

Nunn Hayward LLP Factsheet:

Property tax changes - Updated April 2017

Individuals that own and let residential property are now 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.

They include:

1. An increase in the rent-a-room allowance.
2. The abolition of the wear and tear allowance if you let furnished residential property that is not part of a holiday lets business; and the introduction of a new replacement furniture relief (RFR).
3. The gradual restriction of higher rate income tax relief for finance costs.

The third item, the gradual restriction of higher rate tax relief on finance costs, is likely to be the most impactful of the changes for individuals who have built their property portfolios by borrowing significant amounts when adding properties to their letting business.

These changes are explained in more detail below:

An increase in the rent-a-room allowance

Previously, you could earn up to £4,250 per annum tax free from letting out furnished accommodation in your home. This amount is halved if you share this income with anyone else. From 6 April 2016 the limit has now increased to £7,500.

The abolition of the wear and tear allowance

The government have indicated that they will be replacing the wear and tear allowance (WTA) with a new replacement furniture relief from April 2016.

Previously, landlords of fully furnished property could claim an annual deduction based on 10% of their rents to compensate them for periodic replacement of furnishings. This deduction is given even if no actual expenditure is made. If actual expenditure is higher than the 10% WTA no additional relief is given.

As WTA is based on rents received, landlords where property values (and therefore rents) are higher, were receiving an unfair advantage, as the amount of relief they were claiming will have been inflated even though their actual expenditure was the same across the UK.

Accordingly, the WTA has been abolished from 6 April 2016.

This measure will only affect landlords of fully furnished property. Owners of holiday let property are also unaffected as the WTA is not available to these businesses.

The new replacement furniture relief (RFR)

As of 6 April 2016, landlords of fully, partly or unfurnished residential property can claim for the actual cost of replacing furnishings. The new RFR is not available to furnished holiday lets businesses.

Replacement items that would be available for RFR include:

- Moveable furniture or furnishings, such as beds or suites,
- Televisions,
- Fridges or freezers,
- Carpets and floor coverings,
- Curtains,
- Linen,
- Crockery or cutlery,
- Beds and other furniture.

Fixtures that are part of the building and would not normally be removed if the owner sold the building would not qualify for the RFR. These fixtures would include:

- Baths,
- Washbasins,
- Toilets,
- Boilers,
- Fitted kitchen units.

Additional considerations:

- The new relief only applies to replacement costs. The initial cost of furnishing a property is not included.
- The RFR is based on the replacement cost less any proceeds from the sale of the replaced item.
- Any improvement cost is excluded from RFR. For example, if a washing machine was replaced by a washer/dryer that cost £600, only the replacement cost of a similar washing machine, say £400, is allowable.

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

The restriction of income tax relief applies 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 pay income tax on their property income at the higher (40%) or additional (45%) rates.

It does not apply to:

- Financing costs for purchase of furnished holiday let property,
- Property businesses subject to corporation tax - owned by companies, or
- 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 the 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.

A worked example: consider the case of Linda, who has a buy to let with an annual mortgage interest charge of £10,000. Up to April 2017 she would have been 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 would 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
<i>Net finance costs paid</i>	<i>5,500</i>	<i>6,125</i>	<i>6,750</i>	<i>7,375</i>	<i>8,000</i>
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
<i>Net finance costs paid</i>	<i>6,000</i>	<i>6,500</i>	<i>7,000</i>	<i>7,500</i>	<i>8,000</i>

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 £7,500 in 2020-21.

A further consequence of this change to a basic rate deduction is that the rental income for tax purposes increases with no increase in rents: the finance costs are added back. In some circumstances this may mean that basic rate taxpayers become higher rate tax payers.

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

Basic rate taxpayers that 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 x 20%)	£6,400
Income tax due at higher rate 40% (£87,000 x 40%)	£34,800
Less basic rate tax credit for mortgage interest (£80,000 x 20%)	-£16,000
Net income tax due	£25,200

With no change in his property business cash flow, same rents 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...

Planning going forward

Key areas that may affect your property business may include one or more of the following;

- Incorporate property business
- Increase the basic rate income tax band
- Gift interests in property or other income producing assets
- Claiming expenses
- Reviewing mortgages
- Property sales
- Mergers
- Reduce income
- Increasing rents
- Holiday lets
- Work out future tax position

Next Steps

To understand more regarding any of the above topics, please contact us to arrange an appropriate time to discuss your property business in more detail and be fully aware of the impact that these areas may have on you.

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