LITRG highlights how finance cost restrictions in computing rental profits can affect low-income taxpayers

Personal tax

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Since 6 April 2017, where an individual lets out residential property (other than furnished holiday lets), deductions for finance costs such as mortgage interest are restricted to allow relief only at the basic rate of tax rather than an individual's marginal rate. However, the change – aimed at higher and additional rate taxpayers – has knock-on impacts for individuals on lower incomes. You should make sure you can explain them to your clients, as appropriate.

The issue arises from the fact that the finance costs are disallowed in calculating an individual's rental profits and relief is only given as a tax reduction in Step 6 of the calculation of income tax liability under ITA 2007 section 23.

Higher taxable income could mean higher student loan repayments, even for a basic-rate taxpayer. In certain circumstances, it could also mean that an individual who has adjusted net income which is otherwise less than £50,000 may be pushed within scope of the high income child benefit charge. It could also affect the amount of income needed to be declared for child maintenance purposes, although LITRG successfully campaigned for the changes to be disapplied for tax credits purposes.

LITRG has become aware of a further instance where the changes could affect someone unexpectedly. Assume an individual has gross property income of £17,500, finance costs of £6,000 and other expenses of £3,000. Suppose also that this individual has pension income of £4,000 and savings income of £6,000. Under the 'old' rules, the rental profit of £8,500 and pension income would have fallen within

the personal allowance (which assume is £12,500 in this example) and the savings income would benefit from the full £5,000 starting rate for savings and £1,000 personal savings allowance, meaning no tax is due.

If the finance costs are disallowed in computing the rental profits, the rental profit would instead be £14,500. After adding the pension income (£4,000) and deducting the personal allowance (again, £12,500), £6,000 would be taxable at 20%. This will be covered by the 20% tax reduction for the finance costs. However, as this individual will now have a higher taxable non-savings income, they will no longer be able to benefit from the starting rate for savings, meaning only £1,000 of the savings income is tax free (as a result of the personal savings allowance). The rest (£5,000) is taxable at 20%. This means their total tax liability will be £1,000.

Although it may seem incongruous for a taxpayer to have significant savings income yet also have a mortgage on a rental property, in practice we think there may be people caught out by this. Pensioners, for example, with some savings and investments, may have decided to supplement their state pension income with a small buy-to-let property. This is very worrying, given the starting rate for savings was intended to benefit this population. With mortgage providers lending for increasingly longer terms and the changes to take full effect from 2020/ 21, such circumstances as described above may become more common.

It is not clear to us whether these interactions were known consequences of the rule changes. We have highlighted these concerns to HMRC and asked whether a concession (or at least better guidance), may be in order. Meanwhile, it would be very useful if any advisers might share with us any experience they may have had of these interactions.