The Hornbeam Guide to Taxation of Residential Landlords

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HORNBEAM ACCOUNTANCY SERVICES LTD

The Hornbeam Guide to Taxation of Residential Letting.

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Introduction

This guide is written primarily for individuals who own and let residential property.

Our objective is to write in plain English, about an area of tax that is both complex, and rapidly changing. Only you will judge whether we have been successful.

Chapter 1
Computation of Profit
1.1 Capital Expenditure and Maintenance

It is when you first buy your property that you are most likely to spend a lot of money doing it up. There is therefore a big issue as to what expenditure is allowable against your (future) rental income and what is not allowable for tax purposes. This has changed quite a bit over recent years and we set out here our understanding of the current position.

In general there are no allowances (no depreciation, no capital allowances) against rental income for capital expenditure on the purchase or improvement of a property for residential letting.

Capital expenditure will be allowable in the Capital Gains Tax computation when you come to sell the property, *Our advice is to keep a careful and accurate record of your capital expenditure, it will be important in reducing your tax at some time in the future.* Ideally you should record these capital costs in the balance sheet of the full accounts which are maintained for your rental business.

On the other hand there is full allowance for expenditure on maintenance of a property. It is therefore critical to distinguish between maintenance and capital expenditure.

- The purchase of the land, the buildings on it, together with legal fees and stamp duty land tax will be capital expenditure.
- Any addition to the premises is capital expenditure. Quoting from HMRC Property Income Manual "if you add to the premises something that was not there before, for example if you build an extension or a new porch, this is capital expenditure. It does not matter how small the addition is. If you add an extractor fan or fit an additional cabinet in the bathroom or kitchen, this is also capital expenditure".
- the cost of refurbishing or repairing a property bought in a derelict or run-down state is capital expenditure.

HMRC are very interested in this last point; their manual states that where a property is bought which is not in a fit state for use, or where the price paid for the property was substantially reduced because of its dilapidated state, this may mean the expenditure was capital.

Furthermore HMRC go on to tell us that where standard kitchen units are replaced by expensive customised items using high quality materials, the whole of the expenditure will be capital. There is no longer any deduction for the replacement element of the upgrade, the whole cost is disallowed.

We think that these two rules combine to make those first few weeks after you buy a property a very dangerous time. To avoid finding large elements of your costs disallowed against your rental income, we recommend that if at all possible you let the property before undertaking any maintenance.

The HMRC manual identifies the following as (tax allowable) maintenance expenditure

- exterior and interior painting and decorating,
- stone cleaning,
- damp and rot treatment,
- mending broken windows, doors, furniture and machines such as cookers or lifts,
- re-pointing, and
- replacing roof slates, flashing and gutters.

Furthermore HMRC accept that replacing an old window with a modern double glazed window is not an improvement, but just the modern equivalent, hence it is a replacement not an improvement and is thus allowable in the computation of profits.

Furthermore the courts have pretty much accepted that for residential lettings the whole entity is the house or block of flats, if you replace the leaking roof with a new one this will be a repair (but if you substantially rebuild the whole entity that will be capital).

Carefully distinguish between maintenance works and improvements, get separate quotes, do not carry out improvements at the same time as regular maintenance.

There are no capital allowances for buying the furniture and fittings that first go into a rented property. And from April 2013 the old renewals basis has been withdrawn. In effect there is now NO relief for expenditure on free standing kitchen appliances, furniture, curtains, and carpets for owners of unfurnished property.

This seems to us to be an extremely spiteful change. After consultation with the professional institutes HMRC have confirmed that maintenance and replacement of fittings, including fitted kitchen goods can still be claimed, as can replacement of consumable items such as doormats and waste bins.

However, one way around this is to ensure that wherever possible your properties are leased fully furnished. This requires an alteration to your lease document and that the furnishings exist, even if the tenant prefers to use their own furnishings and yours have to be kept in store. You will then be entitled to a 10% deduction against your rental income

This all changes again from 6 April 2016

- There is no 10% deduction on any type of property letting.
- The renewals basis is coming back with statutory backing (the old renewals basis was an extra statutory concession – all ESC’s are being phased out).

1.2 Expenditure Before Letting Commences

The business of letting does not start until the first property is let and therefore pre – commencement expenditure cannot be claimed until letting commences. This is in accordance with normal accounting practice. Of course when letting does commence pre commencement expenditure can be claimed in the first period. (But as explained above most pre letting expenditure will probably be Capital Expenditure not Revenue Costs).

