

# The Mortgage Trust Buy-to-Let Guide: about tax

January 2005



## Introduction

As a Financial Adviser in the Buy-to-Let marketplace it's important you know about tax – so you can help your clients with any tax questions they may have when buying property or managing their investment property portfolio.

This is why Mortgage Trust, the specialist Buy-to-Let mortgage lender, has teamed up with Perrys Chartered Accountants, of Threadneedle Street, London, to bring you a single source of reference to tax issues relating to Buy-to-Let.

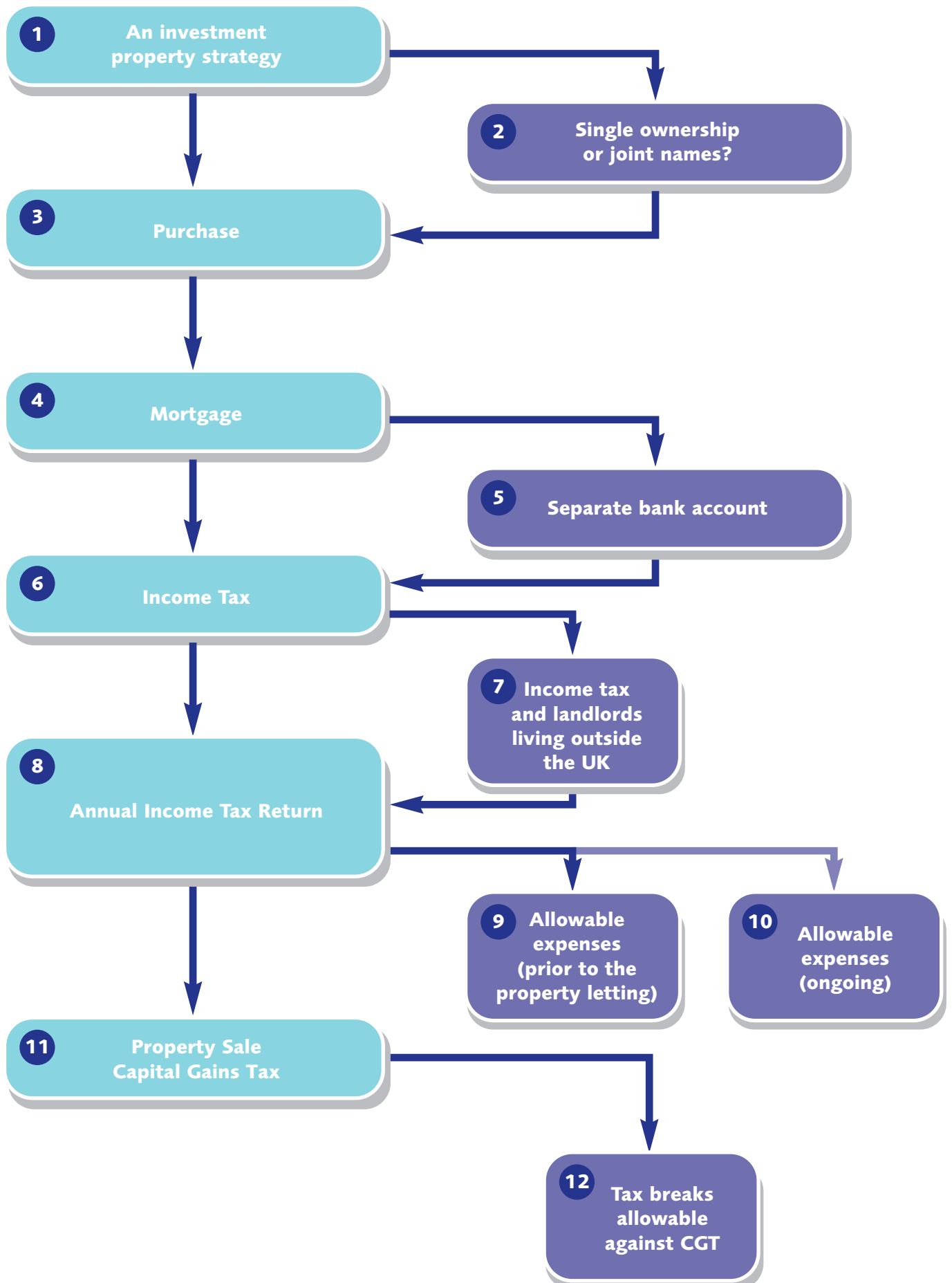
Clearly, good tax planning is key for all your Buy-to-Let clients. How they implement, manage and run their tax affairs could have a major impact on their financial profitability.

