Buy-to-let landlords to pay higher tax from 2017

What's the story?

The summer budget announced a major change to the way that 'buy to let' rental income will be taxed. From April 2017, landlords of residential property ('buy –to-let') will no longer be able to deduct their finance costs from their property income before arriving at their taxable profit. Instead, they will receive a reduction in their tax bill of an amount representing 20% of the finance costs.

Individuals partnerships and trusts will be hit by these changes, but companies (who pay corporation tax) will remain unaffected.

The changes will be introduced over four years starting from April 2017 when 25% of finance costs will be disallowed in the first year, 50% in the second and 75% in the third, until 2020 when no interest costs will be allowed.

Example:

Rigsby has rental income after expenses of £8,000 and also pays loan interest of £3,500.

His tax liability on this rental income will rise over the next few years, depending on his marginal rate of tax as follows –

	2015	2017	2018	2019	2020
	£	£	£	£	£
40%	1,800	1,975	2,150	2,325	2,500
45%	2,025	2,244	2,463	2,681	2,900

In more extreme examples, where mortgage interest payments are high, it is actually possible for the tax liability to exceed 100% of the true rental profit.

Who is affected?

Because the effect of the new rules is to restrict interest relief to the basic rate of tax, it is easy to think that basic rate tax payers will be unaffected. However, as taxable profits of all such rental businesses financed by borrowings will increase, it is quite possible for there to be other knock on affects for a range of tax payers.

- Basic rate tax payers may find themselves in a higher tax bracket.
- As well as losing the ability to claim full tax relief, higher rate tax payers may find total income rises above a threshold so that they lose personal allowance or child benefit, or move into the additional rate tax bracket.
- There may be an impact for those claiming tax credits as a result of the increase in total income.

Is there anything else I need to know?

As with any new tax rules, there are a host of detailed rules and definitions.

'Interest' is widely defined and extended to include anything economically equivalent, such as a premium, discounts and incidental costs.

The restriction applies to the cost of a 'dwelling related loan' meaning any amount borrowed for the purpose of a property business carried on to generate income from dwelling houses. Where the loan relates partly to a business of letting residential property and partly to another business, the interest is apportioned. The rules also apply to a loan taken out to acquire an interest in a property letting partnership.

The rules will not apply to a commercial furnished holiday letting business, but of course this has to meet the strict criteria.

Where the business is carried jointly or as a partnership, each joint owner or partner will have a tax reduction equal to basic rate tax on their share of the disallowed interest.

If the tax deduction cannot be fully used in a particular year, broadly speaking, it is carried forward and can be used in future years.

Is there anything I can do to plan for the new rules?

It will be important to work out how your property business will be affected by the changes. Some businesses with relatively high mortgage interest payments will no longer be viable and borrowings may need to be reduced, perhaps by realising part of the portfolio.

Alternatively, running a business through a company has always had the benefit that profits are taxable at corporate rates (typically 20%) rather than higher rates of income tax. Companies are not affected by the new rules and this may be an added attraction. However, there will be tax costs of moving an existing portfolio of rental properties into a company which will need to be weighed against possible savings.

Any decision to operate as a company should not be taken lightly as it will involve a number of considerations based on individual circumstances.

We at Ensors are here to help and provide guidance, and can carry out an exercise for you to illustrate the potential effect on your tax liabilities so you can decide what action you want to take. For further information on this issue, please speak to your normal Ensors contact or speak to any member of the Ensors Tax Team.