This rule is applied on a business by business basis, not a property by property basis, so an existing rentals business can claim for expenditure on a property which has not yet been let in the period in which the expenditure is incurred.

1.3 Interest on Borrowings

Prior to 2005, only interest incurred on loans taken out to purchase or improve a let property was allowable. The Revenue still seem to think this is the case, that on first principles only interest on loans taken out wholly and necessarily for business purposes will be allowable.

However, the consensus amongst tax professionals is that most interest on borrowing will be allowable, provided that, broadly speaking, the amount borrowed is less than the purchase price of the property. For example the view of Lakshmi Narain in the CCH guide to 'Tax on Property' is that "The purchaser of a property may finance the purchase using his own funds, by borrowing or by a combination of both. If the purchase is financed wholly or partly by the purchaser's own funds, the purchaser may, at some future date, decide to withdraw part of his own capital from the property business and replace it with borrowings. In this case interest on the additional borrowing is not automatically excluded from relief…..the amount of capital withdrawn should not exceed the amount of capital introduced. Further if the amount of gearing is so high that the letting is unlikely to show a profit HMRC may seek a disallowance of interest under the 'wholly and exclusively' rule."

Many buy-to-let landlords are living upon remortgage monies, and presumably claiming the interest on the loans. We are not aware of the outcomes of the inevitable disputes between HMRC and landlords.

There are various strategies that we would advise to avoid conflict with HMRC.

This all changes between now and 2020.

From 2017/18 (so starting 6 April 2017) interest is no longer allowable as a cost of residential letting. Instead it is replaced by a cost which is equivalent to

- 2017/18: Basic rate tax and 75% of higher rate tax
- 2018/19 Basic rate tax and 50% of higher rate tax
- 2019/20 Basic rate tax and 25% of higher rate tax
- 2020/21 Basic rate tax only

The impact on larger (highly geared) landlords, and high earning smaller landlords could be very significant.

For example; a higher rate tax payer who currently has a rental property bringing in £20,000, pays out £5,000 in expenses and £15,000 interest. Clearly with no profit he has no tax to pay in the 2016 tax year, however in 2020 he has £15,000 profit and a £15,000 basic rate allowance so the higher rate tax is £15,000 x (40%-20%) = £3,000. Which is a lot of tax to pay on an enterprise with no income.

Or consider; a full time landlord with £250,000 of gross rental income, £50,000 of expenses and £150,000 of interest. If we assume £50,000 of profit uses up the basic rate allowance, then in 2016 there would be no additional tax to pay: whereas in 2020 there would be £37,000 of additional tax to pay!

Landlords really do need to take action to reduce their exposure to this loss of higher rate tax relief for interest cost

1.4 Other Expenditure.

Most other expenses of running a letting business should now be allowed without too much trouble. Here are a few tips

Travel

- *We recommend that our landlords keep a travel diary and claim for business mileage (currently at 45p per mile for the first 10,000 miles.), which is not particularly open to dispute by HMRC inspectors. However it remains an option to claim for all motor expenses then disallow the private proportion, but you still should keep mileage records.*

Protective Clothing

- *You can always claim for health and safety gear (steel toecap boots, overalls, safety helmet, but if you prefer to do your maintenance wearing trainers, jeans and baseball cap don't expect any cost to be allowed.*

Laundry

- *Don't forget to claim for laundry costs whilst doing maintenance*

Use of home as office

- *Don't forget to claim for use of home as office if you have a home office. HMRC recommend a maximum amount of £4 per week!*

Telephone

- *Use some reasonable method to identify business phone costs – the best technique for all sorts of reasons is to have a separate phone (and answer-phone) for the business (if the costs are enough to justify the expense).*

Since 2005 all but the smallest rental businesses must prepare full accounts, matching costs with revenues over time (the accruals basis) and in accordance with Generally Accepted Accounting Principles.

Like all businesses, landlords have to maintain proper records, and to keep these for at least six years.

So far we have never come across an Inspector levying any part of the maximum £3,000 fine for failure to maintain records. However, in about 2011 HMRC began a campaign of investigations specifically targeted at taxpayers suspected of not maintaining adequate records so this has certainly changed..

1.5 Issues Concerning the Recording of Rental Income

1. Broadly speaking the total gross income due to the landlord in the period will be the figure the Revenue is looking for in the income box.
2. **Gross income** means before agent's commissions (but agent's commissions are an allowable expense).
3. **Due to the Landlord** means rents still unpaid at the year end must be accounted for as income, consideration must then be given as to whether a bad debt provision needs to be made.

