Tax guide for property investors
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Introduction

Investing in property appeals to many people. The attraction goes beyond the rental yield, the prospect of capital appreciation over the long term and the ability to secure borrowings to fund part of the cost. No investment is without risk. But in an uncertain world, where banks can fail and whole countries become bankrupt, an investment in bricks and mortar has a reassuring feel about it.

Property investors come in all shapes and sizes. At MGI Midgley Snelling LLP, we have many property clients including both investors and owner-occupiers, who range from a single shop owner to those with a property portfolio, from individuals to groups of companies, owning both residential and commercial property.

This guide is a brief summary of some of the tax issues which affect property owners. Of course, it cannot be a substitute for proper professional advice, but we hope it will provide some useful pointers for both existing and prospective investors.
A property investor, like anyone going into business, needs to consider the most appropriate structure through which to operate.

This may be by way of:

- personal ownership, either alone or jointly with others
- a trust
- a limited company
- a limited liability partnership
- a pension scheme (for commercial property only)

Often, personal or joint ownership can be the most suitable vehicle for smaller investors. For example, claims to rent a room relief, capital gains tax private residence exemption and furnished holiday let status will generally only be available for personal owners.

Trusts may be appropriate in some cases, particularly as part of an inheritance tax planning strategy as linked to family asset protection, but they can be complex and relatively expensive to run.

Limited companies may suit some investors as profits are subject to corporation tax at a maximum rate of 19% (2017-18). However, if a property is sold and the profits extracted, there can be a double tax charge – firstly corporation tax on the company’s profit on the sale, and then income tax or capital gains tax at a personal level on the extraction of the remaining funds by the shareholders.

A company will probably only be the right choice for larger investors who are planning to hold property ownership long-term for the benefit of future generations of families.

A limited liability partnership or LLP is a corporate entity, very like a limited company for legal purposes. However, it is taxed like a normal partnership in that its profits are allocated to the partners and charged to income tax or capital gains tax.

Investors in high-value residential properties must bear in mind the additional stamp duty land tax, annual tax on enveloped dwellings, and capital gains tax payable both by companies and other “non-natural persons”.

Pension schemes can be a very tax-efficient way to invest in commercial property, including premises used by the members’ business. As well as providing a source of funding, the pension scheme’s tax exempt status allows the rent paid to it by the business to accumulate tax-free, and any profits on the eventual sale of the property can be tax-free too.

In choosing a structure, it is important to consider the commercial picture as well as the tax implications, for example the cost of running a company or trust, and the cost of borrowing.
Some property investors buy property and retain it as a long-term investment. In these circumstances, when a property is sold, the gain arising will usually be subject to capital gains tax (CGT) at a maximum rate of 28% (2017-18). An annual capital gains tax (CGT) exemption (currently £11,300) and various other reliefs may be available for offset.

For individuals, the tax treatment of capital gains will therefore generally be much more favourable than assessment to income tax.

This is less so for limited companies, but, even so, the availability of indexation allowance (for companies only) can give some advantage to capital gains treatment.

Therefore, a property investor should consider carefully whether their activities amount to a trade, thereby bringing their profits into the income tax regime.

**Indicators of trading status**

Factors which may point to a trading activity include:

- short period of ownership
- enhancement expenditure
- pattern of frequent transactions
- property not let
- wording in business plan / loan proposal
- excessive use of borrowings to finance purchase of property as stock in trade
Individuals with rental income must calculate their taxable profits based on them operating a rental income business. This means that all their rental activities form a single business, and income and expenditure must be dealt with under proper accounting principles. A statement of income and expenditure will need to be drawn up to 5 April each year.

**Allowable expenses**

Allowable expenses generally will be those costs genuinely incurred in connection with the rental business. Here is a list of some of the more common items.

- Accountancy
- Advertising
- Agent’s management fees
- Bad debts
- Bank charges
- Caretaking
- Cleaning
- Council tax
- Debt collection
- Electricity
- Energy-saving insulation & draft-proofing
- Gardening
- Gas
- Ground rent
- Insurance
- Interest
- Inventory
- Maintenance costs
- Management charges
- Postage and stationery
- Repairs
- Security
- Telephone
- Water rates
- Renewing furniture and furnishings (for furnished accommodation only)
Repairs

As a general rule, the costs of repairing and maintaining the let properties will be deductible. This can include more substantial items such as, say, replacement windows or re-roofing.

This is subject to two main restrictions:

1. Capital expenditure, for example, extending the property or changing its internal layout, cannot generally be deducted against rental income.

