

Buy-to-let Landlords

This guide examines the tax issues affecting landlords of residential property. The positions of both individual and corporate landlords are considered, as the tax costs and deductions are not identical for these groups. This guide does not deal with the tax challenges of letting commercial property or furnished holiday accommodation.

Why become a landlord?

Many people view an investment in residential property as an alternative pension plan. The let property can also provide a secondary income stream. The income from the property is taxable but with some forward planning the lower tax bands and personal allowances of family members can be used to minimise the tax payable (see **How to hold the property**).

Others acquire a second property through an inheritance or hold on to a former home when moving to a new house, to 'break the chain'. Parents of students may buy a property as an alternative to paying rent for the student while they are at college. Each of these incidental second homes can be the seed of a residential lettings business.

1. How to hold the property

The amount and timing of the tax payments due in respect of rental income depends on how the landlord holds the property.

Single individual

All the income, losses or gains arising from the let properties should be declared on the individual's own self-assessment (SA) tax return. If you have not previously submitted SA tax returns, and your tax liability is likely to be more than £1,000, then you should budget to pay 150% of the tax due for the first tax year of lettings on the 31 January following the end of the tax year, when the SA tax return is due. And then another 50% in the following July.

For example, if your property letting started in September 2020, this falls within the 2020/21 tax year and any tax owed on the period from September 2020 until 5th April 2021 is due for payment by 31 January 2022. However, since you will not have made payments on account (POA) for this tax, you will need to pay the full amount of tax, which is payable as the balancing payment, on 31 January 2022. An additional 50% is also due by 31 January 2022 which represents the first POA for the 2021/22 tax year. A second POA for 2021/22 of 50% will need to be paid by 31st July 2022.

In later tax years, the balancing payment will be reduced by the POAs you have already made and tax will be paid mostly as POAs in two instalments on 31 July and 31 January. However, this only applies if the tax liability is £1,000 or more. If your tax liability is less than £1,000 you will only pay your tax once a year in January.

Where the landlord is taxed under PAYE and the profits from letting are less than £2,500 per year, the tax due in respect of property lettings may be collected through PAYE rather than on the SA tax return. However, this accelerates the payment of the tax for the landlord and can lead to overpayments or underpayments of tax.

If there is more than one let property, or a frequent changing of tenants, it would be advisable to complete a SA tax return each year, to ensure that all the tax-deductible costs relating to the property letting business are claimed.

Two or more individuals

It's not possible to transfer the income from a let property to another person before tax is paid, without first legally transferring part or all the beneficial interest in that property. In England and Wales, a



property can be held as joint tenants (where both owners hold an equal interest in the whole property) or as tenants in common (where each owner holds a separate and identifiable share, say 10% and 90% of the property). There are different rules for properties located in other countries, including Scotland.

However, if the joint owners are not married (or civil partners), they are free to decide who receives what proportion of income from the property. The division of the property income can also be changed from year to year as agreed between the owners

Example 1

Sue and Ruth are sisters who jointly own a let property in the proportions: Sue 30% and Ruth 70%. Sue has no other income in 2020/21, so they agree that the profits from the property should be split: Sue 95% and Ruth 5%.

In 2021/22 Ruth's other income has reduced, so they agree to split the income Sue 60% and Ruth 40%.

When a married couple (or civil partners) jointly own a let property the income from that property must be split equally between them for tax purposes and declared as such on each person's SA return. The married couple can be taxed in proportion to their actual beneficial ownership of the property only if they make a declaration on HMRC form 17. But HMRC will want to see evidence submitted with form 17 that supports the beneficial interest, such as a declaration of trust or a copy of the ownership deeds for the property. Once the form 17 declaration is made, it can only be overturned if the underlying beneficial ownership in the property changes.

Example 2

Tim and Brenda own 20% and 80% of a let property respectively. As Tim and Brenda are married to each other, they must each declare 50% of the property income on their own SA tax returns.

