Finance cost relief for residential lets

Welcome to the second part in our **Property Tax and Landlord** series.

Investment in **rental property portfolios has been a popular choice** with many of our clients over the years. Historically, landlords have enjoyed **strong yields, generous income and capital gains tax reliefs** which helped make residential property an attractive investment. However over recent years the Treasury has eroded these reliefs, both income and capital.

In this article we **examine the reliefs available and provide an example of how these might work**. With careful planning, property rental can still provide a useful income.

Some might remember mortgage interest relief at source, which encouraged home ownership by offering tax relief for interest payments on a mortgage. This was abolished in 2000 but those who bought residential lets could deduct interest payments from their property rental profits in full and reduce their tax liability on their residential let.

However, in 2015, the Government announced plans to cut back this tax relief by restricting the amount of income tax relief landlords could get on residential property finance costs. The changes started on 6 April 2017 and have been phased in over four years, in order to give landlords the time to adjust gradually, with the full changes taking effect in 2020/21. For many over the past three years, this resulted in an increasing tax liability as the **ability to deduct mortgage interest payments from their rental profits has been reduced from 100% to nil.**

Changes to income tax relief

From 6 April 2017, the amount of **income tax relief landlords could get on residential property finance costs was restricted to 20%** – the basic rate of income tax (Scottish rates now differ from UK income tax rates).

These changes affected anyone letting a residential property as an individual, a partnership, or in a trust. As a result, landlords can no longer deduct all the finance costs from their property income to arrive at their property profits.

Instead, they receive **a basic-rate reduction from their income tax bill for their 'finance costs'**, which includes:

- mortgage interest
- overdrafts
- interest on loans to buy furnishings
- fees and any other incidental costs incurred when taking out or repaying mortgages and loans
- discounts, premiums and disguised interest

Not all residential lets have been affected by the introduction of this finance cost restriction.

If the property is let through a UK resident or non-UK resident company, or if the property is a furnished holiday let, relief for interest and other finance costs remains unchanged.

Commercial property lets are also unaffected. **If you have a loan for both residential and commercial properties, you will need to work out a reasonable apportionment of the interest to calculate your finance cost for the residential property as the element relating to the commercial property remains fully deductible.**

The basic-rate tax credit

It was previously possible to deduct some of the finance costs when calculating the property rental profits. The basic-rate tax reduction works by using some of the finance costs to calculate the property profits, with the rest used to work out the basic-rate reduction.

In 2017/18, a landlord could deduct 75% of finance costs from their profits before tax, with the remaining 25% used to work out the tax credit. In 2018/19 this changed so that 50% of finance costs were deductible and 50% were available for the tax credit, then in 2019/20, the deductible amount decreased to 25% and the proportion used for the tax credit increased to 75%.

As of 2020/21, landlords can no longer deduct finance costs from their profits, and can instead claim the basic-rate tax deduction on 100% of the costs. The **basic-rate deduction is up to 20% of the disallowed finance costs** as some restrictions may apply.

How the tax credit works

When there is a restriction, **any finance costs not used to calculate the basic-rate deduction in one year can be carried forward and added to the finance costs of the following year.**

The change can lead to some unforeseen complications. For example, if you currently pay income tax at 20%, you might find you are nudged into the 40% higher-rate band once the finance costs are disallowed in your rental accounts.

In Summary

Owning a residential property to let is still prevalent but ensure that you seek appropriate professional advice before investing and understand the tax position. If you need advice on anything covered in this article, contact Mark Mitchell at mmitchell@thomsoncooper.com or call 01383 628800.

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