

about tax

Introduction

As a Buy-to-Let landlord it's important you know about tax and how it affects you and your investment.

This is why Clegg Gifford Private Clients, the specialist Buy-to-Let mortgage broker, has teamed up with Allen Steinberg accountants, to 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 2006.

Effective Tax Planning

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1. Your property portfolio plan.

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's 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 £4,895 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 Inland Revenue defines owners as follows:

- those with an equal interest in the

property - '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%, as 'tenants in common'. If the property is held in unequal shares the couple can make a declaration on Inland Revenue form 17 to have the rent taxed in the proportion that they hold the beneficial interest in the property. Without a form 17 declaration, two people 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 or not, or operating as a partnership in business, it is important that expert financial advice is sought.*

3. Purchase

All residential properties are exempt from Stamp Duty Land Tax if they are worth less than £120,000.

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 the 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 an accountant. If you borrow money which is not secured on your buy-to-let prop-

erty 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 an Inland 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 Inland 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 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 Inland Revenue, unless a written exemption has been received from the Inland Revenue not to do so. If you are an overseas landlord you can apply to the Inland 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 Inland 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 designed to prevent, such as renewals, repairs or legal fees. Don't forget, you have a legal responsibility to notify the Inland Revenue of any liability. There are strict tax deadlines and late returns not only incur penalties but also increase the likelihood of Inland 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.

10. Allowable Expenses (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 or repair of a let property, where the property is let for 26 weeks or more.

- **Water rates**

- You can include the full amount of water, sewage and any other rates paid on the property, if these are not paid by the tenants.

- **Insurance**

- You may include all insurance policies 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 Inland Revenue is unlikely to permit the replacement of a tatty bathroom with a spa bath and other luxury items. However, the Inland Revenue may be agreeable to replacing wooden window frames with UPVC. Professional advice should be sought or speak to the Inland Revenue directly.

- **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**

- From 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.

11. 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 40% if you are a higher-rate taxpayer. This

means on a £100,000 gain, tax can take up to £40,000 of your investment profit. When you sell you will have to pay CGT on any capital accrued.

12. 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:

- **Inflation**

- You can add up how inflation increased the value in the years up to 1998 when this tax break ended and claim accordingly.

- **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**

- 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.

- **Taper Relief**

- You can claim Taper Relief on capital gains. The basic non-business asset taper relief [NBATR] can reduce taxable gains, before annual exemptions, by up to 40% over a ten-year period. The relief is given in 5% increments but only starts when the asset has been owned for three years from purchase or at 5 April 1998, whichever is the latest. There is a bonus year if the asset was held on 17 March 1998. You should check the date you acquired the property and the proposed date of completion of the sale contract very carefully as you need complete years to qualify for Taper

Relief so a single day out could mean you lose significant tax relief.

• Capital Gains

- Everyone can make a capital gain tax free of up to £8,500 for the 2005/06 tax year. A jointly owned asset therefore will need a chargeable gain in excess of £17,000 before Capital Gains Tax becomes payable.

Questions & Answers

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 tax 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 Inland Revenue?

You have an obligation to register with the Inland 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.inlandrevenue.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 £7000 interest per year on your own home's mortgage and only £4000 interest per year on your buy-to-let mortgage you are

taxed on any rental income over and above the £4000 yearly interest payment. If you were to reduce the interest payable on your own mortgage to £4000 and increase your yearly interest on your buy-to-let property to £7000 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 Inland 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 Inland 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:

1. Have a tax and management strategy, including an 'exit' strategy, before purchasing investment property. This could potentially save a fortune!
2. Make a will
3. Establish ownership - single or joint names - at the outset
4. Consider buying property in one of the Government's designated disadvantaged areas to be exempt from Stamp Duty Land Tax on properties worth less than £150,000
5. Take out the right mortgage
6. Set up a separate bank account for the lettings business
7. Keep detailed records of lettings income and expenditure - essential when completing the Annual Income Tax Return
8. 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.

Find out more

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