RESIDENTIAL PROPERTY LETTING

A PRIVATE LANDLORD'S GUIDE

Spring 2017 update

Residential property letting provides constant challenges to those who operate within this industry sector. At George Hay, we understand the issues that affect property owners and prospective investors including buy-to-let landlords.

This guide aims to provide advice and support to individuals, and trustees, owning residential property; from owning a single property to investors owning multiple properties. It is important to note that, for investment purposes, different rules apply to commercial property, property being traded or developed and to companies owning either residential or commercial property. You should therefore seek advice on regulations which specifically affect commercial landlords, or if you operate as a company.

How is tax calculated and when is it due?

The amount on which tax is charged is the net rental income for each tax year (i.e. for each tax year ending on 5 April). Net income consists of the gross rent attributable to the tax year in question, less any expenses incurred wholly for the purpose of earning that rent.

If rent is charged for a period which overlaps the tax year end, this would normally be apportioned. For example, if letting commenced on 1 October 2016, at £12,000 per annum, the amount assessable in 2016/17 would be £6,000 (6/12). Similarly, if an expense of £1,200 for an annual period such as insurance was paid on 1 December 2016, the amount allowable in 2016/17 would be £400 (4/12).

If the property is jointly owned, the net income is then split in the relevant proportions and assessed separately by each individual, at the appropriate tax rate, after taking into account any brought forward losses or allowances which may be due.

If not held 50:50, it is essential that the appropriate paperwork is completed as HMRC will expect evidence of ownership and will not tolerate retrospective changes.

For each tax year, half of the expected tax liability will normally be due on account on 31 January and 31 July, with any balance due payable the following 31 January. For example, for 2017/18, Payments on Account would be due on 31 January 2018 and 31 July 2018, with any balance payable on 31 January 2019.

Payments on Account may not be required in the first year of letting, or if letting income is small relative to an individual's overall taxed income.

The new Replacement Furniture Relief (RFR)

From 6 April 2016 the government replaced the Wear and Tear Allowance (WTA) with a Replacement Furniture Relief (RFR).

Landlords of fully, partly or unfurnished residential property can claim for the actual cost of replacing furnishings. The new RFR will not be available to furnished holiday lettings businesses, as relief is given for them under normal trading principles.

Replacement items that would be available for RFR include moveable items such a beds, sofas, tables and chairs, televisions, fridges and freezers, carpets and floor coverings, curtains, linen, crockery and cutlery.

Fixtures that form the fabric of the building and would not normally be removed if the owner sold the building would not qualify for the RFR. These fixtures would include items such as baths, washbasins, toilets, boilers, fitted kitchen units etc.; most of which would instead qualify as repairs.

Additional considerations:

- The new relief will only apply to replacement costs. The initial costs of furnishing a property are not included.
- The RFR will be based on the replacement cost net of any proceeds from the sale of the replaced item.
- Any improvement cost would be excluded from RFR. For example, if a washing machine was replaced by a washer/dryer that cost £600, only the replacement cost of a similar washing machine, say £400, would be allowed.

Repairs

The cost of repairs is allowable as a revenue expense for income tax purposes, provided that the work carried out does not represent an improvement.

HM Revenue & Customs (HMRC) will normally accept that repairs do not constitute an improvement merely because more modern materials are used, such as when a single-glazed window is replaced by a double-glazed window.

An example of an improvement would be work carried out on a roof, where instead of simply restoring the roof to its original condition, new windows were installed as part of a loft conversion.

Expenditure in relation to improvements, additions or extensions to a property, is added to the cost of the property for capital gains tax purposes rather than being allowable for offset against income.

As a general rule, the replacement of part of an asset is a repair (income tax deduction), but the replacement of an entire asset is likely to be capital (capital gains tax deduction).

Interest

Interest on a mortgage or other loan incurred for the purposes of property letting was, until recently, an allowable deduction for tax purposes, so a higher rate taxpayer was getting 40% tax relief for any qualifying loan interest paid.

