All you need to know about the Government's plans to restrict finance cost relief for individual landlords

What is the proposal and when was it announced?

The proposal was announced in the Chancellor's Summer Budget on 8 July 2015 and it will restrict relief for finance costs on residential properties owned by individual landlords to the basic rate of income tax. Finance costs include mortgage interest and interest on loans. Property Companies and Institutions who hold residential properties are not affected by the proposal.

In plain English, what does this mean?

Landlords are currently able to offset all their finance interest against their rental income, before calculating their rent profits and therefore their tax bill. This is quite normal in business as the general taxation principle is that tax is applied on profit.

The Government proposes to break this normal taxation practice and require landlords to pay tax on part of their costs. By the year 2021, it will still be possible to get a deduction for finance interest, but the amount will be capped at 20%. This is a big change because in most cases, finance costs will be the landlord's largest cost. No other business is taxed in this way. No other business is taxed on interest on loans taken out to buy assets that generate taxable income. We believe that individual landlords who provide valuable housing across the UK are being unfairly discriminated against by the Government.

What is the Government's policy objective?

In its latest Financial Stability report the Bank of England commented that the buy to let market could pose a risk to financial stability, especially if interest rates go up. The theory is that this could cause landlords to fall into negative cashflow, where their rental payments no longer cover the cost of mortgage payments. This could force them to sell in a hurry, potentially destabilising the housing market. It was following these comments that George Osborne decided he needed to exert some control over buy to let.

The Government say that their policy objective is to make the tax system fairer. The Chancellor has said that landlords are taxed more favourably than home owners. Both the Institute for Fiscal Studies and the Conservative's favourite think tank, Policy Exchange, have warned that this is not correct. Unlike home owners, landlords are taxed on rental income and capital gains.

We believe that the Government's proposal to tax landlord's debt goes too far and will destabilise the housing market, which is what the Bank of England wants to avoid.

When will the measure be introduced?

The measure will be introduced gradually from 6 April 2017 and is 'tapered' over 4 years. By 2021, the full impact of the change will bite. Although the implementation of the proposal is to be phased, it is already causing uncertainty for landlords and tenants.

Who is likely to be affected?

The Government say that individuals that receive rental income on residential property in the UK and elsewhere and incur finance costs will be affected. We believe that the proposal will not only affect landlords as there will be many unintended social and economic consequences of this ill thought out proposal.

How might landlords be affected?

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

1) Landlords remains basic tax payer = no change
2) Change pushes basic rate tax payer into Higher Rate Band = more tax paid
3) Existing Higher Rate Tax payer = more tax paid

Many thousands of landlords will pay more tax as a result of the proposal. For some, the additional tax will not impact on the viability of their businesses. However, for thousands of landlords who have borrowed substantially to invest in their property business, the consequences will be serious. Some landlords will even lose their personal tax allowance because of the unfair way that the Government will calculate taxable income; in many cases, landlords will pay more in tax in connection with their property business than they make in net profit; in many cases, landlords who make a loss from their property business will still be faced with huge tax bills. We cannot understand how the Chancellor considers his changes will result in a fairer tax system.

The implications for some landlords are such that they will need to sell properties to reduce the tax they pay on their finance costs. There is concern that many landlords will be declared bankrupt as their tax bills will exceed their taxable income and they will be left with property businesses that are no longer sustainable. The situation will get worse when interest rates increase. The Governor of the Bank of England has publicly stated that he expects interest rates to increase before the end of 2015.

Can you show some examples of the impact on landlords?

The Government's proposal is quite complicated and we can't go into too much detail here. We can however give 3 simple examples to illustrate the issue.

Example 1: Joe is an architect and earns £ 45,000. He is what has become known as an 'accidental landlord'. He has only one buy to let property. This used to be his home but he let it out when he moved in with his partner Monica. Joe is a 40% taxpayer. His rental income is £7,200 per annum; his mortgage costs are £2,500; and his repairs and other tax deductible costs are £1,000. Under the current tax system, Joe would pay £1,480 tax on his property income. Under the proposed tax system, Joe would pay £1,980 tax on his property, an increase of £500. For Joe, the new tax system still results in him making a ‘real profit’ but his effective rate of tax on ‘real profit’ increases from 40% to 53.5%.

Example 2: Dave and Margaret are a married couple. They consider themselves to be entrepreneurs and operate a sizeable buy to let business. They have invested in property to provide a livelihood for themselves and to provide a pension when they retire. They have tenants who are professional people in employment but most of their tenants are in receipt of housing benefit. Their only source of income is from their rental business. Their property rental assets are jointly owned and they split the rental income 50/50. Properties have been acquired over a period of nearly three decades. They have recently fixed their interest rate at 4.99% for 10 years to protect their business from risks associated with rises in interest rates. That seemed to be the sensible thing to do at the time. Their rental income is £600,000; their mortgage costs are £350,000; and their repair and other tax deductible costs are £200,000. Their net rental profit is £50,000. They are currently basic rate taxpayers. Their taxable income, after deduction of their personal allowance, is £28,000. Under the current tax system, Dave and Margaret each pay £5,600 tax. Their effective tax rate over personal allowance is currently 20%.

