CUBE PARTNERS LIMITED

GUIDE TO

THE TAXATION OF

RESIDENTIAL PROPERTY INVESTMENT

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Introduction

If an individual starts to rent a property in the UK they are required to notify HMRC within 3 months using an SA1 form (which can be downloaded from the HMRC website) and they will need to complete personal tax returns.

If you're employed and your taxable income from property is less than £2,500, your Pay As You Earn (PAYE) tax code can be adjusted to collect the tax on your property income. Your Tax Office will send you form P810 to report your income each year. However, you'll still need to keep records, to enable you to fill in form P810. Your Tax Office can also ask to see your records to check your figures. If your income from rent is £2,500 or more you'll need to complete a tax return.

All lettings in the UK by landlords are treated as a single business and the profit or losses on those rental properties are calculated using normal accounting principles i.e. using the accruals basis. However, by concession if the gross rental income for a landlord is less than £15,000 per tax year they can choose to calculate their profit and losses on a cash basis.

A UK resident landlord will be taxable on their worldwide property income whereas a non-UK resident landlord will only be taxable in the UK on their UK property income. A non UK resident landlord needs to complete a form NRL 1 to obtain HMRC consent to receive the rent gross without deduction of tax. The NRL 1 form confirms to HMRC that tax returns will be filed every year and taxation will be properly accounted for. Without this form being completed and HMRC issuing a notice to confirm it has been completed, letting agents (and tenants) are legally obliged to deduct basic rate tax and pay it over to HMRC quarterly.

Profits and losses on individual properties are pooled to arrive at the UK property income assessable for individuals.

If an individual rents a room in their house a special exemption may apply. There is relief know as a 'rent-a-room relief' which means that they would only be taxed on rental income that exceeds £4,250.

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Furnished Property & Unfurnished Property

When it comes to calculating rental property income you must first establish what kind of property is being let:

- Is the property being let furnished?
- Is the property being let unfurnished?

If the property is being let furnished then an additional relief known as 'wear & tear allowance' can be claimed.

Wear & Tear allowance

Capital allowances are not allowed on furniture used in a residential letting. Instead, HMRC gives relief for expenditure of this nature on a renewals basis. The original cost of furniture and the cost of any improvements are not allowed but the cost of replacing furniture to the same standard is allowed as an expense.

However, rather than using the renewals basis for properties that are let furnished, a 'wear & tear allowance' can be claimed instead. This allowance is only for properties that are let furnished and it is calculated as follows:

10% x (Rents – water rates – council tax)

Note that the water rates and council tax only apply if they have been paid by the landlord.

The cost of repairing and maintaining furniture and fittings is also allowed whether the renewals basis or wear & tear allowance is claimed.

Capital Allowances

As identified above capital allowances are not allowed on furniture used in a residential letting. Capital allowances though may be claimed on plant & machinery used for the maintenance or repair of the properties or plant let as part of the building e.g. lawn mowers.

Income Tax

Property income is always treated as non-savings income in computing an individual's tax liability. The current income tax rates apply for the 2013/14 tax year:

- Basic rate tax payers – 20% (income up to £32,010)
- Higher rate tax payers – 40% (income over £32,010 and up to £150,000)
- Additional higher rate tax payers – 45% (income in excess of £150,000)

For EU citizens, a Personal Allowance can be deducted from the profit before the above rates are charged. The personal allowance for the 2013/14 tax year is currently £9,440.

Calculating Property Income

Rental Income is calculated on a rents receivable basis, unless the cash basis applies, therefore if an individual rents a property and the accruals basis is applied the gross rents that are due to them in the tax year and not what they have received. If the landlord has a tenant in their property and this tenant gets behind on the payment of the rent the landlord will still be taxable on the rents that are due. Bad debt relief for rents unpaid is an allowable relief for landlords and this is covered in the allowable property expenses section of this guide.

Losses

Where a landlord makes a loss overall:

a) The loss is carried forward and set against the first available UK property income in the following and subsequent years.

b) Losses resulting from capital allowances can be set against the landlord's general income for the year of the loss and the next tax year.

The loss relief at (a) is automatic and no claim is required. Losses made under (b) must be claimed within 12 months from the self-assessment filing date for the year of the loss.

If a property is let by a landlord under non-commercial terms i.e. it is let to a relative at a 'peppercorn' rent and a loss arises on the property, this loss is not pooled with profits/losses on any other rental properties. The loss may only be offset against future rental profits made on the same lease to the same tenant. As such it is unlikely that the loss will ever be fully relieved.

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Allowable expenses

Expenses are deductible if they are wholly & exclusively incurred for the business of letting. The following expenses are examples of expenses that would all be deemed to be allowable:

- Advertising
- Accountancy fees
- Insurance
- Bad debts
- Repairs & maintenance
- Letting agent fees
- Ground rent and service charges
- Mortgage Interest
- Loan Interest
- Utility bills
- Renewals basis or wear & tear allowance (see page 2)
- Direct costs in connection with running the property e.g. phone calls, travelling

Bad debts

If a tenant vacates a property and when leaving the property there is still rent owing, the landlord needs to decide whether to write off the outstanding rent owed from the former tenant or agree a plan for the former tenant to repay the amounts owed. If the decision is made to write off the amounts that are owed to the landlord the amount of rent that gets written off can be claimed as a bad debt in the tax year that the debt is written off.