If Tim and Brenda were to complete a form 17 they could be taxed according to their underlying beneficial interests in the property: 20% for Tim and 80% for Brenda.

When the property is sold any capital gain arising must be split according to the beneficial ownership of each owner.

Limited company

Where the landlord already owns a company that holds surplus funds not needed for its trade, investing in buy-to-let property can be a profitable use for those funds. The company will need to secure a mortgage for the balance of the purchase price and corporate mortgages tend to have higher interest and arrangement fees than individual mortgages.

There is a danger that the company's trade may become overshadowed by the value of the let properties and the rents it receives. In such cases the company may no longer be classified as a 'trading', meaning its shares won't be eligible for a number of tax reliefs – including entrepreneurs' relief.

2. Tax rates

A corporate landlord will pay corporation tax on annual profits and capital gains at 19%.

An individual landlord will pay income tax on his annual profits at 20%, 40% or 45%, and capital gains tax (CGT) at 18% or 28%. But a comparison of tax rates is not straightforward as the deductions and allowances claimable by corporates and individuals are not identical.

Deductions

From 6 April 2017, corporate landlords with mortgages have a tax advantage over individual landlords, as the company can deduct from its profits all the interest and finance charges related to



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the property letting business. Those finance charges are restricted for individual landlords (see **Interest and Finance**).

Gains

A company's taxable gains are calculated after deducting an indexation allowance to adjust for the effect of inflation on the asset disposed of, whereas an individual can't include that deduction.

To enjoy the proceeds of the gain, the individual needs to extract funds from the company, which may trigger further tax charges.

Other taxes

When a company acquires a residential property for more than £500,000 it may have to pay Stamp Duty Land Tax (SDLT) at 15% and an annual tax on envelope dwellings (ATED) of £3,700 or more. The ATED threshold reduced from £1 million to £500,000 on 1 April 2016.

Individual landlords will only pay stamp duty land tax at a 3% surcharge and not ATED. Relief from these charges is available if the property is commercially let to an unconnected tenant but that relief must be claimed.

3. Starting the lettings business

Purchase costs

Where a buy-to-let residential property was purchased on or after 1 April 2016, the buyer must pay a 3% supplement on the entire purchase price. In Scotland, this supplement will form part of the Land and Buildings Transaction Tax (LBTT); in the rest of the UK it will form part of Stamp Duty Land Tax (SDLT).

Tip

The rules for the supplemental SDLT and LBTT charges are similar but not identical, so local legal advice should be taken in respect of every purchase.

The SDLT or LBTT paid on the purchase of the property can be deducted from the sale proceeds when it is sold (see **Tax payable on sale**).

Start date

The lettings business commences when the first property is available to be let. This means that the property is in a condition where it can be let, subject to cleaning, furnishing and drawing up letting agreements. The expenses connected with renovating a property to bring it into a habitable condition are not immediately deductible (see **Capital costs**).

Revenue expenses incurred before letting commences, such as advertising or drawing up tenancy agreements, can be deducted from the rents received in the first tax year if:

- the expenses are classified as revenue costs rather than capital; and
- the costs are incurred within seven years of the date on which you first let the property.

Any later expenditure leading up to the letting of the second and subsequent properties is part of the lettings business and can be deducted, if it qualifies as a **tax-deductible cost**.

4. What is property income?

Income

An individual or corporate landlord will pay tax on their property income. This is the sum of the rents received from all UK let properties, less the **tax-deductible costs**. All incomes received from letting property in the UK, both residential and commercial, are combined and taxed as one property investment business. A loss made from one property can be set against profits made from other properties in the same tax year or later years.



Let properties situated overseas and furnished holiday lettings (in the UK or overseas) are treated as separate lettings businesses.

Deposits collected from tenants are not part of the property income unless they become non-returnable under the tenancy agreement. Retained deposits should only be included in the property business accounts when the funds are used to cover the costs the deposit was designed to pay for, such as renewal of furniture, repairs or legal fees.

