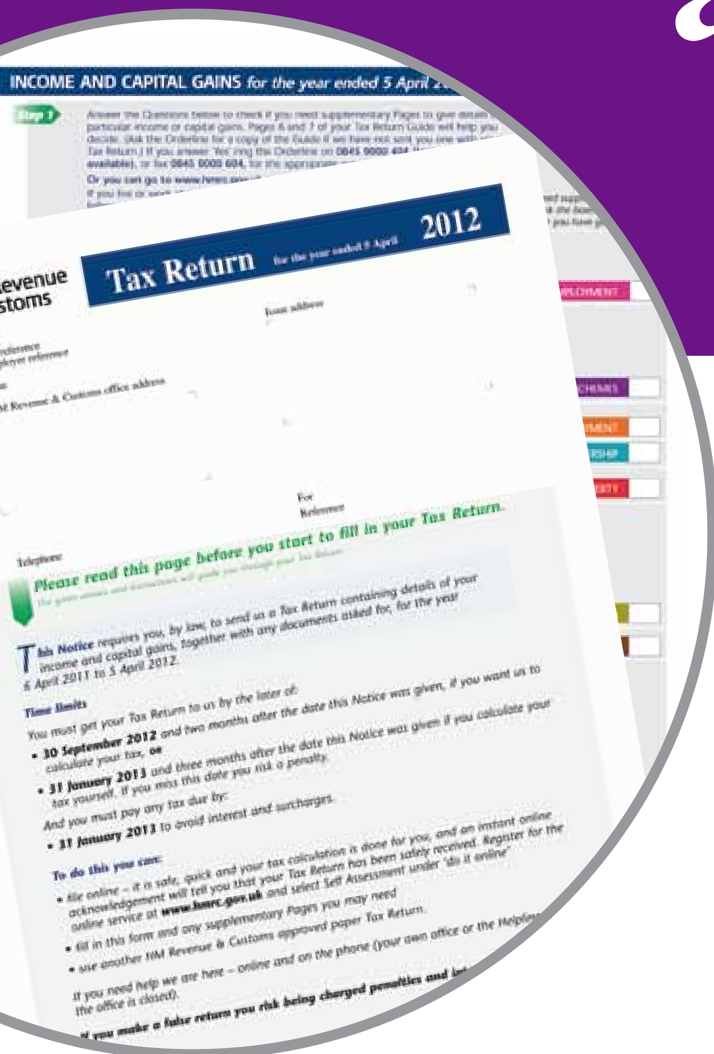
Perrys Chartered Accountants

Buy-to-let guide about tax



Introduction

As a buy-to-let landlord it is important you know about tax and how it affects you and your investment.

This is why Perrys Chartered Accountants bring you this accessible guide to tax issues relating to buy-to-let.

Clearly, good tax planning is key. How you implement, manage and run your tax affairs could have a major impact on your property investments and their financial profitability.

Our comprehensive guide from property purchase through to sale provides valuable information about Income Tax, Annual Income Tax Returns and Capital Gains Tax. It contains much of the information you need to avoid the tax pitfalls and make tax work for your business – ultimately providing you with extra cash to invest.

All figures in this Guide are correct as of April 2011.

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Your Route Map to Improved Tax Efficiency

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1. An Investment Property Strategy

Before you set about purchasing your first or next investment property, it is important that you have a strategy to minimise your tax, otherwise you may pay more tax than necessary. As part of this it is advisable that you have an overall 'exit' plan for the property – i.e. a plan for what you want to do with the property at the end of ownership. This is important because considerations like Capital Gains Tax planning and Inheritance Tax planning are ideally best addressed at the outset – prior to the purchase, despite the fact that the actual tax bills are encountered at the end of the period of ownership. In addition, it is important that you have a Will. Statistically, only about one in three people have a valid Will. Having a Will helps avoid unwanted disputes. The utilisation of tax breaks should also be considered at this stage.