Our comprehensive Guide from property purchase through to sale provides valuable information about Income Tax, Annual Income Tax Returns and Capital Gains Tax. It contains much of the information your clients need to avoid the tax pitfalls and make tax work for their business – ultimately providing them with extra cash to invest and climb the property ladder.

All figures in this Guide are correct as of 4 January 2005.

NB: This publication should not be treated as a definitive legal document nor should it be treated as constituting advice. Individuals who want specific tax advice that relates to their own personal circumstances should contact their own financial adviser or accountant, or Perrys Chartered Accountants on 020 7256 9339 quoting the title of this publication.

# Your Route Map to Improved Tax Efficiency



# Your Route Map to Improved Tax Efficiency

1

## An investment property strategy

Before your Buy-to-Let clients set about purchasing their first or next investment property, it is most important that they have a strategy to minimise their tax, otherwise they may pay more tax than necessary. As part of this it is advisable that they have an overall 'exit' plan for the property – i.e. a plan for what they want to do with the property at the end of ownership. This is most important because considerations like Capital Gains Tax planning and Inheritance Tax planning are ideally best addressed at the outset – prior to the purchase, despite the fact that the actual tax bills are encountered at the end of the period of ownership or the death of the individual concerned. In addition, it's important they consider having a will. Statistically, only about one in three people have a valid will. Having a will helps avoid unwanted disputes. The utilisation of tax breaks should also be considered at this stage.

2

## Single ownership or joint names?

Your clients should establish single or joint ownership before making the purchase. It is much easier to get ownership right at this stage than to change it later on. They may wish to arrange the ownership so that their spouse<sup>†</sup> can maximise their tax-free income allowance of £4,745 per tax year\*. If they have already purchased, they would have to arrange transfer of the property in to their name too. In England and Wales, the Inland Revenue defines owners as follows:

- those with an equal interest in the property – 'joint tenants'. When a married couple<sup>†</sup> own property as joint tenants any rental income must normally be split equally between them 50%-50% for tax purposes.
- those with separate and identifiable shares, for example 15% and 85%, as 'tenants in common'. If the property is held in unequal shares the couple can make a declaration on Inland Revenue form 17 to have the rent taxed in the proportion that they hold the beneficial interest in the property. Without a form 17 declaration, a married couple<sup>†</sup> will be taxed on an equal share of the net rents from a jointly owned property.

If your clients already own the property as joint tenants it is quite simple to change to tenants in common, but there may be a Stamp Duty Land Tax charge where the property is mortgaged.

<sup>†</sup>Whether your clients are living together as a married couple or not, or operating as a partnership in business, it is important that expert financial advice is sought.

3

## Purchase

Residential properties are exempt from Stamp Duty Land Tax if they are worth less than £150,000 and fall within one of the Government's 1,997 disadvantaged areas designated under The Variation of Stamp Duties Regulations 2001.

The exemption applies to all conveyances and transfers of land or an interest in land, and to all leases of an interest in land, executed on or after 30 November 2001, where the land falls wholly or partly within one of the disadvantaged areas and the consideration for the transfer, or the premium for the lease, does not exceed £150,000.

If your clients are renovating a property to bring it back into use as a home, the VAT payable on the material and labour costs can be reduced to 5%. The building has to meet a number of conditions to qualify.

4

## Mortgage

All interest payable on borrowings taken out by your clients to fund their letting business can be deducted from the income generated by the property. These borrowings include a mortgage, a personal loan, or even an overdraft. If your clients borrow money either on their Buy-to-Let property or their own house to spend on the Buy-to-Let property this will lead to interest being allowable. However, if they borrow money which is secured either on a Buy-to-Let property or their own property which is spent on personal items, then interest will not gain tax relief.