2. Repairs incurred when a property is first acquired, in order to bring it up to a rentable condition, will also be treated as a capital cost.

Sometimes a builder’s invoice will cover a mixture of items, some of which are allowable and others which are not. It will be necessary to obtain a breakdown or calculate a realistic analysis and disclose the workings as part of your submitted tax return.
Finance costs

Many investment properties are financed partly by loans; these may be secured on the property itself, on other investment property or on the investor’s own home.

Generally it is the purpose for which the funds were used, not the security given, which matters when considering whether the related interest is tax deductible. So, if a loan is taken out, secured on your private residence, and the money is used to buy a property to let, the interest charged will be allowable.

If a property which has been a private residence is subsequently let, borrowings secured on it, up to its value at the time it is introduced to the letting business, will qualify.

It may be possible to refinance an existing rental property, use the funds for other purposes, and still obtain tax relief on the interest. This will depend on the circumstances, and you should seek further advice if considering this option.

Remember that it is only the interest which qualifies for tax relief. HMRC has commented in the past that a common error found in enquiries into “buy to let” taxpayers is the claiming of tax relief on capital repayments. Also, life insurance premiums, even if a condition of obtaining a loan, are not deductible, although arrangement and valuation fees and other “incidental costs of loan finance” are.

In the summer Budget 2015 the government announced that it would be restricting tax relief on mortgage interest to the basic rate of 20%. This change will be phased in gradually from April 2017 to April 2020.

Travel

Provided that the “rental income business” can be shown to have a base – which may be your home – travel costs incurred in visiting property to inspect it, carry out maintenance, collect rents etc are allowable. You should keep records, and also avoid combining the journey with non-business related travel, as this would disqualify the whole journey from tax relief.

Generally, reasonable claims will not be challenged, however, if there is a single property, some distance away, demonstrating where the business is based will be more difficult.

Furnished lettings

With effect from April 2016 landlords are only able to claim the actual expenses incurred in replacing furnishings and furniture during the course of the tax year.

Note that to qualify as “furnished”, the property must be capable of occupation without the tenants providing their own beds, chairs, tables, sofas, white goods etc. A partly furnished property will not qualify.
Furnished holiday lettings

Furnished holiday lettings (FHL) – see below for how this is defined – are treated as if they were a trade for certain tax purposes, which means they qualify for some tax concessions.

The conditions

To qualify for FHL status for the 2016/17 tax year onwards, the property must be:

- situated within the European Economic Area
- furnished
- let to the public commercially as holiday accommodation
- available for letting for at least 210 days in the tax year
- actually let commercially for at least 105 days, and
- not let for periods longer than 31 days at a time to any one tenant

The tax advantages

The concessions available are:

- Capital allowances are available on furnishings and appliances (not generally the case for other types of residential property).
- Capital gains tax roll over relief (so that a gain on a property sale may be deferred from tax assessment if a replacement property is bought).
- Capital gains tax entrepreneurs’ relief may be due so that capital gains tax on sale is potentially reduced from 28% to 10%.
- Profits count as trading income for pension contribution purposes.

Rent a room

Income from the letting of furnished accommodation which is part of an individual’s main residence is tax-free provided that, before deducting any expenses, it does not exceed £7,500 in a tax year.

The property must be used as the main residence at some point in the tax year.

If the gross rent exceeds £7,500, you have a choice either to pay tax on the excess or to claim property expenses in the normal way.

You can also ignore the exemption, and base your return on the actual income and expenditure, if a loss arises.
Capital allowances on commercial property

Introduction

Capital allowances is the system under which businesses obtain tax relief for their capital expenditure. The legislation categorises capital assets and regulates whether, and at what rate, allowances are given. Generally, in considering property investors, we are concerned with allowances for “machinery and plant”.

There are numerous rules which relate specifically to items contained within buildings, so the area can be a complex one. The rules generally apply equally to property investors and those using the property as trading premises.

In essence, expenditure on plant and machinery will give rise to an annual writing down allowance, the rate of which will depend on the nature of the asset. An annual investment allowance may also be due, which will provide a 100% allowance in the year of expenditure, up to a maximum. The current allowance is £200,000 (from 1 January 2016).

The definition of “machinery and plant” is complex, but will generally include items such as kitchens, WCs, heating systems, fire alarms, air conditioning, lifts, conveyors, racking and some electrical works.

When buying a commercial property, the fact that the purchaser may attribute a value to the machinery and plant element of the cost, and claim capital allowances on it is often overlooked. The amounts involved can be substantial. It is vital that such an appointment of costs be conducted and agreed, or the buyer will not be able to claim capital allowances.
Enhanced capital allowances
The enhanced capital allowances scheme is designed to encourage investment in low emission cars, energy saving and water-efficient technology by giving a 100% first year allowance for expenditure on equipment on an approved list.