Interest may sometimes be deductible on loans used for other purposes. In particular, interest on any loan up to the value of the property when it was first let will be allowable.

For example, if a property is purchased as a private residence for £400,000, with a £200,000 mortgage, but is let out some time later, when it is worth £500,000, an additional mortgage of up to £300,000 could be taken out, and interest on the full £500,000 would be allowable.

There are new rules being introduced, over a period of three years, to gradually restrict the relief given for loan interest.

> *For 2020/21 and onwards all finance costs will only attract 20% basic rate tax relief as a tax reducer rather than as a deduction to reduce rental income.*

This is a significant change for higher rate taxpayers and those basic rate taxpayers that earn close to the higher rate threshold should seek advice early in order to plan for this. The challenge is exacerbated if the taxpayer is receiving child benefit.

For a property investor who is highly geared, this could result in them making an economic loss on the property portfolio, but still having an actual tax liability. This is because the rents will be taxed at say 40%, but tax relief for interest will only be given at 20%.

The table below illustrates how the new rules being introduced will impact taxable profits and net income going forward, of a higher rate taxpayer, even for the smallest of portfolios.

	2016/17	2017/18	2018/19	2019/20	2020/21
Profits	£11,000	£11,000	£11,000	£11,000	£11,000
Interest	£5,000	£3,750	£2,500	£1,250	Nil
	£6,000	**£7,250**	**£8,500**	**£9,750**	**£11,000**
Tax payable @40%	£2,400	£2,900	£3,400	£3,900	£4,400
Interest relief @20%	-	(£250)	(£500)	(£750)	(£1,000)
	£2,400	**£2,650**	**£2,900**	**£3,150**	**£3,400**
Net income	**£3,600**	**£3,350**	**£3,100**	**£2,850**	**£2,600**

The key points to take away from this relatively simple and common example are as follows:

- For this investor, they will have £1,000 less, net of income tax, by 2021.
- Where taxable income was previously £6,000, by 2020/21 the full £11,000 will be taxable. This could create a higher rate tax position earlier than anticipated if the property owner has other earnings.
- If the £5,000 increase in taxable profits results in the owners total taxable income exceeding £50,000, they will also lose child benefit.

Ultimately, the changes could be very costly so strategic planning, with your professional advisers, will be crucial to preserving your investment returns.

Losses

If more than one property is let, a loss for a year on one UK property can be set against a profit on another UK property.

An overall loss cannot be set against income from other sources, such as employment or investment income, but must be carried forward against future profits from the property letting business.

Any interests costs that are unable to be relieved due to losses may be carried forward as a tax credit.

Any losses not utilised at the time when property letting ceases will normally remain unrelieved. Expenses incurred before a property is let on commercial terms, or in periods between letting on commercial terms, will normally be deductible from future rents. Where a property is occupied rent-free or at a low rent, perhaps by a relative, you are unable to offset losses against other rental income.

Tenancy Deposit Scheme

A landlord may not take a deposit in respect of an assured shorthold tenancy unless it is covered by a Tenancy Deposit Scheme.

A Tenancy Deposit Scheme is designed to:

- Safeguard tenants deposits
- Facilitate the resolution of disputes arising in connection with such deposits.

There are two different types of schemes, namely Custodial Schemes and Insurance-based Schemes. The landlord or agent must give the tenant details of how their deposit is protected within 14 days of receiving a deposit. If a letting agent is used to manage the property, the agent is likely to manage deposits on your behalf.

Rent a room

Income arising from the letting of furnished residential accommodation which is part of an individual's main residence is exempt from tax, provided that the rent (before any deductions for expenses) does not exceed £7,500 in the tax year in question. This limit is reduced to £3,750 when someone else also received income from the property.

The property must be used as a main residence at some point in the relevant period for the exemption to apply. For example, if an individual goes overseas on 1 December 2016 for 18 months and decides to let part or all of the house from that date for a year, rent a room relief will not be due for 2016/17, because the property was not in use as a main residence between the start of the period (1 December 2016) and the end of the tax year (5 April 2017).

