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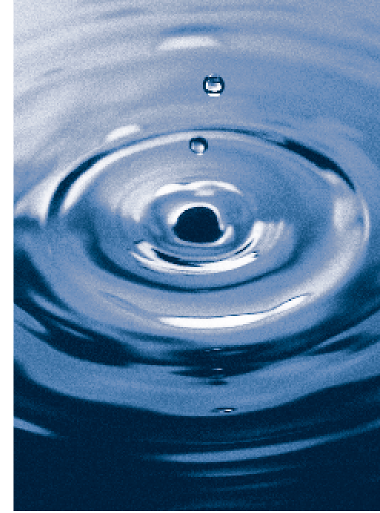

Property letting - understanding the new rules

Buy to let landlords of UK residential properties have been bombarded with tax changes in the last year. As a consequence many will need to rethink their broad and detailed tax strategies on their investments.

Future interest relief restrictions

From April 2017, landlords will no longer be able to deduct all of their finance costs from their property income. They will instead receive a basic rate reduction from their income tax liability for these finance costs. Finance costs include mortgage interest, interest on loans to buy furnishings and fees incurred when taking out or repaying loans or mortgages.

The restriction will be phased in with 75% of finance costs being allowed in 2017/18, 50% in 2018/19, 25% in 2019/20 and be fully in place for 2020/21. The remaining finance costs for each year will be given as a basic rate tax reduction but can't create a tax refund.

Example

Aled is paying higher rate tax on all his rental income of £20,000, his interest expense on the mortgage is £15,000. The impact of the changes on his effective rate of tax on the income is shown below.

	2016/17 £	2020/21 £
Rental income	20,000	20,000
Interest expense	(15,000)	(15,000)
Profit on rental income	5,000	5,000
Tax at 40%	2,000	8,000
Less credit	Nil	(3,000)
Net tax	2,000	5,000
Effective tax rate on net rental income	40%	100%

Relief for finance costs may be restricted further where either total property income or total taxable income (excluding savings and dividend income) of the landlord is lower than the finance costs incurred. For example, if net property income is £4,500 before interest of £6,000, the landlord is making a £1,500 loss. Despite this £4,500 is taxable. Also the interest relief is restricted to £4,500 at 20% rather than £6,000 at 20%. The unrelieved interest (£1,500 at 20%) is carried forward and may get tax relief in a later year.

The non-allowability of finance costs could affect the level of income at which the High Income Child Benefit Charge or the tapering of the personal allowance, apply.

Property investment companies

The new rules on finance costs do not apply to companies so it may be more attractive for landlords to acquire their new property investments in a company. Also corporation tax rates are low compared to personal tax rates and so more funds may be available for reinvestment in additional properties.

There are however other tax issues to consider when holding investments in a company which include:

- The income tax charges if a significant amount of the rental profit will be distributed to the shareholders.
- A potential double tier of capital gain on any sale of a property. Corporation tax is payable on the capital gain (although the gain is reduced by an inflation adjusted base cost of the property). Then, if the gain is distributed to shareholders as a dividend there would be an income tax charge on the dividend paid.
- The different treatment of the assets held by the individual on death may affect the tax paid on subsequent capital gains if the properties are eventually sold. If properties are held directly by an individual, inheritance tax (IHT) liabilities will be based on the value of the properties at death and the value of the properties are uplifted to market value for calculating future capital gains. If the individual has a property investment company, the shares in the property company are valued for IHT purposes at market value but the properties themselves remain at their original base cost.

Transferring an existing property portfolio into a company requires even more careful consideration as it could result in capital gains and stamp duty liabilities arising on the transfer of the properties.

We would be happy to provide further advice on the impact of running a property investment company.

Property repairs and renewals

Tax relief is currently given for the repair of a property but it is important to identify the asset on which the work is being carried out. This is because the cost of repairing an asset is normally an allowable expense but the cost of replacing the whole of an asset is not a repair. Tax relief will only be available for the replacement of a whole asset if it qualifies under the new rules for domestic items which are described below. However, if a fixture in a property is replaced, then the asset for this test would be the whole building not the fixture and so replacing a fixture will be treated as the repair of a building.

Example

Sophia owns a number of residential properties that she lets. The properties are not furnished lettings. The boiler in one property needs replacing. As the new boiler has to be located in a different position, Sophia decides to modernise the kitchen as a whole.

