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Update

Business tax

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Buy to let properties

Recent years have seen a growth of investment in 'buy to let' property, often motivated by low interest rates (on savings and mortgages), a belief that bricks and mortar are a safer investment than equities and the hope that rental returns will be supplemented by long-term capital growth. However, recent tax changes could make such investment less attractive.

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

Rental profits and allowable deductions

The profits of a property business are currently assessable on an accruals basis in broadly 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.

To be deductible costs 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 can include:

- finance costs (subject to the changes below);
- repairs, maintenance and insurance;
- any directly related services paid for by the landlord, such as gardening and cleaning;
- any utility supplies paid for by the landlord;
- advertising for tenants;
- management costs; and
- some legal fees (broadly, those of a revenue rather than a capital nature).

"Under the new rules they may be pushed into a higher tax bracket."

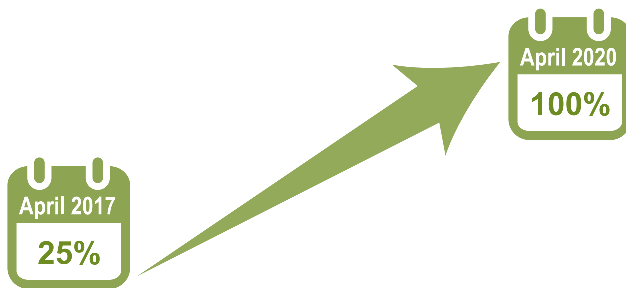
Different rules apply to furnished holiday lettings and to the letting of rooms within the landlord's own residence.

Finance costs

As indicated above, a deduction is currently available for finance costs, which include interest payments on a mortgage, loan or overdraft to finance the property business, an improvement to a property or to purchase equipment used in the business. Because of the impracticality of identifying precisely what tranches of borrowing have been used for what purposes, HMRC accept that relief is also available for interest on other borrowing up to the value of the equity in the property when it was first brought into the lettings business. This, potentially valuable claim, is often overlooked.

Until 5 April 2017 taxpayers could claim a deduction for the full amount of their finance costs against rents received, giving tax relief at their marginal rate of income tax. However, the deduction is being progressively restricted, over the next four years, until no deduction will be available as an expense against the rental income.

Instead, relief at the basic rate of income tax will be given for the restricted amount as a fixed deduction against the tax payer's net tax liability. Whilst some tax relief will therefore still be available, as a result of the mechanism for providing this, some landlords may see a significant increase in their tax liability, in particular those with highly geared portfolios. Under the new rules they may be pushed into a higher tax bracket, see an impact on their Child Benefit or the tax-free Personal Allowance being lost. In some cases the tax liability attributable to the property business may even exceed the actual profit arising.



From 6 April 2017 the restriction applies to 25% of the finance costs; increasing by 25% each year until 5 April 2020, after which 100% of the finance costs will be subject to the restriction. Unused relief at the basic rate under these provisions may be carried forward to subsequent years.

Owning properties through a limited company may become more attractive. However, any savings will need to be weighed against the potential additional charges, including the Annual Tax on Enveloped Dwellings (ATED) charge, Stamp Duty Land Tax (SDLT) charges, additional income and Capital Gains Tax (CGT) charges on profit extraction and professional fees. Professional advice should be taken before transferring an existing property business into a company.

> "The new rules mean that landlords will no longer need to decide whether the property is sufficiently furnished to claim the relief, as with wear and tear allowance."

Capital allowances

Capital allowances are available in calculating the profits of a property business, but items of plant or machinery for use in a single occupation dwelling, such as furniture and fittings, are specifically excluded. The result is that for residential lettings businesses capital allowances are often only available for expenditure on items such as vans and tools. You may be eligible for 'replacement' relief.

Replacement domestic items relief after 5 April 2016

Prior to 6 April 2016 a 'wear and tear' allowance was available for fully furnished properties to compensate the landlord for the cost of furniture and soft furnishings, etc. The allowance was equal to 10% of the 'net rent', i.e. the gross rent less any charges that would normally be borne by a tenant but were in fact borne by the landlord, such as council tax and water and sewerage services. No allowance was available for part-furnished or unfurnished properties.

> "In general, losses of a property business can only be carried forward for use against future profits of the same business."

