Section 24: relief for finance costs related to residential property businesses

Introduction

Some of the worst tax legislation comes from the perception of a public outcry responding to an apparently over-lenient tax treatment of a transaction or activity. One area which invariably features highly in the public mind-set is residential property. Property owners are usually delighted that the home they live in has significantly risen in value since they purchased it and are well aware that this is a tax-free capital gain if they were to crystallise the gain. However, the public also recognise that the route to home ownership for those who are not already home owners—including their children—becomes increasingly difficult as house prices rise ahead of incomes and the opportunity to save a sufficient deposit is often problematic. Accordingly, it is understandable, if not necessarily logical, that the much smaller group of individuals who own residential property for its rental return and capital growth become a focus for solving this complex economic conundrum.

The tax legislation contained in section 24 of the Finance (No.2) Act 2015 (F (No.2) A 2015) seeks to reduce the tax relief available against rental income from residential property to basic relief only so that, broadly, higher rate and additional rate taxpayers do not benefit from a higher 40 per cent or 45 per cent taxpayer "subsidy" and the effective relief is limited to the 20 per cent basic rate of income tax. The key tax technical rules are discussed below in much more detail.

The economic factors

To believe that reducing the tax relief for one group of individuals, the buy-to-let landlords, will automatically assist another group of individuals, the owner-occupiers, has superficial attractions. However, few economic outcomes are so straightforward and this is certainly not one of them. The price of goods is almost invariably determined by the supply and demand for them. It is rarely sensible to focus exclusively upon one of these determinants to the exclusion of the other and there are often complex relationships between the two. Most individuals may prefer to be an owner-occupier rather than a renter in the long-term but their preferences are influenced by a variety of external factors including, but by no means limited to, the stage of their career, their job prospects, their personal life and their other financial priorities. At the margin, it is often a fine balance between preferring home ownership to renting.

The limitation on the tax deduction for interest costs for buy-to-let owners means that it is highly probable that some will dispose of their existing properties and that more will choose not to acquire new properties. The removal of demand from the market and the increase in supply of properties from buy-to-let owners wishing to sell their properties could well reduce the price of houses for potential owner-occupiers but it could also reduce the supply of new build properties as there will be fewer potential buyers. This could result in higher rents, fewer new properties being built or both. Both of these could lead to higher prices in the near future, that is, exactly the opposite of what the Government appears to want.

The broader taxation perspectives

To those who favour tax simplification, new deviations from taxing the accounting profit ought to be generally viewed with concern and as being, prima facie, undesirable.

Such deviations introduce the risk that taxation may arise where an economic loss has been made and, more generally, that the taxation burden becomes less related to the true profits of the activity. Whilst such deviations have been introduced both for a small number of business activities (for example, the taxation of banks) and to control the level of tax deductions available (for example, the replacement of depreciation by capital allowances), it introduces further complexity and uncertainty into tax legislation.

Of particular relevance for residential property investment, it is often the case that smaller development activity undertaken by a property developer in their individual name includes some commercial real estate, some residential property for resale (unaffected by section 24 F (No.2) A 2015) as well as development intended for long-term renting. Such mixed-use development activity will face some complex issues in determining the tax deductibility of financing costs. This might lead to developers favouring sites excluding rental development or needing to "price-in" any additional costs (including taxation) of utilising a corporate structure where the development scale might not otherwise require it.

Relief for finance costs related to residential property business: the legislation

Summary

The legislation only applies to the calculation of property business income (as defined in Part 3 of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA). The rules apply to individuals with modifications for property businesses operated through a partnership with individuals. The rules explicitly do not apply to a property business carried on by a company (unless, of course, it is acting merely in a fiduciary or representative capacity).

Method of restricting deductions

The legislation is drafted so as to disallow all "costs of a dwelling related loan" from tax year 2020–21 (transitional rules, as set out below, apply in the period 2017–18 to 2019–20). New Section 272B ITTOIA defines the meaning of costs as interest on a loan, an amount that, in the hands of the person receiving it, represents a return economically equivalent to interest or the incidental costs of obtaining finance by means of the loan (as defined by section 58(2) to (4) ITTOIA).[1]

A "dwelling related loan" means so much of the amount borrowed as is referable on a just and reasonable basis to so much of the business that is carried on for the purpose of generating income from land which consists of a dwelling house (together with any related gardens or grounds) or part of such a dwelling house or an estate, interest or right in or over land with a dwelling house or part of a dwelling house.[2] The definition can also restrict relief for interest on loans taken out to acquire assets used in the property business such as equipment used for maintenance of the dwellings. Dwelling related loan costs are allowable however to the extent they relate to a commercially let furnished holiday accommodation business.

