the same way as those arranging a mortgage to buy a home for themselves. This means that the lender must carry out affordability checks and follow all the Mortgage Credit Directive Order application and documentation requirements. In theory, lenders have the discretion to include potential rent as part of the affordability assessment.

> **KNOWLEDGE REFRESHER**
>
> A CBTL mortgage contract is one 'which is not entered into by the borrower wholly or predominantly for the purposes of a business carried on, or intended to be carried on, by the borrower' (Mortgage Credit Directive Order, 2015). Borrowers in this category are sometimes described as 'accidental landlords' – in other words, they are people who need to let out a property because of personal circumstances, rather than because they have made a conscious choice to buy a property for rental. Such circumstances might include those who inherit a property, or people who need to move quickly because they have a new job and do not have time to sell their family home before moving.

It is possible, in certain situations, for CBTL borrowers to waive their regulatory protection and opt for a loan on business BTL terms. The business BTL contract states that the property cannot, at any time, be occupied by the borrower or a family member, and the borrower declares that the BTL is for business purposes and they understand that they are waiving their right to protection under mortgage legislation.

Only new mortgages taken out in these circumstances would be CBTL mortgages. If the owner already has a residential mortgage on the property, the mortgage will keep its original status, unless the owner remortgages.

### 24.6.2 Business buy-to-let mortgages

The bulk of BTL mortgage lending is for those looking to use property as an investment. It is possible to arrange business BTL mortgages from a similar range of interest options as conventional mortgages, and they can be on an interest-only or repayment basis. These products usually incorporate an application and/or product fee and an early repayment charge.

The range of products and the approach to BTL lending varies between lenders; this text will consider the typical products and approach rather than provide details of specific products.

**IN BRIEF**

**BUSINESS BTL**

- Lenders usually limit BTL lending to 75–80 per cent of the property valuation, and set a minimum property value.
- They usually insist that a BTL borrower already owns their main residence, or sometimes at least one other property.
- Most lenders require a minimum gross income, typically £20,000–25,000 for single applicants. Where there are joint applicants, one of them typically must have an income of at least £20,000–£25,000. Some lenders will consider joint applicants where neither meets the minimum income requirement but the joint income is above a higher minimum – typically £30,000 or more.
- Most lenders set a minimum and maximum age range – typically between 18 and 25 years old as a minimum, with the mortgage typically ending by age 75. The borrower must usually be employed, self-employed or retired with a pension.
- There are now many buy-to-let mortgages available on a fixed-rate or discounted-rate basis. These products usually incorporate an application fee or a product fee and an early repayment charge.

Although the PRA requires a rental cover ratio of at least 125 per cent, many lenders set a minimum ratio of 145 per cent as a cautionary measure. So, if the net rent is £800 a month, the maximum mortgage payment will be £552 (800 ÷ 145%) and the maximum mortgage will be whatever that level of repayment would provide.

**RENTAL COVER RATIO**

The proportion of the mortgage payment covered by the anticipated rental income.

## Prudential Regulation Authority (PRA) regulatory intervention

If a buy-to-let mortgage is not regulated under the FCA's MCOB regime or the Mortgage Credit Directive Order 2015, the lender and its lending activities are regulated by the PRA.

The Prudential Regulation Authority issued a supervisory statement (SS13/16) in September 2016, entitled *Underwriting standards for buy-to-let mortgage contracts*. The PRA took action in response to concerns about potential issues with the affordability of buy-to-let mortgages that were not regulated under the FCA's consumer buy-to-let regime. The statement details minimum expectations for the standards to be applied by firms underwriting non-FCA regulated buy-to-let mortgages, which are those taken out for business or investment purposes.

The PRA defines a buy-to-let mortgage as one which is secured by a mortgage on land in the UK in pounds sterling, and:

- at least 40 per cent of the land is used, or is intended to be used, as or in connection with a dwelling; and
- the land subject to the mortgage cannot, at any time, be occupied as a dwelling by the borrower or by a related person, and is to be occupied on the basis of a rental agreement – for the purpose of the statement, an agreement to rent a property for less than one month is not a 'rental agreement'.

