Changes for landlords

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Buy to let landlords of UK residential properties have been bombarded with tax changes in the last year. This summary explains the tax legislation around interest relief restrictions and property repairs and renewals.

Interest Relief Restrictions

The amount of income tax relief landlords can get on residential property finance costs will be restricted to the basic rate of income tax from next year. 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 their finance costs.

The restriction in the relief will be phased in as follows:

- in 2017/18, the deduction from property income will be restricted to 75% of finance costs, with the remaining 25% being available as a basic rate tax reduction;
- in 2018/19, 50% finance costs deduction and 50% given as a basic rate tax reduction;
- in 2019/20, 25% finance costs deduction and 75% given as a basic rate tax reduction;
- from 2020/21, all financing costs incurred by a landlord will be given as a basic rate tax reduction.

These rules do not apply in relation to calculating the profits of a property business for the purposes of charging a company to income tax on so much of those profits as accrue to it otherwise than in a fiduciary or representative capacity.

Dwelling-related loans

The restriction applies to 'the costs of a dwelling-related loan', namely the amount borrowed for purposes of the business that is referable, on a just and reasonable basis, to a business carried on for the purpose of generating income from land consisting of a dwelling-house or part, or an estate, interest or right in or over land which is a dwelling-house. This includes building the relevant property but does not apply to furnished holiday lettings.

Costs include interest or any economic equivalent or incidental costs of obtaining finance by means of the loan.

Basic rate relief

If, for a tax year, an individual has a relievable amount in respect of a property business, or two or more relievable amounts each in respect of a different property business, they are entitled to relief. An individual has such an amount if, for that year, the individual has a current-year amount, a current-year estate amount and/or a brought-forward amount.

An individual's relievable amount for a tax year in respect of a property business is the total of:

- the individual's current-year amount (if any) for that year in respect of that business;
- the individual's current-year estate amounts (if any) for that year in respect of that business; and
- the individual's brought-forward amount (if any) for that year in respect of that business.

An individual has a current-year amount for a tax year in respect of a property business if an amount (A) would be deductible in calculating the profits for income tax purposes of that business for that year but for the new rules, the individual is liable to income tax on a percentage of those profits and that liability is not under Chapter 6 Part 5 ITTOIA 2005 (estate income).

An individual has a current-year estate amount for a tax year ('the current year') in respect of a property business and a particular deceased person's estate if:

- an amount (A) would be deductible in calculating the profits for income tax purposes of that business for that year but for the new rules, whether that year is the current year or an earlier tax year:
- the personal representatives of the deceased person are liable to income tax on a percentage of those profits (N%);

- the individual is liable for income tax on estate income treated under Chapter 6 Part 5 ITTOIA 2005 as arising in the current year from an interest in the estate, and
- the basic amount of that estate income consists of, or includes, an amount representative of E% of the personal representatives' N% of the profits of the business for the profits year;

in which event the individual's current-year estate amount for the current tax year, in respect of that business and estate and the profits year, is equal to E% of N% of A.

Where a relievable amount is greater than the actual amount on which relief for the year is to be given in respect of the relievable amount, the difference is the individual's brought-forward amount for the following tax year in respect of the property business concerned.

Reduction for individuals - calculation

In respect of a relievable amount, the actual amount on which relief for the year is to be given is 'L', L being the lower of:

- the relievable amount; and
- the total of:
  - the profits for income tax purposes of the property business concerned for the year after any deduction for property losses brought forward ('the adjusted profits') or, if less, the share of the adjusted profits on which the individual is liable to income tax other than under Chapter 6 Part 5 ITTOIA 2005; and
  - so much of the relievable amount that consists of current-year estate amounts. New s274AA(2) ITTOIA 2005.

If S is greater than the individual's adjusted total income for the year (ATI), the actual amount on which relief for the year is to be given in respect of a relievable amount is ATI/S x L where S is the total obtained by identifying the amount that is L for each relievable amount and then finding the total of the amounts identified and L has the same meaning as above.

