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LET PROPERTY – A BRIEF GUIDE

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From the EDITOR

The growing number of people investing in buy-to-let property led to our initial decision in 2006 to publish a *TAXline Tax Practice* guide to tax on letting income. Inevitably, no sooner had the ink dried, than the rules began to change. Perhaps the biggest change related to furnished holiday letting (FHL) income.

Hidden away deep in the 2009 Budget material was a nasty surprise. While the FHL rules were to be extended in 2009 to include holiday homes anywhere in the EEA, it appeared that the scheme would then be abolished altogether in 2010.

The Tax Faculty explained to anyone and everyone who would listen, why it was that we needed to have these rules retained. Since being brought in in 1984, the clear definition of FHL had simplified the tax treatment and given certainty to the tax charge on the income of many small travel lodge businesses and farms which ran small lettings businesses to boost their income. Without this they would have needed to resort to case law to try to establish the existence of a trade.

A change in Government, many meetings and discussions later, and the new rules have now been agreed. Although the HMRC Property Income Manual is not yet completely updated, for this, the new rules are now settled and this seems a good time for us to publish an update.

The Tax Faculty produces a range of technical information. All items published since January 2000 and selected items prior to that date, can be viewed on the website at icaew.com/taxfac where the information can be found under the heading 'Faculty Publications'.

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LET PROPERTY – A BRIEF GUIDE

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INTRODUCTION

This *TAXline* supplement provides succinct guidance on the tax issues connected with let property from the point of view of the landlord and supersedes *TAXline Tax Practice* 15, published in May 2006. It concentrates on residential property as that is the area where so many clients tend to dabble without taking advice. The new rules that apply to furnished holiday lettings (FHL) which commence from April 2011 and April 2012 are covered in section 6. Commercial property is also covered briefly in section 11. The guide is intended for those who are advising individuals who have bought property as an investment rather than commercial property development companies.

References have been made to the following HMRC manuals which are available on the HMRC website at www.hmrc.gov.uk/thelibrary/manuals.htm:

- *Property Income Manual* (PIM);
- *Business Income Manual* (BIM); and
- *Trusts, Settlements & Estates Manual* (TSEM);

The following HMRC helpsheets may also be useful:

- HS223 – Rent a room for traders
- HS252 – Capital allowances and balancing charges
- HS263 – Calculating foreign tax credit on income

HMRC has also produced a Property Rental toolkit designed to help reduce the incidence of common errors in tax returns: www.hmrc.gov.uk/agents/toolkits/property-rental.pdf

For those not familiar with them, HMRC's toolkits highlight common mistakes in returns and areas which HMRC perceives as risky. They are designed primarily for tax agents and advisers, although they can be used by anyone preparing the relevant return.

Each toolkit focuses on a particular type of tax return or aspect of a return. The toolkit takes the form of a checklist of potentially difficult or problematic issues, together with a more detailed explanation of each issue and links to the relevant HMRC manual sections.

Using the toolkits is optional not mandatory. There are a variety of ways in which an agent might use a toolkit. You do not have to print off the checklist and work through it (though you could do that). Instead you could just check that all the perceived risks are covered by your own tax return procedures and/or in the software you use.

1. THE PROPERTY INVESTMENT BUSINESS

1.1 OVERVIEW

Individual owners of let property are normally taxed on the annual profits they make from letting their property under rules for property income set out in Part 3, Income Tax (Trading and Other Income) Act (ITTOIA) 2005. This part of ITTOIA 2005 also includes provisions for overseas let property, to which the remittance basis may apply if the owner is non-domiciled or not ordinarily resident in the UK (see section 8).

A typical property income business will hold the properties for the medium to long term and cover all the expenses with the rents received. Landlords who hold properties for a shorter period, with a view to creating a profit on sale after refurbishment or development, may have their property business taxed as a trade rather than as property income (see section 5).

The property income rules treat a property letting business much like any other trade. Section 272, ITTOIA 2005 refers back to the rules for calculating profits for trades in Part 2 of the same Act. Their property income differs from a normal trade in a number of respects, some of which can be advantageous:

- The annual profits are not subject to National Insurance.
- Any profit made on the disposal of a property is taxed as a capital gain, allowing any available personal annual exemption to be deducted and possibly a lower rate of tax to be applied (see section 7).
- A residential letting business does not have to be VAT-registered, unless it is a holiday lettings business, but beware the flat rate scheme trap (see 3.11).

There are also disadvantages to the property income rules compared with trading income:

- Losses cannot be set against other sources of income.
- Expenditure connected with aborted sales or purchases of property is not deductible.
- Sales of residential property generally do not qualify for entrepreneurs' relief unless the property was used in an FHL business.
- The value of the properties may be subject to inheritance tax on death (see section 9).
- It is difficult to transfer the business without high tax charges, as roll-over relief does not apply to the value of the property, unless it was used in an FHL business (see section 6).

1.2 WHAT IS PROPERTY INCOME?

Property income is calculated as the rents receivable less the expenses that can be set against those rents for tax purposes (see section 3). It includes the income from all the properties let by the same person in the UK. There is no separation of the income from different types of property such as commercial or residential lets, furnished or unfurnished, although the income from commercially let furnished holiday accommodation (FHL businesses) must be calculated separately as special rules apply, ss 327–328, ITTOIA 2005. Otherwise, all the properties owned by one person in the UK are considered as one business. See section 2 regarding jointly owned property.

Income is calculated on the usual accruals basis unless income is small, ie, less than £15,000. In this case, HMRC will accept profits determined on a cash basis provided this is used consistently and is not substantially different from the strict earnings basis.

Property income does not include the profit made from selling the property, neither does it take into account the costs connected with the capital expenditure of buying or improving the property, nor the costs of selling the property, s 33, ITTOIA 2005.

Deposits collected from tenants are not part of the property income unless they become non-returnable under the tenancy agreement. Any retained deposits should be matched in the letting accounts with the costs the deposit was designed to prevent, such as renewal of furnishings, repairs or legal fees (see PIM1051).

1.3 WHEN DOES THE RENTAL BUSINESS START OR FINISH?

It is important to determine when the rental business starts or finishes, as the costs incurred outside this period may not be tax deductible (but see 1.3.2 below).

1.3.1 Start date

The property business starts as soon as property is acquired **and** it is available for letting. This means the property must be in a condition where it can be let, subject to cleaning, furnishing and drawing up tenancy

agreements and inventories. If the first property acquired is in such a poor state that it cannot be let, it cannot be treated as being part of the property rental business. However, once the property letting business has started any later expenditure leading up to the letting of the second and later properties is part of the rental business and can be deducted, as long as it qualifies as tax deductible (see section 3).

HMRC guidance states at PIM2505 that a property rental business usually begins when letting first commences. However, s 264, ITTOIA 2005, says:

'A person's UK property business consists of:

a) every business which the person carries on for generating income from land in the United Kingdom, and
b) every transaction which the person enters into for that purpose otherwise than in the course of such a business.'

So transactions entered into for the purpose of generating income from the land, ie preparing to let the land, are part of the property letting business, and HMRC accepts that.

Section 266, ITTOIA 2005 defines generating income from land as, 'exploiting an estate, interest or right in or over land as a source of rents or other receipts'.

1.3.2 Pre-letting expenditure

Pre-letting expenses, such as advertising or repairs, can be deducted from the rents received in the first tax year if three conditions are met (s 57, ITTOIA 2005):

- the costs are incurred within seven years of the start date for the business;
- the expenses would have been deductible if they had been incurred after the property rental business started; and
- they are not otherwise allowable as a deduction for tax purposes.

The expenses connected with renovating a property to bring it into a habitable condition are capital costs so are not tax deductible. However, if the property has been unoccupied for at least a year it may qualify for one of the special capital allowances for the renovation of properties (see section 12).

HMRC may query high repair and maintenance costs incurred before letting began. To achieve a tax deduction for these costs the landlord needs to demonstrate the property was in a fit state to be let before the sprucing-up began. Whether it could be let at the same level of rent charged after the 'make-over' is irrelevant to whether a tax deduction applies.

