Business tax

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Buy to let properties

Recent years have seen many challenges faced by those investing in 'buy to let' properties, not least increasing tax liabilities, additional regulations, restrictions on tenant fees and slowing rental yields. However, with continuing low interest rates, the potential for rental returns to be supplemented by capital growth and, for some, a belief that investing in bricks & mortar is safer than the stock market, buy to let properties are still a popular choice for many investors.

This factsheet considers the position of landlords who are UK tax resident individuals with let residential property. Similar rules apply to companies, with the main differences being in the treatment of interest and losses.

Calculating the rental profit or loss

Since the 6 April 2017, taxable profits or losses are calculated on the 'cash' basis; although the landlord may elect to continue to use the 'accruals' basis, if they wish.

If the total income of the property lettings business exceeds £150,000 the landlord must calculate taxable profits or losses on the 'accruals' basis.

Cash Basis

The cash basis for many landlords will be the simplest method for calculating the taxable profits or losses, as they will only be required to take account of the actual rents received and costs paid in the tax year. Therefore, if a tenant is in arrears the income will only be taxable once it has actually been received. This can give a cash flow advantage over the accruals basis, which would recognise the income when it is due, rather than received.

Accruals Basis

Broadly, the profits of the property letting business are calculated in the same way as a trading business, i.e. rental income and costs are taken into account for the period to which they relate, which will not necessarily be when they are received or incurred. For example rent is taxed when due and the cost of insurance straddling two tax years should be time apportioned, etc.

In order for an expense to be allowable for tax purposes it must be incurred wholly and exclusively for the purpose of the business and must not be of a capital nature, for example extensions, conversions and improvements.

Allowable costs may include (this list is not exhaustive):

- Finance costs (subject to the restrictions described below)
- Repairs, maintenance and insurance
- Directly related services paid for by the landlord, such as internet, cleaning and gardening
- Utilities paid for by the landlord
- Advertising for tenants
- Management costs
- Replacement of Domestic Goods (as explained below); and
- Legal fees (of a 'revenue' nature, not 'capital')

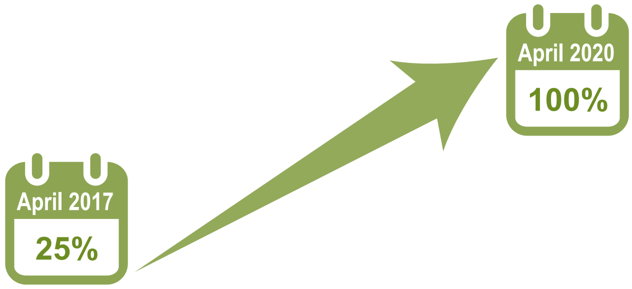
Different rules apply to furnished holiday lettings and to the letting of rooms within the landlord's own home and these are not covered by this factsheet.

Finance Costs

This includes interest and charges paid on a mortgage, or loan, used to acquire or improve a let property and the allowable costs are usually straightforward to identify.

However, it may also be possible to claim a deduction for costs relating to other borrowings, where it can be shown that the funds were used in the rental business, or where there is equity in the property transferred into the rental business.

This is a technical area and the allowable costs are more difficult to identify, which is why this potentially valuable claim is often overlooked.



Finance costs – restriction on relief

The restriction is being phased in over four years and, whilst finance costs will continue to attract a tax adjustment, in many cases the value of the relief will be significantly lower than before the restrictions were introduced.

For the tax year ended 5 April 2020 landlords will only be entitled to deduct 25% of their finance costs directly against their rental profits (50% for 2018/19). The remaining 75% will generate a credit, or tax reducer, at the Basic Rate for Income tax (currently 20%). By 5 April 2021 there will be no direct deduction for finance costs.

If the landlord's total income after the adjustment remains within the Basic Rate tax band they will see little or no impact on their tax position. However, for some the restriction will push them into a higher tax bracket, or cause them to lose valuable Child Benefit, or the tax-free Personal Allowance, or all of these, which may be catastrophic to the property letting business. Careful planning is essential.

In certain circumstances it will not be possible to claim the tax reducer, for example in a period where there is a loss, as the credit may not be used to reduce the tax arising on income from another source. If so, the unused relief will be carried forward for use in subsequent years.

Capital Allowances

Capital allowances are available in calculating the profits of a property business, but only in respect of items of plant and, or, machinery used in communal areas (eg. lighting, signage, or cleaning equipment), or for the business as a whole (eg. a van, or lawn mower used for multiple properties, etc.). Capital Allowances are not available for items used within a single dwelling, such as furniture, furnishings and kitchen equipment.

Replacement domestic items

When replacing items within a single dwelling, such as furniture, furnishings, household appliances and kitchen equipment, the full cost may be deducted in the year of purchase, subject to any element of improvement. No relief is available for the cost of the original item, only the replacement. If items are introduced to the letting business, say from the landlord's own home, that were purchased prior to the business commencing these will not qualify for a deduction, but, subject to any improvement, the replacement will.

A deduction is also available for the incidental costs of disposing of old items, less any proceeds received, and the installation of new ones.