It is also important to emphasise that the rules are not intended to restrict interest in relation to calculating the profits of a property development for sale business or a property dealing business although such businesses may be affected to the extent they have residential letting income.

[1] ITTOIA new s.272B(5)(a)–(c).
[2] ITTOIA new s.272B(2).

Transitional rules

The transitional rules progressively disallow a greater percentage of the costs of a dwelling related loan. Accordingly the percentage of these costs that is allowable in each tax year is as follows:

- 2017–18: 75 per cent
- 2018–19: 50 per cent
- 2019–20: 25 per cent

To the extent an amount is disallowed, relief is available in accordance with the new rules which are intended, broadly, to give basic rate tax relief for the disallowed costs of a dwelling related loan. However, these rules contain certain complexities.

A simple example: Robert

Robert has a number of residential properties which generate income in 2017–18 of £20,000 after personal allowances and interest of £10,000. As this is a transitional year he will disallow 25 per cent of his interest costs making his revised property business income £22,500. However, against his increased income tax bill Robert will be able to set 20 per cent of £2,500, that is, £500.

A more complex example: Vanessa

Vanessa has a large portfolio of residential properties. In 2018–19 she made a loss of £30,000 after carrying out various repairs and after deducting interest of £50,000. For 2019–20 she has net rental income of £80,000 (again after deducting interest of £50,000) and she has other income equal to the basic rate band after personal allowances.

In 2018–19 only 50 per cent of the interest she pays will be allowable so that her property business income calculation will result in a loss of £(5,000) (that is, £30,000 minus 1/2 x £50,000). As Vanessa has not suffered income tax on her property business, she is not entitled to any tax reduction. This is because the relief is calculated in section 274(3) ITTOIA as tax at the basic rate on the lower of the restricted interest, £25,000, and the taxable profits of the property business, £nil. As a result there is a loss carried-forward of £5,000. Section 274A(5) ITTOIA introduces a further relief where the relievable amount has not generated a tax reduction that gives rise to a carry-forward of, in this case, £25,000.

In 2019–20, 25 per cent of the interest will be allowable so that Vanessa will calculate her income tax on profits of £117,500 (£80,000 plus 3/4 x £50,000) less the loss carried-forward of £5,000 resulting in net taxable profits of £112,500. She will be entitled to a tax reduction of 20 per cent of £62,500 (being the disallowed interest of £37,500 plus the carry-forward amount of £25,000) or, if lower, the taxable profits (which in this case is the aforementioned £112,500).

There is a further restriction introduced where the individual's gross finance-costs relief for the year (GFCR) is greater than the individual's adjusted total income for the year (ATI) as defined by section 274A(6) ITTOIA (total income less dividends, interest, certain allowances and GFCR) and GFCR is the gross amount, as calculated in section 274A(3) ITTOIA. Where this applies the relievable amount is given by the calculation:

ATI/GFCR x (BRxL)

Applying this to Vanessa in 2019–20 (ignoring allowances) she has GFCR of £62,500 and ATI of £117,500. Accordingly, the calculation is not applicable as her GFCR does not exceed her ATI.

Accumulated or discretionary trust income

At the Committee Stage, section 274B ITTOIA was introduced to calculate a tax reduction along similar lines to an individual so that basic rate income tax relief should be available to trustees.

Partnerships

Section 399A of the Income Tax Act 2007 (ITA 2007) restricts relief in a similar way for loans taken out to acquire an interest in a property letting business under sections 383(1) and 399B ITA 2007.

Conclusion

In the writers' view, there are four issues which arise from this legislation (but we accept that other economists and tax advisers might identify other concerns). These are:

1. Will the intended economic consequences, including the market becoming friendlier to owner-occupier purchasers in the long-term, be delivered?
2. Will the market be disrupted in an unintended and adverse manner because of the unpredictable decisions made by existing (and potential) buy-to-let owners?
3. Will the overall approach of replacing an interest deduction by a tax credit restricted to basic rate create confusion amongst taxpayers (many buy-to-let owners will not have tax advisers) leading to compliance and assessment errors? (It has already been pointed out that the interface between this legislation and the claw-back of the financial advantage of the child benefit and the personal allowance can produce some unexpected outcomes.)
4. Will this approach be copied for other economic activity which is not considered favourably by a future government?

Hopefully, the writers will be forgiven for suggesting that the legislation ought to be referred to the Office of Tax Simplification immediately after its enactment to identify how it can be improved and simplified.

Stephen Herring[*] and Robin Hutton[**]

Buy-to-let lending; Reliefs; Rent; Residential property

[*] Head of Taxation, Institute of Directors.
[**] Tax Director, Real Estate and Construction, BDO LLP, London.