If the gross rent does exceed £7,500 in a tax year, one can either elect to be assessed on the amount by which the gross rent exceeds £7,500, or alternatively a statement of income and expenses can be drawn up and the net income assessed in the normal way. Similarly, if expenses exceed income, one can elect for the exemption not to apply so that tax relief can be obtained for the loss.

Furnished Holiday Lettings

Furnished Holiday Lettings attract various tax reliefs provided certain conditions are met.

What are Furnished Holiday Lettings (FHL)?

Certain conditions must be satisfied if rental income, rental expenditure and capital expenditure are to be treated as falling within the FHL rules. A property must be furnished accommodation, let on a commercial basis with the view to making a profit and should be situated in the European Economic Area (EEA).

What tax advantages are afforded to FHL?

Under the FHL rules, landlords are treated as though their qualifying FHL business is a trade for capital allowances and Landlords Energy Saving Allowances (LESA) along with certain capital gains tax reliefs, including business asset roll-over relief and entrepreneurs' relief.

Unlike trading income, FHL profits are not subject to Class 4 NIC.

FHL income is also treated as part of net relevant earnings when calculating tax relief on an individual's pension contributions.

FHL as with any other property businesses, also has the potential to be eligible for Inheritance Tax (IHT) Business Property Relief, although claims are often unsuccessful as availability of this relief does require a high burden of proof on the taxpayer to show business activity over and above that of a passive landlord.

Losses

Any loss made from a qualifying FHL business may only be offset against future income of the same FHL business.

Qualifying tests

You must satisfy all three of the following tests if a letting is to qualify:

1. The availability condition (availability test/threshold) – the accommodation is available for commercial letting as holiday accommodation to the public for at least 210 days.
2. The letting condition (occupancy test/threshold) – during the period the accommodation is commercially let as holiday accommodation to the public for at least 105 days.
3. The pattern of occupation condition – the total of all lettings that exceed 31 continuous days must not amount to more than 155 days during the year.

Gains on disposal

Capital Gains Tax (CGT) may be payable when a property which has been let is sold at a profit, at 18% for basic rate taxpayers and 28% for higher rate taxpayers.

CGT may be due where a sale takes place more than 18 months after the date when the property was last used as the owner's private residence, or if there had been a period of ownership of the property when it was not occupied as a private residence.

> *Where a chargeable gain arises on a property which has, at sometime, been a private residence and was also let out at some point, a lettings exemption of up to £40,000 (maximum) is available.*

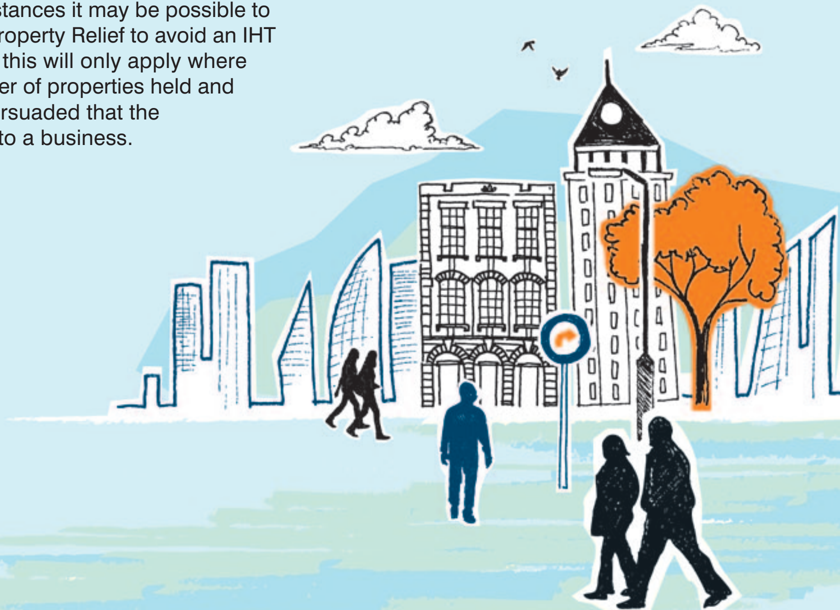
It may be possible to reduce CGT by transferring part of an interest in a property to a spouse or civil partner, in order to maximise the use of annual exemptions and lower rate bands.