2. Single Ownership or Joint Names?

You should establish single or joint ownership before making the purchase. It is much easier to get ownership right at this stage than to change it later on. If your partner* is not working you may wish to arrange the ownership so that they can maximise their tax-free income allowance of £7,475 per tax year. If you have already purchased, you will have to arrange transfer of the property into your partner's name. In England and Wales, the Revenue defines owners as follows:

- Those with an equal interest in the property are 'joint tenants'. When two people own property as joint tenants any rental income must normally be split equally between them 50%-50% for tax purposes.
- Those with separate and identifiable shares, for example 15% and 85%, are 'tenants in common'. If the property is held in unequal shares, the couple can make a declaration on Her Majesty's Revenue and Customs (HMRC) Form 17 to have the rent taxed in the proportion that they hold the beneficial interest in the property. Without a Form 17 declaration, partners will be taxed on an equal share of the net rents from a jointly owned property.

If you and your partner already own the property as joint tenants, it is quite simple to change to tenants in common, but there may be a Stamp Duty Land Tax charge where the property is mortgaged.

* Whether you are living together as a married couple, civil partnership or operating as a partnership in business, it is important that expert financial advice is sought.

Owning properties through a Limited Company

One of the most commonly asked tax questions is whether holding properties in a Limited company, rather than as an individual or partnership, will save tax. Unfortunately, there isn't a definitive answer as it depends on a large number of factors, such as your personal circumstances and how long you intend to hold the properties. Any future changes in legislation could also affect the decision.

2.1 What is a Limited Company?

A company has a separate legal status to its owners. This means that if you use a Limited company to buy a property, its name will appear on the title deeds rather than yours. The ownership of the company depends on who holds the shares (the shareholders). There only needs to be one shareholder, so you could hold the company's only share and be the sole owner. Shareholders are entitled to their share of the profit in the company and this is paid out in the form of dividends.

2.2 How is rental income taxed in a Limited Company?

Instead of income tax, Limited companies pay Corporation Tax (CT) on their profits. The rate they pay depends on their level of profits:

Profits	Tax Rate
Up to £300,000	20%
£300,001 - £1,500,00	27.5%**
Above £1,500,000	26%

So if you're a higher rate taxpayer, you would pay 40% on your net rental income if you owned the property personally, (50%, if your total income exceeds £150,000). In a Limited company, the company would only pay 20% on rental profits of up to £300,000.

However, if a higher rate taxpayer then wants to take the taxed profit out of the company, they will pay tax equivalent to 25% of the dividend taken.

** First £300,000 at 20% then 27.5% up to £1,500,000

2.3 How are Capital Gains taxed in a Limited Company?

Unlike sole owners and partnerships, a company doesn't pay CGT on any capital gains it makes on the sale of property – it pays CT instead. Any capital gains are added to the company's rental profits in the year and the company then pays CT at the rates above. As a sole owner, the CGT rate is 18% for a basic rate taxpayer and 28% for a higher rate taxpayer.

A company also doesn't get the annual CGT allowance or other reliefs available to individuals. Therefore, in many cases, you could be worse off owning rental properties in a Limited company but it is always best to seek advice from a specialist property accountant.

3. Purchase

Transfers of residential property are subject to Stamp Duty Land tax at the following rates:

Property Price (standard)	Property Price (in disadvantaged areas)	Rate
Up to £125,000	Up to £150,000	0%
£125,001 to £250,000	£150,001 to £250,000	1%
£250,001 to £500,000	£250,001 to £500,000	3%
£500,001 to £1,000,000	£500,001 to £1,000,000	4%
Over £1,000,000	Over £1,000,000	5%

All residential properties are exempt from Stamp Duty Land Tax if they are worth less than £125,000. Relief will be available from SDLT at up to £250,000 where the purchaser is a first time buyer and intends to occupy the property as their main residence.

If the value is above the payment threshold, SDLT is charged at the appropriate rate on the whole of the amount paid. For example, a house purchased for £180,000 is charged at 1%, so £1,800 must be paid in SDLT. A house purchased for £350,000 is charged at 3%, so £10,500 is payable.

This threshold is increased for properties that fall within one of the areas designated by the government as disadvantaged. In these areas, designated under 'The Variation of Stamp Duties Regulations 2001', properties are exempt from stamp duty if they are worth less than £150,000. The exemption applies to all conveyances and transfers of land or an interest in land, and to all leases of an interest in land, executed on or after 30 November 2001, where the land falls wholly or partly within one of the disadvantaged areas and the consideration for the transfer, or the premium for the lease, does not exceed £150,000.