The allowances include items such as boiler equipment, heat pumps, ventilation equipment, lighting, hand dryers, refrigeration equipment, uninterruptible power supplies, showers, taps, toilets, washing machines and industrial cleaning equipment.

Important new rules – Finance Act 2012
Since April 2012, where the seller had claimed capital allowances on fixtures, it has been necessary for the seller and buyer to jointly make an election as to their value, so that the same figure is taken into account in dealing with their tax affairs.

If an agreement cannot be reached, either party may refer the matter to the tax tribunal.

If there is neither an agreement nor a tribunal determination, then the purchaser will not be entitled to claim capital allowances, nor will any future owner.

From April 2014 it is only possible to claim capital allowances where the seller has pooled the expenditure for capital allowances purposes by notifying HMRC. Thus buyers will need to ensure that the seller (who may not have had any need to claim capital allowances) has cooperated in making such an election notice in order that the buyer may make a claim for capital allowances.
Private residence exemption
Generally speaking, a gain arising on the sale of your home will be exempt from CGT. Often, some exemption will be available if the property has been let but has also been your home, and the amount of exemption available will depend on the circumstances. However, see the section on trading for cases where a charge to income tax may arise.

Has it really been your residence?
To qualify for the exemption, the house must really be your residence. There is no set period for this, but it has to be more than just living there for a short while, or nominating it as your address when you actually live somewhere else.

HMRC are prepared to challenge borderline cases, and it really is important to be able to prove what is the truth. As well as the length of occupation, factors such as correspondence address, electoral register, children’s schooling and involvement in the local community may be taken into account.

A property may only be treated as an individual’s Principal Private Residence for the tax year where the person has either been tax resident in the same country as the property for that tax year or resident in the property for at least 90 midnights in that tax year. This applies equally to a UK resident disposing of an overseas residence as it does to a non-UK resident disposing of a UK residence.

Is it your main residence?
If you have more than one private residence, you may make an election as to which one will be exempt, providing this is done within two years of acquiring the second private residence. This is to eliminate uncertainty in cases where there are genuinely two homes in which you actually reside. But it may only be used to nominate which actual residence is to be the main residence. You cannot elect for a property to be treated as your residence if, based on the facts, it is not.

If you sell a building plot
The exemption covers gardens up to 0.5 hectare or such larger areas as is required for “the reasonable enjoyment of the property”. So if your garden is within this and you sell off a part of it for development, you can claim the exemption provided that you actually do occupy the property claimed. However, if you sell the house first, the plot will cease to be your residence and will no longer be exempt from tax.
Can married couples claim an exemption each?
No. A couple who are married and not separated may only have one exempt property between them.

If the property was let for part of the time
The gain will be time-apportioned to calculate the exempt portion, and the balance will be subject to CGT. However, you may qualify for a further exemption of up to £40,000 per individual if jointly-owned.

If part of the property was let
The exemption will not apply to the proportion of the property which was let. However, as stated above, a further exemption of up to £40,000 may be available. This extra relief was introduced specifically to encourage people to let surplus accommodation in their homes.

If you have been absent for part of the time
If a property is now your private residence, some additional periods are treated as exempt if you were not living in the property at the time, or if you let it during your absence. Most importantly, the last 18 months is always treated as a period of deemed residence. Other “permitted periods of absence” are only exempt if you resume residence when they come to an end.
Tax advice for non-resident landlords

For people who are not domiciled in the UK (non-doms), there are a number of tax planning opportunities available which can bring a number of financial benefits when investing in UK property.

Careful planning can produce substantial tax savings – however, certain things must be taken into consideration including a person’s length of residence in the UK, and calculating this can be especially complicated. This is why it is recommended that you seek professional advice as early as possible.

Individuals not domiciled in the UK need to check whether tax planning opportunities are still available before becoming resident in the UK, when recording details of their overseas income, gains and the original costs of their assets in order to avoid any unexpected tax liabilities which could otherwise be avoided.

We can advise on a range of areas including:

- Income and capital gains tax
- Services for non-residential landlords
- Inheritance tax
- National insurance contributions
- Tax relief for both foreign and UK pension contributions
- Setting up and managing offshore trusts and companies
- Immigration matters
- International and national VAT reclaims and registrations
- UK tax filing compliance requests
Some people choose to use trusts and company structures to hold UK residential property. Specific tax rules apply, both to domiciled and non-domiciled individuals who own UK residential properties using such structures. One of these rules is the Annual Tax on Enveloped Dwellings (ATED). ATED is a tax payable by companies that own high value residential property or ‘dwellings’ sited in the UK.