Repairs & maintenance

The cost of repairs to the property and simply maintaining the property are allowed as a rental expenses. However, costs incurred that could be classed as 'capital expenditure' on properties i.e. an extension would not be allowed. When significant expenditure on a property is going to be incurred it needs to be established whether this expenditure is for maintaining the property or improving the property. If the expenditure is deemed to be for improving the property it is more likely that this expenditure will be deemed to be capital expenditure and thus is not allowed. Capital expenditure will only get relief on the eventual disposal of the property and this will be covered in the capital gains section of the guide. It is always worth seeking advice if significant expenditure of this nature is incurred to ensure that the correct treatment of the expenses is applied.

Mortgage interest

If there is a mortgage on the property it is only the interest element of the mortgage that is allowed as an expense. Therefore if the mortgage is interest only then all the payments are allowed as an expense. If the mortgage is a capital repayment mortgage it will only be the interest element of the repayments that can be claimed as an expense.

Loan interest

If a loan is taken out and this loan is spent on the property i.e. to make improvements then the interest on this loan will be an allowable expense.

Other points

If the landlord has a property that is not being let because it is under repair before being let or a suitable tenant has yet to be found, the landlord can still claim for the running expenses incurred whilst the property is empty.

Capital Gains Tax

If a landlord sells one of his properties capital gains tax may be payable. This is calculated by deducting the original cost of the property plus any capital improvement costs incurred on the property from the proceeds received on the disposal of the property. A proforma calculation is as follows:

Gross Proceeds -		£X
Less: Costs of disposals -		(£X)
Net Proceeds -		£X
Less:	Original Cost -	(£X)
	Improvement Costs -	(£X)
Chargeable Gain/(Allowable Loss) -		£X/(£X)

If a gain arises on the disposal then capital gains tax may become due, if a loss arises on the disposal then the loss will either be utilised in the tax year against any other gains made in the year or it will be carried forward to be utilised against the first available gains in the future tax years.

Annual Exemption

An individual has a capital gains annual exempt amount per tax year. The current annual exempt amount for the 2013/14 tax year is £10,900. This means that capital gains tax is only payable if the capital gains exceed £10,900 i.e. if a property was sold in the 2013/14 tax year and a gain of £8,000 was realised then the gain would be covered by the annual exempt amount and no capital gains tax would be due.

Tax Rates

The current capital gains tax rates apply for the 2013/14 tax year:

- Basic rate tax payers – 18%
- Higher rate tax payers – 28%

Additional Reliefs

If an individual disposes of a property but at some point this property has also been their principal private residence, two additional reliefs may apply:

- Principal Private Residence Relief (PPR)
- Lettings Relief

Where the house has not been owner-occupied throughout the period of ownership only the proportion of the gain attributable to the period of owner-occupation is exempt. Certain 'periods of absence' are deemed to be periods of occupation. The last 36 months of ownership, if the property has been lived in, is always treated as a period of occupation.
Where the house that has been owner-occupied at some point and it has also been let as residential accommodation, letting relief may be available up to a maximum of £40,000.

Under current tax rules a non-resident landlord does not suffer UK capital gains tax on any gain/s made on the disposal of UK property as they are exempt.

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Record Keeping

You'll need to keep the same sorts of records whatever type of property letting business you have. They should include details of the following:

- rental income
- allowable expenses
- 'capital' costs

Rental income

You'll need to keep a note of:

- the rent you charge and receive
- the dates you rent out each property

Allowable expenses

Your records should include details of all your costs of letting or managing your property i.e. receipts, invoices etc…

To back up your records keep rent books, receipts, invoices and bank statements. Also make sure that you can separate your business from your personal expenses.

How long do you need to keep the records?

You'll need to keep your records for six years after the tax year to which they apply - whether you complete a tax return or not.

Furnished Let

There is no legal definition of what constitutes a furnished let but in order for a property to be classed as such it is recommended that the following items would need to be included in the property when it is being let:

- Lounge – Sofa, Coffee tables etc...
- Dining Room – Dining room table and chairs
- Kitchen – fully equipped with white goods e.g cooker, fridge-freezer, washing machine.
- Bedrooms – Beds, wardrobes etc...
- Bathroom – toilet roll holders, towel rails etc...
- Garden equipment – provide a lawn mower etc...

HMRC allow either a wear or tear allowance or a renewals basis in respect of furniture purchases.

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Contacts

If you are a landlord of a property in the UK and you have any queries with regard to rental income and expenses and the UK tax implications of owning property in the UK please do not hesitate to contact us. Our office details and the main contacts are detailed below:

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Please note that this information sheet is a guide only, specific professional advise should always be taken