

JULY 2015 BUDGET UPDATE

MORTGAGE INTEREST RELIEF RESTRICTED FOR LANDLORDS

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PART 1

ARE YOU AFFECTED?

The July 2015 Budget saw several key changes that will impact landlords in the future – by far the most important is the restriction on mortgage interest relief. This article explains the change, and enables readers to check if it affects them and approximately by how much, and provides some initial pointers as to how to mitigate the impact of this change.

WHAT IS THE CHANGE EXACTLY?

Landlords are currently able to offset all their finance interest against their rental profits, before calculating their rent profit and therefore tax bill. By tax year 2021, it will still be possible to get a deduction for finance interest, but the amount will be capped to 20% of interest paid. The change starts to take effect in tax year 2018, and is 'tapered' over 4 tax years, so that by the tax 2021 the full impact of the change will bite.

OK, SO HOW WILL THIS WORK?

Tax relief will be restricted by adding back the finance interest claimed in the tax return, and then allowing a deduction @20% of the interest paid.

To check how this will affect you, check your last tax return, and do the following:

Go to page UKP2 (page 2 of the property section), and add boxes 26 and 38 together: this 'adds back' your finance interest in full. Add this new figure to your non-property income, which you will find on the SA302 (usually the last page of the tax return). Then, using this new 'total income' figure, calculate the tax due in the usual way. Finally, deduct 20% of the Box 26 (finance costs) from the re-calculated tax bill: this is the new tax bill for you.

LANDLORDS WILL FALL INTO 1 OF 3 CATEGORIES – WHICH ARE YOU?

Landlords will fall into 1 of the following 3 categories, in terms of how this tax relief change affects them:

1. Still a Basic Rate taxpayer after the change = no tax impact
2. Changes push a Basic Rate taxpayer into the Higher Rate band = 'medium' tax bill results (this is the category with the most people affected)
3. Existing Higher Rate taxpayer = 'high' tax bill results



EXAMPLE SCENARIOS:

The impact of the tax change is best-illustrated with some example figures, for each scenario, as on the next few pages. Figures are provided for the final tax year in which the tax changes have their full impact (tax year 2021), as the taper effect will cause confusion to readers.

Therefore I will assume the Government-publicised Personal Allowance of £12,500, and the Basic Rate band of £37,500, since those are the rates that will apply in 2021.

STILL A BASIC RATE TAXPAYER AFTER THE CHANGE = NO TAX IMPACT

SCENARIO:

- Non-property income **£20k**
- Rental profit **EXCLUDING** finance costs **£20k**
- Finance costs **£10k**
- 'Old' tax position: tax due **£3.5k**
- 'New' tax position: tax due **£3.5k = no tax increase**

COMMENTS:

Even with the full value of the rental profit **excluding** interest added onto the non-property income, the new income of £40k falls below the £50k Basic Rate band, and so there is no exposure to 40% tax at all, hence the 20% tax relief on interest allows full tax relief for finance costs = no tax increase.

This scenario is commonly Basic Rate taxpayer 'micro' landlords.

Income calculation	BEFORE CHANGE		AFTER CHANGE	
	£	£	£	£
Non-property income	20,000	-	20,000	-
Rental profit EXCLUDING interest	20,000	-	20,000	-
Interest payable	-10,000	-	0	-
Total income	30,000	-	40,000	-
TAX CALCULATION				
Personal Allowance	12,500	0	12,500	0
Basic Rate tax band (20%)	17,500	3,500	27,500	5,500
Higher Rate tax band (40%)	-	-	-	-
	30,000	3,500	40,000	5,500
Interest tax relief (20%)	-	-	10,000	-2,000
Final tax bill	-	3,500	-	3,500

CHANGES PUSH A BASIC RATE TAXPAYER INTO THE HIGHER RATE BAND = 'MEDIUM' TAX BILL RESULTS

SCENARIO:

- Non-property income **£20k**
- Rental profit **EXCLUDING** finance costs **£45k**
- Finance costs **£35k**
- 'Old' tax position: tax due **£3.5k**
- 'New' tax position: tax due **£6.5k = £3k tax increase**

COMMENTS:

When the finance costs (£35k) are added back, this creates a £65k new income, pushing the investor firmly into the Higher Rate tax band. Tax relief on interest is only allowed at 20%, however as the investor has 'new' income of £15k above the £50k Basic Rate band, the restriction of tax relief to 20% on £15k out of £35k of mortgage interest creates a £3,000 tax bill (20% x £15,000) – note the investor does receive 40% tax relief on the first £20,000 of interest.

Income calculation	BEFORE CHANGE		AFTER CHANGE	
	£	£	£	£
Non-property income	20,000	-	20,000	-
Rental profit EXCLUDING interest	45,000	-	45,000	-
Interest payable	-35,000	-	-	-
Total income	30,000	-	65,000	-
TAX CALCULATION				
Personal Allowance	12,500	0	12,500	0
Basic Rate tax band (20%)	17,500	3,500	37,500	7,500
Higher Rate tax band (40%)	-	-	15,000	6,000
	30,000	3,500	65,000	13,500
Interest tax relief (20%)	-	-	35,000	-7,000
Final tax bill	-	3,500	-	6,500

This scenario will be very common for landlords who currently don't pay 40% tax, but who have significant finance interest costs, which when added back push them into the Higher Rate band.

EXISTING HIGHER RATE TAXPAYER = 'HIGH' TAX BILL RESULTS

SCENARIO:

- Non-property income **£55k**
- Rental profit **EXCLUDING** finance costs **£60k**
- Finance costs **£35k**
- 'Old' tax position: tax due **£19.5k**
- 'New' tax position: tax due **£26.5k = £7k tax increase**

COMMENTS:

When the finance costs (£35k) are added back, this creates a £115k new income. Tax relief on interest is only allowed at 20%, and as the investor's income is already fully in the Higher Rate band, the full impact of the interest relief restriction will hit i.e. 20% of £35k = £7k tax increase.

Income calculation	BEFORE CHANGE		AFTER CHANGE	
	£	£	£	£
Non-property income	55,000	-	55,000	-
Rental profit EXCLUDING interest	60,000	-	60,000	-
Interest payable	-35,000	-	0	-
Total income	80,000	-	115,000	-
TAX CALCULATION				
Personal Allowance	12,500	0	12,500	0
Basic Rate tax band (20%)	37,500	7,500	37,500	7,500
Higher Rate tax band (40%)	30,000	12,000	65,000	26,000
	80,000	19,500	115,000	33,500
Interest tax relief (20%)	-	-	35,000	-7,000
Final tax bill	-	19,500	-	26,500



SUMMARY

The new finance costs tax relief changes will hit in full in tax year 2021, with a phasing in from tax year 2018 (a quarter), 2019 (a half), 2020 (three quarters), which at least allows landlords to plan changes to their affairs to mitigate the full impact. Now more than ever, good tax-planning is advisable for landlords affected by the change, although with the next 2 tax years (2016, 2017) not affected, and the changes taking place gradually over the following 4 tax years, time is on our side to plan for the unexpected issue.