EXAMPLE 1

Susan has purchased a fairly run-down property that has been let as student accommodation, but she would like to let it in the more up-market sector as family accommodation. Before she attempts to let the property she has it deep-cleaned and decorated, and has minor repairs done such as replacing the locks. This work should all qualify as revenue expenses because the property was in a fit state to let before the work was done, as it had been let immediately before Susan purchased it.
If Susan undertook more extensive works before letting, such as removing internal walls and adding new bathrooms where none existed before, HMRC may well disallow the expenditure as improvement costs.

1.3.3 Finish date

The property income business ceases when there is no longer a property available for rent and the landlord is not looking for tenants. This may be because the landlord has decided to occupy the property himself, or he is just keeping the property empty to facilitate a quick sale.

2. WHO IS TAXED AND HOW IS THE TAX PAID?

2.1 JOINTLY HELD PROPERTY

The person or persons who own the property are taxed on the property income in relation to the proportion of the property they own.

Individuals who own their property jointly should tick box 3 on the UK Property supplementary pages of the SA tax return, and decide which of the joint owners will be responsible for holding the records of income, expenses and capital which relate to

the property. The details of this nominated record-holder should be declared in the further information box on the main tax return pages. It is important that this declaration is made every year as HMRC will not go back to earlier tax returns to seek out such information.

2.1.1 Married couples

Section 836 Income Tax Act 2007 (ITA 2007) assumes that a married couple or registered civil partners who are living together, share the income from a jointly held property equally, ie 50:50. This equal split of income applies whatever their actual beneficial ownership, unless a declaration has been made jointly by both partners under s 837, ITA 2007 on HMRC form 17 (see TSEM 9814). The form 17 election must be based on the actual proportions of beneficial interest in the property. Once made, the form 17 declaration cannot be changed unless the underlying beneficial interest in the property changes.

If the property is owned jointly with a spouse and the couple have not made the form 17 declaration, each person should report half the income and expenses on their own tax return. Note the 50:50 split for income does not apply to the profits or losses from an FHL business (see TSEM 9820). Where the FHL business is carried on by both spouses/civil partners, the income is split in a ratio agreed between them, as if the FHL business was a genuine partnership.

A couple can only divide the rental income from a property between them if they both actually own a share in the let property (see section 4).

2.1.2 Partnerships

Joint ownership of a property does not necessarily mean a partnership business exists between those joint owners (see PIM1030). Usually there will not be a partnership business, but where a trading or professional partnership business exists let property may well be held by that partnership. In this case the rental income from the partnership property will be divided between the partners according to the partnership agreement, and taxed in those agreed ratios.

Where an individual holds let property in a partnership, the profits or losses from that partnership-held property is treated separately from any other property rental business carried on by that individual, see PIM1030.

2.2 TAX RETURN

All of the income and expenses from UK let properties held by individuals or trustees should be shown on the UK Property pages of the SA tax return. Clients often believe that if they make a loss from their let property, the income and expenses do not have to be declared. But if the loss is not claimed it cannot be set off against future profits from the same property business.

Income and expenses from overseas let property must be declared on the Foreign pages of the tax return (see section 8).

2.3 RECORD-KEEPING

A landlord is required to maintain complete records of all expenses incurred and income received from his let properties, including the dates of each letting. This means not only keeping every relevant receipt, but also recording details of any personal assets used for the letting business. For instance, where a landlord uses his own vehicle he should record the date and distance of all the journeys made concerning the property business. A claim for use of home as an office may also be relevant where a portion of the home is used to store or process property letting related paperwork.

All the records relating to a property letting business must be kept for six years after the end of the tax year to which they apply. Sale and purchase contracts and receipts relating to property improvements should ideally be kept for six years after the end of the tax year in which the property is sold.

HMRC have an index of the record keeping requirements for different businesses on its website: www.hmrc.gov.uk/record-keeping/index.htm

A penalty of up to £3,000 can be imposed for a failure to maintain adequate records for self assessment purposes (s 12B, TMA 1970).

2.4 WHEN IS THE TAX PAYABLE?

2.4.1 Self assessment

Tax on property income is payable under self assessment for individuals and trustees in the usual fashion. However, it is worth pointing out to clients who are just starting to let property that they may have to pay 150% of the annual tax due on 31 January following the tax year

in which the letting business commences. This is because a client who was previously fully taxed under PAYE will not have paid any tax on account within the current tax year, as in the previous tax year their tax liability was fully deducted at source.

EXAMPLE 2

Sheila starts to let her property on 15 July 2011. She has not previously completed a tax return as all her income has been taxed under PAYE. She must inform HMRC she has a new source of income by 5 October 2012 so that a self assessment tax return can be issued. The tax due on her rental income received in 2011/12 is £1,500, payable on 31 January 2013. However, she will also have to pay the first instalment of the estimated tax due for 2012/13 on that date, being £750. So Sheila's total tax bill payable on 31 January 2013 is £2,250 (£1,500 + £750).

2.4.2 PAYE

The tax due on property income can be collected through the PAYE coding, if the taxpayer agrees. However, the HMRC policy appears to be to code out as much 'other income' as possible, including property income, regardless of whether the taxpayer is also within self assessment. This can cause problems with double-counting of the tax liability if the rental income is left within the code, and a certain amount of hassle to get the PAYE coding changed.

Some clients prefer to pay the tax due on property income through PAYE, as it removes the need to complete a self assessment tax return. If a non-SA client has property income taxed through their PAYE code, it is important to check after the tax year end that the amount of rental income in the code is correct. However, where there is more than one let property, or frequently changing tenants, the taxpayer should be advised to complete a SA tax return every year to ensure all the eligible expenses are claimed. The same applies if there are losses to claim.

2.4.3 Corporation tax

Where the let properties are held by a company, the corporation tax on the company's total profits is generally due nine months and one day after its accounting year end. Where the company is subject to the main rate of corporation tax the tax is due in four instalments, starting six months and 13 days into the accounting period.

The rules for deducting interest and other financial charges from property income differ for companies compared to individuals (see section 3.6). Companies pay tax at different rates to income tax paid by individuals and can claim different tax reliefs on property disposals (see section 4).

2.5 INCOME LOSSES

A loss realised on let property cannot be set against the taxpayer's other income for the same tax year. The loss can generally only be carried forward for relief against future property income profits, s 118 ITA 2007. However, if the loss is created by capital allowances on equipment used for the property trade (see 3.9), or exceptionally when initial allowances are claimed under the business premises renovation allowance or flats over commercial premises schemes (see section 12), that loss can be set against the taxpayer's other income for the same tax year, s 120, ITA 2007.

Profits/losses from a property held by a partnership cannot be combined with or set against profits from let property held by the individual alone. This also applies to losses from a property held within a company or a trust.

2.6 CAPITAL GAINS OR LOSSES

Any gain made on the disposal of a let property must be declared on the Capital Gains pages of the self assessment tax return. This includes properties given to relatives, who are regarded as connected parties, s 993, ITA 2007. A gain made on a transfer between connected parties should be calculated as if it was a sale made at market value. This does not apply to transfers between husband and wife (or civil partners) who are living together at some point during the tax year, when the transfer is treated as a no-gain, no-loss disposal for CGT purposes.

If the property has been used as the taxpayer's main residence for any period, further reliefs will reduce the chargeable capital gain (see section 7).

3. TAX ALLOWABLE EXPENDITURE

3.1 TYPES OF COSTS

The range of items that can be deducted from rents received include the following:

- Legal fees for drawing up tenancy agreements or collecting debts, not those connected with acquiring properties
- Letting or managing agents' fees
- Accountancy fees for drawing up property accounts
- Advertising for tenants
- Gardening, cleaning, and security services where relevant
- Motor expenses for travelling to the property (see 3.10)
- Ground rent and service charge for leased property
- Wear and tear or renewals allowance (see 3.5.2)
- Maintenance and repairs (see 3.3)
- Buildings and contents insurance
- Interest paid on borrowings to fund the property business (see 3.6)
- Water rates and council tax, regional or district council tax in Scotland
- Heating and lighting costs.

