GUIDE TO TAXATION FOR LANDLORDS

This guide has been written by Young & Co. Chartered Accountants and Registered Auditors, as a simple guide to aspects of taxation that landlords might face. It covers most common areas of UK taxation but since the UK has one of the worlds most complicated tax codes, it cannot be fully comprehensive and neither does it cover some of the more unusual or complicated aspects of taxation. When it comes to taxation, everyone's case is unique and sometimes what is good advice for one taxpayer is wrong for another. We recommend that if you are not sure about anything, or if you want more detailed advice that is tailored to your particular situation, you should consult a suitably qualified accountant or tax advisor. Therefore no liability can be accepted for any loss resulting from reliance on the contents of this booklet.

The advice in this booklet is based on legislation and tax case law as at July 2014. Be aware that rules do change from time to time, so it is worth taking the time to keep up to date with changes that may affect you in future years.

CONTENTS

1. Getting started – the basics

a. Basics of Income Tax

Income from land and property is subject to Income Tax. Tax law requires that each taxpayer calculates their rental profits, defined as taxable income less allowable expenditure, and declares them to H M Revenue & Customs ("HMRC"). Profits are always calculated for the tax year which runs from 6 April to 5 April next.

Profits have to be calculated on the "accruals" basis in line with UK Generally Accepted Accounting Principles. In simple terms this means that the income included in your profit is income due for the tax year (not just what was received), and expenditure is the costs incurred (not just what was paid). So if a tenant owes you for rent on 5 April then you must include that rent. Conversely, if a tenant has paid rent in advance, you can carry forward the proportion of rent relating to the period after 5 April to the income of the next tax year. Similarly, if you owe a tradesman for work done at 5 April you can include this as an expense, but a proportion of expenses paid in advance, such as insurance for example, should be carried forward to the next year. It is obviously important that you keep good records of how you have calculated your income and expenditure.

Property rental is treated as a single "business". This means that if you have more than one property you pool all of the income and expenditure to give a single profit or loss.

If you own property jointly with someone else, you are each treated as having your own separate property business, even if you only share the same properties. The income and expenditure for each property is split in the same proportion as the ownership of the property and allocated to the individuals. The individuals are then taxed according to their own circumstances. There is an assumption of an equal split unless otherwise specified in the property title.

If you already complete a tax return then you will need to include your rental income and expenditure on the Land and Property pages of your self-assessment tax return. If you don't complete a tax return you need to inform HMRC that you have a new source of income by 5 October following the tax year during which the income started. Beware - there are penalties for late notification. Notifying HMRC is easiest to do using their form SA1, which is available to download from their website. Keep a copy of the form in case they lose it.

The Land and Property pages are fairly simple to complete. There are two sections, one for holiday letting and another for all other rentals. HMRC produce a guide on how to complete the Land and Property pages as well as helpsheets for particular issues.

You need to file your tax return by 31 October following the tax year if you use the paper return, or by 31 January if you file online. There are penalties if you file your return late. The idea of the self-assessment tax system is that you provide all the information required on the return to calculate the tax liability. However, HMRC can enquire into your tax return at any time in the 12 months after the 31 January filing deadline. This may take the form of specific questions, or it may be a full enquiry where they want to see all of your records.

You need to bear in mind that if there is an error in your tax return that is found by HMRC, penalties may be charged of up to 100% of any tax that is due for serious evasion (or even 200% if you have tried to conceal the income in an offshore tax haven). However, as long as you can prove that you have taken reasonable care to get things right, the penalty can be reduced to nil.

Tax is payable on 31 January following the end of the tax year. If your tax liability is significant then you may be asked to make payments on account towards the following year's liability. The payments on account are 50% of the tax liability for the previous year and are paid on 31 January in the tax year and 31 July following the end of the tax year.

Example: your tax liability for the year to 5 April 2014 is £3,000. You have to pay this amount on 31 January 2015 plus a further £1,500 for the first payment on account for the year to 5 April 2015. The second payment on account is £1,500 and this is due on 31 July 2015.