From April 2013, ATED was initially charged annually on residential property valued at over £2 million held by a 'non-natural person' such as a company or a collective investment vehicle. The charge has since been extended to cover property valued at £500,000.

The amount due depends on the value of the property on 1 April 2012, its subsequent purchase price or its market value if purchased from a connected person. Additional bands on which ATED can be charged were announced in the March 2014 Budget, and introduction is being staggered to ease transition.

From 2014 onwards, the ATED return for properties worth more than £2 million will be due for filings with tax payable on 30 April each year (or, if later, within 30 days after the property has been acquired). Where property is acquired part way through the year, the charge will be adjusted to reflect the period of ownership and a relief can be claimed in respect of the part of the charge which relates to the period in the tax year prior to purchase.

<table>
<thead>
<tr>
<th>Property value</th>
<th>ATED 2016-17</th>
<th>ATED 2017-18</th>
</tr>
</thead>
<tbody>
<tr>
<td>£500,000 – £1m</td>
<td>£3,500</td>
<td>£3,500</td>
</tr>
<tr>
<td>£1m – £2m</td>
<td>£7,000</td>
<td>£7,050</td>
</tr>
<tr>
<td>£2m – £5m</td>
<td>£23,350</td>
<td>£23,550</td>
</tr>
<tr>
<td>£5m – £10m</td>
<td>£54,450</td>
<td>£54,940</td>
</tr>
<tr>
<td>£10m – £20m</td>
<td>£109,050</td>
<td>£110,100</td>
</tr>
<tr>
<td>£20m +</td>
<td>£218,200</td>
<td>£220,350</td>
</tr>
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</table>
Non-residents owning UK residential property – Capital Gains Tax (CGT)

Gains arising on the sale of all UK residential properties are subject to CGT, even if owned by non-UK resident persons. Only the gains relating to the period from 6 April 2015 will be taxed.
Entrepreneurs’ relief for capital gains tax is broadly intended to allow interests in business, or shares in a trading company, to suffer CGT at 10% rather than the maximum rate of 19% (2017-18).

The rules are complex and many potential sellers will not qualify. In each case, it is essential to check the position prior to committing to a transaction.

The relief can extend to properties owned personally and used by the owner’s trading partnership or company, if, in broad terms, it is usually sold in conjunction with a disposal of the business itself.

Relief will be restricted if a rent has been charged for its use.

The owners of trading companies will sometimes wish to own the company premises through a separate company in order to protect it from commercial risks arising from a failure of the trading activities conducted by the trading company.

However a “standalone” company used for this purpose will not qualify for entrepreneurs’ relief. A group structure where the holding company owns the property with the trade in a subsidiary may be a more tax-efficient structure, whilst still providing the desired asset protection.
SDLT is a levy on transactions in land in the UK. 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 briefing note.

**Rates**
The current rates of SDLT are as follows:

<table>
<thead>
<tr>
<th>Purchase price</th>
<th>SDLT rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>On the first £125,000 of the property price</td>
<td>0%</td>
</tr>
<tr>
<td>On the next £125,000</td>
<td>2%</td>
</tr>
<tr>
<td>On the next £675,000</td>
<td>5%</td>
</tr>
<tr>
<td>On the next £575,000</td>
<td>10%</td>
</tr>
<tr>
<td>On the rest (above £1.5 million)</td>
<td>12%</td>
</tr>
<tr>
<td>Over £500,000 (if purchased by non-natural persons)*</td>
<td>15%</td>
</tr>
</tbody>
</table>

*There are some exceptions where the SDLT rates above will apply

From 1 April 2016 the rates charged on the purchase of an additional residential property is 3% above the current SDLT rates.
Leases

For both commercial and residential properties, 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 or £150,000 for a non-residential or mixed use property.

<table>
<thead>
<tr>
<th>Purchase price/Lease premium</th>
<th>SDLT rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to £150,000</td>
<td>0%</td>
</tr>
<tr>
<td>Over £150,000 to £250,000</td>
<td>2%</td>
</tr>
<tr>
<td>Over £250,000</td>
<td>5%</td>
</tr>
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Value Added Tax (VAT)

VAT on property transactions is a complex area and, as with other taxes, it is essential to take timely expert advice.

Some of the main points to consider are outlined below.