The last two items will only be deductible against the rents received if the letting agreement does not make the tenant responsible for paying these charges. The liability to pay council tax normally falls on the individual residing in the property. However, if the property is empty or is a multiple occupation property the landlord may be required to pay the council tax (see PIM2030).

3.2 TIMING

Revenue costs should generally be deducted from the rents received for the period in which the expense was incurred. However, if the landlord has an obligation to pay an expense in the future, that cost can be taken into account if the liability is certain and can be included in the letting accounts following the principles of FRS 12 (see BIM46901).

EXAMPLE 3

Joe bought a leasehold flat in a block of flats in January 2011 and let it immediately. The flat management company asked all the owners to contribute to the cost of repairing the external fire escape. Joe's share was £2,000 payable when the work was completed in September 2011. Joe can include his share of the fire escape repair cost in his property letting accounts for the year to 5 April 2011, as he was committed to paying this cost.

3.3 REPAIRS OR IMPROVEMENT

The cost of repairs can be set against the rental income, but an improvement adds to the value of the property so will only receive tax relief when the property is sold.

Strictly it is not the quantum of the cost that determines whether the item is a repair or an improvement, but the nature of the work. However, where the improvement element is so small as to be incidental to a repair, HMRC will treat this entire cost as a repair (see PIM2020).

For large repair costs, HMRC may ask whether a part of the building or structure has been replaced or added to. The boundary between the definition of repair and the replacement of the entire asset was examined recently in the case of *G Pratt & Son v HMRC* TC01269. The farm drive was resurfaced at a cost of over £23,000, which was claimed as a repair. HMRC argued that the work represented a replacement of the asset in its entirety. As the drive was not extended or widened, and the load-bearing capacity was not increased, it was held the work constituted a repair.

The boundary between a repair and an improvement can also move over time. The windows in a house built over 30 years ago are likely to be single glazed, but where a window is replaced the standard modern equivalent will be a double-glazed unit. HMRC used to argue that the double-glazing represented an improvement, so would not allow a deduction for the cost of the replacement window. HMRC now accepts that a technological change in materials does not necessarily represent an improvement (see PIM2020).

3.4 INSTALLING INSULATION

Until 5 April 2015 (31 March 2015 for companies) landlords can claim up to £1,500 per residential dwelling for the cost of insulating the property using floor, wall, loft or hot water system insulation. This tax allowance, known as the landlord's energy saving allowance (LESA), is deducted from the rents received in the year of expenditure. Any costs exceeding £1,500 are treated as a property improvement, so cannot be deducted from the rental profits.

Expenditure will qualify for the LESA if the work is done up to six months before the commencement of the letting business, but only where the insulation is installed in a finished property, not in the course of construction. The LESA cannot be claimed where the property is let as FHL (see section 6), or as rent a room (see section 10).

3.5 FURNISHED PROPERTY

3.5.1 What is meant by furnished?

The term 'furnished lettings' is not defined in the legislation, so you have to look at its ordinary everyday meaning. Unfortunately there is a wide variation in what different people would regard as adequately furnished.

In PIM3200 a furnished property is defined as:

'one which is capable of normal occupation without the tenant having to provide their own beds, chairs, tables, sofas and other furnishings, cooker etc.'

Various landlord associations define a fully furnished property as:

'one which is ready for immediate occupation including all the furniture and facilities an occupier would expect.'

So what constitutes 'furnished' depends on the expectations of the tenant.

HMRC appears to consider a property as furnished when it is 'fully furnished', as opposed to 'partly furnished', because it warns in PIM3200 that the provision of nominal furnishings will not meet the requirement to be furnished. A partly furnished property would generally include only white goods such as cooker, fridge and washing machine. Even an unfurnished property would however normally include some minimal furnishings such as carpets and curtains.

3.5.2 Wear and tear allowance

Where the property is let fully furnished (according to the HMRC definition), the landlord can claim either:

- the renewals basis for the extra cost of replacing an asset (see 3.5.3); or
- a wear and tear allowance calculated as 10% of the net rents for that property.

In either case the initial cost of providing furniture for the property cannot be claimed.

The net rents are calculated as the rental income received less any expenses paid by the landlord which would normally be borne by a tenant, such as water rates, heating bills or council tax. As the wear and tear allowance only applies to furnished property, not to unfurnished properties, the allowance needs to be calculated on a property by property basis before the expenses for all properties held by the landlord are combined for reporting on the self assessment return.

The wear and tear allowance is designed to cover 'movable' items such as furniture, furnishings, electrical goods, kitchenware, crockery, linen and white goods such as cooker fridge and washing machine. Guidance on the wear and tear allowance is given at PIM3200. The wear and tear allowance cannot be claimed for properties that qualify as FHL because capital allowances can be claimed for those properties instead (see 3.8).

3.5.3 Renewals basis

The renewals basis allows the landlord to claim relief for the cost of replacing furniture and fittings in a let property, but not the original cost of the items. This covers the same items as the wear and tear allowance and it can also be claimed where the property does not qualify as 'fully furnished'.

Using the renewals basis is usually more complicated to monitor than just claiming the 10% wear and tear allowance. Indeed, reducing the administrative burden was the rationale for bringing in the 10% allowance in the first place. This is because every item of furnishings must be compared to the item it is replacing to judge whether the new item includes an element of improvement, in which case the value of the improvement must be disregarded. Any scrap value of the replaced item must also be taken into account.

EXAMPLE 4

Fred replaces the washing machine in his let property with a washer-dryer costing £600. A washing machine with no dryer would cost £250. Fred can only claim £250 under the renewals basis as a deduction against his rental income.

3.6 INTEREST AND LOANS

The principles for receiving tax relief for interest paid on loans taken out to finance a property income business are the same as for any other business, see BIM45700. Note that companies which own let property are subject to the loan relationship rules, see section 4.3.

As long as the borrowings are used to fund the letting business in some way it does not matter whether the loan is short or long term, nor how it is secured, as made clear at PIM2105. The normal wholly and exclusively rules apply. Where the loan has been used partly for private purposes, the interest must be apportioned on a just and reasonable basis. Also, as with all business loans, it is important to check the deduction being claimed relates only to interest and not to repaying the loan capital.

HMRC accepts that tax relief can be given on 100% of the capital value of the property as it stood at the time it was brought into the letting business.

EXAMPLE 5

Buy-to-let property is purchased for £100,000 with an £80,000 mortgage and is let immediately. Two years later the property is valued at £120,000 and the loan is increased to £100,000. All the interest is tax deductible as the loan does not exceed the capital introduced to the business (the initial value of the property). If the loan were to be increased to £102,000 the interest payable on the extra £2,000 would not be tax deductible.

To show that the funding of the property business does not exceed the capital in the business it is usually necessary to draw up a balance sheet.

3.7 EXTRACTING CAPITAL

The additional loans secured on the let property in example 5 need not be used for the property business. The capital can be extracted and used for any purpose as long as the owner's capital account within the business does not become overdrawn.

EXAMPLE 6

(Adapted from BIM45700)

Alan owns a flat in central Belfast, which he bought 10 years ago for £125,000. He has a mortgage of £80,000 on the property. He has been offered a job abroad and decides to keep his flat and rent it out while he is away. His Belfast flat has a market value of £375,000 when he starts his property renting business.

The opening balance sheet of his rental business shows:

	£		£
Mortgage	80,000	Property at market value	375,000
Capital account	295,000		
Total	**375,000**	**Total**	**375,000**

He borrows a further £125,000 on the flat and withdraws that sum for his own use.

The balance sheet at the end of Year 1 shows:

		£		£
Mortgage		205,000	Property at market value	375,000
Capital account brought forward	295,000			
Less: capital taken out	125,000	170,000		
Total		**375,000**	**Total**	**375,000**

Although Alan has withdrawn capital from his business, the interest on the mortgage is allowable in full because it is funding the transfer of the property to the business at its open market value at the time the business started. His capital account within the business is not overdrawn.