Capital

Property income does not include the profit made when selling a property. That is a capital gain which is subject to CGT, or corporation tax if the gain is made by a company (see **Tax payable on sale**).

Tax deductible costs

Expenses associated with letting fall into two categories:

- Capital costs – which must be deducted from the gain made on the sale of the property, see Tax payable on sale.
- Revenue costs – which is all other costs.

Not all revenue costs can be deducted from the rental income for tax purposes. If the tenant is responsible for paying a bill, such as council tax, the landlord can't also claim a deduction for that cost.

The types of expense that are tax deductible will tend to fall under these headings:

- Accountancy fees for drawing up the property business accounts.
- Advertising for tenants.
- Ground rent and service charges for leased property paid by the landlord.
- Heating and lighting paid by the landlord.
- Insurance for the buildings and landlord's contents.
- Interest and finance charges (see Interest and finance).
- Legal fees for drawing up tenancy agreements or collecting debts (not costs connected with acquisitions or disposals).
- Letting or managing agents' fees.
- Maintenance and repairs (see Repairs).
- Travel to and from the property.
- Replacement of furnishings (see Furnishings).
- Water charges and council tax paid by the landlord

This is not a complete list – other costs may be deductible. For example, where the landlord has an obligation to pay a specific sum in the future, say for a repair, that cost can be deducted in the current period.

Interest and finance

Where an individual landlord borrows to finance their property business, the interest and arrangement fees related to that loan could be deducted in full for periods before 6 April 2017. The borrowed funds can be used for any purpose within the letting business, from property purchase to repairs. The loan doesn't have to be secured on the let properties for the interest to be deductible; it can be secured on the landlord's own home. However, in such cases, to demonstrate where the funds have come from a balance sheet should be drawn up for the lettings business.

Restriction from 2017

From 6th April 2017, individual landlords (not corporate landlords) have their interest and finance costs disallowed for tax purposes, in these proportions in each tax year to 2020:

Tax year Finance costs disallowed

2017/18 25%

2018/19 50%

2019/20 75%

2020/21 and later 100%

In place of the interest and finance charge that has been disallowed, the landlord will receive a 20% credit to set against the income tax payable on the rental income. Any unused tax credit will be carried forward to be relieved against tax payable on rents in a future tax year. This change will have a devastating effect on landlords who are higher rate tax payers and who pay high interest charges.

Individual landlords may need to restructure their property portfolios and borrowings to avoid their lettings business becoming uneconomic. Options for restructuring include:

- convert the residential properties into furnished holiday lettings
- sell residential properties and reinvest in commercial buildings
- transfer the residential properties into a company.

Any of those options will allow the landlord to deduct all their interest and other finance costs from the rents received. However, any sale and repurchase, or transfer of the properties into a company may create capital gains subject to CGT and incur SDLT or LBTT charges (see **Purchase costs**). Also, the mortgage provider must agree to transfer any loans into the company.

Repairs

The costs of repairs made to the property, or to the fittings attached to the property, are deductible from the rental income. But the cost of improving a property is a capital cost which is not immediately deductible (see **Capital**). For guidance on the boundary between a repair and improvement a useful rule of thumb is: A repair restores what was originally there without adding new functionality – other changes relating to the structure of the property are capital improvements.

Tip

It is important to keep copies of all documents relating to large scale repairs and improvements, so the categorisation of those costs can be justified to HMRC long after the cost was incurred.

Example 3

Sylvia installs an en-suite bathroom in her let property and at the same time redecorates the adjoining bedroom. The new bathroom is an improvement as it has added a new feature to the house. The redecoration is a repair. Sylvia asks her builder to provide separate bills for the bathroom and bedroom. She claims the cost of redecorating the bedroom against rental income and treats the bathroom cost as a capital improvement.