All the existing base units, wall units and sink etc, are stripped out and replaced, as is the fitted cooker and hob. New units of an equivalent quality are installed but in a different layout to allow for the re-location of the boiler. Finally the kitchen is re-plastered and re-tiled.

The entirety is the house, not the fitted kitchen. The new kitchen is slightly different but it does the same job as before. Sophia has simply replaced the old kitchen with a modern equivalent. This is a repair and allowable expenditure.

From April 2016, landlords can also claim to deduct the costs of replacing domestic items in a property. Domestic items includes furniture, furnishings, household appliances and kitchenware. This relief is not available for furnished holiday lets where capital allowances are still available for the cost of items. Where the old item is replaced with a new asset which is an improvement, the available deduction is what it would have cost to replace the original asset. For example, replacing a washing machine with a washer-dryer is an improvement. If the washer dryer cost £600, and the cost of buying a new washing machine like the old one would have been £400 then the replacement furniture relief will be £400.

Additional Stamp Duty Land Tax (SDLT) and Land and Building Transaction Tax (LBTT)

A higher rate of SDLT and LBTT is payable on additional residential properties bought on or after 1 April 2016 where the purchase is for £40,000 or more. Where the additional property is replacing the main residence the higher rate will not apply. If a purchaser buys a new main residence but the sale of the previous main residence is delayed, they will pay the higher rates as they own two properties. The purchaser can, however, get a refund for the amount above the normal SDLT rates if they sell their previous main residence within three years. Also, if the purchaser already has two or more properties, and they sell their main residence, they won't have to pay the higher rate if they buy a new main residence within three years. The above applies for properties in England, Wales and Northern Ireland and there are equivalent rules for LBTT for properties in Scotland but the time limit is 18 months to replace the main residence.

Joint purchases

Where the purchase of the additional property is being made by joint purchasers then if the higher rate would apply to either of those buyers it will then apply to both purchasers.

Spouses or civil partners are treated as joint purchasers even if the additional property is individually bought by one of the couple. In Scotland, this is extended to include couples cohabiting as a married couple.

Example

Jane owns a house which she and her husband live in as their main residence. Her husband is planning to buy a flat to rent out – this will be in his name only. As a married couple all property owned by Jane or her husband is treated as owned jointly. The purchase of the flat will therefore be classed as an additional residential property.

Companies

The higher rate also applies to companies buying any residential properties worth £40,000 or more.

Capital gains tax (CGT) rates

From 6 April 2016 CGT rates have fallen. Chargeable gains within the basic rate band are now taxed at 10% and non-basic rate band chargeable gains are taxed at 20%. However these rates are not applicable to gains on residential properties. The CGT rates on chargeable gains on buy to let properties therefore remain at 18% and 28% depending on what income tax band the chargeable gains fall within.

Commercial property

There are different tax rules for commercial property including non-residential SDLT rates and lower CGT rates. In addition, the restriction for finance costs for residential property, detailed above, does not apply to commercial property. We would be happy to advise you if you are considering investing in commercial property.

Non-tax issues

There are many other non-tax considerations which should be considered when renting out properties. Two of the more recent changes are detailed below.

Right to rent checks

In England it is now an offence for a landlord to allow a person who does not have a 'right to rent' to occupy premises such as buy to let properties. A landlord that does not check that a person has such a right to rent may be liable for a fine of up to £3,000. These rules do not currently apply in Scotland, Northern Ireland and Wales. Details of these requirements can be found in a Code of Practice (goo.gl/ZoQKM5) issued by the government.

Registering as a landlord

Landlords who own rental property in Wales which is rented on an assured, assured shorthold or regulated tenancy, are required to be registered with Rent Smart Wales before 22 November 2016. Landlords who undertake the letting and management tasks at their rental properties also need to obtain a licence. In order to obtain a licence, the landlord will need to complete an approved training course. Registration and a licence both last for five years. Landlords who do not self-manage their properties in Wales are required to use a licensed agent.

There are similar registration requirements in Scotland and Northern Ireland. The registration in Scotland and Northern Ireland lasts for three years. Further details for each area can be found in the attached links - Wales (goo.gl/JVHRNi), Scotland (goo.gl/3iKP8I), Northern Ireland (goo.gl/1WUqxR).

Conclusion

With more regulations and tax changes applying to buy to let landlords it is important to review your property portfolio regularly to ensure you are up to date. There are a number of areas in this briefing where you may need specific advice depending on the circumstances so please do not hesitate to contact us.

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