The value of the let property cannot be increased in the letting accounts to extract the perceived increase in value (due to the revaluation) as surplus capital.

All properties let by one person in the UK on the same basis are treated as being part of one business, although FHL properties must be kept separate (see section 6). If the landlord holds several properties, the values of all the properties as they stood when they were brought into the letting business are aggregated.

3.8 CAPITAL ALLOWANCES

Landlords cannot claim capital allowances for furniture and fittings used by the tenants in a let residential property, s 35, Capital Allowances Act 2001. The cost of furniture and similar capital items is relieved by the wear and tear allowance, or under the renewals basis (see 3.5). However, if the landlord is actively involved in managing the properties he may claim capital allowances on equipment used to run the lettings business. The items that may qualify include:

- Office equipment
- Vehicles used for travelling between the properties and moving furniture
- Garden tools
- Extendable ladders for external maintenance.

Capital allowances may be claimed for capital items used by tenants in an FHL property, including furniture and fixtures added to the property during construction or at a later date (see new Helpsheet HS 253 and the Property Rental toolkit).

3.9 COST OF OWN TIME

A landlord cannot deduct the cost of his or her own time from the rental income unless the property is let through a company that employs him or her. However, a landlord may deduct the wages of another family member who undertakes property business related tasks. This can be a useful way of distributing some of the rental profits around the family without transferring a share in the property to the spouse (see 4.1). The amount paid to the family member must be reasonable, and the fee must actually be paid, not just accrued in the property business accounts. The landlord should also pay the family member under PAYE and deduct any National Insurance contributions applicable.

3.10 TRAVELLING COSTS

A landlord can claim a tax deduction for the cost of journeys relating to the property business, if they are wholly connected with the letting, any other personal purpose being merely incidental.

3.11 VAT

Letting residential property is exempt from VAT under, Group 1, Sch 9, VAT Act 1994 (VATA 1994), unless the property is let as holiday accommodation (see section 5 of VAT notice 709/3). All holiday accommodation, including caravans and tent pitches, are standard-rated for VAT purposes, whether or not the property passes the tests to qualify as FHL (see section 6).

A landlord who lets residential property is making an exempt supply, so cannot reclaim the VAT on inputs relating to those exempt supplies. Such a residential landlord would not normally be registered for VAT, so the VAT reclaim would not be possible.

However, where the landlord also conducts another standard-rated trade through the same business vehicle, he or she may be required to become VAT-registered in respect of that VATable turnover. A VAT-registered landlord may be able to reclaim VAT on the costs of running the residential lettings under the partial exemption *de minimis* rules (see 4.3.4).

If a VAT registered landlord joins the flat rate scheme for small businesses he or she must apply the flat rate for their main trade to all of their business income, including exempt rental income. This can mean the flat rate scheme is not beneficial. The turnover test for leaving the flat rate scheme includes all business income, including exempt income, so a high level of exempt income can mean the trader must leave the flat rate scheme (see VAT notice 733 para 3.5).

3.12 HOUSES IN MULTIPLE OCCUPATION

The Housing Act 2004 introduced a legal definition of a house in multiple occupation (HMO). Broadly, this is a house which is occupied by persons who do not form a single household. The term also includes any purpose built or converted flat whose occupants do not form a single household. This Act imposes a requirement for certain types of HMO to be registered with the local authority.

From 6 April 2006 an HMO which contains three or more storeys and which is occupied by five or more persons forming two or more households (ie unrelated tenants), must be licensed. The fees charged by the local authority for an HMO licence vary significantly across the country, but the cost of the licence should be tax deductible. Additional requirements regarding the space which must be available to tenants, fire exits, etc may also vary from area to area.

4. HOW SHOULD THE PROPERTY BE HELD?

4.1 JOINTLY HELD PROPERTY

Where a let property is owned by one spouse, a transfer into joint ownership can save income tax on the rents if one spouse has a lower marginal tax rate. There may also be a CGT saving on the eventual sale of the property for the same reason and in addition up to two annual exemptions may be available to reduce a chargeable gain.

In England and Wales one can own property as:

- joint tenants, where the owners hold an equal undivided interest in the whole property, or
- tenants in common, where the individuals hold separate and identifiable shares, say 10% and 90% of the property.

If the owners are either married or in a civil partnership, the property will be treated as being held in equal shares (50:50), even if this is not the case. To take the benefit of an unequal share of profits and gains the couple need to

elect on HMRC form 17 for the actual beneficial ownership to apply (see 2.1.1).

Where a property is already held as joint tenants it is quite simple to change to tenants in common, but there can be an SDLT charge where the property is mortgaged.

A gift of a share in a property between husband and wife (or civil partners) who are living together in that tax year is treated as a no-gain no-loss disposal for capital gains tax (CGT). No CGT arises at that the date of the gift, but the donee is treated as acquiring the share in the property at the donor's base cost. When the property is sold the capital gain must be split according to the proportional ownership.

HMRC may challenge the validity of transfers of property between spouses/civil partners which are completed shortly before the sale of the property. HMRC argues that the full gain should be taxed on the original owner, on the basis that the primary motive for the inter-spouse transfer was to gain a tax advantage and, as such, the inter-spousal transfer should be ignored as an artificial step. To counter such challenges it is prudent to make the inter-spouse transfer sometime before the property is placed on the open market. The transfer should also be fully documented with the names of both spouses registered as owners with the Land Registry.

The transfer between spouses is exempt from inheritance tax, unless one spouse has non-UK domicile, in which case the transfer will be a potentially exempt transfer (PET) that becomes fully exempt after seven years. When transferring property between partners who are not married, the pre owned asset charge should be considered (see *TAXGUIDE 02/07*).

4.2 PARTNERSHIP OR LLP

Where property is held jointly, the owners can form a partnership or limited liability partnership (LLP) to manage that property letting business. Where a genuine partnership exists the profits and losses from that business can be allocated between the partners in any ratio the partners agree on and that ratio may be varied from year to year.

Some evidence may be required to convince HMRC that a property business partnership exists, as the mere existence of jointly held property does not, in the view of HMRC, constitute a partnership (see PIM1030). The nature of a partnership is discussed in the HMRC *Business Income Manual* at BIM72000 onwards.

Where the let properties qualify as FHL (see section 6), it may not be in the long term interests of the joint owners to operate as a formal partnership. Entrepreneurs' relief can generally be given in a more flexible manner for gains realised on assets which were previously used in businesses which were not partnerships or companies.

4.3 COMPANY

4.3.1 Several properties

Where an individual plans to let two or more properties it may be worthwhile holding those properties through a limited company. A trading company that has accumulated some surplus funds could invest in buy-to-let property provided the company can secure a mortgage for the necessary balance of the purchase price. Lenders are aware of the tax advantages of corporate landlords and there are a number of mortgage products on the market specifically designed for buy-to-let companies.

4.3.2 Compare tax rates

Before the investment decision is made the landlord needs to consider his or her long term plans for the property and, his or her need to extract any cash, and compare the potential tax charges for the company and individual. This may require some crystal ball gazing, for example:

- The company will pay corporation tax (probably at 20%) on income and gains, but income extracted from the company in the short term may also create a higher rate or additional rate tax charge for the individual.
- An individual will pay income tax on the property income profits at 20%, 40% or 50%, after deducting the personal allowance and depending on any other income.
- An individual will pay tax on capital gains at 18% or 28%, after deducting any available annual capital gains exemption.
- Entrepreneurs' relief can reduce the rate of CGT to 10%, but only for FHL properties.
- The company does not have a capital gains exemption, nor can it claim entrepreneurs' relief, but it can claim the indexation allowance.

The company's tax rates may be higher if the landlord already controls one or more companies. This is because those controlled companies will be associated with the property holding company, and the profit threshold at which the next corporation tax rate starts to apply must be divided by the total number of associated companies.