Furnishings

For periods before 6 April 2016 (1 April 2016 for companies) landlords letting fully furnished residential properties could deduct a wear and tear allowance each year. This allowance is equivalent to 10% of the rents and it could be deducted even when no furnishings are replaced in the year.

However, from 6 April 2016 landlords are permitted to deduct only the actual cost of replacing furnishings used in the let property. As well as the cost of replacement furniture, the cost of replacing domestic items such as carpets, curtains and freestanding white goods can be claimed. However, the initial cost of those items can't be deducted, only the cost of the replacements and the cost of disposing of the old items. Where something that is fixed to the property (e.g. a built-in oven) is repaired or replaced, the cost should be claimed as **repairs**.



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Losses

Where the letting business makes a loss, that loss can only be carried forward to set against profits from lettings made in a future period. The loss can't be set against income from furnished holiday lets or against profits from letting property overseas. It is not possible to set a loss from letting property against the individual landlord's other income such as a salary or self-employed profits.

5. Closing the lettings business

The property letting business ceases when the landlord is no longer offering a property for rent and is not looking for tenants. This may be before the last property is sold. After the lettings business has ceased, the landlord may incur expenses relating to the empty property such as:

- electricity and gas
- council tax and water charges
- repairs and redecoration
- rubbish disposal and cleaning.

These costs can't be deducted from the sale proceeds of the property as they are not capital expenses, neither can they be deducted from the lettings business, as that business has ceased.

Tax payable on sale

When a property is sold it's important to deduct all the allowable capital costs such as:

- solicitors' and estate agents' fees paid on the sale and purchase
- SDLT, or LBTT paid on purchase
- cost of improvements made throughout the period of ownership
- capital losses from the same or earlier year which haven't been set off elsewhere.

Individual landlords

An individual who used the property as their own main home for a period may claim the following reliefs to reduce the taxable gain:

- Main residence exemption – for the period of occupation and the last 18 months, if you sold the property between 6 April 2014 and 6 April 2020 (but only 9 months if you sell the property after 6 April 2020)
- Lettings relief – for the period of letting, capped at £40,000 and value of main residence exemption. From 6 April 2020 the government introduced so that lettings relief can only be claimed for periods where the landlord has lived in the property at the same time as the tenant.

Lettings relief can't be claimed for a buy-to-let property that the owner has not lived in as their main home. In addition, the individual can deduct their annual exemption of £12,300 (for 2020/21) from the taxable gain if that has not already been used against other gains in the same year. The net capital gain will be taxed at 28% for higher rate taxpayers and at 18% to the extent the gain lies within the basic rate band.

Report and Pay Tax

From 6 April 2020 individuals are required to report and pay capital gains tax arising on the sale of residential property **within 30 days of the sale**. This is a significant change which not all landlords are aware of. Prior to 6 April 2020 these rules only applied to landlords who were not resident in the UK.

Corporate landlords

A company can reduce the taxable gain by the indexation allowance (see Corporation Tax on chargeable gains: Indexation Allowance rates). This applies the retail price index (RPI) to calculate the effect of inflation on the property's value when it was acquired and on the value of any improvements. The indexation allowance can't turn a profit into a loss but it can reduce a profit to nil. A company will pay tax on the net gain at the corporation tax rate of 19%.



Conclusions

The nature of the person or structure that holds the property (individual, joint ownership, company) has a significant effect on the level of tax payable on the annual profits from the lettings business. This is particularly the case since 6 April 2017, when the tax treatment of finance costs diverged between individuals and corporate landlords.

The tax payable on the sale of the property will also differ between individual and corporate owners. Where there are no exemptions available for an individual owner relating to their occupation of the property, the taxable gain on the disposal of a property may be lower for a company than for an individual owner, due to the operation of indexation allowance. However, this will depend on how long the property has been held for.

Contact Us

If you need help or advice with the best way to structure your property portfolio for tax purposes or you simply need some assistance with your self-assessment tax return, please get in touch.

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