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Tax aspects of property letting

There are many issues for the prospective investor to take into consideration before deciding to plunge into property letting. Good impartial advice is needed from lawyers, banks and surveyors. This briefing assumes that specialist advice has been taken and will concentrate on the tax aspects involved in the purchase, letting and sale of let residential property. It will also consider the options available for holding property.

Buying UK property

Stamp Duty Land Tax (SDLT) must normally be paid by the purchaser of the property within 30 days of completing the purchase. The rate of the tax is determined by the value of the property and SDLT is payable on its full value at the rate of the band into which it falls. The rates currently vary between 0% and 4%.

Where the purchase price includes fixtures such as carpets, the purchaser is responsible for establishing a 'just and reasonable' apportionment of the sale price between the property and the fixtures. No SDLT is due on fixtures.

Letting property in the UK

The letting of property in the UK is treated for income tax purposes as a UK property business. Where more than one property is rented out, the letting of all the properties is treated as a single business, which allows a loss made on one property in a year to be effectively set against profits made on others. No distinction is made for these purposes between property let unfurnished and furnished, except for the special rules which apply to furnished holiday lettings (see overleaf).

Make sure record keeping is good

Accounts should be prepared for the business in accordance with generally accepted accounting principles, although in most cases this should simply mean making sure that all rental receipts have been recorded and only expenditure of a revenue nature has been deducted in arriving at profits.

Receipts

Rents should be included on the basis of the sum actually due for the tax year. This means that any rent paid in advance that relates to a period after the end of the tax year should be brought into account not when it is received but in the following tax year. If you exclude such a receipt in year 1 make sure you remember to pick it up when you prepare your figures for year 2.

Expenses

You can claim expenses which are revenue in nature. Capital items cannot be claimed directly against income although some other relief may be available. You must also show that the expense is incurred 'wholly and exclusively' for the purpose of the letting business. If an expense has a personal element, it is generally apportioned, with only the business element allowed as a deduction.

Typical expenses that can be claimed will include:

- advertising for tenants (but not for sale)
- agents' fees in relation to the letting but not the purchase or sale
- expenditure on maintaining common areas of a building
- fees in respect of finance arrangements
- interest on borrowing to fund the purchase (don't simply claim the total sum payable to the lender in the year as this will probably include some capital repayment as well)
- expenditure on various forms of insulation (ie loft) can be claimed up to 1 April 2015 (there are some restrictions on this so you need to check carefully)
- any expenditure on services such as gardening or cleaning that you agree to provide.

Expenditure on the building

There may be a particular issue in dealing with expenditure on the fabric of the property. A repair can be deducted from income but where there is a clear element of improvement that takes the property beyond its original condition, then the repair will be regarded as capital and cannot be claimed against income.

Common items of repair that can usually be claimed will include:

- exterior and interior painting and decorating
- repointing brickwork
- damp and rot treatment
- mending broken windows, doors, furniture and equipment such as cookers
- replacing roof tiles, flashing and gutters.

Where expenditure is clearly of a capital nature and results in an improvement to the property, it may be possible to claim the cost of it in calculating the capital gain when the property is sold. Improvement expenditure is deductible against the gain, provided it is still reflected in the state of the property at the time of the disposal.

Expenditure on furniture and fittings

The capital allowance rules that give some deduction for plant and machinery expenditure do not generally apply to the rental of residential property.

Where a property is let on a furnished basis there is an optional allowance towards the cost of furniture. HM Revenue & Customs (HMRC) allow a 10% deduction of the net rents to

cover the wear and tear on furnishings such as carpets, beds, settees etc. Net rents means the rental income less certain costs incurred by you as landlord but which are normally incurred by the tenant - essentially council tax and water and sewage rates. There is no requirement to demonstrate actual expenditure on the replacement of these items.

As an alternative, where the property is let furnished, the landlord can claim a renewals allowance when furniture and fixtures such as baths etc are replaced. The allowance cannot cover the original cost of the item, nor can it include any improvement element in the replacement. This latter relief is also available on fixtures where a property is let unfurnished.

Capital gains on the sale of the property

When the property is sold there may be a liability to capital gains tax (CGT) on the disposal. The gain is calculated by deducting from the sale proceeds:

- the original cost of purchase
- the incidental costs of purchase and sale such as legal costs and estate agents' fees
- any improvement expenditure which is still reflected in the state of the property.

Where the property that is being sold has also qualified at some time during the ownership of the vendor as their only or main residence, part of the gain may be exempt. In addition a letting relief of up to £40,000 may be claimable. Note that this is generally available to anyone with a share in the property meaning a couple, even if married, could potentially qualify for relief up to £80,000.

Any gains above the annual exemption which is currently £10,100 will attract CGT at a rate of 18% (subject to any Budget changes on 22 June 2010).