4.3.3 The long or short term plan

If the landlord plans to churn the investment properties every few years to realise the capital profit that has built up, the tax charges are likely to be lower if the properties are held personally, unless the business is taxed as a trade (see section 5).

Where the plan is to hold the investment property for some years, say until retirement, using a company has some advantages:

- It may be possible to sell the company on as a rental business, when entrepreneurs' relief can reduce the CGT payable on the shares to 10%.
- Shares in the company can be passed on to the next generation more easily than a share in the let properties; business property relief (BPR) may be available for inheritance tax on the shares.
- A corporate landlord may find it easier to open trade accounts with suppliers.

4.3.4 VAT

Letting residential property is generally an exempt supply, in which case input VAT relating to those exempt supplies cannot be reclaimed (see 3.11). However, the VAT registered company may be able to reclaim the input VAT on the property-related expenditure, under the partial exemption *de minimis* limits.

The company's input tax relating to exempt supplies must be less than:

- £625 per month on average, which is £7,500 a year; and
- no more than 50% of its total input VAT.

Alternatively the business can use one of these two optional tests to check if it is partially exempt for the particular VAT quarter:

Test 1

- The total input tax is less than £625 per month on average; and
- The exempt income is less than 50% of the total sales.

Test 2

- The total input VAT less exempt input VAT is less than £625 per month on average; and
- The exempt income is less than 50% of the total sales.

Great care is needed to ensure these limits are not breached, otherwise the whole business will become partially exempt, which could adversely affect the VAT that can be reclaimed on the main trade.

For further guidance concerning the VAT partial exemption tests see the HMRC toolkit: VAT Partial Exemption and VAT Information Sheet 04/10.

5. TRADING OR INVESTMENT

5.1 NO CHOICE

The landlord does not have a choice as to whether his property business is taxed as property income or a trade. The facts will determine the tax treatment. HMRC may consider any of the following activities to be trading:

i) Buying and selling properties within short periods.

ii) Buying and renovating, then selling properties.

iii) Managing properties owned by others, collecting rent, etc.

iv) Providing services connected with the property, so the letting amounts to serviced accommodation.

In i) and ii) above the landlord may be considered to be trading in properties, where the property is an item of stock rather than an investment.

In iii) the individual does not actually own the properties himself or herself so is operating a trade of providing the services of a property manager.

EXAMPLE 7

Mike buys a dilapidated house for £90,000 and spends £30,000 over four months on repairs and modernisations to the bathroom and kitchen, with the intention of selling the property as soon as possible for a profit. In this situation Mike is a property developer and the profits he makes are trading profits.

5.2 TAX CONSEQUENCES

Where a landlord is considered to be trading in property, the following tax consequences apply:

- All the gains made on selling properties are subject to income tax (or corporation tax if held within a company).
- There is no annual capital gains exemption to set against the gains made from selling properties (see 7.3).
- The main residence exemption and letting exemption are not available (see 7.4).
- National insurance contributions will be due on the trading profits.
- A management business may need to register for VAT.
- HMRC must be notified about the new source of income before 6 October, and the business must register with HMRC by 31 January following the tax year in which trade began.
- The value of the business will generally attract 100% BPR from IHT.
- Tax relief is available for indirect or abortive expenses connected with buying and selling properties.
- Pension contributions paid out of a property trading business attract tax relief;
- Losses made by the trading business can be set against other income made in the same and/or previous tax year.
- The shares of a trading company qualify for entrepreneurs' relief on disposal.

6. FURNISHED HOLIDAY LETTINGS

6.1 LOCATION OF THE PROPERTY

Where a property qualifies as commercial furnished holiday lettings (FHL) that letting activity is treated as a trade for most income tax and capital gains tax purposes. In other words the FHL business is a 'deemed trade'. This brings a number of tax advantages as listed in 6.4 below.

The original furnished holiday lettings (FHL) rules, as introduced in 1984, only applied to properties situated in the UK. In 2009 the Government determined this was in breach of EU law so extended the FHL rules by concession to properties situated in any EEA country with retrospective effect. The EEA countries consist of all 27 member states of the EU plus Iceland, Norway and Liechtenstein.

Schedule 14, Finance Act 2011 then introduced a distinction between the FHL business a person conducts in UK properties and the FHL business that person conducts using properties in other EEA countries. From 6 April 2011, or 1 April 2011 where the FHL business is conducted through a company, the profits and losses from the FHL properties in the UK must be kept completely separate from the profits and losses made from FHL properties in other countries. The treatment of losses arising from all FHL businesses was also amended from 2011/12 for income tax and from 1 April 2011 for companies (see 6.3).

The FHL property does not have to be located in a specified tourist area, properties located anywhere in the country can qualify.

6.2 REQUIRED PERIODS OF LETTING

The properties within an FHL business must be let on a commercial basis with a view to making a profit. They must also be let furnished (see **3.5** for the definition of furnished). In addition, the pattern of lettings must satisfy the three conditions in Part 3, Ch 6, ITTOIA 2005. These conditions are amended from 6 April 2012 (1 April 2012 where the FHL business is conducted through a company) so that:

1. The property must be available for commercial letting as holiday accommodation for at least 210 days a year (previously 140 days).
2. It must be actually let as **holiday accommodation** for at least 105 days a year (previously 70 days).
3. It must not normally be let for a continuous period of more than 31 days to the same tenant in seven months of the year, and those seven months include any months in which it is actually let as holiday accommodation. This is unchanged.

Holiday accommodation means letting to the general public for periods which do not normally exceed a month, but this can include letting to business people for short periods as well as to tourists. The seven months of short lettings in condition 3 do not have to be a continuous period. The property may be let to one tenant in the other five months of the year.

6.2.1 Grace period

These apparently simple conditions are complicated by the introduction of the grace period from April 2012. If an FHL property has not actually been let for the required 105 days, but it did meet this condition in the previous year, the owner can elect under s 326A, ITTOIA 2005 (s 268A CTA 2009 for companies), for a period of grace to apply. The property is then treated as meeting the letting condition for that tax year. The election can be made for up to two consecutive years, but if the property is not actually let for the required days in the fourth year it ceases to qualify as FHL. This period of grace election can only apply where there is a genuine intention to let the property, and the property must be available for letting for the full 210 days per year. The election must be made by the first anniversary of 31 January following the end of the tax year it applies to.

EXAMPLE 8

Martyn lets his cottage in France as an FHL. The actual days let in each year are:

Tax year	Days let	Period of grace election?	Qualifies as FHL?
2011/12	77	Not applicable	Yes
2012/13	84	Yes	Yes
2013/14	77	Yes	Yes
2014/15	91	Not permitted	No

Martyn's cottage ceases to qualify as FHL from 6 April 2014.

6.2.2 Averaging

Where the taxpayer owns more than one property that is let as FHL, he may average the days let across the properties when determining if the number of days let is met. Where some properties easily meet the letting requirement and others do not, this averaging exercise can ensure that all properties qualify as FHL. Properties in the UK cannot be averaged with properties let outside of the UK.

This averaging exercise should be performed before the period of grace election discussed in 6.2.1 is then considered for each property.

6.3 LOSSES

For periods before 6 April 2011 losses from FHL businesses could be set against the business owner's other income for the same tax year or the previous tax year. This is known as sideways loss relief. Any losses unrelieved in this way could be carried forward to set against losses from the same business in future periods. Relief for the FHL losses was also available as carry back to the previous three tax years where the losses were made in the first four years of the business, or as terminal loss relief where the losses were made in the final 12 months of the business.

From 2011/12 the losses from FHL businesses cannot be set against other income, not even against other property income. The only way an FHL loss can be relieved is to carry it forward and set it against profits from the same FHL business. As indicated in 6.1 the losses from UK properties cannot be set against profits from non-UK properties, or vice versa.

Where the property ceases to qualify as FHL for a period of less than three years the losses can be carried forward over that gap period, if it can be shown the same FHL business is carried on before and after the gap period.

