FINANCE INTEREST WHAT CAN BE CLAIMED?

By specialist property accountant Stephen Fay FCA

Most property investors use mortgage and other types of finance to fund their property rental business, and so have to pay interest in order to do so. This article looks at what finance interest can be claimed as tax deductible, and how relief is obtained.

FINANCE INTEREST IS AN ALLOWABLE EXPENSE, GENERALLY

As a general principle, interest payable on borrowings used to fund a property rental business is a tax deductible expense against rental business profits.

For most landlords, the main interest payable is on mortgages secured on rental property. However, interest is allowable ***regardless of whether*** the borrowings are secured by a lender (usually via a charge on the rental property), and ***regardless of where*** the borrowings are from.

Therefore, interest on any type of borrowing is in principle allowable. Finance sources may include:

- **Mortgage on a rental property (usually buy-to-let mortgage, but also commercial finance, bridging finance, and borrowings on a private residence that is then let out)**

And, if the funds are used for business purposes:

- **Mortgage on private residence to funds deposits / business expenses**
- **Credit card interest**
- **Personal loan interest**
- **Private JV partner interest**
- **Loan from a family member or other individual**
- **Bank overdrafts**
- **Hire purchase interest (if the asset is used for business purposes – e.g. a computer, van, etc.)**
- **ZOPA, Funding Circle, or other 'crowd funding' sources**
- **Loans from family and friends**

So, regardless of the ***type*** of finance, if the funds are used for business purposes, the interest is allowable.

WHAT DOES 'BUSINESS PURPOSES' MEAN WHEN ASSESSING FINANCE INTEREST

The most common reason for a landlord to borrow money is to purchase a rental property. For tax purposes, interest on borrowings up to the full purchase price can be claimed as an allowable expense – so, even if the deposit is borrowed (regardless of whether lenders 'like' this!), the interest on the mortgage and the deposit, if borrowed, can be claimed.

Note that the 'purchase price' means net of any 'below market value' discount which may be structured to achieve a particular result with a lender.

The most common scenario would be a landlord taking a further advance on property #1, to then use as the deposit on the purchase of property #2. Therefore, the full purchase price is funded by borrowings, and interest on the full borrowings can be claimed.

But, "business purposes" can also mean expenditure on things other than the purchase of a property:

- **Funding the purchase costs of a property (SDLT, legal fees, finders fees, etc.)**
- **Funding of repairs / refurbishment projects**
- **Funding of capital improvements / alterations**
- **Funding insurance payments via a third party loan**
- **Funding of capital assets, e.g. business vehicles, IT equipment, jetwashers, gardening equipment, etc.**

The main challenge for investors in claiming a tax deduction for borrowings not used to purchase rental property is proving that the borrowed funds were specifically used to fund the business purpose.

So, ensure that good records are kept of the borrowed funds coming in, and the use of the funds for business purposes, i.e. don't allow the borrowed funds to become mixed in with personal finances.

> **"The source of the borrowed funds is not relevant to the deductibility of the interest."**

INTEREST IS PAYABLE ON THE ACCRUALS BASIS – NOT CASH BASIS

Rental accounts are prepared using standard accounting methods, sometimes known as GAAP (Generally Accepted Accounting Practice). This means that interest chargeable is included in the accounts regardless of when the actual payments are made.

For most investors, interest is paid on their mortgage each month, because it is due each month. This means that there is no difference between the accruals basis and the cash basis. However some investors use private or bridging finance, and may choose to roll up the interest and pay the full amount due at the end of the finance deal. In such cases, the interest is still included ('accrued') in the accounts each month, regardless of when paid.

BUT... WATCH OUT FOR THE 'WHOLLY AND EXCLUSIVELY LET ON A COMMERCIAL BASIS' TEST...

Only interest on borrowings used to fund business expenses (purchase a rental property, fund a refurbishment, etc.) can be offset against rental profits. So, interest on borrowings used to fund private vehicles or a second home, or used for private purposes, is not tax deductible.

BEWARE THE 'TAX DEDUCTION = OVER-LEVERAGE' TRAP...

As the interest cost of funding a property business is potentially fully tax deductible, it can be tempting to fund expenditure entirely from borrowings, and not from an investor's own cash resources. This can have a very depressive effect on business profits, as well as cash flow, and of course lenders are unlikely to be happy with a general picture of over-indebtedness.
So, sensible investors think about the level of borrowings that their property business can afford, and that they are comfortable with, as much as whether a tax deduction is available for the interest payable on the borrowings.

SUMMARY

Interest on borrowings used to fund the purchase of rental property, or assets or expenses used in a property rental business, are tax deductible against rental profits. The source of the borrowed funds (bank, friend, Zopa, etc.) is not relevant to the deductibility of the interest. Whether the funds are secured or not (and if so, on which asset) is not relevant to the deductibility of the interest. Of course, borrowing carries risk attached, and so investors should not lose sight of the risk of over-leverage, plus the profit-eroding impact of excessive finance interest.

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