KEYSTONE
INDEPENDENT

Buy-to-Let and Tax Implications

The Government's tax changes for buy-to-let landlords could significantly eat into profits and potentially wipe them out completely.

Chancellor George Osborne has announced these changes will be phased in from 2017, therefore anyone who is already a landlord and those intending to be landlords need to plan now for the impending changes.

Currently, if a buy-to-let property is owned personally, capital expenses cannot be used to offset your income tax, but many other costs can.

Mortgage interest

You can currently use the interest you pay on your mortgage each year to offset your tax bill. Landlords can claim relief at their highest marginal of income tax rate, however this is about to radically change from 2017.

Landlords will no longer be able to deduct the cost of their mortgage interest from their rental income when they calculate a profit on which they pay income tax. Income tax will simply be applied to the rent received.

The tax changes, whilst being phased in from 2017, will be fully implemented by 2020. As an example, a higher rate taxpayer landlord whose mortgage interest is circa 75% or more of their rental income, net of all other expenses will see their returns wiped out completely. For an additional rate taxpayer, the threshold at which their investment returns are wiped out by the additional tax is when mortgage costs reach circa 68% of rental income.

Also some current basic rate taxpayers will also be hit if the change pushes them into the higher rate tax bracket.

Worked Example - Higher Rate Taxpayer

Now

Your buy-to-let earns £20,000 a year and the interest-only mortgage costs £13,000 a year. Tax is due on the difference or profit. So you pay tax on £7,000, meaning £2,800 for HMRC and £4,200 for you.

2020

Tax is now due on your full rental income of £20,000, less a tax credit equivalent to basic-rate tax on the interest.

You pay 40% tax on £20,000 = £8,000

Less 20% tax credit, 20% on £13,000 - £2,600

HMRC receive £5,400 and you receive £1,600, an increase of 93%.

It should be noted that as a landlord, you are currently enjoying a relatively low interest environment. At some point in the future, the Bank of England base rate will increase and this will result in an interest rate rise 'on the High Street'. Should interest payments rise to say £15,000, whilst the rental yield remains at £20,000:

You pay 40% tax on £20,000 = £8,000

Less 20% tax credit, 20% on £15,000 = £3,000

HMRC receive £5,000 and you receive nothing at all.

Earned Income (excluding BLT)	£ 50,000				
Annual Rental Income:	£ 20,000				
Annual Mortgage Interest:	£ 15,000				
	Now	**Transitional Rules**			**New Rules**
	2016/2017	**2017/2018**	**2018/2019**	**2019/2020**	**2020/2021**
Rental Income	£ 20,000	£ 20,000	£ 20,000	£ 20,000	£ 20,000
Mortgage Interest	£ 15,000	£ 15,000	£ 15,000	£ 15,000	£ 15,000
Profit before Tax	£ 5,000	£ 5,000	£ 5,000	£ 5,000	£ 5,000
% Interest Relief	100%	75%	50%	25%	0%
Interest Taxable	£ -	£ 3,750	£ 7,500	£ 11,250	£ 15,000
Taxable Profit	£ 5,000	£ 8,750	£ 12,500	£ 16,250	£ 20,000
Tax Chargeable	£ 2,000	£ 3,500	£ 5,000	£ 6,500	£ 8,000
Less 20% tax credit	£ -	£ 750	£ 1,500	£ 2,250	£ 3,000
Tax Due	£ 2,000	£ 2,750	£ 3,500	£ 4,250	£ 5,000
Net Profit after Tax	£ 3,000	£ 2,250	£ 1,500	£ 750	£ -

In order to negate this additional tax it could be prudent to establish a Limited Company and purchase your buy-to-let property through this Company to shelter profits.

If you already own secondary properties, any transfer of ownership would give rise to a potential capital gain levy of up to 28% over the annual capital gains exemption allowance (currently £11,100 per annum, per individual).

Whilst Limited Companies can incur additional charges through accountancy fees, these can be offset against profits and could be substantially less than the future tax liability.

In your circumstances, as higher and additional rate taxpayers, I recommend you establish a Limited Company to purchase your intended buy-to-let property portfolio.

For completeness, I have listed below other fees and costs and whether these are tax deductible or not;

Mortgage fees

Broker and arrangement fees are currently tax deductible and can be claimed back in the year you arranged a mortgage. However, this is also likely to be restricted when the changes to mortgage interest relief come into effect.

Letting agent fees

If you choose to employ an agent to find a tenant or manage your property, you could pay between 10pc and 15pc of the monthly rental income in fees. This means on a typical tenancy worth £750 per calendar month, you could claim £1,350 a year for letting fees alone.

Securing a tenant

If you decide to rent your property privately, you can claim back the cost of advertising for tenants, purchasing a tenancy agreement, credit checking, referencing, deposit protection and professional inventory costs. These could come in at more than £300 each time a new tenant moves in, according to the National Landlords Association.

Buildings and contents insurance premiums

Specialist landlord insurance will cover the building, your liability as a landlord and loss of rent. You can also add contents cover, home emergency, legal expenses and rent guarantee insurance. Cover for a typical low-risk buy-to-let property costs around £200 a year.

Maintenance and repairs

Any money you spend keeping the property in a good state of repair is tax deductible. While you cannot claim for renovations, extensions or improvements that add value to the property, you can offset expenses to correct wear and tear.

Property repairs can include mending broken windows and doors, repairing broken cookers, white goods, furniture or guttering, painting and decorating and replacing or fixing the roof.

Furniture

The rules here are changing. If the property is furnished, you can currently choose to claim back either a general "wear and tear" allowance or the exact cost of replacing individual items.

The wear and tear allowance is 10pc of the rent annually, minus any costs you pay on behalf of the tenant such as council tax. You do not have to have spent any money replacing or repairing the furniture in a given year to claim this allowance.

Alternatively, you can claim the exact cost of replacing furniture in the property. This only applies to existing furniture – you cannot claim back the cost of furnishing it in the first place.

But from April 2016, landlords will only be allowed to deduct costs that they actually incur. So if you don't spend any money correcting wear and tear, you cannot claim.

Ground rent and service

If you are a leaseholder, you will usually pay ground rent to the freeholder. Service charges are common in blocks of flats and can vary greatly. Basic charges cover cleaning, maintenance, heating and lighting for common areas, but other costs could include security or concierge staff. You can also claim back any on-site services such as gardening and electrical costs.

Council tax and utility bills

If you pay any council tax or utility bills that a tenant would normally pay, you can claim the whole cost. You can also claim these costs during void periods, when there is no tenant living in the property.

Others

Other direct costs of letting the property such as phone calls, stationery and the costs of travelling between different properties for the purposes of the rental business are also claimable expenses.

Before you submit a tax return

As a landlord you must submit a self-assessment tax return each year. If an accountant prepares this for you the fees are tax deductible.

Further advice

For more specific advice on these tax relief changes please contact us on 020 8939 4545 or email us at info@keystoneifa.co.uk

Your home may be repossessed if you do not keep up repayments on your mortgage.

The Financial Conduct Authority do not regulate some buy to let mortgages.

Tax treatment varies according to individual circumstances and is subject to change.

We charge an administration fee of up to £500 payable upon application and a further fee of up to 0.5% of the loan amount of the facility, payable upon production of an offer. For example, on a loan of £100,000 the maximum fee payable would be £500 (plus any administration fee payable on application). We may also receive commission from the lender.

Alternatively, we can work on a 'fee only' basis which would be 1% of the mortgage arranged and any commissions of fees received from the lender will be rebated back to you.

You will receive a key facts illustration when considering a particular mortgage, which will tell you about any fees relating to it.