Where the taxpayer provides a significant amount of services alongside the provision of the FHL property, such as meals, or entertainments, the whole business may qualify as a trade in a similar fashion to a hotel. If it can be shown to be a trade any losses will be available for sideways loss relief. Unfortunately there is no HMRC guidance on when an FHL business can be treated as a trade in its own right, rather than as a deemed trade.

6.4 ADVANTAGES OF FHL

Commercial furnished holiday lettings are treated as a deemed trade for many tax reliefs, although it is not actually a trade. This means:

- Capital allowances can be claimed for furniture, furnishings and fittings used within the FHL properties, as well as for equipment used in running the FHL business.
- The profits count as earnings for pension purposes.
- The profits are not subject to class 4 NICs.
- The capital gain made on the disposal of an FHL property may:
  - attract entrepreneurs' relief (see example 9);
  - be rolled over against the purchase of another FHL property or into a different business asset which is acquired within the specified period; or
  - qualify for held-over relief if the disposal is a gift or transaction at less than market value.

In addition the FHL may qualify for business property relief for inheritance tax, see section 9.

6.5 DISADVANTAGES OF FHL

The disadvantages of letting as FHL as opposed to standard six month residential lets are:

- The turnover of tenants is much higher.
- Advertising and cleaning costs are higher.
- HMRC may try to impose class 2 NIC on the owners.
- The relief for losses is now even more restrictive than for normal lettings.
- The landlord may have to register for VAT (see 6.6).

The issue of class 2 NIC on property income is a strange one as guidance cannot be found in the HMRC manuals and indeed the *Property Income Manual* clearly states that as furnished holiday letting is not a trade class 4 NIC is not due (PIM4120). However class 2 NICs are frequently demanded where various types of letting are undertaken. Note that in the case *Rashid v Garcia* SpC 348, HMRC argued the opposite when Mr Rashid tried to claim benefits based on the class 2 NICs he had paid. It was held that Mr Rashid was not in business although he let and managed four properties.

6.6 VAT

All holiday accommodation is standard rated for VAT purposes, whether or not it qualifies for FHL (see 3.11). This means the landlord may have to register for VAT if the total of rental income received from the FHL properties plus any other VATable supplies made by the landlord exceeds the compulsory registration limit (£73,000 from 1 April 2011). If the landlord is already VAT registered for another business standard VAT must be applied to all FHL fees.

6.7 LOCAL TAXATION

Residential property is normally subject to council tax. However, the Business Link website advises that properties which are available for short term letting for more than 140 days per year are subject to business rates rather than council tax. Thus all properties that qualify as FHL in 2011/12 should be subject to business rates. It is not known whether the availability period of 140 days will increase to 210 days from April 2012 in line with the direct tax rules.

EXAMPLE 9

Alfred and Bert both purchased identical apartments to let for £200,000 in April 2000 and sold the same apartments for £315,000 in July 2011. Costs of buying the apartments came to £5,000, including SDLT. Bert's apartment was let on standard short-term tenancies of six months duration, while Alfred managed to let his apartment so it qualified as FHL. He did not have any other FHL properties and ceased letting the apartment on 31 March 2011.

The gain on Alfred's property qualifies for entrepreneurs' relief as he has disposed of his entire FHL business (see 7.2). Alfred thus pays CGT at 10% on his entire gain, which easily lies within his lifetime entrepreneur's relief limit. Bert is a higher rate taxpayer in 2011/12, so he pays CGT at 28% on all his gains. Bert and Alfred's respective capital gains tax bills are calculated as follows:

2011/12	**Alfred's flat**	**Bert's flat**
	£	**£**
Net sale proceeds	315,000	315,000
Less purchase cost	(200,000)	(200,000)
Less fees and SDLT on purchase	(5,000)	(5,000)
Chargeable gain	110,000	110,000
Annual exemption for 2011/12	(10,600)	(10,600)
Taxable gains:	99,400	99,400
CGT due at 10%/ 28%	9,940	27,832

Alfred saved CGT of £17,892, compared to Bert, by letting his property in a flexible way so it qualified as FHL for the entire period of ownership.

If the holiday letting is seasonable the Valuation Office will apparently take this into account when setting the level of business rates. If the rateable value of the property for business rates is less than £18,000 (£25,500 in greater London) the property owner may qualify for small business rates relief. Different thresholds for this business rate relief apply in Wales and Scotland. Business rates are not charged on properties in Northern Ireland, where the old rates system applies to both domestic and business properties.

6.8 PRIVATE USE

Where an FHL property is used by the landlord's family for no charge, any capital allowances claimed for that tax year must be restricted for that private use on a just and reasonable basis. This restriction should also logically be applied to the annual expenses for the property such as local property taxes, power and water charges. HMRC guidance on this issue is expected to be included in the next revision of its *Property Income Manual*.

7. CAPITAL GAINS

7.1 WHAT IS THE TAXABLE GAIN?

The following deductions or reliefs may reduce the taxable amount of gain realised on the sale or disposal of let property:

- Professional fees
- Stamp duty land tax
- Entrepreneurs' relief (see 7.2)
- The annual exemption (see 7.3)
- Main residence exemption (see 7.4)
- Lettings relief (see 7.5).

7.2 ENTREPRENEURS' RELIEF

7.2.1 When it applies

Where entrepreneurs' relief applies, and the total gains subject to a claim for that relief by the taxpayer are within his or her lifetime limit (currently £10m), the rate of CGT applied to the gain will be 10%.

However, for entrepreneurs' relief to apply there must be a trading business or trading company. A property letting business is not a trading business unless it is deemed to be a trade because it qualifies as FHL (see section 6). Thus the disposal of residential let property will only qualify for entrepreneurs' relief in the following circumstances:

- The property was used by an unincorporated FHL business, and is disposed of as part of the disposal of all or part of that business.
- The property was owned by the individual but used by a trading partnership or company (including a deemed FHL trade) and disposed of as part of the individual's withdrawal from that business. This is known as an associated disposal (see 7.2.3).
- The property was used by an FHL business and was disposed of within three years after the cessation of that business.
- Disposal by a trust where the property was used in the FHL business run by a qualifying beneficiary as a sole trader or partner.

In all of the above cases the ownership conditions must also apply for at least 12 months to the date of disposal or to the date of cessation of the trade, if earlier. For individuals, the ownership condition is that the individual must have been involved as the owner or a partner in the business. For companies the individual must hold at least 5% of the ordinary shares and voting rights of the company, and be an officer or employee of that company, or of another company in the same trading group.

7.2.2 Disposal on or after cessation

When the FHL business consisted of just one property, clearly the FHL business has ceased and the whole business has been disposed of when that property is sold. Where the FHL business contains several let properties and only some of the properties are disposed of, HMRC may not accept there has been a disposal of part of the business, so entrepreneurs' relief may not apply to the disposal of a single property when the FHL business continues.

The FHL business may cease trading some months or even years before the disposal of the property. Where the lettings business ceases to qualify as FHL and becomes an ordinary lettings business, the deemed trade of FHL business is treated as ceasing, subject to the grace period (see 6.2.1).

Entrepreneurs' relief can be claimed where the business assets are disposed of up to three years after the business ceases to trade (s 169I(4), Taxation of Chargeable Gains Act 1992 (TCGA 1992)). As long as the property was used for the FHL business at the date the FHL business ceased, it can qualify for entrepreneurs' relief (s 169I(2)(b), TCGA 1992). For a sole trader business there is no restriction on the relief if the properties are used for some other purpose between the cessation of the FHL business and the sale, for example if the properties are let but do not qualify for FHL.

7.2.3 Associated disposal

Where the associated disposal rules apply to the disposal of a property used in a company or partnership that operated the FHL business, the gain subject to the relief may be restricted on a just and reasonable basis if any of the following conditions apply (s 169P(4), TCGA 1992):

- The property was only used by the business for part of the period of ownership by the individual, in which case the gain taken into account will reflect the period of business use.
- Only part of the property was being used for the purposes of the business, in which case the gain taken into account for the relief must reflect the proportion of the asset used for business purposes.
- The individual concerned has only been involved in the business as a partner in the partnership or employee/officer of the company for part of the time during which the asset was used by the business.
- Any payment of rent was paid to the owner for the use of the property by the personal company or partnership for a period after 5 April 2008.

