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BUY TO LET GUIDE

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Buy-to-let: the basics

Why become a landlord?

You may become a landlord accidentally by inheriting a house, or by retaining a former home when you move house. There is an attractive tax incentive for letting a former home (see Former home). Alternatively, you may buy property with the specific intention of letting it.

An investment in let property can create a second income stream for you or your spouse, if he or she also holds an interest in the property (see Joint owners). Some people hold property to provide an alternative fund for retirement and let it in the meantime.

In this brief guide we look at the pros and cons of letting out residential property in the UK, including furnished holiday accommodation. We do not cover the letting of commercial properties in this guide but we are happy to advise on that area of investment on an individual basis.

What are you taxed on?

The tax you pay depends on how you hold the let property – as an individual, jointly, or through a company (see How to hold your property).

As an individual landlord you must pay income tax on your 'property income'. This is the sum of the rents you receive less the tax deductible costs (see Tax allowable expenditure). Property income does not include the profit you make when selling the property, and it does not take into account the costs of buying, selling or improving the property.

All of the income you receive from letting property in the UK, both residential and commercial, is combined and taxed as one property investment business. A loss on one property can be relieved against profits made from another in the same tax year or later years. Overseas property, and furnished holiday lets are treated as separate businesses.

Deposits collected from tenants are not part of your property income unless they become non-returnable under the tenancy agreement. You should only include the retained deposit in your property business accounts when the funds are used to cover the costs the deposit was designed to pay for, such as renewal of furniture, repairs or legal fees.

Start

Your property letting business commences when you have acquired your first property and it is available for letting. This means the property is in a condition where it can be let, subject to cleaning, furnishing and drawing up letting agreements. If the property is in such a poor state that it cannot be let, it cannot be treated as part of your property letting business. The expenses connected with renovating a property to bring it into a habitable condition are not immediately deductible (see Capital costs).

Expenses incurred before you start the lettings business, such as advertising or minor repairs, can be deducted from the rents you receive in the first tax year if two conditions are met:

- the expenses are classified as revenue costs rather than capital
- the costs are incurred within seven years of the date on which you first let the property

Once your property letting business is up and running, any later expenditure leading up to the letting of the second and subsequent properties is part of your lettings business and can be deducted, as long as it qualifies as tax deductible.

End

Your property letting business finishes when you no longer have any properties available for rent, and you are not looking for tenants. This may be because you have decided to occupy the last property yourself, or you are keeping the property empty prior to sale.

You can't deduct any revenue expenses which are incurred after the last property has been withdrawn from the lettings market. Thus the costs of sprucing-up the property post-letting but pre-sale won't be tax deductible.

How to hold your property

Single individual

If you hold the let properties in your own name, you will be taxed on the income and gains arising from those properties. You can't transfer the income before tax to another person without first transferring an interest in the property.

You should declare all of the income and expenses from those properties on the property income pages of your personal self-assessment tax return. Even if you don't make a profit from the letting, you need to declare the loss you make so it can be deducted from profits made from lettings in a later period.

Overseas properties

If you let properties which are situated overseas, the income and expenses from those properties must be shown on the foreign income pages of your tax return. Profits or losses from overseas properties need to be calculated separately from those arising from UK properties.

Joint owners

Where a let property is held in the joint names of a married couple or civil partners it can provide a useful income stream for the spouse/civil partner who has little or no other income.

In England and Wales you can own a property as joint tenants; where both owners hold an equal interest in the whole property; or as tenants in common where each owner holds a separate and identifiable share, say 10% and 90% of the property. There are different rules for properties located in other countries, including Scotland.

When a legally joined couple (married or civil partners), own property; as joint tenants, any income from that property must be split equally between them for tax purposes and declared as such on each person's tax return.

If the same couple hold the property as tenants-in-common in unequal shares, they can make a declaration on HMRC's Form 17 to have the property income taxed in the proportion that reflects each partner's beneficial interest in the property. Without the Form 17 declaration the couple will each be taxed on an equal share of the income from the property. The Form 17 election is not reversible, so once you have elected to be taxed on your actual share that's it, unless your actual ownership in the property changes.