It is very important that you, as landlord, document any void periods – keep records of when the old tenancy ceased and the new tenancy commenced – the Revenue inspector will want to know (It is the inspectors job to look for understated income!)

4. For individuals or couples who are landlords **the period** will always be 6 April to 5 April.
5. Deposits are not income until it becomes clear that they will be held against a specific item of expenditure.
6. Lease premiums can also be income for tax purposes. See below

Actually there are not usually any major **issues** in recognising income from residential lettings.

Lease Premiums
Although lease premiums are rare for residential landlords, it is perhaps worth knowing how these are taxed

a) A lease is a legal right to occupy a property for a specified time for a specified rent.
b) A premium is the amount paid by a tenant to a landlord for the granting of the lease.
c) If the lease is for more than 50 years there is no income tax charge, but the premium will be liable to Capital Gains Tax.
d) If the lease is for less than 50 years (a short lease) then the premium paid is subject to income tax.
e) This is calculated as follows

Premium	P
Less: 2% x P x (n-1)	(C)
Income	A

Where n is the number of years of the short lease.
f) Income (A) is charged to income tax in the year of receipt.

Chapter 2
Taxation of Residential Letting

2.1 Income Tax

The profits from a landlords' rental business are added to their other income and taxed at the appropriate rates.

Usually HMRC expect rental profits from jointly owned properties to be split between the owners in the same proportion as the properties are owned. For husband and wife it is always assumed to be a 50:50 split unless it is owned in different proportions and they elect to have it split according to that ratio (There is a standard form for this election).

Rental profit is not 'Relevant Earnings' for pension purposes, so landlords can't get income tax relief for making payments into a pension fund.

Losses from residential letting can never be set off against other income in the same or future tax years and can never be carried back (contrast with Furnished Holiday Lets 3.3).

Losses from residential letting are first set off against profits of any other property letting business in the same year. If there are losses from property letting overall these are carried forward against future profits from letting. They are set off against the first future profits automatically.

Where property is let for less than a commercial rent (eg. To a friend or family member) this is known as a 'Nominal' lease. In this case expenses are only allowable up to the amount of the rent received, and therefore a loss can never be created!

2.2 National Insurance

Because they are not considered to be earned income, profits from a letting business are not subject to National Insurance.

This simple fact gives landlords a considerable tax advantage over other traders, a fact which is often forgotten when established letting businesses campaign to be taxed as any other trade (to get capital gains tax advantages). However this advantage does not apply to

- Property letting businesses making a loss
- Landlords who already pay the maximum NI (the saving is still 2% here)
- Incorporated property businesses

Not paying National Insurance also makes tax planning for Landlords completely different to tax planning for other traders. For example there is much less advantage in incorporating.

Since this was first written HMRC have been making sporadic attempts to assert that full time landlords are pursuing a business and are in gainful employment and should therefore be paying National Insurance. The problem is the legislation on this is not clear. Everyone has always assumed that collecting rents is not a business or self-employment, so National Insurance is not payable (as above). However HMRC are sporadically writing to Landlords asking them to pay National Insurance. HMRC argument is that where running a property portfolio is a full time occupation then this is a business and NI is payable.

We do not agree that National Insurance is payable by residential landlords, except perhaps in exceptional circumstances and if HMRC approach you to do so you should refer to us immediately

2.3 VAT

Residential Lettings are exempt from VAT.

However this is not the case for Furnished Holiday Lets or Self Storage which are liable to be VAT registered.

Watch out for this if you have a VATable trade – if registered you should be declaring the VAT on the FHLs; if unregistered you need to add in the income from letting when checking if you need to register.

2.4 Capital Gains Tax

Whereas Residential Landlords are pretty much exempt from worries about National Insurance and VAT, Capital Taxes are a major worry. Many buy-to-let landlords in particular seem to be in the business for Capital Appreciation (and in a country where planning laws create a permanent shortage of residential accommodation this has paid off handsomely for many).

Capital Gains Tax is levied upon the difference between the net sales proceeds and the costs of buying and improving a property.

So the first point is to make sure you have all the allowable costs mustered:

- Legal fees of buying and selling
- Agents fees of selling
- Any Stamp Duty Land Tax paid
- All those improvements that were not allowed as costs against the rental income.
- Purchase cost.

