Buy-to-let: a future tax trap?

A close reading of the summer Finance Bill has highlighted a further tax consequence of the government's moves to limit tax relief for interest on buy-to-let mortgages.

The July Budget included an attack on individual investors in buy-to-let residential property. As well as abolishing the 10% wear-and-tear relief for furnished lettings from next April, the Chancellor also announced a deferred and staged reduction in the maximum amount of tax relief on finance costs. At present all interest for purchasing buy-to-let housing is fully tax-relievable against rental income, so if you are a higher rate taxpayer, the interest you pay benefits from 40% tax relief. In 2017/18, 75% of your interest will be fully relievable and a quarter will be relieved at only basic rate. In 2018/19 the split becomes 50/50 and in 2019/20, 25/75. By 2020/21 the tax relief you will receive will be limited to basic rate on all interest.

The way this will be achieved has now been made clear in the Finance Bill. The basic rate relief will be given as a tax credit rather than allowing a proportion of the interest to be offset against rental income. This may sound an arcane difference, but it could be costly for some buy-to-let investors because it increases their total net income figure. The example below shows the effect on child benefit tax, but there are similar consequences for phasing out of the personal allowance and loss of the forthcoming personal savings allowance.

Buy-to-let and increased income

Tom has income from earnings and non-property investments of £45,000. He also owns a buy-to-let property which produces £15,000 a year rental income after fees, but before deduction of £11,000 a year mortgage interest. In 2016/17, his net taxable income is £49,000 (£45,000 + £15,000 - £11,000). As this is under £50,000, he is not subject to the child benefit tax charge.

In 2017/18, the new rules for buy-to-let interest relief start to be phased in and only 75% of the interest is allowable against the rent. All other things being equal, Tom's net taxable income thus rises to £51,750 (£45,000 + £15,000 - £11,000 x 75%) and he starts to be liable for some child benefit tax charge. By 2020/21, none of the interest is allowable and Tom's net income is £60,000, at which point the child benefit tax charge is equal to 100% of the child benefit).

Buy-to-let has been a popular investment, but this latest twist is another reminder that the tax benefits will not be as good in coming years.

The value of tax reliefs depends on your individual circumstances. Tax laws can change. The Financial Conduct Authority does not regulate tax advice.