

Taxation of Rental Properties

Taxation of property letting covers the range from commercial letting of business premises and other receipts from land to renting a room at home. Companies are charged to corporation tax on their rental profits while others are charged to income tax. It is the purpose of this article to broadly explain the taxation of residential properties let by individuals. The Rent a Room scheme and rules relating to Income from Furnished Residential Property and Furnished Holiday Lettings are set out in separate paragraphs below.

Legislation on the rules on Property Income can be found in Part 3 of Income Tax (Trading & Other Income) Act 2005.

Rental Income

All of a person's rents and other income from UK land or property including income from the use of a caravan or houseboat at a fixed location, whether consisting of one or several properties, are taxed as one property rental business arising in a tax year. This includes rental income from a tenancy, leasing or licensing agreements over land or property, furnished, unfurnished, commercial and domestic accommodation, although income from furnished holiday lettings (FHL) has to be computed separately for the purposes of capital allowances, loss relief and relevant earnings towards pension contributions. This one business will include the agreed share of property held jointly, either with a spouse, a civil partner or with someone else. However, income from properties held in partnership will be treated as a separate partnership business.

The overall profit or loss is declared in the UK Property pages of the Tax Return, but there is a separate section for income from FHL. Rents from properties outside the UK are taxed as a separate property business to be returned in the Foreign Pages of the Tax Return, except for income from letting furnished holiday accommodation in the European Economic Area (EEA) which should be entered on the UK Property pages. Tax is paid half yearly on 31 January and the following 31 July.

Profits and losses of a property business are calculated in the same way as profits of a trade, that is using similar accounting rules as in the computation of trading profits - all rents and similar receipts from land or property in the UK less business expenses incurred in earning the income. Rents are those earned in the tax year regardless of when they are due or when they are received. Property income accounts drawn up to a date other than to 5 April will have to be apportioned to relate to income earned in the tax year. However, if gross receipts do not exceed £15,000 HMRC will accept profit calculations based on the cash received and paid in the year without any adjustments for amounts received in advance or in arrears provided the 'cash basis' is used consistently and not give a materially different result from the strict 'earnings basis'.

Expenses to be deducted are those incurred wholly and exclusively for business purposes and not of a capital nature or improvements. They would include rent, rates, insurance, property repairs, maintenance and renewals, insurance, costs of obtaining a loan to buy a let property and any interest on such a loan. Note that expenses relating to the first letting of a property for more than one year are capital expenditure and therefore not allowable. Examples of such expenses include legal costs (such as the cost of drawing up the lease), agent's, surveyor's fees and commission. Where total property income in the year, including FHL income, before expenses is less than £73,000 for 2011/12 (£77,000 for 2012/3), total expenses can be recorded in the tax return without detailed analysis.

Although described as a business, income from rental properties is not classed as trading and so does not attract the wider range of tax reliefs of trading income, unless the business amounts to a

hotel or a range of hotel like services are provided as in guest houses or bed and breakfast businesses. However, income from FHL does not enjoy many of the reliefs of trading income.

Capital allowances Capital expenditure is not an allowable deduction in computing profit or loss of a rental business. Instead capital allowances on plant and machinery may be claimed. Capital allowances and balancing charges are calculated in the same way as for trades. They are deducted as an expense and are taken into account in arriving at the profit or loss (but see restrictions for rental of residential accommodation in Furnished Lettings paragraph). A claim for Annual Investment Allowance (AIA) of 100% may be made against the purchase of equipment during the year up to an annual amount of £25,000 (£100,000 for purchases before 6 April 2012). Writing down allowances would apply to remaining balances at 18% for plant and machinery and 8% for 'integral features' of a building. HMRC Help Sheet 252 gives a fuller review of capital allowances.

Alternative possible allowances explained below are 'wear and tear allowance' and 'renewals allowance'

Various other allowances

An allowance may also be due for the cost of installing loft, cavity wall or solid wall insulation and draught proofing and insulation for hot water systems in a residential property which is let.

The Business Premises Renovation Allowance provides for a claim of 100% allowance against certain capital costs of conversion, renovation or repairs to business premises in Assisted Areas which have been unused for at least a year before the work starts and which brings them back into business use.

Landlord's Energy Saving Allowance may enable landlords to claim an income tax deduction for expenditure before 6 April 2015 of up to £1,500 for each let property for installing loft, floor, cavity wall or solid wall insulation, draught proofing and insulation for hot water systems in residential let property. The deduction is not available on property where the Rent a Room scheme is claimed or for a property that is used for furnished holiday letting.

Rent a room scheme is an optional simplified scheme whereby a room at home may be rented to earn up to £4,250 tax free. It is available to owner occupiers and tenants who receive rent from letting furnished accommodation in their only or main residence. No tax is payable where gross receipts (before expenses and including any amounts received for meals, goods and services provided, such as cleaning or laundry) and any balancing charges do not exceed £4,250. A room used exclusively as an office does not count. Where the letting is by a couple the relief is £2,125 each.