From 6 April 2016 the wear and tear allowance was superseded by the 'replacement domestic items relief' which enables landlords of residential property to deduct costs they incur on replacing items for domestic use, such as furniture, furnishings, household appliances and kitchenware. No relief is available for the initial expenditure on these items. The cost of replacing fixtures will normally qualify for deduction as a repair. The new relief applies to landlords of unfurnished, part-furnished and furnished properties but not to furnished holiday lettings.

A deduction is also available for the incidental costs of disposing of the old item(s), less any amounts received on that disposal. Any part of the cost of the replacement asset that exceeds the cost of a like-for-like replacement is excluded from the relief.

The new rules mean that landlords will no longer need to decide whether the property is sufficiently furnished to claim the relief, as with wear and tear allowance. In practice, they will no longer need to be concerned with whether the items being replaced are fixtures or furnishings because a deduction will be available in both cases, albeit under different provisions.

The use of losses

In general, losses of a property business can only be carried forward for use against future profits of the same business. Where a landlord 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 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 sale of a property the gain will be subject to CGT, unless during ownership the property has ever qualified for the individual's principal private residence exemption, in which case relief may be available, including Let Property Relief. The CGT annual exemption for 2017/18 is £11,300 and if the property is in joint names each partner will have their own annual exemption, unless already utilised against other gains.

For residential property CGT is charged at 18%, or at 28% to the extent that taxable income and gains, taken together, exceed the basic rate band. Clearly, this is likely to be the case if a significant gain has arisen.

From 6 April 2016 CGT rates generally were reduced to 10% and 20%, but the reduction specifically excluded residential property, being a further blow to landlords.

Property used for furnished holiday lettings may qualify for entrepreneurs' relief, giving a tax rate of 10% irrespective of the level of other income and gains.

Joint ownership

If the property is owned in joint names by spouses or civil partners who live together, the income is normally split between them equally for tax purposes. If they own the property in unequal shares and make an appropriate election, the income may be split in accordance with those shares, which may enable the best use to be made of

the personal allowances and basic rate band of the partner with the lower income. However, any changes in beneficial interests will also affect the CGT treatment on the eventual sale of the property.

Stamp Duty Land Tax (SDLT)

Another factor to take into account when purchasing a buy-to-let property is the SDLT payable. This applies at increasing rates to each slice of the purchase price, rising to 12% for the portion above £1.5 million. From 6 April 2016 a surcharge of three percentage points applies to purchases of buy-to-let properties and second homes. This may prove to be a significant additional cost for landlords looking to expand their property portfolios.

Inheritance tax

The assets in a property business form part of the landlord's estate and, subject to any directly attributable borrowings, will augment the value of the estate for calculating inheritance tax. If the total value of the estate exceeds the nil rate band available inheritance tax will be payable on the excess.

"From 6 April 2016 a surcharge of three percentage points applies to purchases of buy-to-let properties and second homes."

Making tax digital (MTD)

Landlords may keep their records in a variety of ways, from paper records, spreadsheets to sophisticated accounting software. These records are used to prepare the supplementary pages of the annual tax return.

Under the MTD initiative, the Government are proposing that all landlords will be required to maintain their records digitally (spreadsheets will still be allowed) and report summary information to HMRC on a quarterly basis, followed by an annual activity report confirming the taxable profit, or loss, for the year. The form of the current tax return will change to a 'final declaration'.

At the same time it is expected that rental profits will need to be reported on a cash basis, rather than the current accruals basis.

The proposed timetable is for property businesses with turnover exceeding £85,000 to join MTD from 6 April 2018 and for businesses below this threshold to join from 6 April 2019. Property businesses with turnover below £10,000 are expected to be exempt from MTD and will continue to file an annual tax return - for the time being.

Will making tax digital apply to me?

In the Spring Budget, the Government announced its proposed timetable for the introduction of making tax digital, including the various thresholds, which can be seen in the table below:

Unincorporated property businesses with an annual turnover above the £85,000 VAT threshold	6 April 2018
Unincorporated property businesses with an annual turnover at or below the £85,000 VAT threshold but above 10,000	6 April 2019
Businesses with an annual turnover of less than £10,000	Exempt

Conclusion

With the numerous changes to the rules relating to the deductibility of certain expenses, it is more important than ever that landlords be aware of which rules apply to any particular tax year and are prepared for the potential impact on their tax liabilities.

If you would like further information on any item within this brochure, or information on our services please contact your usual Moore Stephens adviser.

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