Demanding Tax

There have been three changes to landlord taxation announced in recent months and due into force shortly. These are, a) the switching from a furniture depreciation allowance to replacement costs, b) the loss of higher rates of tax relief on mortgage interest and c) the extra three percent in stamp duty for second homes.

The ten percent depreciation allowance, which was previously only available for furnished lettings, is to be scrapped and replaced with the ability to claim the cost of replacement items, as and when they are purchased. The ten percent allowance was generally considered a little more generous for those allowed to claim.

Now if the sofa is worn out, instead of having claimed ten percent of the rent each year and not claiming the cost of the sofa, the landlord will claim the cost of the sofa when purchased. This is exactly the same as the unfurnished letting is already doing. There is a small opportunity for landlords to delay replacing items till after April if they were previously on the depreciation allowance scheme.

The second change is the loss of higher rate income tax allowance for mortgage interest. This is actually quite complicated so in the article we will only give a 'broad idea' of how it might work.

Some landlords may be affected when they have not yet realised it. For example, under the old scheme a landlord would deduct the mortgage interest and other tax deductible expenses from rental income. This net amount was then added to other income and taxed at the marginal rate (that is which ever rate of income was appropriate, maybe some at 20% and some at 40%).

The new system takes the 'other tax deductible costs' off the rent but then adds net rent before mortgage interest relief and this decides the rate at which tax is paid.

For example, if a landlord has other income of £25,000 and rental income of £40,000 but other tax deductible costs of £6,00 and mortgage interest of £28,000 then the rent net of costs and mortgage interest would be £6,000. Under the old system the landlord would be a standard rate tax payer as the combined income would be £31,000.

However, under the new system the landlord's £25,000 income would be added to £34,000 rental income (rent net of other tax deductible costs) giving a combined income of £59,000 and enough to be paying higher rate tax, thereby limiting relief.

You can even have a situation where a landlord is making a loss on the rental portfolio, but still has to pay income tax as not all of the mortgage interest paid is tax deductible.

The larger the portfolio the greater the risk (as more properties in any given location usually means more rental income). The second risk factor is the more highly geared the landlord the greater the risk will be. This latter point is because a landlord with a lot of borrowing will be paying more interest and so the effect of not being able to get complete tax deductibility for the interest will be greatest. Obviously a combination of the two creates the worst possible conditions for a landlord with a large rent roll and a lot of mortgage borrowing.

In the current low interest market there is less interest to offset but when rates rise the affect will become more pronounced still.

This proposal is being phased in over four years with 25% not counting for higher rate relief in the first year, 50% in the second year etc. This should give time for landlords to adjust their portfolios in order to mitigate the worst of the problems.

The third change is the increase stamp duty payable by buy to let landlords and second home owners. This takes most of the standard rate stamp duty and adds three percent to all purchases over £40,000. Below £40,000 no stamp duty is payable, at £41,000 the three percent is payable on the whole £41,000. As the rates increase (for example at £125,000) the three percent is simply added to the normal tax payable.

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