'Adjusted total income' for a tax year is identified as follows:

Step 1 - identify the individual's net income for the year (per Step 2 s23 ITA 2007);

Step 2 - exclude from that net income so much of it as is within s18(3) or (4) ITA 2007 (income from savings) or is dividend income;

Step 3 - reduce the remainder by the amount of any allowances deducted for the year in the individual's case at Step 3 s23 ITA 2007. The result is the individual's adjusted total income for the year.

Reduction for accumulated or discretionary trust income - entitlement

Similar rules apply to the trustees where the property business profits are classed as accumulated or discretionary income per s480 ITA 2007.

Clearly, these changes are significant and will affect a number of clients, so it is worth making sure that they are fully aware of the changes as soon as possible.

Property business - replacement of domestic items

The non-statutory renewals basis, which was a concession, ceased to have effect in April 2013.

Wear and tear allowance is abolished for 2016/17 onwards for income tax purposes (accounting periods beginning on or after 1 April 2016 for corporation tax). Where a company has an accounting period beginning before 1 April 2016 and ending on or after that then so much of the straddling period as falls before 1 April 2016, and so much of that period as falls on or after that date, are treated as separate accounting periods. Any amounts brought into account in calculating the profits of a property business for the straddling period are apportioned on a time basis or if that method produces a result that is unjust or unreasonable, on a just and reasonable basis.

In addition, the statutory renewals basis, which provided relief for expenditure incurred by a business on replacement and alteration of trade tools, does not apply to expenditure incurred from 6 April 2016 for income tax purposes (1 April 2016 for corporation tax).

Some had argued that the statutory renewals basis could be used to provide relief for the replacement of domestic items in partly furnished properties. The Government's response has been to remove this possibility. However, this change also affects trades.

Statutory renewals basis - replacement of domestic items

In calculating the profits of a property business, a deduction for the expenditure is allowed if Conditions A to D are met.

Condition A is that a person (P) carries on a property business in relation to land which consists of or includes a dwelling-house.

Condition B is that:

- a domestic item has been provided for use in the dwelling-house ('the old item');
- P incurs expenditure on a domestic item for use in the dwelling-house ('the new item');
- the new item is provided solely for the use of the lessee;
- the new item replaces the old item; and

- following that replacement, the old item is no longer available for use in the dwelling house.

Condition C is that a deduction for the expenditure is not prohibited by the normal wholly and exclusively test but would be prohibited as capital expenditure.

Condition D is that no allowance under CAA 2001 may be claimed in respect of the expenditure.

A 'domestic item' means an item for domestic use (such as furniture, furnishings, household appliances and kitchenware) and does not include anything that is a fixture.

'Fixture' means any plant or machinery that is so installed or otherwise fixed in or to a dwelling-house as to become, in law, part of that dwelling-house and includes any boiler or water-filled radiator installed in a dwelling-house as part of a space or water heating system.

The basic amount of the deduction is:

- where the new item is substantially the same as the old item, the deduction is equal to the expenditure incurred by P on the new item; or
- where the new item is not substantially the same as the old item, the deduction is equal to so much of the expenditure incurred by P on the new item as does not exceed the expenditure which P would have incurred on an item which is substantially the same as the old item.

Special rules

No deduction is allowed for expenditure in a tax year if the business consists of or includes the commercial letting of furnished holiday accommodation and the dwelling-house constitutes some or all of that accommodation for the tax year.

No deduction is allowed if the person derives rent-a-room receipts from the dwelling-house and ss793 or 797 ITTOIA 2005 applies in relation to those receipts (rent-a-room relief).

If P incurs incidental expenditure of a capital nature in connection with the disposal of the old item or the purchase of the new item, the deduction is increased by the amount of the incidental expenditure.

If the old item is disposed of, the deduction is reduced by the amount of any consideration in money or money's worth which P or a person connected with P receives, or is entitled to receive, in respect of the disposal.

Similar changes are made for corporation tax purposes.

The changes have effect for expenditure incurred on or after 6 April 2016 for income tax purposes (1 April 2016 for corporation tax).