If you are renovating a property to bring it back into use as a home, the VAT payable on material and labour costs can be reduced to 5%. The building has to meet a number of conditions to qualify.

4. Mortgage

As with many tax issues relating to buy-to-let the individual circumstances surrounding mortgage interest tax allowance will dictate the level of relief that will be applicable. Each case will need to be assessed individually, however, the following information can be used as a guide.

All interest payable on borrowings taken out to fund your buy-to-let business can be deducted from the income generated by the property before tax becomes payable. These borrowings include a mortgage, a personal loan, or even an overdraft. This means that all interest payable on borrowings secured on a buy-to-let property or residential property used to repair or purchase a buy-to-let property can be off-set against the rents received.

In certain circumstances tax relief can also be enjoyed on the interest payable on borrowed money which is used to fund personal items. This is only applicable if the borrowing is secured on your buy-to-let property and is equal to, or less than, the value of the buy-to-let property at the time that the property became part of your buy-to-let business. If you wish to borrow money for personal use which is in excess of the value of your property at the time it became part of your buy-to-let business, the interest payable on this excess is not eligible for tax relief. This is an area of tax planning that is highly dependent on each individual case and one that we recommend should be discussed with a specialist property accountant such as Perrys.

If you borrow money which is not secured on your buy-to-let property to spend on personal items, then interest will not gain tax relief.

Choosing the right mortgage, such as interest only or repayment is important because it may provide you with significant financial benefits. The structure and precise timing of the loan facilities are very important. Of course, it is normally advisable that you take out life cover for the mortgage on any investment property you are purchasing. The beneficiary of the policy should not necessarily be the policyholder. The policy could be written in trust to the beneficiaries of the estate to mitigate Inheritance Tax on death.

5. Separate Bank Account

You should have a separate bank account for your rental business to record all rental income received and expenditure incurred. This will assist you in the event of Revenue investigation and completion of your annual rental accounts and Self Assessment Tax Return.

6. Income Tax

As a buy-to-let property investor you are liable to pay Income Tax on rental and other income from your property whether or not you are resident within the property and whether or not the property is furnished. You have to pay Income Tax if the total of your taxable income is greater than your tax allowances. Tax is payable on the rental income after allowable expenses/deductions have been taken into account. However, it is possible that no tax will be payable, for example, if your let property is mortgaged and your mortgage interest and related costs exceed the rent you receive.

It is your responsibility to declare your rental income to the Revenue. It is important you understand how Self Assessment works and that you need to make provision for your tax payments and be aware when they are due. A good specialist property accountant will help you estimate your likely tax liability and advise you about when this should be paid.

7. Income Tax (landlords living outside the UK)

The letting agent collecting the rent on behalf of a non-resident landlord (one living outside the UK), must deduct tax from the rental income and pay the tax deducted to the Revenue, unless a written exemption has been received from the Revenue not to do so. If you are an overseas landlord you can apply to the Revenue by way of completing a NRL1 form.

So long as your tax history is good and your tax affairs are up-to-date, you should be issued with a certificate. This will authorise the letting agent to pay you rent without deduction of tax. At the end of each year, you are obliged to submit a UK Tax Return showing details of your rental income and expenditure. Most non-resident landlords appoint an accountant to handle tax affairs on their behalf.

8. Annual Income Tax Return

Rental income must be declared on a Self Assessment Tax Return. As the Revenue assesses income individually, properties that are jointly owned require Annual Returns to be completed by each legal owner. You need to compile a Letting Income Schedule which details all the expenditure and costs involved in letting property (see 'Allowable Expenses').

This means keeping separate details of all income and expenditure incurred on all lettings. For example detailed records of all borrowings should be maintained to support loan interest claims. You need to make clear which parts of your mortgage have been used to fund buy-to-let properties – so you need to draw up a simple balance sheet that shows exactly how much capital has been invested in the letting business. Records must be kept for six years. They should exclude the deposits you have received from new tenants when calculating taxable rental income. Deposits are not taxable unless they become non-returnable under the tenancy agreement. You should only include the retained deposit when it is used to cover the costs it was designated to prevent, such as renewals, repair or legal fees.