The following are excluded from the requirements:

- Corporate lending.
- An application from an existing borrower for consent-to-let, although existing consent-to-let exposures should be taken into account when assessing affordability for a new buy-to-let mortgage contract.
- A buy-to-let mortgage contract with a term of 12 months or less.

The new requirements do not apply where an existing buy-to-let customer remortgages and does not borrow more than the outstanding balance of the existing mortgage, plus associated remortgaging costs.

The PRA buy-to-let regime requires lenders to assess the affordability of a buy-to-let mortgage contract using an approach that includes whether the income from the property is sufficient to cover the monthly mortgage cost and, if the borrower's personal income is used to support the mortgage, whether that income is sufficient for this purpose. There are three main elements to the requirements – the interest coverage ratio, the income affordability test and the interest rate affordability stress test.

### Interest coverage ratio (ICR)

The ICR is the ratio of rental income to mortgage payments and associated costs and tax, and can be set by each lender. The ICR factors in assumptions for tax and other costs, and so is applied to the actual rent received. The PRA requires the lender to set an ICR based on rental demand and typical rent levels in the area, with expected rental income verified by an independent, qualified surveyor, the use of automated valuation models or an existing rental agreement. The assessment must allow for property running costs for which the owner is responsible, together with tax liabilities. The statement quotes a minimum standard as 125 per cent, and makes it clear that it does not see ICRs reducing; if anything, they are expected to increase, and many lenders use an ICR of 145 per cent.

### Income affordability test

If the borrower intends to use personal income to supplement rental income to support the mortgage, the lender must carry out a detailed affordability assessment.

Income could be income from all rental properties, employment, pensions, savings and investment after deductions for tax and National Insurance, and taking into account any likely changes to the income in the future, such as retirement. The lender can take into account the overall wealth of a high-net-worth customer, as defined in MCOBS, as part of the affordability assessment.

Expenditure is calculated using the same methodology as a FCA regulated mortgage.

### Interest rate affordability stress test

As with an FCA regulated mortgage, the lender is required to consider the effect of interest rate increases on the borrower's ability to service the mortgage. The basic requirements for the lender are as follows:

- The lender must consider potential interest rate increases over a minimum period of five years from the start of the mortgage, unless the mortgage is on a fixed or capped rate for at least five years or the mortgage term is less than five years. The PRA also expects firms to consider the borrower's refinancing risk at the end of the fixed or capped rate period.
- When deciding on the interest rate to use for the stress test, the lender must take into account market expectations and the latest Financial Policy Committee (FPC) recommendations regarding the assumptions to use. It must be able to justify the decision based on those factors.
- The minimum increase to use is 2 per cent, and the minimum future rate to use is 5.5 per cent, even if the indicators suggest the rates will not reach that level. So, if current rates are 3 per cent, the minimum rate to use would be 5.5 per cent, because adding 2 per cent to the current rate would not

equate to the minimum 5.5 per cent future rate. However, if current rates are 4 per cent, the minimum future rate to use would be 6 per cent.

- The lender can allow for inflation-linked rent increases where they will mitigate some of the effect of interest rate rises, but only in line with increases in the CPI, maximum 2 per cent a year.

Where an individual has four or more buy-to-let properties, the lender is also required to consider the borrower's general experience as a landlord, their existing portfolio, overall wealth and other financial factors specific to their business.

### Why does a BTL mortgage represent a greater risk to a lender?

A BTL mortgage presents a greater risk to the lender because:

- there is no guarantee that the property will be permanently tenanted – lengthy periods during which no rental income is received may affect the borrower's ability to maintain monthly repayments;
- the borrower may treat the financial commitment less seriously than if the property were their own home;
- the value and saleability of the property may be adversely affected if it is badly treated by tenants and not adequately maintained by the borrower.

