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Taxation of Landlords

A summary for CIOT Members of tax issues for landlords of residential property

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1. Introduction

This brief guide is designed to provide an overview of the tax issues connected with letting residential property, including furnished holiday lettings (see chapter 8). It does not cover the letting of commercial property.

This guide can only provide an outline of the tax issues affecting landlords, detailed advice should be sought for complex situations.

1.1 HMRC materials

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

- Property Income Manual (PIM);
- Business Income Manual (BIM);
- Capital allowances Manual (CA);
- Trusts, Settlements & Estates Manual (TSEM);
- VAT registration manual (VATREG); and
- Inheritance tax manual (IHTM).

The following HMRC helpsheets may be useful (https://www.gov.uk/self-assessment-forms-and-helpsheets):

- HS223 – Rent a room for traders
- HS252 – Capital allowances and balancing charges
- HS263 – Calculating foreign tax credit on income
- HS264 – Remittance basis

HMRC also publish a Property Rental toolkit designed to help reduce the incidence of common errors in tax returns: http://www.hmrc.gov.uk/agents/toolkits/property-rental.pdf. The toolkit consists of a checklist of the areas relating to property letting which HMRC view as problematic, and includes links to their more detailed guidance on those issues.

Tax advisers and taxpayers are not required to use the HMRC toolkits when completing tax returns. However, if it can be shown that the HMRC toolkit, or a similar risk-assessment procedure was followed as part of the tax return completion process, HMRC should accept that reasonable care was taken in the tax return preparation. This factor could be important where a subsequent error is discovered in the tax return or accompanying computations, and penalties may be in point.

Note that HMRC are in the process of moving their guidance to the GOV.UK website and so some of the links to the HMRC website above may redirect the reader to the GOV.UK website in due course.

2. The property investment business

2.1 Overview

Individual owners of let property are normally taxed on the annual profits they make from letting their property under the rules for property income set out in ITTOIA 2005 Part 3. These rules also apply to income from property located overseas. However, if the landlord is not domiciled in the UK, he or she may be eligible to claim the remittance basis such that foreign income is not taxed in the UK until it is remitted to the UK (see **12.2.3**).

A typical landlord will hold the properties for the medium to long term and ensure all the expenses are covered by the rental received from those properties. Landlords who hold properties for short periods, with a view to creating a profit on sale after refurbishment or development, may be taxed as if they were conducting a property development trade rather than as property investment business (see chapter **6**).

The rules used for calculating profits for trades (ITTOIA 2005 Part 2) are read into the property income rules to establish the profits or losses from the profit investment business (s 272 ITTOIA 2005). However, once the profit or loss is established it is not treated as if it arose from a trade as the following apply:

- losses cannot be set against the taxpayer's other income, but must be carried forward;
- expenditure connected with aborted sales or purchases of property is not deductible for income tax or capital gains tax;
- capital allowances can only be claimed for the cost of equipment used outside of the properties (see **4.5**), unless the business qualifies as commercially let furnished holiday accommodation (a FHL business) (see **8.6**);
- sales of assets generally do not qualify for entrepreneurs' relief unless the property was used in a FHL business (see **7.5**);
- there are no reliefs to shelter gains where proceeds from sales of assets are reinvested in replacement properties, unless those properties are used in a FHL business; and
- there are no reliefs to specifically protect value of the properties from IHT (see chapter **13**).

Property income is afforded some advantages over a normal trade:

- any profits made on the disposal of properties are taxed as capital gains at a maximum rate of 28% (for individuals), after deduction of the annual exemption (see Chapter **7**); and

- a residential letting business does not have to be VAT registered as residential lettings are exempt from VAT, unless they are holiday lettings (see **9.2**).

2.2 What is property income?

Property income is calculated as the rents received less the expenses that can be set against those rents for tax purposes (see chapter **4**). 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. But income from 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 chapter **3** regarding jointly owned property.

Property income does not include the profit made when selling the property, and it does not take into account the costs connected with the capital expenditure of buying or improving the property, or 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 insure against, such as cleaning, repairs or legal fees, (see PIM1051).

2.3 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, (see **2.3.2**).

2.3.1 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 subsequent properties is part of the rental business and can be deducted, as long as it qualifies as tax deductible (see chapter **4**).

HMRC advise that a property rental business begins when the first property is let (PIM2505). However, section 264, ITTIOA 2005, says that 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.

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. Transactions entered into for the purpose of generating income from the land, i.e. preparing to let the land, are part of the property letting business, and HMRC accept that (see **2.3.2**).

2.3.2 Pre-letting expenditure

Pre-letting expenses can be deducted from the rents received in the first tax year of the letting business if the following 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.

Pre-letting expenses may include minor repairs to the property such as replacing locks, painting and cleaning. The property must be in a habitable condition before those repairs are carried out, and in a fit state to let out. The landlord should record evidence of the state of the property before and after the pre-letting work is undertaken, to demonstrate the property was in a fit state to be let before the sprucing-up began (see example 1).

The cost of renovating a property to bring it into a habitable condition should be categorised as capital expenditure, and added to the capital cost of the property, not deducted from the rental income.