Under certain circumstances, the Revenue will not require you to complete a tax return. If you are employed and the annual profits are less than £2,000, they may send you a form each year on which you need to give your rental profits. This is used to adjust your PAYE tax code in order to collect the tax that you owe through the PAYE system. If you would prefer to complete a tax return then you can still request one.

b. What records should I keep

You need to keep at least basic records to prove your income and expenditure. If your property is managed by an agent, then you will receive regular statements showing the rent received, any expenses incurred by the agent and the management fee. If you manage the property yourself, keep copies of the tenancy agreements or some other record of income. If you pay for expenses yourself make sure you keep the invoices or receipts. If you have a mortgage or loan, make sure that you keep the statements.

There is no requirement to have a separate bank account for the rental property activity, but many landlords find it easier to keep things separate from their personal or other business transactions.

HMRC expect taxpayers to keep records for the previous six tax years, so you should retain records for at least this period of time. Ideally, we would recommend that you keep all records for a property for as long as you own it since you will need to know some details, such as the original cost and the cost of any improvements, for Capital Gains Tax purposes when you come to dispose of the property.

In short, the better the records you keep, the easier it will be to work out your income and expenditure at the end of the tax year and if necessary prove the figures should HMRC enquire into your tax return. If this is not a sufficient incentive, there are penalties for not keeping adequate records.

2. What is income and expenditure for tax purposes?

a. Income

The main type of income from land and property is rent receivable. However, there may be other types of income that you have to include. A tenant may pay you a premium for the lease (an additional payment in return for your granting a lease) although this is more common with commercial property. If a tenant wants to end a lease early, they may pay a surrender premium. If the property has a gas or oil tank, don't forget that if a tenant pays you for the contents at the start of a tenancy, this will be income.

If you make a claim on your landlord's insurance that pays you for loss of rent, then this also is income.

Deposits from tenants are <u>not</u> income. However, if you retain all or part of a deposit at the end of a tenancy then this becomes income.

b. Expenditure in general

You are allowed to claim as an expense any costs that are directly related to the rental property. However, expenditure falls into two categories – capital and revenue. Only revenue expenditure may be claimed against income on your tax return. Capital expenditure can only be claimed against the sale proceeds when you dispose of the property (see Capital Gains Tax below).

Examples of typical expenditure are:

- Insurance – buildings, contents or landlords insurance;
- Council tax – if not paid by a tenant;
- Utility bills – again, if not paid by a tenant;
- Property maintenance – e.g. gas or electric safety checks, repairs and maintenance of the building;
- Bad debts – any rental income that you fail to collect can be treated as an expense;
- Management charges – fees charged by a letting agent for managing the property and arranging new tenants;
- Legal fees – for dealing with the property or with tenants, for example (but not for buying or selling the property);
- Finance costs – mortgage and loan interest and charges, including bank charges where you have a dedicated bank account for rental property transactions;
- Accountancy fees – the cost of preparing rental accounts.

c. Particular types of expenditure

There are certain areas of expenditure that have proved to be more difficult or less well understood by landlords over the years.

i) Repairs and renewals

As mentioned above, only revenue expenditure may be claimed against rental income. What is revenue and what is capital exercises many pages of legislation, case law and commentary. This is an area where you may need to take professional advice. However, in simple terms if you are replacing part of the property on a like for like basis, this is probably revenue expenditure. For example, replacement windows, a replacement boiler or a new kitchen may be allowable renewal expenses as long as there is no element of improvement. Creating a new bathroom, adding a conservatory or installing patio doors in place of a window will all be capital improvements and cannot be claimed as revenue expenses. Instead they will form part of the cost of the property for Capital Gains Tax purposes.

It should be noted that by concession replacing single glazed windows with double glazing is allowed as revenue expenditure since double glazing is a requirement of building regulations.

