Smith & Williamson

Buy-to-let property

What do the recent changes mean for you?

Buy-to-let property

With extra stamp duty land tax on the purchase of additional residential properties and the new restriction on relief for finance costs, landlords need to take action to minimise the impact of these changes.

Extra stamp duty

Since 1 April 2016, generally, anyone buying a second or subsequent UK residential property has been subject to a 3% stamp duty land tax (SDLT) surcharge or 3% land and buildings transaction tax supplement if the property is in Scotland. This can add substantial cost to a buy-to-let property purchase, as shown in the following example.

Original purchase price	£250,000
Standard SDLT	£2,500
SDLT surcharge	£7,500
Total SDLT due	£10,000

Restriction on finance costs

Prior to 5 April 2017, residential landlords were able to claim various costs of financing buy-to-let property as an expense against rental income. This included interest on servicing debt used to fund the rental business and any incidental costs of obtaining or repaying finance. Income tax relief was available at their marginal rate of 20%, 40% or 45%. In some cases, this could produce a rental loss for the tax year, which could be carried forward and offset against future rental profits from the same property business.

Since 6 April 2017, however, if you are subject to income tax, you will have a restriction applied to the relief you receive on the finance costs of running your rental business. This will apply to interest paid on any debt, as well as the incidental costs of obtaining or repaying finance. Partnerships and trustees are included, although there is a specific exclusion for non-UK resident companies subject to UK income tax and for furnished holiday lettings.

The restriction completely removes any finance costs from the tax calculation and introduces a basic rate tax credit, equal to 20% of the related finance costs. To complicate matters further, this tax credit is restricted where the property profits are less than the finance costs, ensuring that the finance tax credit is not given against tax on other sources of income. If the finance tax credit is restricted, the excess can be carried forward and used against rental profits in future tax years.

This restriction is being phased in from 6 April 2017 and will be fully implemented from 6 April 2020. Since 6 April 2017, 25% of finance costs will be disallowed and subject to the basic rate tax credit. This will increase by 25% each tax year until the restriction applies to the total finance costs. Some landlords may see their tax bill increase by more than the difference between their marginal tax rate and the 20% tax credit.

Impact of the restriction

A resulting increase in taxable income may have the following consequences.

- Your income may be pushed above £100,000, resulting in a reduction in your income tax personal allowance.
- Your income may be pushed into the additional rate band (above £150,000), with the associated decrease in your annual pension relief allowance.
- Other income, such as dividends and savings, may be taxed at a higher marginal income tax rate.

Illustrative scenarios

The scenarios below illustrate the impact of the restrictions in two different scenarios. In each case the illustration outlines the position prior to any restriction (2016/17) and the position after the restriction has been fully implemented (from 2020/21 onwards).

Scenario 1 is for a higher rate tax payer, paying income tax at a rate of 40%.

Scenario 1	£
Rental income	50,000
Tax deductible rental expenditure	12,000
Mortgage interest	15,000

	2016/17	2020/21
Gross cash after expenses (A)	23,000	23,000
Taxable profit	23,000	38,000
Tax on taxable rental profit (B)	9,200	15,200
20% tax credit on mortgage interest (C)	-	(3,000)
Tax on rental income (D) (B-C)	9,200	12,200
Additional tax due to changes	-	3,000
Net cash	13,800	10,800
Effective tax rate on rental profits (D/A)	40%	53%

Scenario 2 is for an additional rate tax payer, paying income tax at a rate of 45%.

Scenario 2	£
Rental income	500,000
Tax deductible rental expenditure	100,000
Mortgage interest	200,000

	2016/17	2020/21
Gross cash after expenses (A)	200,000	200,000
Taxable profit	200,000	400,000
Tax on taxable rental profit (B)	89,400	179,600
20% tax credit on mortgage interest (C)	-	40,000
Tax on rental income (D) (B-C)	89,400	139,600
Additional tax due to changes	-	50,000
Net cash	110,600	60,400
Effective tax rate on rental profits (D/A)	45%	70%

Corporate entities

The income tax provisions restricting the deduction of interest costs related to residential property do not apply to companies. This means that companies will continue to receive full tax relief on any finance costs in relation to rental properties.

We are able to advise on the tax implications of different ownership structures and ways to implement changes to your current structures.

Other Action

Other ways to reduce the impact of the tax changes may be to involve your spouse or children in the business or to cut business debt. We can advise on the tax implications of these alternatives too.

For more information and advice on the changes to buy-to-let, please see the back page for details of how to contact a member of our team.

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