Initially, lenders countered this increased risk by charging a higher rate of interest than for conventional mortgages; as the demand for these schemes has grown, interest rates have fallen.

Before deciding to proceed with a BTL application, the prospective borrower should assess the proposition carefully by checking information on the local rental market and appointing a reputable letting agent to manage the tenancy.

The lender will want to ensure that a suitable form of tenancy agreement is used so that it is not prevented from obtaining a possession order in the event of default. It is usual for an assured shorthold tenancy agreement to be drawn up because this also gives the landlord the right to take possession of the property when the lease expires.

The rapid growth in the BTL market has caused concern for some time. In some areas of the country, it is felt that BTL purchasers have been pushing first-time buyers out of the market. They are often competing for the same relatively lower-priced properties, which has driven up prices and reduced the stock available for those wishing to put a foot on the property ladder. The Chancellor's decision to cut tax relief on BTL mortgage interest from April 2017, together with the SDLT surcharge (see section 15.9.1), was an attempt to redress the balance. However, many experts feel that the changes will result in rent increases and some landlords deciding the investment is not viable. Their withdrawal from the market could reduce the supply of rental property available for those who either wish to rent rather than buy or cannot afford to buy.

### 24.6.3 Taxation of individually held buy-to-let property

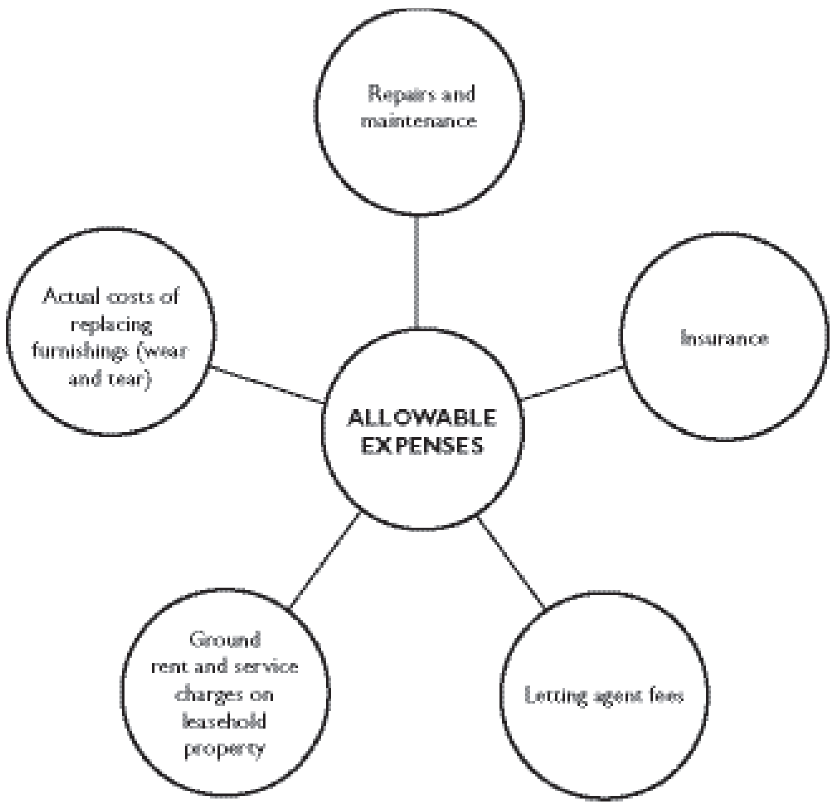
#### Taxation of rental income

Rental income, after the deduction of certain expenses, is taxed as non-earned income at the rate applicable to the owner's tax band.

The income is taxable in the tax year it is received, regardless of whether the owner takes the income or leaves it in the business account.

Expenses that can be deducted from rental income are summarised in Figure 24.4.

**FIGURE 24.4 EXPENSES DEDUCTIBLE FROM RENTAL INCOME**




#### Capital gains tax

Personally owned BTL property is subject to capital gains tax (CGT) on sale, levied at different rates for basic-rate taxpayers and for higher-rate taxpayers on gains above the annual exemption. SDLT can be claimed as a purchase expense against capital gains tax. CGT is payable within 60 days of the transaction.