Gains realised by any non-residents on any UK residential property are also liable to CGT.

Inheritance Tax (IHT)

In many cases, the value of the residential properties, net of any mortgages, will be within the landlord's chargeable estate for Inheritance Tax purposes. So, in the event of their death IHT, on the estate value, at 40% might be due.

In limited circumstances it may be possible to claim Business Property Relief to avoid an IHT charge, however this will only apply where there are a number of properties held and HMRC can be persuaded that the activity amounts to a business.



Main residence exemption

Most people are aware that when they sell their main residence no Capital Gains Tax is due as the gain is covered by the Principal Private Residence (PPR) relief. This is a valuable relief which benefits many people and with careful tax planning it can go further than you may think.

An individual's residence is a place where one lives. However, where an individual has more than one residence and a notice is not made HMRC will consider which property attracts the relief as a matter of fact. It is not automatically accepted that the main residence is where the individual spends the majority of their time. HMRC will look at various criteria to establish which of your properties is your main home, including but not limited to the following examples:

- the address used for utility and other bills;
- the address used on the Voting Register;
- address used with your bank;
- the inclusion of personal artefacts and décor.

If your property includes more than one building, whether the out buildings are included within the definition of dwelling house will depend upon their relationship to the main property and whether they can be considered a single entity.

If you are, or have been, non-resident in the UK for tax purposes, the ability to claim the main residence exemption can be restricted.

Gardens and grounds

Garden or grounds will include any enclosed land surrounding or attached to your dwelling house for the purposes of enjoyment of the property.

If your garden and grounds exceed half a hectare, (c.1.25 acres) it may not all qualify for the relief. However, larger gardens or grounds may qualify if they are appropriate to the size and character of the property and required for reasonable enjoyment of it.

Sale of part of the garden

Relief may be available where a part of the garden or grounds is sold before the sale of the main dwelling house. However, where the grounds are in excess of half a hectare and they are disposed of separately it may be difficult to demonstrate that they are required for the reasonable enjoyment of the property.

The PPR relief is one of the most valuable capital gains tax reliefs, however, the operation of the relief is not always straightforward nor its availability a foregone conclusion. Tax planning can help enormously in identifying potential issues and maximising the available relief.

Periods of occupation

You are entitled to relief on a disposal of a property to the extent that it was your only main residence during the period of ownership and that there has been some period of occupation of the property, (ignoring any periods before 31 March 1982).

If the property was not your only main residence for the entire period of ownership then the gain must be apportioned between periods when it did and when it did not qualify for PPR.

Certain periods of absence quality for relief such as:

- last 18 months of ownership;
- a period of absence not exceeding three years, where you did not occupy another main residence;
- a period of absence during which you were working abroad where you did not occupy another main residence qualifying for relief;
- and a period of absence not exceeding four years where you were required to reside elsewhere by your employer where you did not occupy another main residence qualifying for relief.