VAT exempt status
Income received from the sale or rent of land and buildings will normally be exempt from VAT, in which case a 20% output VAT on the income is not charged. Neither is the recipient of such income entitled to reclaim the input VAT paid.

Where a person carrying on a business has only exempt supplies, there is no requirement to register for VAT.

However, there are some very important exceptions to the general VAT exemption.

New residential property
The sale of a new residential property is zero-rated rather than exempt. This means whilst the builder will generally not be required to charge VAT on its sale, the builder will be able to recover the input tax on the costs of building the property.

DIY housebuilders
There is also a scheme to enable “do it yourself” builders to recover the input tax they pay on constructing a new dwelling. However, there are strict rules governing what may be reclaimed, when claims must be submitted, and what supporting documents are required.

Details are available at the HMRC’s website at www.hmrc.gov.uk/vat/sectors/consumers/new-home.htm
The “option to tax”

The option to tax – or, technically, the making of an election to waive VAT exemption – as the name suggests, makes supplies subject to VAT which would otherwise have been exempt.

The election will generally be made to enable the recovery of input tax in connection with a sale which would otherwise have been exempt (for example, on the development of a commercial building for sale or rent).

Once an election is made, there is a cooling off period of six months during which it may be withdrawn, but after that it may not be revoked until 20 years after the date it was made.

With substantial amounts of tax often at stake, the decision as to whether to make an option to tax should only be made after careful advice and consideration prior to completing any property transaction.

If you buy a “taxable” building, you will need to consider the implications carefully, and may need to register for VAT if you are not already registered.

Holiday lettings

The general rule that rental income is VAT exempt does not apply to holiday accommodation, which is standard rated.

Many investors will not need to worry about this rule, as their annual rental turnover will be under the registration threshold of £85,000.

However, where a number of properties are owned, this may not be the case.

Particular care should be taken by those who are already VAT registered, as the registration applies to all the business activities of the person or entity so registered.

For example, a farmer letting out a cottage as holiday accommodation may need to account for VAT on the income because overall, the farmer’s total business income exceeds £85,000 per annum.
Investment properties generally

Property portfolios which have been built up over a period of time can give rise to substantial potential IHT liabilities on either the death of or gifting of such assets by their owners.

Owners are unlikely to qualify for IHT business property relief (BPR), so, if their land assets remain in the owner’s estate until death, they will be subject to IHT. However, if they have appreciated in value, a lifetime transfer may create a CGT bill if gifted prior to death. A gift is treated as a disposal at market value for CGT – so giving the property away is not a simple solution either.

Similar problems can apply to shares in property investment companies.

There may be some possible solutions if IHT planning is structured by way of making lifetime gifts is desired:

- Transfers into some trusts allow gains to be held over so that, instead of an immediate CGT charge arising, the trustees inherit the CGT base cost of the person creating the trust. However, the value which is transferred may be restricted to the IHT nil rate band as trust transfers are generally chargeable to IHT at the lifetime rate of 20%.

- Capital losses on property or other assets may be realised and set against gains on those being gifted.

- Trusts owning properties where there is a history of personal occupation may qualify for the private residence exemption to reduce the CGT arising.

- Shares in property companies may be carefully transferred over a period of time to use the CGT annual exemptions available.

For substantial property companies, where the measures listed above would not really make much impact on the problem, it may at least be possible to freeze the value of the existing shares and enable future capital growth to pass to the desired beneficiaries in a tax-efficient manner.

Property used for business purposes

Care should be taken where a property is used in a business to ensure that BPR is not wasted.

For example, property owned personally, but used by a family company or partnership may possibly qualify for BPR at 50% rate.

Property owned in a standalone company, but let to a trade under the same control, may not qualify for BPR.

In either of these scenarios, the tax position can generally be improved. There is often a significant amount of tax at stake, so planning steps should always be considered.
Furnished holiday lets (FHLs)

The tax concessions extended to FHLs do not include an automatic right to IHT BPR. FHL properties will normally be fully subject to IHT. To qualify for the relief, the owners (either personally or through employees) would be expected to play an active part, beyond the usual activities such as dealing with bookings, cleaning and changeovers. In short, active business participation is required to be performed by the owner(s).

To make it a qualifying business for BPR would require either something more akin to a hotel, with the provision of meals and other services, or an involvement in the holiday activity itself, such as providing guided tours, or other sport and leisure activities.

Whilst a tax tribunal found – rather surprisingly – in favour of an estate claiming relief on an FHL (in the case of Pawson v HMRC), this decision was overruled by the upper tax tribunal in 2013. The current position is still uncertain.