Furnished holiday lettings (FHL)

Special rules often perceived as tax advantageous have been in operation for many years where a property letting qualified as a FHL. The Labour government had announced that these tax rules would be repealed generally from the 2010/11 tax year but the legislation was not passed before the General Election got underway.

Comment

Although the outcome of the election is now known, uncertainty remains as to which aspects of taxation policy will prevail and specifically the eventual treatment of this category of letting. The continued delay in legislating the repeal proposals means there are two key issues:

- whether any change can be operative for 2010/11 and
- whether the changes will go ahead as currently proposed.

The coalition government may amend the proposals or even scrap them altogether and as this would inevitably lead to a further time delay before such changes are introduced into tax law, implementation for this current tax year 2010/11 looks less likely. It will be essential to monitor developments in this area so please contact us for any new announcements before considering key transactions.

In the meantime, the current rules in force are detailed below.

What are the conditions for special treatment?

The rules apply to the commercial letting of FHL accommodation in the European Economic Area (EEA). This means that letting simply to family members or friends will not qualify unless they pay a commercial rent. In order to qualify the property must be:

- available for holiday letting to the public on a commercial basis for 140 days or more, and
- let commercially for 70 days or more, and
- not occupied for more than 31 days by the same person in any period of seven months.

The period by reference to which those limits must be considered will normally be the tax year. Special rules apply at the start and end of lettings.

If you own more than one FHL, you can claim to calculate the 140 and 70 day limits, based on the average for all the properties you own, in order to satisfy the test.

Advantages

- A qualifying loss on FHL can generally be set against other income (including non property income) of the same year and/or preceding tax year.
- A qualifying loss made in the first four tax years of letting may be carried back up to three years against general income.
- Income from this source can be used to calculate entitlement to tax relief on pension contributions.
- Capital allowances on qualifying plant and machinery (including furniture) for use in a FHL are available.
- Capital gains made on the sale of a FHL can be 'rolled over' against the cost of buying another similar property (or any other qualifying asset used in a trade) purchased up to a year before or three years after the date of sale.
- If a property is gifted, a claim can be made to 'hold over' the gain so that it does not become due until the recipient sells it.
- Capital gains arising on the disposal of FHL businesses are eligible for Entrepreneurs' Relief. The effect of the relief is to reduce the gains qualifying for relief by an amount which results in an effective CGT rate of 10%. There is a lifetime limit of £2 million of gains that qualify.
- For inheritance tax purposes it may be possible to claim a reduction of up to 100% in the value of the property passing on death or on a chargeable transfer (this is subject to conditions which HMRC impose).

If you own FHL properties as well as other let properties you are required to keep the activities separate for the purposes of calculating income and establishing available reliefs.

Rent-a-room relief

In circumstances where a home owner lets part of their home to a lodger, rental income is only chargeable to income tax where the income from the property as a whole exceeds £4,250. In this situation no expenses are tax deductible. If more beneficial, expenses can be deducted from income under the normal rules as described above.

Student lettings

If you have children at university or college then consideration could be given to them acquiring a property (with you acting as guarantor to the mortgage). Spare rooms could then be let to other students in order to fund the mortgage repayments. Rent-a-room relief, as described above, would be available in these circumstances.

When the property is sold providing that it is their only property, it will be regarded as their main residence and any gain would be exempt from CGT.

Alternative routes for holding property

So far this briefing has assumed that the property is owned by individuals who are liable to income tax and CGT in the UK, which can mean a current liability of up to 50% on income and 18% on gains (subject to any Budget changes). Obviously some reduction in liability can be created by having joint ownership with individuals who are either not liable to tax or pay at a rate below 50%. Other routes are available to hold property but there are issues which need to be carefully considered.

Using a company

Rental income in a company will usually be taxed at the small companies rate (currently 21%). This seems to be attractive when set against a potential 50% rate for an individual. If rents are significant this may be an option to consider although there are additional compliance problems to deal with, not least Companies Act requirements.

From a tax viewpoint it must be remembered that income has to be extracted from a company by an individual generally either as salary or dividend and that this may trigger a tax liability. It is also important to remember that when a property is sold by a company any gain is generally only reduced by an inflation allowance. Other reliefs are generally not available. The gain (after CT) then has to be extracted from the company at a further additional cost.

Using a trust

There may be estate planning opportunities to consider in using a trust to hold rented property. The type of trust will determine the income tax rate but this could be 50% and the CGT rate for all trusts is currently 18%. However, the assets in the trust may be effectively placed outside any individual's estate for IHT purposes, which may give some significant tax savings over a long period.

There are many issues to consider here and this is an area where specialist advice is needed. Please talk to us if you would like to discuss any of the matters raised in this briefing.

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