Buy-to-let is changing - are you ready?

In the 2015 Summer Budget and Autumn Statement, the Chancellor introduced several changes that will affect anyone buying or owning a buy-to-let property in the UK. It is important that landlords understand these changes because they may affect the profitability of many buy-to-let portfolios, however small or large they are.

From 1 April 2016, higher rates of Stamp Duty Land Tax (SDLT) (3% above the current rates) will be charged on the purchase of additional UK residential properties. This may impact buy to let investors.

For example, a property bought now for £500,000 would attract an SDLT rate of 5% or £25,000. But after 1 April it will be 8% or £40,000 if the purchaser already owns one or more UK residential properties.

Also, from 2017 the amount that some landlords can claim in tax relief on their finance costs (such as mortgage interest payments, interest on loans to buy furnishings and fees incurred on taking out and repaying mortgages) is being gradually reduced over 4 years.

When the new restrictions are fully in force from the beginning of the 2020/21 tax year, landlords will be only be able to claim tax relief at the basic tax rate of 20%, instead of 40% or 45% for those in higher or top rate income tax brackets respectively.

How the current rules work

At the moment, you can claim all of the annual mortgage interest you pay against your income from a property, and then only pay tax on the difference. So if your income tax rate is 40% then your tax bill is 40% of this difference.

Here's an example. Let's say your buy-to-let property generates a rental income of £10,000 a year, while you pay £9,000 interest on your annual mortgage payments. At the moment, you only pay income tax on the £1,000 difference between the rental income and the mortgage interest.

If you pay the basic rate of tax (20%), you'll owe £200. Those who pay the higher rate of tax (40%) will owe £400, and if you pay the top tax rate of 45%, it would be £450. In another example, if you receive £15,000 in rent annually and pay mortgage interest payments of £10,000 a year, a basic-rate taxpayer will owe £1,000 under the current rules, while a higher-rate taxpayer will owe £2,000 and a top-rate taxpayer would owe £2,250. These examples assume there are no other deductible expenses for tax purposes.

The new rules explained

From 2017, the way the tax relief is calculated is going to change. Under the new rules, you will owe tax at your personal tax rate on the entire income from a property. From 2020/21, when the rules are fully in force, you will only be able to deduct a maximum of 20% of your mortgage interest payments from this tax liability to calculate the amount of tax due.

This means that if you pay income tax at the basic rate of 20%, you won't see any change in the amount you owe.

Imagine that your buy-to-let property generates a rental income of £10,000 a year with mortgage interest paid of £9,000. In 2020, when the new rules are introduced in full, you will be taxed at 20% of £10,000 (or £2,000). Then 20% of your £9,000 mortgage interest payments (or £1,800) can be deducted, leaving you with a tax bill of £200, the same as before.

But higher and top-rate taxpayers will pay more. Based on the same scenario, in 2020, higher-rate taxpayers will be taxed at 40% of £10,000 (or £4,000), but will only be able to deduct 20% of their £9,000 mortgage interest payments (or £1,800).

This will leave higher-rate taxpayers with a tax bill of £2,200, compared to £400 under the current system. Those paying the 45% tax rate will owe £2,700, compared to £450 today.

Looking at the example where the annual rent received is £15,000 and mortgage interest payments are £10,000 a year, basic-rate taxpayers would still owe £1,000 under the new rules, the same as before. However, higher-rate taxpayers will owe £4,000 from 2020, compared to £2,000 under current rules, and top-rate taxpayers will owe £4,750, rather than £2,250.

Wear and tear

That's not all that may be changing. The Chancellor has proposed that, from April 2016, you'll only be able to claim for 'wear and tear' costs actually incurred on replacing furnishings when calculating taxable profits. You'll do so by providing itemised receipts that show the replacement goods you've purchased or repairs you've carried out. Currently, you're given an allowance regardless of your actual expenditure.
Prospective landlords and those with existing properties may want to work out how their plans will be affected by the proposed new rules to avoid a surprise later on. When planning, remember that just as these rules are changing now, they might do so again in the future. The effect of tax rules can change and will depend on your own circumstances. We recommend that you take your own independent tax and legal advice tailored to your individual circumstances.

Safety rules are changing

Landlords must already follow certain safety rules. These include obtaining an Energy Performance Certificate for a property before advertising it to tenants, as well as an annual Gas Safety Certificate for their property's boiler and other gas appliances. New measures include rules for preventing legionnaire's disease and for fitting smoke and carbon monoxide alarms.
Also, the government is proposing new rules to make it more difficult for landlords to evict a tenant if the property's appliances don't have a current Gas Safety Certificate.

Focus on the long term

With changing tax rules and tighter regulations being introduced for buy-to-let landlords, it's vital to think carefully about the type of investment you want to make. Properties can offer both asset growth through rising house prices and an income from rents - although neither of these can be guaranteed; values can fall and any rent might be exceeded by outgoings.
It's also important to understand the risks involved. If you're thinking about investing in buy-to-let, bear in mind that it's a relatively high-risk and illiquid investment.
Also remember that, just as tax rules are changing now, they could change again in future and their effect on you will depend on your circumstances - which can also change. The government is still encouraging everyone to take greater responsibility for their long-term needs by "giving them more flexibility about how they spend their pensions savings". For many people who are looking to release funds, considering becoming a landlord is their next step.

The property on which any lending is secured may be repossessed or a receiver of rents may be appointed if you do not keep up repayments on the mortgage.