### 24.6.4 Using a special purpose vehicle

**CHECK YOUR UNDERSTANDING 2**

We introduced SPVs as a way of owning property in Topic 2. Can you recall:

a) what kind of legal entity an SPV is?

b) who owns the property held in an SPV?

**TABLE 24.1 OWNING BTL PROPERTY VIA AN SPV**

| Advantages | Disadvantages |
|---|---|
| ▪ Changing ownership is relatively simple, as SPV shares can be sold to a new owner without the property being transferred. Advice should be taken regarding potential CGT and IHT issues<br>▪ If the property itself were transferred to a new owner, SDLT would be payable. If the property remains in SPV ownership, and ownership of the company changes hands, only stamp duty of 0.5 per cent of the value of the shares transferred is payable, if the SPV is UK-based<br>▪ Companies are able to claim expenses not available to individual landlords<br>▪ The SPV can be used to hold a number of properties as and when they are purchased<br>▪ Directors are not liable for the debts of the SPV unless they have given personal guarantees | ▪ Number of lenders who will consider lending to a BTL SPV is limited – restricts range of mortgages available<br>▪ Lack of competition and level of work involved means SPV mortgages tend to be more expensive to arrange than loans to individuals<br>▪ Accounting and administrative requirements for limited companies are more onerous than those for an individual<br>▪ Most lenders require personal guarantees from directors to support the mortgage |

Experts accurately predicted that changes to the taxation of BTL property (outlined in section 24.6.3) were likely to lead to an increase in the number of property-letting SPVs.

An SPV can claim the same running expenses as an individual landlord, but in addition, an SPV can claim mortgage interest in full as a business expense (although many experts anticipate that this may change in the future).

- **Corporation tax** – as companies, SPVs pay corporation tax on rental income received (after expenses) at a specified rate.

  Expenses include the costs of running the property and the company, and salaries paid to directors and employees. Unlike salary payments, dividends do not qualify as a business expense, so cannot be deducted from profits.

  The income is only subject to corporation tax once, when it is received; leaving it in the account will not result in further tax in future years, other than on any interest received on it.

- **Income tax on salary and dividends** – it is up to the board of directors to decide whether to distribute some or all of the income to shareholders as salary and/or dividends. The company is not obliged to pay a salary or a dividend to directors; it can retain the income (less corporation tax) in its bank account. This means that the directors can decide if and when to pay dividends, allowing them to control the amount of income tax they pay. Salary and dividends are added to the individual's taxable income for the tax year.

- **Capital gains** – capital gains made by an SPV are treated as trading receipts and subject to corporation tax. SPVs are not able to claim the annual CGT exemption available to individuals. SDLT paid on purchase can be claimed as an acquisition cost to be set against the gain. The individual shareholder would have a potential CGT liability if they decided to sell their shares in the SPV, although the annual CGT exemption would be available.

- **Stamp duty land tax** – if a company buys a property to let out as part of a rental business, the SDLT surcharge applies.

### 24.6.5 Transferring property from individual ownership to an SPV

While SPVs may seem to offer tax benefits for owners, they should be approached with caution. The position is relatively straightforward if an SPV is set up to purchase a property. SDLT is paid on purchase, and from then on company taxation rules apply. If a property held in the SPV is sold, it is usually achieved by selling shares in the SPV rather than selling the property itself – the company is the legal owner of the property. This means that no SDLT is payable by the new shareholder, but stamp duty may be payable on the shares purchased.

If an individual is looking to transfer an existing buy-to-let property into an SPV, the transfer is treated as a disposal for CGT purposes: the individual will have a CGT liability on the notional gain made between original purchase and transfer.

The SPV will have to pay SDLT on the property value because ownership of the property will change.

## 24.7 What is a second charge?

We look at second charges in detail in Topic 26 but consider them briefly here as they are a different type of mortgage loan.