Where the rent exceeds £4,250, there is a choice to pay tax on either

- actual profit (gross rents less expenses and capital allowances), or
- gross receipts (and any balancing charges) minus £4,250 – with no deduction for expenses or capital allowances

A person may decide not to use the scheme and be taxed in the normal way, for example where expenses exceed receipts and it is advantageous to claim the loss.

The time limit for this election and the choice of calculation in the previous paragraph is 12 months from 31 January following the end of the relevant tax year.

Furnished lettings

Capital allowances are not allowable for any let furnished residential accommodation (other than as a 'furnished holiday letting') for example on the provision of furniture or furnishings, nor on any fixtures that are part of the dwelling house. Instead, a 10% deduction is given to cover the sort of household equipment that a tenant or owner-occupier would normally provide in unfurnished accommodation such as furniture or furnishings, beds, suites, televisions, carpets and floor-coverings, curtains, linen, crockery or cutlery, equipment of a type which, in unfurnished accommodation, a tenant would normally provide for himself (for example, cookers, washing machines, dishwashers).

The wear and tear allowance is calculated by taking 10% of the net rent received for the furnished residential accommodation. To find the 'net rent' a deduction is made for charges and services that would normally be borne by a tenant but are, in fact, borne by the taxpayer (for example, council tax, water and sewerage rates etc).

However, in addition to the 10% allowance, the landlord can also deduct the net cost of renewing or repairing fixtures that are an integral part of the buildings, such as washbasins, toilets, central heating installations. The net cost means the cost of the replacement less anything received for the old item.

As an alternative to the 10% wear and tear allowance, the 'renewals basis' may be claimed, whereby a claim is made for the costs of replacing furniture, furnishings and machinery provided with the let property. The claim can also include the costs of renewing small items such as cutlery, but any money received for the items being replaced should be deducted from the cost of the replacement. The renewals allowance is also available for unfurnished property. Whatever basis is chosen must be followed consistently. It is not permissible to chop and change between the wear and tear allowance and the renewals allowance from year to year.

Furnished holiday lettings in the UK or EEA

FHL are assessed as property income and most of the rules concerning receipts and expenses also apply. FHL formerly qualified for most of the advantages that apply to trades but from April 2011 the trading treatment of losses was withdrawn. However, FHL still benefit from certain of the advantages of trading income. Profits count as earnings for pension purposes, but there is no liability to Class 4 NIC.

FHL may claim capital allowances on, for example, furniture, furnishings and fixtures that cannot be claimed in a dwelling house in furnished lettings, as well as on plant and machinery used outside the property (such as vans and tools). The wear and tear allowance is not permissible in calculating the profits of a holiday lettings business. A claim to either capital allowances or a renewals deduction may be made for plant and machinery.

FHL landlords may claim capital gains tax reliefs for traders including business asset rollover relief, entrepreneurs' relief, relief for gifts of business assets and relief for loans to traders.

From 6 April 2012 (1 April 2012 for companies) property must be available for letting on a commercial basis for at least 210 days (previously 140 days) and actually let for at least 105 days (previously 70 days). The property must not be let for longer term occupation of more than 155 days in a year. Letting the property to the same person for more than 31 days will disqualify that letting. If the total of "longer term occupation" lettings exceeds 155 days during the tax year the property will no longer qualify as a FHL for that period. However, a property may be let to the same person more than once and still qualify for FHL as long as each let is less than 31 days.

In order to satisfy the 105 days test, an election may be made to average the number of days for which the properties were actually let.

Alternatively, there is provision “the period of grace” whereby businesses which have met the actually let threshold in one year may elect to be treated as having met it in the two following years. The elections must be made within one year of the 31 January following the end of the first tax year in which the letting condition is not met.

Losses

The general rule is that rental business losses are automatically carried forward against future rental business profits. However, a claim may be made to set a loss against other income of the same year and or the following year to the extent that the loss is attributable to excess capital allowances. The time limit for the claim is one year from 31 January following the year in which the loss arose.

Losses made on an individual FHL property may be set against the profits of other FHL profits in the same FHL business but losses of an FHL business cannot be set against the profits of a non FHL rental business. Losses made in a qualifying UK or EEA furnished holiday lettings business may only be set against income from the same UK or EEA furnished holiday lettings business.

VAT

Detailed advice on VAT is not part of this article, except to say that

> Generally, letting of residential property is exempt from VAT (Section 31 & Group 1, Schedule 9 VAT Act 1994).

> Excluded from this exemption, and liable to VAT is holiday accommodation (see VAT notice 709/3). Therefore, a supply of holiday accommodation by an otherwise registered VAT trader will generally carry VAT at the standard rate.

> However, the threshold level to register for VAT is £77,000

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