Keeping these records over many years requires iron discipline, but is well worth the effort.

From April 2008 for individuals who are residential landlords, decades of complicated rules concerning indexation (until 1998) and taper relief (until 2008) have been swept away. Instead property gains will be taxed at a flat rate of 18%.

Since that time this has been increased to 28% for higher rate taxpayers.

The reduction in rates to 10% and 20% for share transactions from 6 April 2016 DOES NOT APPLY to residential landlords

There are two other reliefs crucial to Capital Gains Tax planning:

Firstly, each property owner has an annual exemption (£11,100 for 2015/16.) in addition to the annual allowance for income tax purposes.

Where appropriate, the strategy for tax minimisation should therefore include making sure that a husband and wife each own 50% of a property before sale. If this is not so, your solicitor can prepare a "deed of gift", which does not attract stamp duty or Capital Gains Tax! Both partners can thus benefit from the annual exemption.

A strategy for tax minimisation should aim to spread the sale of properties (making capital gains) over the years, to maximise the number of annual exemptions and lower rates of tax that are utilised.

However, it is not usually practical to realise property gains just to minimise Capital Gains Tax. Stamp-duty-land-tax, solicitor's fees, and agent's fees will tend to outweigh any Capital Gains Tax saving.

Secondly, there is the much loved Principle Private Residence Relief. British people "know" that they do not pay capital gains tax when they sell their own home.

- To obtain Principle Private Residence Relief **the owner must live in a house as his own home at some point.**
- An individual or a married couple can only have one Principal Private Residence at a time.
- If a person lives in a property for only part of the time he owns it then the Principal Private Residence Relief is given pro-rata to the period of occupation – but the last eighteen months (previously three years) of ownership are always treated as a period of occupation for calculation of Principal Private Residence Relief.

Example 2.4.1.
Jim sells, before April 2014, a house making a £100,000 gain, he has owned the house for 100 months. He occupied the house for 12 months when he first bought it, after which he moved out and allowed his mother to occupy the property free of charge. Jim gets 12 months Principal Private Residence Relief for the first 12 months of actual occupation, plus the last 36 months of ownership, 39 months in total. His total Principal Private Residence Relief is £48,000 being the £100,000 gain multiplied by 48 months/100 months.

If the House is sold after 5 April 2014 – then the relief for the last 36 months has been reduced to the last 18 months and the PPR relief has been reduced to 30 months / 100 month = £30,000.

- There is a further less well known relief, called Letting Relief. If after occupying a property himself the owner lets the property, he is entitled to a further relief (effectively

an extension to Principal Private Residence Relief) related to the period of letting but limited to a maximum of the lower of the amount of the Principal Private Residence Relief or £40,000 or the gain made in the period of letting.

Example 2.4.2
So if Jim had let the property instead of allowing his mother to occupy it free of charge he would have been entitled to £30,000 Principal Private Residence Relief, plus a further £30,000 letting relief – a total of £60,000 of the gain would be free of Capital Gains Tax.

Example 2.4.3
If Jim had occupied the property for 48 months instead of 12 he would be entitled to £48,000 of Principal Private Residence Relief, but his letting relief would be restricted to £40,000

These are valuable tax reliefs to Landlords who do not mind living in a property themselves for a period of their ownership.

A Landlord may already have a £500,000 residence and would have some trouble in convincing the tax inspector that the £100,000 residence he is occupying during the week (whilst he renovates a nearby property) is his main residence. Fortunately he doesn't have to. A taxpayer (or married couple) may, within two years of a change in the number of residences which they occupy, nominate which property is to be their Principal Private Residence.

Example 2.4.4
Jim has lived in a £500,000 house in mid Norfolk and hopes to be there for many years to come. Whilst his daughter is at University in Manchester, Jim becomes interested in the buy-to-let opportunities in that City. He buys a terraced house close to the University and spends the next ten weeks renovating the property. As he finishes the property he buys a further property on the next road and begins to renovate that, still staying in the first property during the week.

Jim's accountant finds out what he has been up to at the next meeting and as it is within 2 years of the purchase of the first Manchester property nominates that as Jim's Principal Private Residence from when it was purchased. A couple of weeks later he changes the nomination back to Jim's Norfolk property, with effect from a couple of months after purchase of the Manchester property. As we have seen in example 2.4.2 this nomination of the Manchester property for a couple of months might easily wipe out the Capital Gains Tax charge on the first Manchester property when it is eventually sold.