Under the proposed tax system, because Dave and Margaret will not be able to offset any of their mortgage costs against their rental income, they will become higher rate tax payers and their individual taxable income will increase to a staggering £400,000, the same as their rental profit because they lose their personal allowance at £121,000 each. The actual tax they would each pay would be £38,900, making £77,800 in total. This is £27,800 more than they actually make in profit from their rental business.

Their effective tax rate on their real profit is now 155.6% as the amount of tax paid exceeds their income. Dave and Margaret are now higher rate tax payers. For Dave and Margaret, the Government’s proposal is catastrophic as their business is no longer sustainable as the tax they pay exceeds their ‘real profit’. Dave and Margaret are now very worried and feel trapped. Their once profitable business is no longer viable. If they were to look at selling their properties they would incur early repayment charges, incur selling costs, be required to pay a significant sum in Capital Gains Tax and repay their outstanding mortgage balances in full, the sum total of which would be greater that the proceeds of sale. They are responsible landlords and are concerned about what will happen to their 187 tenants if their properties are repossessed, especially those tenants in receipt of benefits. The are scared to share their concerns with their tenants as they fear that their tenants may give notice to quit and look for a tenancy that is more secure.

Example 3: Emily is a civil servant and has non-property income of £40,000. She started to invest in property to create an additional income stream to fund her children through university. Her rental profit is £25,000 and she pays £35,000 in mortgage interest on her rental properties giving her a total income of £65,000. Her total tax bill under the current tax system would be £15,200, of which £9,400 arises from her rental income. This would increase to £22,200 under the new tax regime of which £16,400 would arise from her rental income. Emily’s effective tax rate on her real profit of £25,000 would increase from 37.6% to 65.6%. Emily is now concerned that her tax bill has increased by £7,000 and that her profit from her property rental business has been substantially eroded. She is becoming increasingly concerned about risk, especially knowing that if interest rates go up, her margins will be further eroded. This was not what she had in mind when she used all her savings to invest in property to fund her children's further education. She assumed that the long established principle of income – expenses = profit would remain and that tax payable would be based on profit made. The Government's proposal fundamentally changes that formula.

How many landlords will be affected?

The Government has stated that 1 in 5 landlords will be affected. Such figures completely miss the point, since what matters is not the number of landlords affected, but the number of properties. Properties are mortgaged, not landlords. The Government has to date been unable to confirm how many properties will be affected. Many property businesses will own more than one property so the proportion of the private rented supply affected is likely to be quite high.

How will the proposal affect the private rented sector?

For decades, the private rented sector has been providing much needed homes to meet a growing demand for flexible accommodation. A healthy supply of rental properties keeps rents down and tax relief on mortgage interest payments is a key way for the Government to incentivise investment.

At the end of 2014, the Council of Mortgage Lenders reported that there were around 1.6m buy to let mortgages in the UK, with an aggregate balance of £188bn. This money is used by landlords to invest in their property businesses. For many people, the private rented sector is their tenure of choice and currently 21% of all households in the UK rent privately. 18% of new home loans are buy to let. The sector has grown in recent years to meet demand.

As a result of the Chancellor's Summer Budget, many landlords would cease to make a profit and would decide to sell. Landlords with several properties will want to sell to reduce their mortgage debt to ensure that they are not faced with unsustainable tax bills. There is a risk that some landlords will be declared bankrupt as their tax bills will exceed their profit. In cases of bankruptcy, rental properties will be repossessed by lenders and this will further reduce supply.

Future purchases would require a higher yield to make business sense. This could result in the provision of more Houses of Multiple Occupation (HMOs). Less family housing would be provided in the private rented sector. Investment in the private rented sector is likely to decline and the supply of rental properties will not meet the growing demand.

Once individual landlords begin to withdraw from the private rented sector, it will become increasingly dominated by large private companies and City Institutions.

We desperately need more rental property and the reduced supply of available homes for rent in the private sector would be devastating for the UK housing situation.

How might tenants be affected?

A fall in the supply of private rental properties will result in rents increasing. An interim survey of 1,146 landlords by the Residential Landlords Association (RLA) has revealed that 65% of landlords are already considering rent increases to mitigate the impact of the Government's rental property tax levy.

