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Changes announced in Summer Budget 2015 to tax relief for buy to let owners

Two key changes were announced in the recent Budget and we are therefore advising you about these and what action you may want to consider.

Restricting finance costs for landlords

The government will restrict the amount of income tax relief landlords can get on residential property finance costs to the basic rate of income tax. There is, of course, no relief for the capital repayments of a mortgage or loan.

Landlords might no longer be able to deduct all of their finance costs from their property income. They will instead receive a basic rate deduction from their income tax liability for their finance costs. To give landlords time to adjust, the government will introduce this change gradually from April 2017, over a four year period. From 2020/21, all financing costs incurred by a landlord will be given as a basic rate tax reduction.

Please note that the restriction relates to finance costs not just interest – so relief for application fees charged by the lender would also be restricted.

The restriction will not apply to landlords of furnished holiday lettings.

How much extra tax will you have to pay?

This will depend on your marginal rate of tax and the amount of interest expected to be payable. If you are a basic rate taxpayer there will be no substantive changes to your tax bill. A higher rate taxpayer will, in principle, get 20% relief for interest paid rather than 40%. So if interest paid is £10,000 p.a. the extra tax liability will be £2,000 (£10,000 x (40% - 20%)).

The full restriction does not happen until 2020/21. In 2017/18, the deduction from property income will be restricted to 75% of finance costs, with the remaining 25% being available as a basic rate reduction. So if interest paid is £10,000 p.a. the extra tax liability in 2017/18 will arise on £2,500 of the interest only. This will result in an extra tax liability of £500 (2,500 x (40% - 20%)).

What action can be taken to improve the position?

The restriction in interest relief does not apply to companies. Therefore you may want to consider owning properties through a limited company. However there are a number of issues you will need to think about carefully before you adopt this strategy. In addition the government has announced changes to the taxation of dividends which will impact on the attractions of using a limited company.

If you are thinking about making new investment in residential properties without using a company, you need to factor in the lack of full tax relief in the long term in order to decide the viability of taking on the additional finance.

Removal of the Wear and Tear allowance

Many businesses receive capital allowances to recognise the depreciation of equipment used in the business. However, there are no capital allowances due for equipment bought for use in a residential property.

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There are exceptions to this rule for property which falls within the definition of a furnished holiday letting and expenditure on assets which are used in the non-residential part of a block of flats, for example the hallways.

Since April 2013 where a taxpayer lets a fully furnished residential property, a deduction could only be claimed for a wear and tear allowance of 10% of the 'net rent' from the furnished letting, designed to cover the depreciation of equipment.

Furthermore from the same date where a dwelling is let partly furnished, there are no allowances due at all unless costs are incurred on equipment and can be classified as a repair. Relief will then be given for these costs. In some cases, a repair will include the replacement of that item if that item can be regarded as a 'fixture' in the building.

Whether expenditure is a repair can be complex and is governed by principles established in a number of tax cases.

From April 2016 the government is proposing to remove the wear and tear allowance. A new relief will allow all residential landlords (in respect of a fully furnished dwelling or not) to deduct the actual costs of replacing furnishings provided for the tenant's use in the residential property. The initial cost of furnishing a property will not be included.

Capital allowances will continue to apply for landlords of furnished holiday lettings.

The appendix to this letter lists the common types of expenditure for the new relief and examples of fixtures which are, and will continue to be, treated as repairs.

What action can be taken to improve the position?

The wear and tear allowance is given whether or not you have replaced any furnishings. From 6 April 2016 (1 April 2016 for companies) specific relief will be given for these costs, so it makes sense, if possible, to defer replacement expenditure to after these dates.

A similar point applies if you let out a property only partly furnished. No relief is given at the moment for replacing furnishings but relief will be given for such expenditure from April 2016.

Please speak to us if you have any general questions regarding property income and the changes announced.

APPENDIX

Examples of items eligible for new relief for replacement furniture

Under the new replacement furniture relief landlords of all non-furnished holiday let residential dwelling houses will be able to claim a deduction for the capital cost of replacing furniture, furnishings, appliances and kitchenware provided for the tenant's use in the dwelling house, such as:

- movable furniture or furnishings, such as beds or suites
- televisions
- fridges and freezers
- carpets and floor-coverings
- curtains
- linen
- crockery or cutlery
- beds and other furniture.

Examples of 'fixtures' which are eligible for relief as repair expenditure

Fixtures integral to a residential property are not normally removed by the owner if the property was sold. The replacement cost of these are, and will continue to be, a deductible expense as a repair to the property itself. Fixtures include items such as:

- baths
- washbasins
- toilets
- boilers
- fitted kitchen units.