This means that if they extend the mortgage on their own home to release funds to buy or repair a let property, they can set-off the interest on the extended portion of the mortgage against the rents received from the let property.

Choosing the right mortgage, such as interest only or repayment, is important because it may provide them with significant financial benefits. The structure and precise timing of the loan facilities are very important. Of course, it is normally advisable they take out life cover for the mortgage on any investment property they are purchasing. The beneficiary of the policy should not necessarily be the policyholder. The policy could be written in trust to the beneficiaries of the estate to mitigate Inheritance Tax on death.

5

## Separate bank account

Your clients should have a separate bank account to record all rental income received and expenditure incurred. This will assist them in the event of an Inland Revenue investigation and completion of their annual rental accounts and Self-Assessment Tax Return.

6

## Income Tax

Buy-to-Let property investors are liable to pay Income Tax on rental and other income from property whether or not they are resident within the property and whether or not the property is furnished. They have to pay Income Tax if the total of their taxable income is greater than their tax allowances. Tax is payable on the rental income after allowable expenses/deductions have been taken into account. However, it is possible that no tax will be payable, for example, if your client's let property is mortgaged, and their mortgage interest and related costs exceed the rent they receive. It is your client's responsibility to declare their rental income to the Inland Revenue. It is important they understand how Self Assessment works and that they need to make provision for their tax payments and be aware when they are due. A good accountant will help them estimate their likely tax liability and advise them about when this should be paid.

7

## Income tax and landlords living outside the UK

The letting agent collecting the rent on behalf of a non-resident landlord (one living outside the UK), must deduct tax from the rental income and pay the tax deducted to the Inland Revenue, unless a written exemption has been received from the Inland Revenue not to do so. If your client is an overseas landlord they can apply to the Inland Revenue by way of completing a NRL1 form.

So long as their tax history is good and their tax affairs are up to date, they should be issued with a certificate. This will authorise the letting agent to pay your client rent without deduction of tax. At the end of each year, your client is obliged to submit a UK Tax Return showing details of their rental income and expenditure. Most non-resident landlords appoint an accountant to handle tax affairs on their behalf.

# Your Route Map to Improved Tax Efficiency

## 8 Annual Income Tax Return

Rental income must be declared on a Self-Assessment Tax Return. As the Inland Revenue assesses income individually, properties that are jointly owned require Annual Returns to be completed by each legal owner. Your clients need to compile a Letting Income Schedule – this details all the expenditure and costs involved in letting property (see 'Allowable expenses'). This means keeping separate details of all income and expenditure incurred on all lettings. For example, detailed records of all borrowings should be maintained to support loan interest claims. Clients need to make clear which parts of their mortgage have been used to fund Buy-to-Let properties – so they need to draw up a simple balance sheet that shows exactly how much capital has been invested in the letting business. Records must be kept for six years. They should exclude the deposits they have received from new tenants when calculating taxable rental income. Deposits are not taxable unless they become non-returnable under the tenancy agreement. They should only include the retained deposit when it is used to cover the costs it was designed to prevent, such as renewals, repairs or legal fees.

Don't forget, your clients have a legal responsibility to notify the Inland Revenue of any liability. There are strict tax deadlines and late Returns not only incur penalties but also increase the likelihood of Inland Revenue investigation.

## 9 Allowable expenses (prior to the property letting)

Pre-letting advertising can be deducted from rents received in the first year. However, most costs prior to letting cannot usually be deducted from rents received. There are some allowable expenses so long as they are not incidental to the letting. Therefore, they are likely to be appropriate only for landlords with large portfolios or those who use the services of a managing agent.



## 10 Allowable expenses (ongoing)

Only those expenses incurred "wholly and exclusively" in generating income are allowable.