Where the joint owners of a property are not married or in a civil partnership, they can agree to share the income from the property in whatever ratio they choose, although this profit-sharing ratio would normally reflect the underlying beneficial ownership of the property.

If you want to split the property income in unequal shares instruct your solicitor to acquire the property as tenants-in-common in the ratio of ownership desired. Where you already own the property as joint tenants it is quite simple to change to tenants-in-common, but there can be a Stamp Duty Land Tax (SDLT – LBTT in Scotland) charge where the property is mortgaged.

When the property is sold, any capital gain arising must be split according to the beneficial ownership of each owner.

Limited company

There can be tax advantages to running a let property business through a limited company, as the company pays tax at 20% on income and capital gains. In comparison, an individual pays income tax at 20%, 40%, or 45% and Capital Gains Tax (CGT) on gains at 18% or 28%. However, the company's taxable capital gains are calculated differently to those of an individual, so the tax rates are not directly comparable. Also, there may be further tax and National Insurance charges when you extract funds from your company.

The company may also be subject to a 15% rate of (SDLT) when it buys residential property worth over £500,000. The Annual Charge on Enveloped Dwellings (ATED) can also apply to company-owned properties worth over £1m. Relief from both of these tax charges can be claimed if the property is commercially let to an unconnected tenant.

If you already own a company which holds funds not needed for its trade, investing in buy-to-let property can make commercial sense, provided the company can secure a mortgage for the balance of the purchase price. However, where the trade may become overshadowed by the value of the properties it holds it may no longer be classified as a 'trading' company, which means it is no longer eligible for a number of tax reliefs, including entrepreneurs' relief.

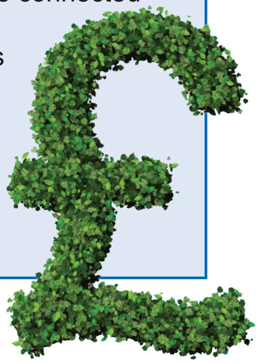
Tax allowable expenditure

Not all expenses associated with letting a property are deductible from the rental income for tax purposes, so you need to sort your expenses into categories. Start by dividing them into the 'capital' costs connected with buying, selling or improving your properties, and other costs which reoccur as the tenants change – known as revenue expenses.

Allowable revenue expenses can generally be deducted from the rents received for the period (normally the tax year), in which the cost was incurred. But if you have an obligation to pay a sum in the future (e.g. for a specific repair) you can deduct that future cost in the current period if you are certain of the amount you will have to pay.

Allowable revenue expenses can include:

- accountancy fees for drawing up the property business accounts
- advertising for tenants
- gardening, cleaning, and security services where relevant
- ground rent and service charges for leased property
- heating and lighting costs
- insurance for the buildings and contents
- interest paid (see below)
- legal fees for drawing up tenancy agreements or collecting debts, but not those connected with acquiring properties
- letting or managing agents' fees
- maintenance and repairs
- motor expenses for travelling to the property
- water rates and council tax
- wear and tear allowance (see below)



This is not a complete list – ask us about any other costs you have incurred that don't fall under one of those headings, as they may be deductible. If your tenant is responsible for paying some expenses – such as the water, energy and council tax bills – you can't also claim a deduction for those items.

Interest paid

You can currently deduct all the interest paid on all loans used to finance your property letting business (see below for changes from 2017). It doesn't matter whether the money borrowed was used to purchase the property, improve it, or pay for a repair – the interest is deductible, as is any loan arrangement fee, or similar finance charges.

If you extend the mortgage on your own home to release funds to help to finance your let property business, you can set off the interest on the extended portion of the mortgage against the rents received from the let property. However, to show HMRC where the capital has come from you need to include a balance sheet for your property-letting business with your tax return. We can help you with that.