HMRC are likely to look at such nominations pretty hard, so make sure

- You can prove that you actually lived in the house, by keeping utility and telephone bills and ordering milk and newspaper, for example.
- The nomination is technically correct in all its particulars.
- Don't overdo it – if you change nomination repeatedly HMRC will try much harder to prove that you did not actually occupy these properties as your home (actually the onus will be on you to prove that you did).

To conclude, by organising ones affairs appropriately it is possible to massively reduce Capital Gains Tax. However, we have observed over the years that the majority of landlords are pretty reluctant to move home "just" to minimise tax!

2.5 Inheritance Tax

Inheritance tax is charged on estates over £325,000 at 40% of the excess over £325,000 (in 2013/14)

For the children (beneficiaries) of more successful Residential Landlords this can be a massive tax.

> Example 2.5
> Jim dies leaving an estate worth £2,325,000. His executors will have to find £800,000 Inheritance tax within 6 months of the end of the month in which death occurs.

Inheritance tax requires a whole leaflet on its own account (please ask us for a copy),
The main ways to minimise this tax are

- Spend it before you die – many people's preferred option!
- Make sure you have appropriate wills (so that each spouse uses their £325,000 allowance effectively)
- Consider lifetime gifts – there are complex rules covering gifts both large and small.
- Gifts out of income are allowed as long as the donor's lifestyle is not harmed, so instead of growing your investments consider setting up standing orders in favour of the grandchildren – or whoever.
- Consider insurance products.

This is one of the few taxes where reliefs have been extended recently. Where the property being left is the deceased's home the allowance is raised to £500,000. Where the spouse's allowance is inherited then the total can rise to £1,000,000. Although this is being staged from 2017 to 2020, and there are further restrictions (of course).

Chapter 3
Special types of letting

3.1 Furnished Lettings

The rules for furnished lettings are broadly the same as for other types of letting. However for furnished lettings only, the landlord can opt to forgo claiming for replacement furnishings and to claim a 10% reduction in the rent instead.

> *We rather like this option. Most properties are let with carpets, curtains, kitchen fittings and equipment, but they are not **furnished** unless there is also provision of a bed, wardrobe, sofa, table and chairs (ie it is possible to live in the property). Most landlords could source these items for relatively small cost and thus obtain a 10% reduction in their taxable income….*

Some of our more thoughtful clients have expressed the view that the furnished lettings industry is much more trouble than unfurnished letting, which is a good point but…

More income can be earned from furnished lets than from unfurnished lets.

Anyway, you must decide what market you are targeting, and if you decide to provide furnished lettings, you can consider taking advantage of the 10% allowance.
The 10% allowance is withdrawn from 6 April 2016

Furnished lettings are still considered to be rental income for all other Income Tax (i.e. not relevant earnings for pension purposes), National Insurance, Capital Gains Tax, and IHT purposes.

A change to the rules in April 2013 made it impossible for landlords to get any relief at all for carpets, curtains, freestanding kitchen appliances, and furniture in a property which is not fully furnished. This seems to us quite a spiteful change and we do not know why it was introduced.

However, one way around this is to ensure that wherever possible your properties are leased fully furnished. This requires an alteration to your lease document and that the furnishings exist, even if the tenant prefers to use their own furnishings and yours have to be kept in store. You will then be entitled to a 10% deduction against your rental income.
From 6 April 2016 the replacement allowance is reintroduced for all types of letting including furnished letting. In fact from 5 April 2016 there are no differences between furnished lettings and any other type of letting for tax purposes.

3.2 Serviced Lettings

Some landlords provide serviced lettings. Serviced properties are usually let to visiting business people. The services may include laundry and maid services.

Serviced lettings are still rentals for income tax purposes, although the landlord has the option of splitting out the services business and having that taxed as a trade.

3.3 Furnished Holiday Lets

To qualify as a holiday let a property must be

- Furnished
- Situated in the EU – Available for commercial letting to the general public for at least 210 days in the relevant period (usually 12 months),
- Actually let for at least 105 days,
- Not in the same continuous occupation for more than 31 days per visit for more than 155 days

Being defined as a Furnished Holiday Let has the following advantages.

- Profits are treated as EARNED income and therefore are relevant earnings for pension contribution purposes
- Capital Allowances are available.
- Losses can be set off against other income (such as salary, trading profits, or interest) in the year.
- Furnished Holiday Let's qualify for various Capital Gains Tax Reliefs such as Rollover Relief and Gift Relief.