7.3 ANNUAL EXEMPTION

Most individuals are entitled to an annual exemption for CGT, which is worth £10,600 for 2011/12. Where the taxpayer is not UK domiciled and claims the remittance basis for the tax year, he or she cannot also make use of the annual exemption for that tax year.

Where a let property is owned jointly, the annual exemptions of both owners may be used to cover part of the gain on the disposal of that property.

7.4 MAIN RESIDENCE ELECTION

The main residence exemption is very valuable, as it can reduce the chargeable gain arising on a property that has been let for some periods. Any periods during which the property is occupied by the taxpayer as his or her main residence, or is deemed to be the taxpayer's main residence, are free of CGT. Also, where such a period of main residence has applied for a property, the gain made in respect of the last three years of ownership is exempt from CGT (s 223(2) TCGA 1992).

An individual, married couple or civil partners can have only one main residence at any one time. To qualify as a main residence the property must actually be occupied as a home for at least some of the year. A property that is fully let cannot be the owner's main residence. Where two or more properties are occupied as a home concurrently the taxpayer may elect for one to be the main residence, but that election must be submitted to HMRC within two years of the second or subsequent property becoming the taxpayer's residence or home. Once made, that election can be changed at any time. This change of election of main residence is also known as 'flipping'.

The main residence exemption does not apply where the property was acquired wholly or partly to realise a gain from its disposal, s 224(3), TCGA 1992. If HMRC believes the main residence election was made wholly for tax avoidance purposes the tax relief will not be given.

EXAMPLE 10

Donna bought a holiday home in Dorset on 1 September 1999, which she used as a second home, but she continued to live for most of the time in her own home in London. She elected for her London house to be her main residence with effect from 1 September 1999. Donna let out the Dorset property from 1 June 2002 to 31 May 2010. She then decided to spend the summer in the country so moved into the Dorset property on 1 July 2010. At the same time she changed her main residence election to make the Dorset property her main residence. She returned to live in her London house from 1 October 2011, and changed her main residence election back to the London property at that time. Donna sold the Dorset property on 1 September 2012 making a capital gain of £130,000 (£10,000 per year of ownership).

As the Dorset property was Donna's main residence for three months in 2011, three months' worth of the gain is exempt: £2,500. Also the last three years' worth of gain is exempt, £30,000. Of the remaining gain of £97,500, up to a further £32,500 is exempt under the letting exemption (see 7.5).

If Donna had not made the main residence election when she bought the Dorset property in September 1999, she would not have been able to alter that election in favour of her holiday home in July 2011 and alter it back again in October 2011. The full gain of £130,000 made on selling the Dorset property would be subject to CGT.

7.5 LETTING EXEMPTION

Where a property that has been a main residence has been let as residential accommodation either as a whole property or in part, the letting exemption may apply, s 223(4), TCGA 1992. This tax relief cannot apply to a buy-to-let property that has not been occupied by the owner and been their actual or elected main residence for some period.

The tax relief is restricted to the lowest of three amounts:

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

EXAMPLE 11

In Example 10 Donna let the property for eight years and occupied it as her main home for three months. The gain is £130,000 or £10,000 per year of ownership. The taxable gain is calculated as follows:

	£
Capital gain before tax relief:	130,000
Exemption for main home for three months, plus last three years of ownership	32,500
Relief for letting restricted to lowest of £32,500, 8 x £10,000 and £40,000	32,500
Net gain chargeable	65,000

8. OVERSEAS ISSUES

8.1 LETTING OVERSEAS PROPERTY

When a UK resident invests in property abroad, unless they claim the remittance basis (see 8.2.2), they must report the income and expenses from the foreign let property on the Foreign pages of the UK tax return. The overseas letting business is treated as a separate business from any UK lettings, so any losses suffered on the overseas property cannot be carried back to off-set against other UK income, but can only be used in the same year or carried forward to set against the overseas letting income.

The rental income from the overseas property is also likely to be taxed in the country where the property is situated. However, the local accounting rules may permit different allowances and expenses to be deducted, and the rental profits may have to be calculated over different period to align with the local fiscal year. This means that it may be necessary to draw up two different sets of property accounts, one for the UK tax return and one for the overseas tax return.

The landlord should inform the local tax authorities and should be advised to take local tax advice. Tax Faculty members may use the Tax Faculty referral scheme to find an expert in the relevant tax system to advise on the matter. If a local property agent is employed to manage the overseas property that agent may be required to deduct withholding tax from the rents. However income tax paid in the country where the rent arises can normally be deducted from the UK tax liability on the same income, subject to double taxation relief.

It is not possible to reclaim any excess foreign tax paid if that foreign tax exceeds the UK tax due.

8.2 GAINS ON OVERSEAS PROPERTY

8.2.1 UK-domiciled landlords

A double taxation treaty may allow the UK resident landlord to offset foreign CGT against the UK CGT due when the overseas property is sold. However each type of foreign tax can only be set off against its equivalent UK tax. If the landlord actually lives in his foreign property for a while he or she can elect for it to be his or her main residence for UK tax purposes. This will protect a proportion of the gain from UK CGT on sale (see 7.4).

8.2.2 Remittance basis

Where the remittance basis applies the UK-resident taxpayer only pays UK tax on amounts of income or gains remitted to UK, or which arise in the UK.

Non-UK-domiciled landlords who are resident or ordinarily resident in the UK can elect to be taxed on the remittance basis for a particular tax year. Most landlords in this position will also have to pay the remittance basis charge (RBC) for any tax year for which they wish to use the remittance basis. The RBC was initially set at £30,000 per year, but will rise to £50,000 from April 2012 for those who have been resident in the UK for 12 years or more. The RBC does not apply in any of the following circumstances:

- Unremitted income and gains amount to £2,000 or less for the tax year.
- The individual is aged under 18 in the entire tax year.
- The individual has been resident in the UK for less than seven of the previous nine tax years.

The rules that determine when an amount is remitted to the UK are very complex. For further information refer to *TAXline Tax Practice 22: The new tax regime for residents and the remittance basis*.

8.3 HOLDING FOREIGN LET PROPERTY THROUGH A COMPANY

Holding the overseas property in a foreign registered company will not necessarily remove the capital gain from the UK tax net. Where the property is disposed of by the company and funds are not distributed, s 13, TCGA 1992, can attribute the gains of certain non-resident companies to the shareholders.

8.4 UK PROPERTY OWNED BY LANDLORDS WHO LIVE OVERSEAS

8.4.1 Non-resident landlord scheme

A non-resident landlord may be an individual, a company, a trust, or even a foreign head of state or government department, known as a sovereign immune. Any managing agent or tenant in the UK, who pays more than £100 per week in rent to a non-resident landlord must withhold the basic rate of income tax from the rent net of certain expenses and pay over the tax deducted to HMRC.

Details of the non-resident landlord scheme can be found on the HMRC website at: www.hmrc.gov.uk/cnr/nr_landlords.htm

8.4.2 Landlords

The landlord can apply to HMRC for approval to receive rent with no tax deducted. To receive this approval the landlord must show that:

- their UK tax affairs are up to date; or
- they have not had any UK tax obligations before they applied; and
- they do not expect to be liable to UK income tax for the year in which they apply; or
- they are not liable to pay UK tax because they are sovereign immunes.

HMRC may refuse approval for gross payment and may withdraw approval, although these HMRC decisions may be appealed against.

8.4.3 Agents

A letting agent acting for a non-resident landlord must also register with HMRC within 30 days of taking rent for the UK property. The agent must complete an annual information return by 5 July each year, account for any tax deducted on a quarterly basis and issue a tax deduction certificate to the landlord where tax has been deducted.