2017 onwards

The interest and finance charges paid by individual landlords will be restricted as follows:

Tax year	Amount of interest deductible
2017/18	75%
2018/19	50%
2019/20	25%
2020/21 and later	Nil

Up to 20% of the disallowed interest will be deducted from the tax due on the rental income. Where this interest deduction exceeds the tax charge for the year, the excess amount will be carried forward to be relieved against tax payable on the profits from the let property business in a future tax year.

This change effectively gives you tax relief for the interest at 20%, equivalent to the basic rate of income tax. Corporate landlords are not affected as they already pay tax at a maximum rate of 20%.

Where you have significant loans connected to your let property business, we can help you calculate whether that level of borrowing will be sustainable after 6 April 2017.

Repairs

The cost of repairs is always deductible from rental income, but the cost of improving a property is a capital cost which is not immediately deductible (see below). The difference between a repair and an improvement is: a repair restores what was originally there without adding new functionality – everything else is a capital improvement.

Example

Refurbishing a kitchen will count as a repair if the new kitchen is of a similar standard as the one it replaces. HMRC will accept the following as repairs: rewiring, plastering, tiling and replacement of fixed fittings such as sink and cooker. If the kitchen is substantially upgraded by, say, increasing the size or by using higher quality materials, the whole project cost should be treated as a capital improvement.

You can't apportion the cost of a project between improvement and repairs. If the work done will fall into both headings, ask the builder to quote and bill for each piece of work separately.

Example

Fred has a new bathroom fitted where one didn't exist before, and at the same time redecorates the adjoining bedroom. The new bathroom is an improvement as it has added a new feature to the house. The redecoration is a repair. Fred asks his builder to give him separate bills for the bathroom and bedroom. He claims the cost of decorating the bedroom against rental income, and treats the bathroom cost as a capital improvement.

Capital costs

Any capital costs, such as improvements, can only be deducted from the sale proceeds of the property. You need to keep track of which capital expenses relate to which let property and keep hold of all the relevant receipts and contracts.

Wear and tear

If you let your residential property fully furnished (not partly furnished or unfurnished), you can deduct a wear-and-tear allowance of 10% of the rents every year. In HMRC's view, a furnished let property is one 'let with sufficient furniture, furnishings and equipment for normal residential use'.

The wear and tear allowance is supposed to cover the cost of replacing movable items supplied in the property, such as furniture, carpets, curtains, electrical goods and kitchenware. The cost of replacing items that are fixed to the property will normally be claimed as repairs (see above). Currently, the wear and tear allowance can be deducted even if you don't replace any items in the tax year.

However, from 6 April 2016 the wear and tear allowance will be abolished. Instead, all landlords will be able to deduct the actual costs of replacing furnishings in the property. This is good news for landlords who let partly furnished properties as they will be able to get a tax deduction for the cost of *replacing* carpets, curtains and free-standing white goods, although not for the initial cost of those items.

Record keeping

Landlords, just like other business owners, must keep adequate records to enable them to calculate their profits or losses accurately, without recourse to estimates. You should retain a record of every relevant expense, the original documents are ideal, but a scanned copy is acceptable. Deposits will relate to individual tenancies, so details of the start and finish dates of each tenancy should be recorded.

Note down details of any personal assets you use for the letting business, such as the date and distance of car journeys, or time spent on administration at your own home.

All the records relating to your property business must be kept for at least six years after the end of the tax year in which the property is let or sold, in case the tax inspector asks about the figures shown on your tax return. So documents relating to the tax year to 5 April 2015 should be retained until 6 April 2021.

Holiday lettings

If you can let your furnished property for short term lets (each less than a month) it can qualify as a furnished holiday letting (FHL). This has a number of tax advantages.

Conditions

The property doesn't have to be in a recognised holiday centre; it can be situated in any part of the UK or even in another European country. However, it must be let to the general public (not just to family and friends), on a commercial basis for short lets totalling 105 days or more in the year, and be available for short-term lets for at least 210 days in the year. For the remaining seven months of the year it can be let for longer periods. The 105 day total can be averaged over a number of properties and skipped for a year or two, if the other conditions apply.