There is however one potential drawback; FHL are standard rated for VAT and the income from a FHL must be amalgamated with trading income when checking if registration is required.

The obvious way around this is to put the trade into a Ltd Company.

If you already have a VAT registered trade and have failed to report income from FHL you may well already be in breach of VAT regulations.

If you have a FHL in the UK but live abroad you will automatically be required to register for VAT, there is apparently no de-minimus for non-residents. You will probably need to appoint a UK letting agent to avoid registering.

If you live in the UK and have a FHL in another EU country then you may be liable to register for VAT in that country and should take advice off a local accountant immediately.

3.4 Non UK Property Business

If a taxpayer lets out an overseas property such as an apartment in Florence or villa in Bulgaria, the profits are charged to Income Tax as 'Foreign Income'.

Although beware the profits of a furnished holiday let are supposed to go on the Rental pages of the tax return even if the property is located elsewhere in the EU and this can make claiming back the tax charged on the property by the state in which the property is located….complex.

The profits are calculated in the same way as for a UK property.

The advantages of UK Furnished Holiday Lets carry over to holiday lets in the EU, but not outside the EU.

If there is a loss, this can first be set against other foreign income of the same year. If not fully utilised, then the remainder of the loss can only be carried forward against future non UK rental business profits. FOREIGN PROPERTY LOSSES CAN NOT BE SET AGAINST UK PROPERTY PROFITS (and vice versa) unless the property making the loss is a Furnished Holiday Let.

As 3.4 above, you may need to register for VAT if you have a FHL in an EU country.

3.5 Bed and Breakfast Accommodation.

Letting Bed and Breakfast accommodation is a trade for tax purposes – not property income – and as such:

- Capital Allowances can be claimed on furnishings
- Losses are treated differently
- Profits are relevant earnings for pension purposes.
- National Insurance is payable on profits.
- Capital Gains Tax rules are different

3.6 Rent-a-Room Relief

If you let out a room or rooms in your own home and you also live in the house yourself, you have a choice of how this can be treated. Either the normal rules of income and expenditure apply (including the possibility of it being treated as the carrying on of a trade, if you are providing services for the tenants), or alternatively you can simply deduct the "rent a room relief" of £4,250 (which hasn't changed since 1992 Great news; Rent a room relief increases to £7,500 from 6 April 2016) from the rent. There is one allowance per property, not per room rented, and the allowance is split between a married couple.

This allowance is particularly valuable to any taxpayer who takes a lodger into their home.

3.7 Overseas Landlords

Almost all the tax treaties to which the UK is a signatory, give the UK the right to tax income and gains arising from UK property in advance of the Country in which the tax payer is resident.

Historically, the UK has been quite weak at this, not taxing gains of non-residents (although if the property was bought when the taxpayer was resident, he will be taxed on a gain if he is abroad for) less than three complete tax years, when he returns to the UK.

Secondly, probably the majority the majority of none resident landlords (including UK citizens, EU citizens, and many commonwealth residents) are entitled to an annual personal allowance. For a couple this will be £21,200 in 2015/16 which makes most rental profits free of tax (BUT NOT OF THE DUTY TO PUT IN A TAX RETURN).

There has been a consultation on withdrawing the allowance for overseas resident landlords and I think we must consider the possibility of this happening being quite high.

Taxation of gains is already a reality, although it is only gains arising after 5 April 2015 which are (currently) taxable.

Chapter 4 Whether to Incorporate

We are often asked whether it is worth incorporating a residential letting business?
The answer is that the pro's and cons of incorporation are extremely complicated, and like so many things relating to tax it depends on your existing situation and on how you view the future…. Here are some of the main factors.

4.1 Profit Taxes

Many small businesses have been incorporated so that that income ends in the hands of the proprietor as dividends rather than trading profit, and thus National Insurance is avoided. Although changes in the April 2007 Budget eroded the advantage of incorporation, this basic principle remains effective for small traders. However, Landlords don't have to pay National Insurance, so the fact is that small incorporated letting businesses will now pay more tax on profit than equivalent unincorporated businesses. This will be decisive in persuading most small letting businesses not to consider incorporation further.

For larger businesses with rental profits over £50,000 there may still be a reduction in income taxes from incorporating, but this will depend on a number of factors, particularly how much of the profit is to be withdrawn and how much retained for reinvestment.