The use of losses

In general, losses of a property letting business can only be carried forward for use against future profits of the same business. Where a property owner has UK and foreign properties these are treated as separate property businesses and the losses from one may not be used against the profits from the other. To the extent that the losses are attributable to certain capital allowances it may be possible to set them against general income of the year of the loss, or the following year, but given the limited scope for claiming capital allowances this situation arises only rarely.

Capital Gains Tax (CGT)

On the disposal of a property, which may be a sale or a gift, the gain will be subject to CGT, unless during ownership the property was only ever used as the owners only, or main, residence. Where there has been mixed use, owner occupation and lettings, the property is likely to qualify for periods of Principle Private Residence exemption (PPR) and, potentially, Let Property Relief of up to £40,000.However, these reliefs are under attack.

As long as the property has qualified for PPR exemption for any length of time during ownership, it will also qualify for a further period of exemption covering the final 18 months of ownership. This period is being reduced to 9 months, unless the owner is moving into residential care. Furthermore, let property relief will only be available for periods where the property was let and the owner of the property was in shared occupancy of it with their tenant. At present there is no requirement for the owner to be present during the time the property is being let.

Both changes are being introduced from 6 April 2020 and an urgent review of the potential value of accumulated reliefs should be made in order to plan effectively.

As highlighted by a number of recent tribunal cases, it is important to seek professional advice on what qualifies as main residence.

In addition to the above, the Annual Exemption for CGT is available (£12,000 for 2019/20) and if the property is in joint names each owner will have their own exemption to use against their share of the gain.

For residential property CGT is charged at 18%, within the Basic Rate band, and 28% to the extent that the owners taxable income and gains, when added together, extend into the Higher Rate band (£37,500 for 2019/20). Properties that meet the strict criteria for furnished holiday lets (FHLs) may qualify for Entrepreneurs' Relief, reducing the CGT rate to 10%, irrespective of the level of other income and gains.

The qualifying conditions for FHLs have become more onerous and careful planning is required to maintain this status, in order to qualify for Entrepreneurs' Relief

Stamp Duty Land Tax (SDLT)

When purchasing a buy-to-let property a key factor to consider is the SDLT payable. SDLT is applied on a sliding scale depending on the value of the property and should be factored into the viability study.

In addition, a 3% surcharge is applicable to properties acquired where one or more of the purchasers has a beneficial interest in one or more other properties. This can be a significant additional cost for the property letting business when landlords are looking to expand their property portfolios.

We have been appointed to advise on and 'fix' a number of cases where the amount of SDLT was incorrectly calculated by the original adviser. This is a technical area and requires specialist advice.

Inheritance Tax (IHT)

The assets in a property letting business form part of the owner's estate for Inheritance tax purposes. Subject to any directly attributable borrowings, the assets will augment the value of the estate for calculating Inheritance tax. If the total value of the estate exceeds the nil rate bands and transferable nil rate bands available Inheritance tax may be payable on the excess.

Jointly held property

If the property is owned in joint names by spouses, or civil partners, the income is deemed to be split equally between them tax purposes. If the couple actually own the property in unequal shares they may elect for the tax treatment to follow their beneficial interest. This could enable the couple to make better use of their tax-free Personal Allowances and lower rate tax bands. The beneficial interest in the property for Income tax purposes is also likely to affect the position for CGT treatment.

This is a technical area and requires specialist advice before any changes are made.

Limited Company

Owning a property portfolio through a limited company has, for some, become more attractive. However, a viability study is required to weigh any apparent tax savings against potential additional tax charges and costs, especially where an existing portfolio is to be transferred; including Annual Tax on Enveloped Dwellings (ATED), SDLT, CGT, 'double' tax charges on extracting income and gains from the company and professional fees associated with a corporate structure.
This is a technical area and specialist advice is essential, especially in cases where a property portfolio is to be transferred to a company.

Making Tax Digital (MTD)

Property owners may keep their records in a variety of ways; from paper records, spreadsheets to sophisticated accounting software, and these records are used to prepare the annual SA tax return.

Under the proposed rules for MTD, the Government will require landlords to maintain their records digitally and to report summary information to HMRC on a quarterly basis, with a final 'end of year' summary being required to confirm the taxable profit, or loss.

This initiative was due to be introduced in April 2018, but was postponed until April 2021 at the earliest. If it is introduced, it is expected there will be a threshold under which a landlord will not be required to file under MTD, however you are likely to be able to do so voluntarily, if desired.

Even with MTD being delayed, landlords may wish to consider the benefits of maintaining their records digitally; using spreadsheets or one of a number of accounting solutions available. These products can help to maintain up to date records and provide valuable reporting, to help with budgeting, credit control, cash flow and cost analysis, providing information to third parties, including the bank and tax adviser for the end of year return, etc.

Conclusion

With continuous changes to the tax system and the introduction of new, complex rules and criteria, it is now more important that ever for landlords to be aware and understand the rules and the potential impact on their tax position; simply to correctly calculate their tax liabilities and accurately plan for the future.

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