Tax effects

The profits and losses for an FHL business are calculated in the same way as for an ordinary lettings business, but your total costs may be higher as the turnover of tenants is more frequent. You may also have to register for VAT as holiday lettings are subject to standard rate VAT, whereas normal residential letting is exempt from VAT.

On the plus side, you can claim capital allowances on equipment used in and around the property, instead of the wear and tear allowance. Your profits are treated as earnings for pension contributions, but losses can only be set against other FHL profits.

When you sell the property any CGT due on gains can be deferred by buying another business asset. Entrepreneurs' relief can also reduce the CGT to 10% when you close your FHL business.

Selling the property

Capital gains

When you sell your let property you would expect to make a profit after deducting allowable costs (see below). If all the capital profits you make in the year (not just from property disposals) exceed your annual capital gains exemption (£11,100 for 2015/16), you must declare the profits on the capital gains pages of your tax return.

Gains in excess of the exemption are subject to CGT at either 18% or 28%, depending on the level of your net taxable income for the tax year. The CGT is payable by 31 January following the end of the tax year in which the property was sold or disposed of.

When you give away the property to someone other than your spouse/ civil partner, or sell it to someone connected to you at a discount, that disposal is treated as a sale at market value for tax purposes.

Allowable costs

The following costs may reduce the taxable gain on the disposal of a property:

- solicitors' and estate agents' fees paid on the sale and purchase
- SDLT, or LBTT (in Scotland) paid on purchase
- cost of improvements
- capital losses made in the same or earlier tax year
- exemption as a main home (see Former homes)
- lettings relief (see Former homes)

Former homes

When you live in a property the gains made relevant to your period of occupation are exempt from CGT on disposal of the property. Other periods you spend away from the property may qualify as deemed periods of occupation if you return to live there at a later date.

If you live in more than one home concurrently you can nominate which property is to be treated as your tax-exempt 'main home' and change that nomination at will. You must make the first nomination within two years of the date on which you started to use the second property as your home. A husband and wife, or civil partners, can only have one tax-free main home between them.

The nomination of a property as your main home can save you CGT in the long term. If you move out before the property is sold, the gain relating to the last 18 months of your ownership is also exempt from CGT. This can include a period when the property was let or unoccupied.

Lettings relief

If a property, or part of the property, was treated as your main home either before, during, or after the time it was let out, you can get a deduction for lettings relief on the proceeds of the sale. Lettings relief is restricted to the lower of three amounts:

- the part of the gain exempt because it was used as your main home
- the gain attributed to the let period
- £40,000 per owner

Lettings relief cannot apply to a buy-to-let property that you have never lived in yourself. We can help you claim all the reliefs due on the sale of your property.

Inheritance Tax

The value of all your possessions, including the home you live in and your buy-to-let properties, are all potentially subject to Inheritance Tax (IHT) on your death. There are exemptions for gifts made more than seven years before you die, amounts left to your spouse/civil partner or to charities, and the value of your estate falling in the nil rate band.

This nil rate band is frozen at £325,000 until 6 April 2021, but any unused nil rate band may be passed on to your spouse/ civil partner. From April 2017 there will also be a property-related nil rate band of £100,000 per person that can be set against a property that has been your home. It's essential to have a well drafted Will to take full advantage of the IHT exemptions available on death.

Non-resident landlords

If you live outside the UK and let property located in the UK your letting agent (or tenant where there is no agent) should deduct 20% tax from the rents before paying you. However, where you gain approval from HMRC under the non-resident landlord scheme to receive gross rents, that tax is not deducted. You have to promise to declare the income from your let properties on a UK tax return, and pay tax due on the profits.

Capital Gains

Any gains arising from 6 April 2015 on disposals of UK residential property are subject to CGT in the UK, even where the landlord lives in another country. Such gains made by non-resident owners must be declared to HMRC within 30 days of completing the sale. Gains made by purchasing 'off-plan' and selling before the property is finished are also taxable. The gain made on disposal must be divided between the exempt period before 6 April 2015 and the taxable period from that date. We can help you with the calculations.