- **Mortgage interest**  
Your clients may generally claim tax relief on interest payments on a mortgage or loan secured on the property, where the property is let for 26 weeks or more.
- **Water rates**  
They should include the full amount of water, sewerage and any other rates paid on the property, if these are not paid by the tenants.
- **Insurance**  
They may include all insurance policies in connection with their property.
- **Service charge, ground rent**
- **Council Tax**  
In certain circumstances, a landlord may be liable for Council Tax. This could then be included.
- **Legal**  
In respect of ongoing tenancies.
- **Accountancy**
- **Repairs and maintenance**  
When making good you may be able to go beyond replacing 'like with like' and make an improvement, although you need to be careful about how much of an improvement you make. For example, the Inland Revenue is unlikely to permit the replacement of a tatty bathroom with a spa bath and other luxury items. However, the Revenue may be agreeable to replacing wooden window frames with uPVC. Professional advice should be sought or speak to the Revenue directly.
- **Management or Letting Agent's fees**  
Tax breaks may mean that it actually pays to have someone else managing their property. On request, at the end of the tax year, the letting agent should be able to provide your client with details of their rental income and management fees.
- **Wear and tear**  
For furnished properties to let, your clients can claim for wear and tear on all their furnishings (but not fittings), calculated as 10% of the rental income for the year, less water rates and Council Tax (if paid by the taxpayer). Alternatively, they can claim for replacement costs – but in most cases, the 10% allowance is both more beneficial and simpler.
- **Motor vehicle costs for visiting/inspecting the property**
- **Advertising**
- **Unused personal allowances**
- **Energy Saving Allowance**  
From 6 April 2004, landlords are allowed a deduction for Income Tax purposes up to a maximum of £1,500\* when they install loft or cavity wall insulation in a dwelling house, which they let.

## 11 Property Sale Capital Gains Tax

Should your clients sell their property, they may become liable for Capital Gains Tax. Any profit made on a property other than a main residence is subject to Capital Gains Tax – at 40% if the owner is a higher-rate taxpayer\*. This means on a £100,000 gain, tax can take up to £40,000 of their investment profit. When they sell they will have to pay CGT on any capital accrued.

## 12 Tax breaks allowable against CGT

- **Inflation**  
They can add up how inflation increased the value in the years up to 1998 when this tax break ended and claim accordingly.
- **Living-In**  
They can claim an exemption against Capital Gains Tax for the time they have lived in the property as a main residence even if this is only for a short time during their overall ownership. Also, they can claim an exemption for the final 36 months of ownership (regardless of whether they lived there during this time or not).
- **Private Residence Relief**  
They can claim a Private Residence Relief lettings exemption of up to £40,000\*. This is the maximum relief available and is reduced dependent on other gains.
- **Taper Relief**  
They can claim 'Taper Relief' on capital gains. After 3 years, they can deduct 5% a year from profits. If they owned the property before April 1998, they can claim an extra year. So for three years they can pay tax on just 85% of the gain. The basic non-business asset taper relief [NBATR] can reduce taxable gains, before annual exemptions, by up to 40% over a ten-year period. The relief is given in 5% increments but only starts when the asset has been owned for three years from purchase or at 5 April 1998, whichever is the latest. There is a bonus year if the asset was held on 17 March 1998. Your clients should check the date they acquired the property and the proposed date of completion of the sale contract very carefully. They need complete years to qualify for Taper Relief so a single day out could mean they lose significant tax relief.
- **Capital Gains**  
Everyone can make Capital Gains Tax free of up to £8,200 for the 2004/05 tax year\*. A husband and wife therefore will need a chargeable gain in excess of £16,400 before Capital Gains Tax becomes payable.



# Frequently Asked Questions

## Q. What is the best way to set about building a portfolio?

A lot of people generally assume that property has to be sold in order to release equity to create deposits for new properties as the value of their property portfolio increases. It is important from a Capital Gains Tax point of view to know that a portfolio can be built up by bringing properties into a specific portfolio and using the equity as deposits against new purchases without selling the original properties. This certainly has significant savings when one is looking at Stamp Duty Land Tax, legal costs and Capital Gains Tax as no one pays Capital Gains Tax until they physically dispose of a property.

## Q. With regard to mortgages, are capital repayments tax deductible?

Capital repaid on a repayment mortgage and endowment/life insurance payments are not tax deductible against the income.