Don't forget, you have a legal responsibility to notify the Revenue of any liability. There are strict tax deadlines and late returns not only incur penalties but also increase the likelihood of Revenue investigation.

9. Allowable Expenses

Prior to the property letting

Pre-letting advertising can be deducted from rents received in the first tax year.

However, most costs prior to letting cannot usually be deducted from rents received. There are some allowable expenses so long as they are not incidental to the letting. Therefore, they are likely to be appropriate only for landlords with large portfolios or those who use the services of a managing agent.

Ongoing

Only those expenses incurred "wholly and exclusively" in generating income are allowable.

- **Mortgage interest**
  You may generally claim tax relief on interest payments on a mortgage or loan taken out to fund the purchase, refurbishment or repair of a let property.
- **Water rates**
  You can include the full amount of water, sewerage and any other rates paid on the property, if these are not paid by the tenants.
- **Insurance**
  You may include all insurance policies paid by you in connection with your property.
- **Service charge, ground rent**
  You can include the service charge and ground rent on the let property in question if these are not paid by the tenant.

- **Council Tax**
  In certain circumstances, a landlord may be liable for Council Tax. This could then be included.
- **Legal**
  Legal fees in respect of ongoing tenancies are allowable.
- **Accountancy**
  Any accountancy costs can be offset as long as they relate directly to the let property.
- **Repairs and maintenance**
  When making repairs to your let property you may be able to go beyond replacing 'like with like' and make an improvement, although you need to be careful about how much of an improvement you make. For example, the Revenue is unlikely to permit the replacement of a tatty bathroom with a spa bath and other luxury items. However, the Revenue may be agreeable to replacing wooden window frames with UPVC. Professional advice should be sought from a specialist property accountant.
- **Management or Letting Agent's fees**
  You may claim tax relief on any management or letting agent expenditure. On request, at the end of the tax year, the letting agent should be able to provide you with details of your rental income and management fees.
- **Wear and tear**
  For furnished properties to let, you can claim for wear and tear on all furnishings (but not fittings), calculated as 10% of the rental income for the year, less water rates and Council Tax (if paid by you). Alternatively, you can claim for replacement costs but in most cases, the 10% allowance is both more beneficial and simpler.
- **Motor vehicle costs for visiting/inspecting the property**
  As long as they are appropriate to the circumstance and are incurred visiting the rental property, petrol and vehicle costs are an allowable expense. You should speak to your accountant to identify what is and isn't deemed to be an acceptable expense.
- **Advertising**
  Any costs you incur advertising for tenants to fill your rental property are allowable.
- **Energy Saving Allowance**
  After 6 April 2004, landlords are allowed a deduction for Income Tax purposes up to a maximum of £1,500 when they install loft or cavity wall insulation in a dwelling house, which they let. From April 2006 this was extended to include draft proofing and insulation for hot water systems. From April 2007 this has been further extended to include floor insulation.

10. Property Sale Capital Gains Tax (CGT)

Should you sell your property, you may become liable for Capital Gains Tax. Any profit made on a property other than a main residence is subject to Capital Gains Tax at 18% where your total income and gains are within the basic rate tax threshold. Where your total income and gains exceed the basic rate threshold, CGT is charged at 28%. When you sell you will have to pay the CGT by 31 January following the tax year you sell the property, however, your Capital Gains Tax bill can be reduced by a number of reliefs summarised below.

11. Tax Breaks Allowable Against CGT

There are lots of tax breaks especially if you have ever lived in the buy-to-let property you are selling. For example:

- **Principle Private Residence Relief**
  You can claim an exemption against Capital Gains Tax for the time you have lived in the property as a main residence even if this is only for a short time during the overall ownership. Also, you can claim an exemption for the final 36 months of ownership (regardless of whether you lived there during this time or not).
- **Letting Exemption**
  If the property was your main residence at some point during the period of ownership you can claim a Private Residence Relief Lettings Exemption of up to £40,000. This is the maximum relief available and is reduced dependent on other gains.
- **Capital Gains Annual Exemption**
  Everyone can make a capital gain tax free of up to £10,600 for the 2011/2012 tax year. A jointly owned asset therefore will need a chargeable gain in excess of £21,200 before Capital Gains Tax becomes payable.