If landlords decide to sell to avoid unaffordable tax bills, they will want to sell with vacant possession and tenants will be forced to move as a result of the Government's tax policy. Some tenants may find themselves homeless if lenders repossess landlords' properties. We are concerned that the supply of rental properties available to those on benefits will fall and that this will result in people having to move into temporary, unsuitable bed and breakfast accommodation at considerable expense to the public purse. The demand for social housing will increase at a time when there are already very large waiting lists for social housing.

Has the Government considered the impact on tenants?

It would appear not. The Government's impact assessment is silent on how tenants may be affected. We have asked the Government to consider the impact on tenants.

Will the proposal have any impact on home owners?

There is a risk that the housing market will be flooded with houses for sale as landlords try to withdraw from the market or as a result of lenders repossessing houses from landlords. This could lead to a collapse in house prices, resulting in owners being in negative equity and having difficulty selling if they wish or need to move. The Bank of England has acknowledged in its July 2015 Financial Stability Report that 'investors selling buy to let properties in an illiquid market could amplify falls in house prices'.

Falling house prices is likely to result in a decline in new house building, thus reducing housing choice. This is what happened during the credit crunch and it could happen again. A decline in house building generally will adversely impact on the delivery of much needed affordable housing as much of this type of housing is provided as part of private housing developments to meet the requirements of local planning authorities.

Will the proposal reduce demand for housing?

The Government say that the proposal could marginally reduce the demand for housing. We cannot see how this will be the case and the Government has not provided any evidence to back up its claim. Demand is influenced by demographic factors and household formation rates and all the available evidence points to population and household growth in the UK.

Will the proposal affect businesses and the economy?

The Government has said there will be no impact on business. We disagree. Landlords provide support for local economies by employing solicitors, letting agents, accountants, mortgage brokers, plumbers, joiners, electricians, builders, painters, cleaners etc so any reduction in investment in housing by landlords will impact on these types of businesses. The UK needs more houses in all tenures to cater for the expected demand for housing.

The Financial Secretary to the Treasury, David Gauke, has previously admitted that rented housing provides an important boost to the economy ‘ through improved labour market flexibility’. This flexibility will be greatly reduced if there is a reduction in the supply of privately rented accommodation.

Landlords will, with immediate effect, be less inclined to buy the new-builds which the Government is hoping to facilitate by making planning approval automatic in England. Historically they bought 57% of new-builds, but are unlikely to volunteer to increase their potential liability from this proposed new tax treatment.

What has been said in the media about the proposal?

We are actively campaigning to raise awareness of the issue and in particular the unintended social and economic consequences. We would welcome your support to raise awareness. Here are some of the comments that have already been made by organisations who share our concerns:

The Residential Landlords Association has said *‘ The reality is that the Chancellor’s belief that rental property is taxed more favourably than home owners is simply not correct. Rather than supporting the sector to provide the vital homes needed to support a flexible labour market, today’s Finance Bill will choke off supply and drive up rents.’*

The **Scottish Association of Landlords** has said *‘this is a shocking decision by the Chancellor of the Exchequer which unfairly discriminates against landlords. As a result of this increased cost and risk to landlords, you may see some within the sector feeling they are forced to increase their rent levels which would obviously have a huge negative impact on tenants.’*

The **Institute of Fiscal Studies** (IFS) has pointed out *‘the Budget red book states that the current tax system supports landlords over and above ordinary homeowners and that this puts investing in a rental property at an advantage.’* In response to this claim the IFS has said *‘This line of argument is plain wrong. Rental property is taxed more heavily than owner occupied property’.*

Price Waterhouse Coopers (PwC) has said *‘if interest rates increase over the coming years, and rental yields don’t keep pace, investors could be paying tax on a loss’.*

The **National Association of Landlords** (NAL) has said *‘private lettings’ profitability is less than 5%, which leaves little room to squeeze margins. Landlords would be left with no other option than to recoup their increased costs through higher rents. The last thing the UK economy needs right now is to put greater pressure on the cost of housing’.*

What do you want the Government to do?

We want the Government to withdraw its proposal to restrict finance cost relief for individual landlords. We want the Government to take stock, to listen to all relevant stakeholders and to bring forward revised proposals for consultation that are aimed at meeting sensible policy objectives and help address the country’s housing needs.

We want the Government to support small businesses. We want the Government to think about the housing market more holistically and to recognise that the private rented sector is an important tenure. We want the Government to have more balanced approach towards landlord taxation.

We think the big housing issue in the UK is one of supply. We want to see more land freed up for house building so that the demand for housing is met.

If I am concerned about the proposal, what can I do?

We are writing to the Chancellor and our local MPs to express our concerns. We suggest you do the same. An an e-petition to try to get the issue debated in Parliament has been created.

https://petition.parliament.uk/petitions/104880