



## PROPERTY TAX CHANGE FROM APRIL 2017 BUY- TO- LET INTEREST CHAOS

Individuals who own and let property are facing a number of changes to the way in which their rental income, and more importantly the deductions they can make from their rents for income tax purposes, are calculated.

**The most impactful change is the gradual restriction of higher rate income tax relief for finance costs, which includes a landlord's major cost, mortgage interest.**

As a direct result of this one change, landlords who have borrowed heavily to grow their property portfolio may find themselves paying income tax at higher rates. They will need to work out the impact on their future tax payments and take the necessary steps to maintain the sustainability of their property business.

**Action needs to be taken before April 2017.**

This change denies a deduction for finance costs when working out your property business taxable profits and replaces the deduction with a tax credit limited to 20% of the finance costs expended.

**If you have properties that have significant mortgages or loans you will likely be paying an increasing amount of income tax from April 2017.**

## Key features

### The gradual restriction of higher rate income tax relief for finance costs

The restriction of income tax relief will apply to individuals:

- Who let residential property in the UK or elsewhere, and
- Who are claiming a deduction for financing costs (see below for list of costs included) from April 2017, and
- Who, from April 2017, pay income tax on their property income at the higher (40%) or additional (45%) rate

It will not apply to:

- Financing costs for purchase of furnished holiday let or commercial property
- Property companies
- Individuals who pay tax on their property income at basic rate only

The new measure will gradually restrict landlords' tax relief for finance costs to purchase residential properties to the basic rate of income tax. From 6 April 2020 landlords affected will no longer be able to deduct their finance costs from their property income. Instead they will receive a basic rate deduction from their income tax liability.

Between now and 6 April 2020 relief will be tapered as follows:

2017-18	The deduction of allowable finance costs will be restricted to 75%, with 25% being available as a basic rate income tax deduction.
2018-19	The deduction of allowable finance costs will be restricted to 50%, with 50% being available as a basic rate income tax deduction.
2019-20	The deduction of allowable finance costs will be restricted to 25%, with 75% being available as a basic rate income tax deduction.

Finance costs include: mortgage interest, interest on loans to buy furnishings, and fees incurred when taking out or repaying mortgages or loans.

## Examples:

Consider the case of Linda, who has a buy to let property with an annual mortgage interest charge of £10,000. Up to April 2017 she will be able to deduct the full amount, £10,000, from her property income before she pays tax. Obviously, the higher her rate of income tax the more tax relief she will currently receive. The table below sets out the effective loss of tax relief if Linda is a higher rate or additional rate taxpayer. If Linda only pays tax at the basic rate there is no change in her income tax position.

	2016-17	2017-18	2018-19	2019-20	2020-21
Finance cost allowed	10,000	7,500	5,000	2,500	0

### If additional rate taxpayer:

Additional rate 45% relief	4,500	3,375	2,250	1,125	0
Basic rate deduction	0	500	1,000	1,500	2,000
Total tax relief	4,500	3,875	3,250	2,625	2,000
Net finance costs paid	5,500	6,125	6,750	7,375	8,000

### If higher rate taxpayer:

Additional rate 40% relief	4,000	3,000	2,000	1,000	0
Basic rate deduction	0	500	1,000	1,500	2,000
Total tax relief	4,000	3,500	3,000	2,500	2,000
Net finance costs paid	6,000	6,500	7,000	7,500	8,000

Because the amount of tax relief is gradually reduced from April 2017 to April 2020, the cash flow impact is progressively negative for higher rate or additional rate tax payers. In our example, if Linda is a higher rate taxpayer her net finance costs (after deduction of tax relief) increase from £6,000 in 2016-17, to £8,000 in 2020-21.

A further consequence of this change is that the rental income for tax purposes increases with no increase in rents because the finance costs are added back. In some circumstances this may mean that basic rate taxpayers become higher rate tax payers or pass certain means tested thresholds (such as Child Benefit Payments).

## Examples:

### Basic rate taxpayers who become higher rate tax payers

Let's say that Bob's only income for 2016-17 is £120,000 from rents received before deductions for mortgage interest of £80,000. After a deduction for the basic personal allowance of £11,000 his income tax liability would be £5,800.  $(£40,000 - £11,000) \times 20\%$

For comparison purposes, if we recalculate Bob's income tax for 2016-17, disallowing the deduction for mortgage interest and applying the basic rate tax credit, his income tax liability would increase dramatically:

Net rents received – no deduction for mortgage interest is allowed	£120,000
Less personal allowance – restricted as income exceeds £100,000	£1,000
Taxable income	£119,000
Income tax due at basic rate 20% ( $£32,000 \times 20\%$ )	£6,400
Income tax due at higher rate 40% ( $£87,000 \times 40\%$ )	£34,800
Less basic rate tax credit for mortgage interest ( $£80,000 \times 20\%$ )	-£16,000
Net income tax due	£25,200

With no change in his property business cash flow (same rents and same costs), Bob's tax bill under the new rules would increase by £19,400.

This would reduce Bob's after tax income from £34,200 to just £14,800.

Depending on Bob's savings, he may feel obliged to pay off part of his loan so that rents received and costs, including tax, return to equilibrium – alternatively he may have to sell if he has no spare cash available.

## How can Bates Weston help?

Landlords have until April 2017 to consider the effects of this measure on their property businesses. Please contact us if you would like to explore your planning options in more detail.

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