Frequently Asked Questions

Q What is the best way to set about building a portfolio?

A lot of people generally assume that property has to be sold in order to release equity to create deposits for new properties as the value of their property portfolio increases. It is important from a Capital Gains Tax point of view to know that a portfolio can be built up by using the equity as deposits against new purchases without selling the original properties. This certainly has significant savings when one is looking at Stamp Duty Land Tax, legal costs and Capital Gains Tax as no one pays Capital Gains Tax until they physically dispose of a property.

Q With regard to mortgages, are capital repayments deductible?

Capital repaid on a repayment mortgage and endowment/life insurance payments are not tax deductible against the income.

Q Why do I make so little money on my property and yet I still have to pay tax?

You are probably referring to the fact that from a cash flow point of view, you may make little excess over the mortgage payments. The capital element of a repayment mortgage and any life insurance policy alongside it as well as any endowment payments on an interest only mortgage are not tax deductible.

Q Should I put my properties into a limited company?

There can be instances when purchasing a property through a limited company can be beneficial but it is best to consider all such cases individually and seek advice from an accountant in these circumstances. Any such decision would first require an understanding of the Corporation Tax system and the tax efficient removal of remuneration from the business, which again requires further discussion with an accountant.

Q How important is it that I register with the Revenue?

You have an obligation to register with the Revenue and to submit Annual Income Tax Returns to them. There are penalties for late registration and submission. You should obtain financial advice. See www.hmrc.gov.uk.

Q How can I maximise the benefits from my mortgage/interest?

It is important to know the benefits that can be realised by effectively mortgaging your buy-to-let properties. Because the interest payable on any borrowings taken out to fund your buy-to-let properties enjoys tax relief, and the mortgage interest on your own home used to fund your residential property or personal items does not, it makes sense to have lower borrowings on your main residence than on your let property. For example, mortgage lenders will work to a certain loan to value and it makes sense to ensure that when the buy-to-let property is purchased it is mortgaged to the maximum amount which will obtain maximum tax relief. If you are paying £7,000 interest per year on your own home's mortgage and only £4,000 interest per year on your buy-to-let mortgage you are taxed on any rental income over and above the £4,000 yearly interest payment. If you were to reduce the interest payable on your own mortgage to £4,000 and increase your yearly interest on your buy-to-let property to £7,000 your taxable rental income would be reduced. This is an important planning area and one that we recommend you should discuss with a qualified accountant.

Q What is the tax position if I have lived in the property I am renting out?

If you have lived in a property that you subsequently decide to let out, you are eligible to claim an exemption against Capital Gains Tax for the time you lived in the property as a main residence. You can also claim an exemption for the final 36 months of ownership (regardless of whether you lived in the property during this time or not). In this instance a lot of people are unaware of the three-year usage rules and residential property relief. Some people choose not to live in their own property to rent, even when they have had the opportunity to do so. By living in the property you can establish main residence exemptions, however you should be able to prove to the Revenue that it was your intention to have that property as your permanent main residence. Therefore, by definition, if you move into the property on a temporary basis the Revenue can challenge your intention and in some cases the residential relief can be lost.

Summary of our Top Tax Tips

Buy-to-let investors should:

- Have a tax and management strategy, including an 'exit' strategy, before purchasing investment property. This could potentially save a fortune!
- Make a will.
- Establish ownership – single or joint names – at the outset.
- Take out the right mortgage.
- Set up a separate bank account for the lettings business.
- Keep detailed records of lettings income and expenditure – essential when completing the Annual Income Tax Return.
- Claim for allowable expenses incurred both prior to the start of the letting and for ongoing expenses.

Tax laws are extremely complex. Therefore, regarding the tips above, we suggest that you obtain appropriate professional advice in order that matters can be related to your personal circumstances at the earliest possible time.

about...

Perrys Chartered Accountants

Perrys Chartered Accountants specialise in business and tax planning advice. Our aim is to help our clients increase their profits and reduce their tax liabilities, whilst providing peace of mind. Our core business involves the provision of audit, accountancy and tax services.

We are happy to offer free, no obligation, initial consultations on tax matters arising from this tax guide. If you wish to discuss any of the points contained in this guide or arrange a free, initial meeting, get in touch.

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