There is an important exception to the general rule. When you first buy a property, any repair costs that you incur before it is first let may well be treated by HMRC as capital expenditure. Their argument is that if the property requires certain repair work when it is acquired then this will be reflected in a lower purchase price and any work that you do to bring it up to an acceptable standard to rent out is therefore part of the initial capital cost. Whilst some work may be essential before a property is first let, some landlords will let a new property for a short period before carrying out work such as replacing the kitchen or bathrooms in order to be able to claim these as revenue repairs.

You also need to be aware that HMRC views major refurbishment work as capital expenditure, even if you are replacing like with like. For example if you have to replace the entire roof, this is so fundamental that it will be treated as capital expenditure.

There is an exception to the rules on capital expenditure for "energy saving" items. Items such as cavity wall, loft, floor and hot water insulation, or draft proofing, are allowable as revenue expenses even if they are capital in nature up to a limit of £1,500 per dwelling per annum. Flats qualify individually as dwellings so a block of three apartments would have a total limit of £4,500. There are certain conditions and restrictions.

ii) Mortgage interest

If you have borrowed funds to purchase your rental property then you are allowed to claim the interest that you pay on the loan. Note that if you have a repayment mortgage, only the interest element of the payments is allowed as expenditure. Repayments of the loan capital are never allowed as expenditure.

It doesn't matter whether the loan is secured on the rental property itself, on another property or is unsecured. It is the purpose that the loan was taken out that makes the interest allowable. For example you may have taken a further advance or a second mortgage on your home in order to fund the deposit for a rental property. As long as you can show that the purpose of the loan was to purchase the rental property then the interest will still be allowable.

You need to take care when arranging your borrowings that you can demonstrate a direct link between the loan and the property. For example, for practical reasons of timing you might use savings to physically pay part of the purchase price and then a few days later take a loan to replace your savings. It is possible that HMRC will not allow tax relief on the loan interest since they will argue that the purpose of the loan was to replace savings and not to purchase the property.

You may decide to release some equity from a rental property by taking a loan secured on the property. Just because the loan is secured on the property does not make the interest an allowable expense. You would only be able to claim the interest as expenditure if you could demonstrate that the loan was used for an allowable purpose, for example major repairs to the property (whether capital or revenue) or the purchase of another rental property.

Sometimes a loan may be used partly for a rental property and partly for private purposes. In this instance the interest needs to be apportioned. If it is a repayment loan, you can't argue that you are repaying the private part first; the interest apportionment will always be on the basis of the initial use of the funds.

You are allowed to re-finance loans. A replacement loan will take on the tax treatment of the original loan. Where several loans are consolidated, or where you borrow extra funds at the same time, then the loan interest will have to be apportioned on the basis of the purpose of the different elements of the loan capital.

iii) **Wear and tear allowance for furnished letting**

If you let a furnished property there is a special concession for the replacement of furnishings and freestanding equipment provided in the house. Until 5 April 2013 you could either use the renewals basis (where you claim the cost of the replacement items as revenue expenditure) or you could use the 10% wear and tear allowance. From 6 April 2013 only the wear and tear allowance is available. The amount you can claim each tax year is 10% of the following amount:

"Total rents received from furnished property, less council tax and water rates, less the cost of any services provided by the landlord that a tenant would normally pay for themselves".

If you claim the wear and tear allowance then you cannot claim the replacement cost of any furnishings or equipment as well (and from 6 April 2013 you cannot claim the replacement cost at all). However, you can still claim for the replacement of fixtures that would not normally be removed by a tenant or owner on vacation of the property (e.g. sanitary wear, kitchen units or sinks). You can obviously also still claim the cost of repairs to the fabric of the building.

If you decide to use the allowance then you have to use it consistently for all furnished properties that you rent out.

d. Losses

As stated above, where you have more than one rental property, it is treated as a single business. Therefore a loss on one property is automatically used against profits on other properties in the same year. However, you may find that you make an overall loss for the year, perhaps due to high finance costs, void periods or exceptional repairs.

The basic rule is that property losses can only be carried forward to be used against rental profits of future years. Losses have to be used against the first available profits. There is no time limit on carrying forward the loss. If the losses are larger than the profit of a later year, the unrelieved losses continue to be carried forward until they are all used.