**CHECK YOUR UNDERSTANDING 3**

From your studies in Topics 2 and 3, can you recall what a second charge is and the rules under which it is regulated?

Second charges are ranked after first charges for repayment, which means that the lender is taking a higher level of risk than with a conventional mortgage, and will charge a higher rate of interest to reflect that risk.

## 24.8 What is bridging finance?

Bridging finance is secured lending designed to enable a home owner to bridge the funding gap when they have to complete on the purchase of a property before they have received the funds from the sale of their existing property.

**CASE STUDY**

Alan has agreed a completion date of 30 October for the purchase of a family home, but delays mean that the sale of his existing family home will not be completed until 21 November, leaving him temporarily £80,000 short of the finance needed to complete his purchase. A conventional mortgage lender would not allow him to have mortgages on both properties at once, unless he was able to prove he could afford repayments on both, which would be unlikely. Bridging finance for £80,000 for three weeks, secured on his existing property, would solve his problem. The loan would usually be on an interest-only basis, and Alan might be able to defer paying the interest until the loan is repaid.

We will look at bridging finance in more detail in Topic 26.

**THINK AGAIN . . .**

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain how a foreign currency mortgage works?
- explain how a sub-prime mortgage product differs from a standard mortgage?
- describe two methods by which an individual can support someone else (eg a relative) to take out a larger mortgage than would be permitted under normal affordability criteria?
- describe the two methods of arranging Islamic home finance?
- summarise the advantages and disadvantages of using an SPV for buy-to-let property?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

## Test your knowledge

?

Use these questions to assess your learning for Topic 24. Review the text if necessary.

Answers can be found at the end of this book.

1) Foreign currency mortgages can be secured on UK properties. True or false?
2) Which of the following is true of a typical sub-prime mortgage compared with a standard mortgage?
   a) Interest rates are usually slightly lower.
   b) Application and/or product fees tend to be higher.
   c) Maximum loan to value tends to be higher.
   d) The range of interest-rate options is very limited.
3) Which of the following is true in relation to a guarantor mortgage?
   a) The guarantor must agree to guarantee the whole mortgage.
   b) The guarantor must be able to afford their own commitments as well as the guarantor mortgage.
   c) The lender cannot take a charge over the guarantor's own property.
   d) The guarantee usually lasts for the term of the mortgage unless the lender is satisfied it is no longer needed.
4) Islamic home purchase plans reflect the principle that Muslims must not enter into transactions where interest is paid. True or false?
5) Which of the following is true of both *Ijara* and *Murabaha* methods of Islamic home finance?
   a) The bank buys the property initially.
   b) The term can be up to 25 years.
   c) They require the payment of rent.
   d) Monthly payments are fixed for the term.
6) Self-build mortgages usually provide funds for up to 90 per cent of the cost of the land. True or false?

7) Which, if any, of the following is **not** an allowable expense for a buy-to-let landlord?

   a) Buildings and contents insurance.

   b) Repairs to a broken window.

   c) Replastering the kitchen ceiling following a water leak.

   d) A standard flat rate allowance for damage caused by wear and tear to furnishings.

8) Joe is planning to invest in a buy-to-let property when he gains access to his pension fund in August this year and is unsure whether to use a special purpose vehicle (SPV) or buy a property in his own name. Which of the following would be an important consideration for him?

   a) The SPV will pay higher stamp duty land tax.

   b) The SPV will be able to claim mortgage interest as a business expense in full.

   c) Holding the property in his own name will enable him to avoid paying income tax on rental income he does not withdraw from the business.

   d) Joe would lose control of the property if he bought it through a SPV.

9) If Joe were to go ahead and set up the SPV and later sell his shares in it, the buyer of the shares would be liable for stamp duty. True or false?

10) Capital gains made on sale of a property by an SPV are subject to:

   a) corporation tax.

   b) capital gains tax.

   c) income tax.

   d) stamp duty land tax.