Mortgage interest relief restriction for individual landlords

Under the current law, individual landlords can deduct mortgage interest to calculate their taxable rental profit. However, from 6 April 2017 mortgage interest relief will be restricted to basic rate (20%) income tax and this will be phased in over four years from April 2017, as descibed below:

Tax year 2017/18 – 75% of mortgage interest will be fully allowable and the remaining 25% available at the basic rate;

Tax year 2018/19 – 50% of mortgage interest will be fully allowable and the remaining 50% available at the basic rate;

Tax year 2019/20 – 25% of mortgage interest will be fully allowable and the remaining 75% available at the basic rate; and

Tax year 2020/21 – mortgage interest deduction will only be given at the basic rate.

The mortgage interest relief restriction does not apply to properties qualifying as 'furnished holiday lets' and commercial properties.

Whilst the government's intention behind the measure is to restrict mortgage interest relief to 20%, the actual mechanism of how the restriction works has wider impact for individual landlords. When the new measure takes full effect, the interest cost will be completely disallowed in computing rental profits and instead a tax credit equal to 20% of the interest will be given against the person's income tax liability.

As the interest cost is completely disallowed, it means the individual will have higher overall taxable income. This could push an individual into a higher rate of income tax (40% / 45%), reduce their personal allowance (if their income now starts to exceed £100,000), affect their entitlement to child benefit and restrict the amount on which they can claim tax relief for pensions.

Example one

Alice is retired and owns a number of residential buy-to-let properties. Her only source of income is the rents from her residential property portfolio which total £60,000 per annum. She has mortgages on the properties and she pays annual interest of £25,000. Therefore, her net profit before tax is £35,000.

Alice's income tax position and net profit after tax over the next five years is shown in table one below:

Table one

	100%	75%	50%	25%	
Tax year	**2016/17**	**2017/18**	**2018/19**	**2019/20**	**2020/21**
Rental income	60,000	60,000	60,000	60,000	60,000
Loan interest	(25,000)	(18,750)	(12,500)	(6,250)	-
Net rental income	35,000	41,250	47,500	53,750	60,000
Less: personal allowance	(11,000)	(11,000)	(11,000)	(11,000)	(11,000)
Taxable income	24,000	30,250	36,500	42,750	49,000
Income tax payable	4,800	6,050	8,200	10,700	13,200
20% tax credit for interest cost	-	1,250	2,500	3,750	5,000
Total income tax payable	4,800	4,800	5,700	6,950	8,200
Net profit after tax	30,200	30,200	29,300	28,050	26,800

Alice would assume that she is not affected by the changes because her net income, after deducting the personal allowance, comes within the 20% tax band. However, the table above shows that Alice's tax bill increases by £3,400 when the restriction takes full effect in April 2020. The reason for this is because of the way the restriction operates and it pushes Alice into the 40% rate of income tax. Alice's overall effective rate of income tax increases by nearly 10% as a result.

Example two

John is employed and earns £80,000 in salary and bonuses per annum. As well as his employment income, John owns a buy-to-let residential property from which he receives £40,000 a year. John has a mortgage on the property and pays £25,000 interest per annum, so that his net rental profit before tax is £15,000.

John's income tax position and net profit after tax over the next five years is shown in table two:

Table two

Tax year	100% **2016/17**	75% **2017/18**	50% **2018/19**	25% **2019/20**	**2020/21**
Employment income	80,000	80,000	80,000	80,000	80,000
Rental income	40,000	40,000	40,000	40,000	40,000
Loan interest	(25,000)	(18,750)	(12,500)	(6,250)	-
Net rental income	15,000	21,250	27,500	33,750	40,000
Less: personal allowance	(11,000)	(10,375)	(7,250)	(4,125)	(1,000)
Taxable income	84,000	90,875	100,250	109,625	119,000
Income tax payable	27,200	29,950	33,700	37,450	41,200
20% tax credit for interest cost	-	1,250	2,500	3,750	5,000
Total income tax payable	27,200	28,700	31,200	33,700	36,200
Net profit after tax	9,000	7,500	5,000	2,500	-

John would expect that the new rules will restrict the tax relief on the mortgage interest to the basic rate, but because the mechanism operates to increase John's overall taxable income above £100,000, he starts to lose his personal allowance by £1 for every £2 of income over this threshold. By 2020/21, John's personal allowance is restricted to just £1,000, resulting in a £9,000 increase in his tax liability and reducing his net rental profit to nil.

Higher rate and additional rate taxpayers investing in residential property will need to consider the appropriate property ownership structure in light of the changes. A corporate structure may be more attractive going forwards, as the same restriction for mortgage interest will not apply to companies. In addition, the main rate of corporation tax will reduce to 17% by 2020, further increasing the difference between corporate and personal tax rates.

If you wish to discuss anything in this article, please speak to your usual contact at Blick Rothenberg or:

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