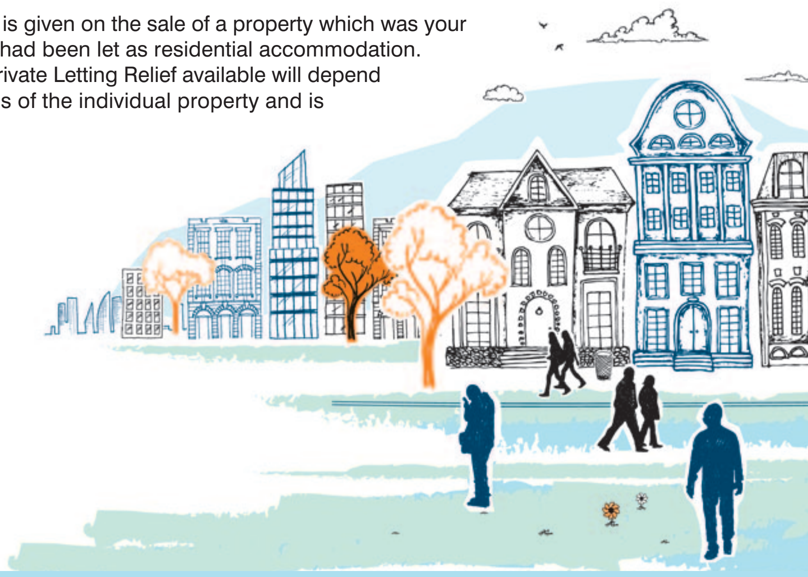
Nominating a residence

You can only have one main residence for PPR purposes. If you own two properties, it is possible to nominate one that you would like to be treated as your main home.

By doing this it is possible to minimise the tax charge on both properties by switching your PPR between them. The election must be made in writing to HMRC within two years from the date of acquiring the second property. In the case of married and civil partnership couples both partners must sign the election for this to be effective.

Private Letting Relief

Private Letting Relief is given on the sale of a property which was your main residence and had been let as residential accommodation. The amount of the Private Letting Relief available will depend on the circumstances of the individual property and is capped at £40,000.



Stamp Duty Land Tax (SDLT)

SDLT is a levy on transactions in land. It applies to “chargeable transactions”, which generally means a purchase or the grant of a lease.

The tax as it affects most transactions, is relatively straightforward. There are inevitably more detailed provisions to deal with complex transactions and tax avoidance schemes, but these are beyond the scope of this guide.

Introduced from 1 April 2016 is the additional stamp duty land tax of 3% on the purchase of any residential property where, at the end of the day of the transaction, an individual owns two or more residential properties and has not replaced their main residence. This also applies to all residential purchases made in companies or other entities.

Purchasers have 36 months (18 months in Scotland) to claim a refund in the event that there is a period of overlap in the ownership of two main residences.

Rates

The current rates of SDLT are as follows:

For residential property		
Purchase price	Standard SDLT rate	With additional SDLT rate
On the first £125,000 of the property price	0%	3%
On the next £125,000	2%	5%
On the next £675,000	5%	8%
On the next £575,000	10%	13%
On the rest (above £1.5 million)	12%	15%

Leases

Additional SDLT can be charged at 1% on the grant of a new lease or sublease, based on the net present value of the rents over the term of the lease.

There is no additional charge if the net present value is less than £125,000 for a residential property.

Non-resident landlords

For non-resident landlords a return must be submitted, usually by the letting agent, and tax accounted for to HM Revenue & Customs (HMRC), on a quarterly basis, payment being due 30 days after the end of each quarter.

Where there is a letting agent, the amount subject to tax is the rent less expenses for that quarter, with possible adjustments when expenses have exceeded rent in any quarter. If there is no letting agent, the tenant should deduct tax at the basic rate from the gross rent and remit this to HMRC, unless annual rent is less than £5,200, in which case rent may be paid over gross.

It is, however, possible for landlords to apply to HMRC for exemption from the scheme, so that the landlord can receive the gross rent. For an application to be accepted, it must be shown either that all UK tax obligations have been met (or that there have been no UK tax obligations) before making the application, or that it is not expected that there will be any UK tax liability for the year in which the application is made.

Landlords may still be entitled to UK personal allowances (which can be used against letting income) despite being non-resident. The main categories of those entitled are British and European Economic Area citizens. An individual non-resident landlord will normally have to submit an annual self-assessment tax return to HMRC.

If you are not resident in the UK and dispose of UK residential property you must report the disposal to HMRC, and potentially pay the CGT due, within 30 days of the conveyance of the property. This also applies to gifts (other than to a spouse or civil partner), in which case the disposal is deemed to have been made at its current open market value. This additional reporting requirement is still required even if you are registered to submit a tax return.

For more information, please contact us.

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