Where the tenant pays rent directly to the non-resident landlord, or to another person who is either outside the UK, or is not a letting agent, the tenant must operate the non-resident landlord scheme.

Some letting agents and tenants are not aware of their obligations under the non-resident landlord scheme. HMRC has produced a booklet, *Non-resident landlords – guidance notes for letting agents and tenants*, which can be downloaded from the HMRC website: www.hmrc.gov.uk/cnr/nrl_guide_notes.pdf

9. INHERITANCE TAX

There are no special reliefs from inheritance tax for let property. The value of the property less any debt secured on the property must be included in the total value of the estate on death.

Business property relief (BPR) can apply to the value of assets used wholly or mainly for the purposes of a business. However, property letting is not regarded as a business for these purposes. Property held wholly or mainly as an investment will not qualify for BPR (s 105(3), Inheritance Tax Act 1984 (IHTA 1984)).

Although an FHL business is a deemed trade, it will not necessarily qualify for BPR. To do so, the FHL business needs to provide a level of services over and above that which would be expected from a landlord. This may be achieved in the case of a caravan park or seasonal short lets where catering, entertainment and other services are also provided. HMRC will refer any case concerning FHL property to its technical team (litigation).

Where the accommodation is merely furnished and no other services are provided to the tenants, HMRC concludes in its *Inheritance Tax Manual*: 'In most cases the level of services provided will not be sufficient to weigh the balance away from investment (IHTM 25276)'

10. RENT A ROOM RELIEF

Rent a room relief was introduced in 1992, and the tax-free threshold was last raised in 1997/98 to £4,250 pa. This tax relief is for letting accommodation in the individual's only or main residence, which may include ancillary services such as laundry or meals. Main residence in this context is the property actually occupied, not one subject to a main residence election (see 7.4). The relief can apply to small bed and breakfast businesses as long as the owner also occupies the property. It may also apply where the whole house is let for a short period while the owner goes on holiday.

If the gross income is under the threshold of £4,250, rent a room relief applies automatically, unless the taxpayer elects otherwise. If the gross rents exceed this threshold the taxpayer may choose to be taxed on just the excess or elect for the relief not to apply and use the normal income and expenditure rules. If a loss is likely to arise the relief should be disclaimed so the loss can be claimed.

Where more than one person owns and occupies the property, each owner-occupier is entitled to rent a room relief of half the threshold. This may potentially increase the amount of total rent a room relief available where there are more than two owner occupiers.

EXAMPLE 12

Herbert jointly owns a house with his sons John, Alan and Sam. The sons live in the property and let two rooms to students at a total rent of £8,000 per year, which is divided equally between father and sons. Herbert is not entitled to rent a room relief as he does not live in the property. John, Alan and Sam each have an annual rent a room relief threshold of £2,125, so their portion of the rent is covered by this limit.

Rent a room does not cover:

- Space let as an office, storeroom or garage (see Helpsheet HS 223).
- Letting property not also occupied by the taxpayer.
- Where the taxpayer is a company or partnership.
- Letting a house while working abroad.
- Rent paid by a child to its parents (outside the scope of tax).

HMRC's denial of rent a room relief for office space is based upon the phrase 'furnished accommodation' which is not defined in statute so is taken as having its ordinary meaning. HMRC says 'furnished accommodation' means **residential** accommodation not office space. The *Hansard* reports of the standing committee debates support this view.

11. LETTING COMMERCIAL PROPERTY

11.1 INCOME

Investment in commercial properties such as offices and shops can show a good return, and letting these properties can involve less management than residential lets for the following reasons:

- The leases tend to be drawn up for longer periods, so there is less turnover of tenants.
- The tenant is normally responsible for repairs, renovation and insurance.

The rental income is taxed just like income from residential lettings, although fixtures and fittings in commercial buildings may qualify as integral features for capital allowances. A portfolio of residential and commercial lettings will be treated as one lettings business.

11.2 GAINS

The gains arising on the disposal of commercial buildings that are used by the personal company of the owner, for that company's trade, can qualify for entrepreneurs' relief. However, the disposal needs to be timed carefully so it qualifies as an associated disposal. Also any rent paid by the company to the building owner will reduced the amount of gain that can be subject to entrepreneurs' relief.

11.3 VAT

The VAT issues concerning commercial property can be quite complicated, for example:

- The purchase price of the building may or may not have standard rate VAT attached. The sale of a commercial building which is less than three years old will be subject to standard rate VAT.
- If the previous owner of the building has made the VAT option to tax election the sale will be subject to VAT at the standard rate, otherwise a sale of a commercial building will be exempt from VAT.
- Where the building costs over £250,000 the capital goods scheme may restrict the VAT that can be reclaimed if the building is sold within 10 years.

Where the purchase of the building has had VAT added to its cost, letting that building will also generally be subject to VAT. Expert advice on VAT matters should be taken whenever the lease or purchase of commercial property is being considered.

11.4 STAMP DUTY LAND TAX (SDLT)

When dealing with commercial buildings it is important to know the difference between a lease and a licence to occupy. Broadly a lease is an exclusive right to occupation and a licence is a personal interest and does not amount to an interest in the property. A lease will generally be subject to SDLT if the relevant value exceeds the exempt threshold, but a licence will not.

A lease normally has two components:

- a premium, which is subject to SDLT as if it was a purchase consideration, so SDLT may be due at up to 4% depending on the amount of premium paid; and
- rents, which are subject to SDLT at 1% of the net present value (NPV) of those rents that exceed the exempt band (£150,000 for commercial property).

The NPV of the rents is the discounted future value of all the rents to be received under the lease, the discount being applied at 3.5%. The formula for calculating the SDLT due on the NPV of a lease is complicated, but there is an interactive tool on the HMRC Stamp Taxes website: www.hmrc.gov.uk/sdlt/calculate/calculators.htm

12. REFURBISHING PROPERTY

12.1 REFURBISHING COMMERCIAL PREMISES

The business premises renovation allowance (BPRA) provides a 100% initial capital allowance for the capital costs of renovating or converting unused business premises in disadvantaged areas (as defined by The Assisted Areas Order 2007, SI 2007/107), and in the whole of Northern Ireland. Any commercial building can qualify for the allowance, including offices, except for buildings used by certain excluded trades which include fishing, shipbuilding, steel and coal.

The business property must have been unused for a period of at least 12 months ending with the date renovation starts. The allowance is claimed by the person who actually incurs the capital expenditure on refurbishment, who may not be the owner of the freehold.

All of the BPRA can be claimed in the year the expenditure is incurred; any unclaimed balance of the initial allowance may be claimed as a 25% writing down allowance in subsequent years if the building still qualifies. However, any initial allowance is withdrawn if the building is sold before it is first used after renovation. The allowances given are also clawed back if the building is sold, demolished, ceases to qualify as business premises, or if a long lease is granted out of the relevant interest within seven years of the date it is first used after the renovation.

The BPRA scheme came into effect from 11 April 2007 and has recently been extended to run to 11 April 2017. The relief is set out in Part 3A Capital Allowances Act 2001 (CAA 2001).

12.2 FLATS ABOVE COMMERCIAL PREMISES

The flat conversion allowance was introduced in 2001, and is due to be abolished in 2012.

The relief operates in a similar fashion to the BPRA described in 12.1. However, the property does not have to be situated in a disadvantaged area. The relief is set out in Part 4A, CAA 2001.

The property must have been built before 1980, and be used for a commercial purpose on the ground or lower floors, while the upper storeys must have originally been designed for residential use. To claim the allowance those upper floors must have been either unoccupied or used only for storage for at least 12 months before the conversion back to residential use commences.

The 100% initial allowance is claimed in respect of the capital cost incurred in converting unused space on the upper floors into separate residential flats. Each flat created must have no more than four rooms and have access separate from the commercial area below. Each flat must also have a notional rental value set by legislation, which has not been increased since 2001. This may limit the usefulness of this tax relief to fairly run-down areas away from the south east of England. In addition the flats need to be held for seven years or more after conversion, or the tax allowance is clawed back.

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