## Q. Why do I make so little money on my property and yet I still have to pay tax?

Your clients are probably referring to the fact that from a cash flow point of view, they tend to make little excess over the mortgage payments. The capital element of a repayment mortgage and any life insurance policy alongside it as well as any endowment payments on an interest only mortgage are not tax deductible.

## Q. Should I put my properties into a limited company?

There can be instances when purchasing a property through a limited company can be beneficial but it is best to consider all such cases individually and seek advice from an accountant in the circumstances. Any such decision would lead to an understanding required of the Corporation Tax system and the tax efficient removal of remuneration from the business which again requires further discussion with an accountant.

## Q. How important is it that I register with the Inland Revenue?

Your clients have an obligation to register with the Inland Revenue and to submit Annual Income Tax Returns to them. There are penalties for late registration and submission. Your clients should obtain financial advice. See [www.inlandrevenue.gov.uk](http://www.inlandrevenue.gov.uk)

## Q. How can I maximise the benefits from my mortgage/interest?

These days we come across a lot of people who are now looking to buy second properties to rent, possibly as a result of having excess funds maybe from inheritances or as couples coming together where they have previously owned two houses, or simply by releasing the equity in one property. We still come across instances where the main residence has a significant mortgage and they have not taken out the maximum mortgage available on the rental property. This means they are reducing the tax efficiency considerably as they get no tax relief on the mortgage interest on their own home. For example, mortgage lenders will work to a certain loan to value and therefore are likely to ensure that the property when purchased is mortgaged to its maximum amount to obtain maximum tax relief. This is an important planning area and one that is almost impossible to rectify after the event without actually disposing of a rented property and reinvesting.

## Q. What is the tax position if I have lived in the property I am renting out?

A lot of people are unaware of the three-year usage rules and residential property relief. Some people choose not to live in their own property to rent, even when they have had the opportunity to do so. By living in the property you can establish main residence exemptions. Though many people have felt it was sufficient to live in the property, the Inland Revenue in recent tax cases have begun to challenge the exact definition of this. They are saying it should be the intention of the individual to have that property as their permanent main residence. Therefore, by definition, if it would be someone's intention merely to move in on a temporary basis to improve a property only to leave and rent it out, the Inland Revenue can challenge this and thereby the residential relief can be lost. (See overleaf 'Tax breaks allowable against CGT').



# Summary of our Top Tax Tips



## Buy-to-Let investors should:

- Have a tax and management strategy, including an 'exit' strategy, before purchasing investment property. This could potentially save a fortune!
- Make a will
- Establish ownership – single or joint names – at the outset
- Consider buying property in one of the Government's designated disadvantaged areas to be exempt from Stamp Duty Land Tax
- Take out the right mortgage
- Set up a separate bank account for the lettings business
- Keep detailed records of lettings income and expenditure – essential when completing the Annual Income Tax Return
- Claim for allowable expenses incurred both prior to the start of the letting and for ongoing expenses.

The tax laws are extremely complex. Therefore, regarding the tips above, we suggest that your clients obtain appropriate professional advice in order that matters can be related to personal circumstances at the earliest possible time.

## About Perrys Chartered Accountants

Perrys Chartered Accountants specialise in business and tax planning advice. Our aim is to help our clients increase their profits and reduce their tax liabilities, whilst providing peace of mind. Our core business involves the provision of audit, accountancy and tax services.

We are happy to offer free, no obligation, initial consultations on tax matters arising from this Mortgage Trust Tax Guide. If you or your clients wish to discuss any of the points contained in this Guide or to arrange a free, initial meeting, get in touch.

Contact **Stewart Pope** on:

**020 7256 9339**

Or visit our website at:

**[www.perry-company.co.uk](http://www.perry-company.co.uk)**



## About Mortgage Trust

Mortgage Trust specialises in providing Buy-to-Let mortgages. Our expertise, tailored product features and commitment to the mortgage intermediary combine to offer the Buy-to-Let solutions you need.

We are experts in this marketplace and have a proven track record of success.

Our outstanding service is designed to help you help your client landlords grow their property portfolios and realise their property investment dreams.

Contact us on:

**0870 411 2488**

Or visit our website at:

**[www.mortgagetrust.co.uk](http://www.mortgagetrust.co.uk)**

