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Tax Relief on Finance Costs.

The Changes

This guide is produced by Habitat Lettings proudly in association with Carrie Stokes - Chartered Accountant.

All information included is correct at the time of distribution - April 2016..

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Tax Relief on Finance Costs – The Changes

Summary

Significant changes to the way in which individual and trustee buy to let landlords get income tax relief on finance costs were announced in the summer budget on 8 July 2015. The proposals detail how tax relief on finance costs, such as mortgage interest on loans to acquire a property will be restricted.

Whilst these changes do not come into effect until 5 April 2017, it is important that buy to let landlords seek advice sooner rather than later, as the additional tax that will become payable by some landlords may make them re-think how they are running their property portfolio.

Consideration needs to be given to all taxes such as income tax, corporation tax, stamp duty land tax (SDLT) and Annual Tax on Enveloped Dwellings (AETD) as all of these could affect the most tax efficient way of running a property portfolio.

Ellie

Ellie Garbett,
Habitat Lettings

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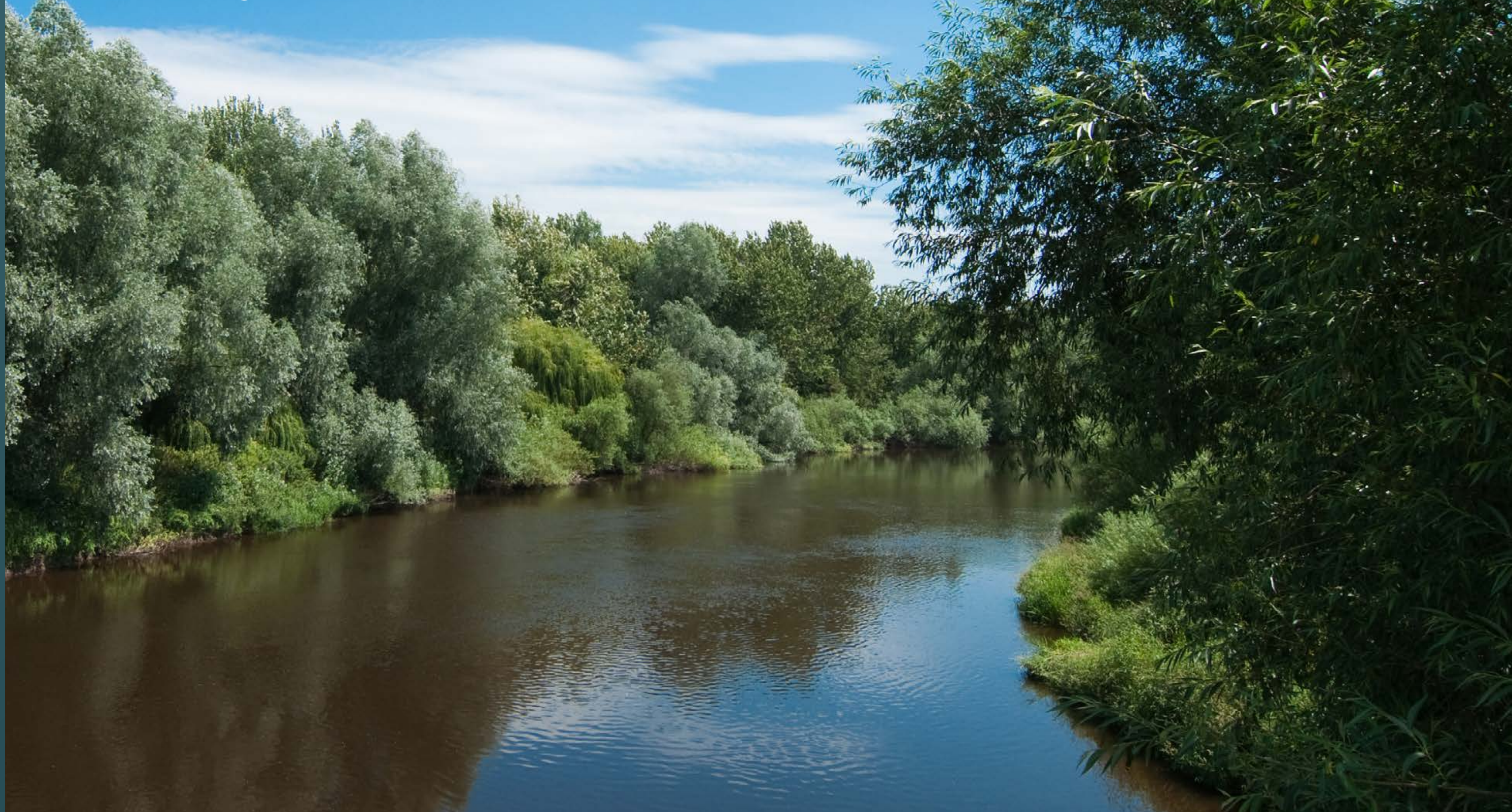
Tax Relief on Finance Costs – The Changes

Who will the changes affect?