In general, losses cannot be used against other types of income such as earnings from employment or self-employment, pensions or investment income.

If there are still unrelieved losses when the rental business ceases, they can be set against any income that arises after the business ceases. For example if you manage to recover a bad debt from a tenant or manage to successfully claim compensation for damages. Any excess unused losses are then lost.

3. Capital Gains Tax

Capital Gains Tax (CGT) applies to disposals of property. This is usually a sale, but CGT may equally apply to a gift of property (see below).

CGT is paid on the capital profit that you make on a property. The profit is the difference between the net sale proceeds and the allowable cost. Net sales proceeds are the sale price less any costs of disposal (e.g. agent's fees and legal costs). The allowable cost is the purchase price (or probate value for a property that you inherited), plus any expenses associated with the purchase (e.g. legal costs and stamp duty), plus the cost of any improvements.

Everyone has an Annual Exempt Amount (currently £11,000 for tax year 2014/15). If a property is owned jointly by two or more people they can each use their exempt amount on their share of the capital gain.

Despite being described as a business for Income Tax purposes, the disposal of rental properties never qualify for Entrepreneurs' Relief for the sale of business assets. This means that the normal CGT rates will apply to the profit.

The capital gain (after deducting any capital losses from other assets sold in the year or brought forward from earlier years, and after deducting the Annual Exempt Amount) is added on top of the taxpayer's income for the year. The amount of the capital gain falling in the range of the basic rate Income Tax band is taxed at 18%. Any capital gain falling in the higher rate Income Tax band is taxed at 28%. There is no additional CGT on capital gains falling in the 50% additional rate Income Tax band.

Capital losses can only be used against capital gains of the same year or carried forward against future capital gains. There is no restriction on the source of capital gains against which the losses may be used. For example a loss on a property may be set off against a gain on shares in a later year and vice versa.

Capital gains and losses must be reported on the Capital Gains pages of the self-assessment tax return for the tax year in which they occur.

If the property has been your main home at any time, either before or after you rented it out, part of the capital gain will be exempt from tax under the Principle Private Residence relief (PPR). The capital gain is time apportioned on the basis of the time used as your home and the time it was available to rent. In fact there is an extension to the PPR rule that says that if the property has been your main home at any time, then the last 18 months will also be tax free (this was 36 months before 6 April 2014). By way of an example, if you lived in a property for two and a half years then rented it out for four and a half years, four sevenths of the capital gain is exempt.

Note that if the last 18 months coincides with your occupation of the property as your home, you only get one lot of PPR. So if you rented a property for two years then lived in it for five years, you only get five sevenths of the capital gain exempted under PPR.

In addition there is currently an additional letting relief worth up to £40,000 if you sell a property that has been your home at any time. The capital gain arising as a result of the rental period is reduced by the lesser of the PPR claim and £40,000.

If you are considering making a gift of all or part of a property to a family member, you need to be aware that as far as HMRC are concerned this is deemed to be a sale at market value. This means that there may be CGT to pay on a gift equivalent to the amount that you would pay if you had sold the property. This does not apply to gifts between spouses or civil partners, which are deemed to be at a value which gives rise to no gain and no loss (i.e. the value of the property for the acquiring spouse or partner is the same as the cost including incidental expenses and improvements for the donor).

4. Other taxes

a. Inheritance tax

Inheritance Tax (IHT) can be a very complicated area and it is recommended that professional advice is sought. Basically, rental properties are treated as investment assets and no Business Property Relief is available (except in very exceptional and isolated circumstances). Agricultural properties may qualify for Agricultural Property Relief where they are connected to working farms.

IHT is payable on the probate value of the property, which is usually the same as the open market value.

b. VAT

The renting out of residential property is always an exempt supply for the purposes of Value Added Tax (VAT). Therefore no VAT should be charged on rental income and conversely no VAT can usually be claimed back on rental expenses. However, where an individual or a partnership has a VAT registered business and they also rent out property they may under certain circumstances be able to claim back VAT on the expenses.