Several more factors need to be considered since this pamphlet was last updated. The 7.5% tax on dividends which commences 6 April 2016 will be particularly painful for landlords who don't pay NI. Less so perhaps for landlords who are mainly repaying debt.

However, incorporation may be forced upon landlords who are highly geared as higher rate tax relief for interest payments is phased out between 2016/17 and 2019/20.

4.2 Stamp Duty Land Tax

Another factor which will make incorporation of an established letting business impractical is stamp duty land tax. This tax, plus legal fees, will tend to make the cost of conveying an existing property portfolio from individual ownership to company ownership prohibitively expensive.

Remembering that there is a 3% surcharge for buy to let landlords

There was a relief called "Multiple Dwellings Relief" by which the value of the portfolio of at least six houses incorporated is divided by the number of dwellings to get the right "rate band", however this cannot be less than1%. However this was ended 5 April 2016.

On the other hand an entrepreneur starting to build up a property portfolio might prefer to do this in a company, in that if the entrepreneur sells the company, rather than the properties, Stamp Duty will be at half a percent on the shares compared with a maximum of 4% on the properties.

4.3 Regulations and Costs

Legislation regulating the operation of Limited Companies and the conduct of directors, is extensive and restrictive. Although there are some advantages (Limited Liability for shareholder-investors is the obvious example) these regulations are inevitably seen as red tape by most landlords. These rules lead to much more complex sets of accounts which have to be deposited at Companies House. Thus accountant's costs are inevitably higher than for an equivalent sole trader.

4.4 Capital Taxes

The Capital Gains Tax regime is different for companies. Companies still receive an indexation allowance based on the cost of the property and general inflation as per the indexation. If you think that general inflation will continue in the coming years then this might be a considerable advantage.

However, the problems with companies are getting the properties in and getting the profit out. There is no Capital Gains Tax relief on incorporating a portfolio of companies in the way that there is on incorporating a trade. The properties transfer at market value and CGT is triggered.

Higher rate taxpayers will pay £25 income tax on every £100 of net dividend received (32.5% from 6 April 2016). Capital distributions will also be highly taxed.

Finally, there is no Inheritance Tax advantage or disadvantage with incorporating. The shares will pass into the estate, presumably at the same value as the properties, and will attract the same 40% tax as would have the properties themselves.

4.5 The Rare Case

Some years ago, some tax whiz came up with the following idea. Husband is a higher rate taxpayer, wife is not. Company is 90% owned by wife, 10% by Husband. Husband borrows £200,000 which he lends to Company free of interest. Company buys residential property and lets it out. Husband gets 40% tax relief on the interest on his £200,000 borrowing. Company pays 20% tax on the letting profit, which it distributes 90% to wife who has no further tax to pay.

So the husband gets 40% tax relief on the loan, but the company pays only 20% tax on the rental income – HMRC help to fund the letting business!

We have to admit that whilst we have known about this possibility for several years, we have yet to set one up!

4.6 Summary

It will be very rare that it is worth setting up a company to handle new residential lettings.
It will be incredibly rare that it will be worth changing the incorporation status of existing residential lettings.

Chapter 5

Disclaimer
Taxation is incredibly complex, and incredibly easy to get wrong. This leaflet is intended as a guide to some of the main factors influencing the taxation of Residential Letting. Almost every rule set out in this guide will be subject to many exceptions and caveats. You should not take action based on what is written in this guide. If you think something applies to you, you should obtain specific qualified advice concerning your particular situation.

Chapter 6

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Addendum *Phil's view on the 2016 budget.*

The really weird thing about modern budgets is trying to find something that starts in the coming year.

- *Personal allowances up to £11.500 - from April 2017*
- *High rate band to start from £45.000 - from April 2017*
- *Rate relief increased to £15.000 - from April 2017*
- *Corporation tax reduced to 17% - from April 2020*
- *Employers will pay class 1A National Insurance on severance pay over £30.000 – from April 2018*
- *Class 2 National Insurance (the Stamp) abolished – from April 2018*
- *£1000 extra earnings from trading on rentals, not subject to tax – from April 2017*

Then finally

- *Capital gains tax reduced from 18% to 10% and 28% to 20% - from April 2016 Hooray!*

- *Although yet again, landlords are selected for special (unfavourable) treatment and don't get the reduction.*

- *And landlords have been hit again with the extension of the 3% stamp duty land tax surcharge to portfolios over 15 properties.*