The changes will affect individual landlords, partnerships and limited liability partnerships who incur finance costs in respect of UK and overseas residential property. The changes do not apply to commercial property, furnished holiday lettings or residential property owned by a company.

Most buy to let landlords will be affected and those considering investing in a buy to let property, as it could change how their investments are held.



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Current Rules

All finance costs incurred wholly exclusively and necessary for the purpose of the rental business can be deducted from rents received, reducing the taxable rental profits. This reduces the landlord's property income which consequently reduces income tax payable.

Deductions can also be current claimed for other allowable expenses such as rates, insurance, ground rents, repairs, renewals, management and professional fees.

What are finance costs?

As well as interest incurred on a mortgage finance costs include incidental costs incurred in obtaining loan finance, such as arrangement fees, refinancing fees and legal fees incurred in obtaining finance.

Finance costs also include costs incurred for loans used for the purpose of repairs and improvements.

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The New Rules

Landlords assessable to income tax will no longer be able to deduct finance costs from the rental income to calculate property income assessable to income tax. Instead a basic rate tax reduction will be given from the individuals income tax liability.

Whilst the changes will start to apply from 6 April 2017, they are being phased over 4 years with the full changes coming into effect on 6 April 2020. These changes will result in an increased tax liability for the many landlords, including some landlords that are basic rate tax payers under the old rules, but will be pushed into the higher rate without the finance charge deduction.

The restriction will apply as follows:

2017/18 – Allowable deduction restricted to 75% of finance costs, basic rate deduction of the remaining 25%.
2018/19 – Allowable deduction restricted to 50% of finance costs, basic rate deduction of the remaining 50%.
2019/20– Allowable deduction restricted to 25% of finance costs, basic rate deduction of the remaining 75%.
2020/21– No deduction for finance costs, basic rare deduction on finance costs incurred.

The restriction of tax relief only applies to finance costs. All other expenditure incurred that qualifies for a deduction such as management fees, should not be affected.

Landlords also need to be aware of the proposed removal of the 10% wear and tear election. From April 2016 it is being replaced with a relief for the actual costs of replacing furnishings in the property.

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What are the main implications for landlords?

These changes will give rise to higher income tax liabilities for affected landlords. Due to the reduction of allowable expenditure, their taxable rental income will increase, which will increase their total taxable income.

For basic rate tax payers the increased taxable rental income may move them into higher rates of tax, and consequently higher rate tax payers may move into additional rate tax payers. Increased income can also affect other allowances and benefits such as Child benefit.

Landlords will need to consider the impact of any increased tax liability on the Cashflow and profitability of the rental business. Whilst the profit of the property may not change it may have to fund higher tax bills.

Landlords currently have a window to assess the implications of these changes as the new rules will not start to apply until 6 April 2017.

Actions that Landlords may consider take will include transferring property into a company or acquiring a new property within a Company. Before doing so, landlords will need to consider the impact these changes have on different taxes including:

- Capital gains tax
- Stamp duty land tax (SDLT)
- Inheritance tax
- Income tax and corporation tax
- Annual Tax on Enveloped Dwellings (ATED)

Capital Gains Tax

A transfer of a property into a company they control is a disposal to a connected person for capital gains (CGT) purposes. Therefore it is deemed to have taken place at market value. Therefore, when transferring a Buy to Let property into a company the landlord could incur a tax charge of up to 28% of the gain.

The market value at the date of transfer will become the base costs of the property on any future sale. This gain will be assessed at corporation tax rates.

Non-UK resident landlords should be aware of their obligation to report any disposals of property to HMRC via a non-resident CGT return.

Stamp duty land tax (SDLT)

Whether a Buy to Let property is purchased personally, via a company, or transferred to a company, SDLT could be payable at rates of up to 12%. This could fall to 4% where six or more residential properties are transferred to a company as part of the same transaction.

Higher rates of SDLT will be charged on purchases of additional residential properties (above £40,000) such as Buy to let properties and second homes.

The higher rates are 3% above current SDLT. Higher rates will not apply to corporates or funds making significant investments in residential property.

Inheritance Tax

When a property portfolio is transferred into a company, the value of the shares in that company will form part of the individuals estate, rather than the value of the portfolio.

Transferring ownership of a property portfolio to a company could be an opportunity to reduce their estate for inheritance tax purposes, as it can be easier to gift portions of the portfolio value to future generations.

Landlords should seek specialist advice in order to explore the options available to them.

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Income tax and corporation Tax

By transferring the property portfolio into a limited company, the rates of tax assessable on their rental profits will change. Corporation tax (currently 20% but falling to 18% by 2020) will be due on profits rather than income tax (up to 45%).

However, if the landlord wants to take income from the company, additional tax will be paid on any dividends takes (up to 38.1% based on 2016/17).

Landlords therefore need compare the tax that would be payable holding their properties personally or via a company.

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Carrie Stokes is chartered accountant that has been providing accountancy services, tax and business advice for over 10 years.

With a unique approach, taking the time to understand how a clients business works, what they want to achieve from their business and how to do it in the most tax efficient way. No question is a silly one and it is important that we work together to ensure that clients have a full understanding of the finance and tax aspect of their business.

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