The rental properties must be under exactly the same ownership as the VAT registered business. So a husband and wife partnership who also jointly own rental properties may be able to claim VAT on the rental expenses. But a wife who has a VAT registered sole trade and owns a rental property jointly with her husband will not be able to claim back any VAT.

VAT on rental expenses may only be claimed back where it is less than £625 per month on average and is less than 50% of the total input VAT for a VAT return period. The calculation is initially done for each individual VAT return, but an annual adjustment is then made by recalculating for the whole year.

Note that the limit of £625 per month is all or nothing. If the limit is breached, no VAT may be recovered for that period.

This can be a complicated area and it is strongly recommended that professional advice is sought.

c. National Insurance

Property income is never treated as earnings and therefore National Insurance never applies to rental profits.

5. Non-Resident landlords

If you live abroad then you may not be resident in the UK for tax purposes. The rules around who is and isn't non-resident are very complicated and this is another area where advice should always be sought. To complicate matters there is an extra definition of temporary non-residence for Capital Gains Tax which means some non-residents will still pay CGT.

If you are non-resident in the UK you do still have to pay UK tax on income arising in the UK. Rental profits on property situated in the UK are always treated as arising in the UK and are therefore always taxable.

It should be noted that if you rent out properties both in the UK and outside the UK, you will be treated as having two separate property businesses (this actually applies to everyone whether they are UK residents or not). Profits from UK and overseas properties have to be calculated separately and losses on one business may not be used against profits of the other. If you are non-resident your overseas property profits are not taxable in the UK.

Even if you are non-resident, you may still qualify for the UK personal allowance for Income Tax. British, Irish and Commonwealth citizens all get a personal allowance as do European Economic Area nationals and certain other special cases. The personal allowance is £10,000 for the 2014/15 tax year and this amount of income can be received free of Income Tax.

Don't forget that interest received on UK bank or building society accounts, dividends from UK companies and other income arising in the UK is also still taxable.

In order to make sure that tax is collected on UK property rental profits, the Non-Resident Landlords' Scheme applies. Under the scheme, the letting agent, or if there isn't one the tenant themselves, must deduct basic rate tax of 20% from the rents they pay. Agents are allowed to deduct any expenses that they are reasonably satisfied will be revenue expenses before the tax is calculated. The tax is calculated and paid to HMRC quarterly. An annual return must be submitted by the agent or tenant to HMRC and a tax certificate given to the landlord. When the landlord completes their UK self-assessment tax return, credit is given for any tax deducted in this way.

Landlords can apply to HMRC on form NRL1 to have rent paid to them without deduction of basic rate tax.

Publisher Details
This guide is published by Young & Co. Chartered Accountants and Registered Auditors, Bewell House, Bewell Street, Hereford, HR4 0BA and 3 Worcester Road, Great Malvern, WR14 4QY in association with Philip Laney & Jolly, 21 Worcester Rd, Great Malvern Worcestershire WR1 4QY and 30 College Street, Worcester WR1 2LS.

Disclaimer

1. This guide is produced for General guidance only, and professional advice should be sought before any decision is made. Individual circumstances can vary and therefore no responsibility can be accepted by the author, Young & Co or by Philip Laney & Jolly, for any action taken or any decision made to refrain from action, by any readers of this guide.

2. Tax rules and legislation are constantly changing and therefore the information printed in this guide is correct at the time of printing July 2014.

3. Neither the author nor Philip Laney & Jolly offer financial, legal or investment advice. If you require such advice then, we urge you to seek the opinion of an appropriate professional in the relevant field. We care about your success and therefore encourage you to take appropriate advice before you put any of your financial or other resources at risk. Don't forget, investment values can decrease as well as increase.

4. To the fullest extent permitted by law, Young & Co and Philip Laney & Jolly do not accept liability for any direct, indirect, special, consequential or other losses or damages of whatsoever kind arising from using this guide.

   The guide itself is provided 'as is' without express or implied warranty.

5. Young & Co reserve the right to alter any part of this guide any time without notice.