Example 1

Alison 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, decorated, and replaces all the locks. This work should all qualify as revenue expenses as the property was in a fit state to let before the work was done, as it had been let immediately before Alison purchased it.

If Alison undertook more extensive works before letting, such as removing internal walls and adding new bathrooms where none existed before, the expenditure would be disallowable as improvement costs.

The pre-letting expenditure must be incurred by the same person who commences the letting (see BIM46355).

In example 1 Alison personally met the costs of preparing the property for letting. If she transferred the property to her personal company before letting commenced, that company could not claim a deduction for the pre-letting expenditure. Alison also would not receive a tax deduction for the pre-letting expenditure as she did not commence the letting business in her own name.

2.3.3 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 the property is left unoccupied to facilitate a quick sale. Any revenue expenses incurred in that final period, such as cleaning, council tax and utility bills, are not deductible from the rental income and are equally not deductible from the sale proceeds of the property as they represent revenue and not capital costs.

3. Who is taxed?

Generally the person who receives the income from the let property is taxed on that income, but that only applies where the income is received by the person who holds the beneficial interest in the property. These two factors can be confused where a property is legally owned by one member of a couple and the income is diverted to the other person.

3.1 Jointly held property

The person or persons who own the property are taxed on the property income, in relation to the proportion of the beneficial interest in the property they own, unless those persons are married to each other or in a civil partnership (see **3.1.1**).

3.1.1 Married couples and civil partners

Section 836 ITA 2007 assumes that a married couple or registered civil partners who are living together, share the income from a jointly held property equally, i.e. 50:50. This equal split of income applies whatever their actual beneficial ownership, unless a declaration has been made jointly by both individuals under s 837 ITA 2007 on HMRC form 17 (available here: http://www.hmrc.gov.uk/forms/form17.pdf; see also TSEM9814). The form 17 election must be based on the actual beneficial interest held 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 (or civil partner), 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 a FHL business. 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 chapter **5**).

3.1.2 Partnerships

Joint ownership of a property does not necessarily mean a partnership business exists between those joint owners (see Partnership Act 1890 s 2 and PIM 1030). 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 that 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 are treated separately from any other property rental business carried on by that individual (see PIM 1030).

3.1.3 Records

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 area 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.

3.2 Rent-a-room relief

Rent-a-room relief is a tax relief for up to £4,250 of annual income received from letting rooms as furnished accommodation in the taxpayer's home (ITTOIA 2005 Pt. 7 Ch. 1). The taxpayer is not required to own the home for which rent-a-room relief is claimed, but it must be his or her only or main home at some time in the basis period (see also PIM4001). However, whether the property is treated as the taxpayer's main residence for CGT purposes is irrelevant. The relief cannot apply where the taxpayer is a company or partnership.

Rent-a-room relief can apply to income from a small B&B business as long as the owner also occupies the property, as it covers payments for meals, cleaning and laundry as well as rent. It may also apply where the whole house is let for a short period while the normal occupier goes on holiday, as long as the taxpayer does not have another "main residence" during his holiday. Rent-a-room relief can never apply to income from a property which is not also occupied by the landlord.

If the gross income is under the annual threshold of £4,250, rent-a-room relief applies automatically, unless the taxpayer elects otherwise. If the gross income exceeds this threshold the taxpayer may choose to be taxed on just the excess gross income (HMRC call this method B), or elect for the rent-a-room relief not to apply and use the normal income and expenditure rules for rental income (method A). If a loss is likely to arise from letting rooms, rent-a-room relief should be disclaimed within one year of 31 January following the tax year in which the loss arose (s799 ITTOIA 2005; see also PIM4030).

Where more than one person receives income from letting rooms in the same property, each of those individuals are permitted to use **half** of the rent-a-room threshold. This may increase the amount of rent-a-room relief available where there are more than two primary occupiers, see example 2.

Example 2

Harry owns a five bedroomed house which is occupied by his sons: John, Alan and Sam. The sons let two rooms of the property at a total rent of £6,300 per year, which they divide equally between them. Even if Harry received some of the rent he would not be 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 relief will not be given for income arising from:

- space let as an office, store-room or garage, (see HMRC helpsheet HS223).
- a property that is not also occupied by the taxpayer.
- letting a house while working abroad.
- rent paid by a child to its parents, which is outside the scope of tax.

HMRC will not accept rent-a-room relief claims for rooms used as offices, as the relief must be given for "furnished accommodation" which is not defined, so is takes its ordinary meaning. HMRC say "furnished accommodation" means residential accommodation not office space (PIM4002).

3.3 Tax return

All of the income and expenses from UK let properties held by individuals or trustees should be shown on the land and property pages of the SA tax return. Landlords 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 Chapter **12**).

3.4 Record keeping

As for any other business, a landlord is required to maintain complete records of all expenses incurred and income received from the let property business. There is no specific HMRC guidance on record keeping for landlords, but the advice on business records for the self-employed applies equally to landlords (https://www.gov.uk/self-employed-records).

Where the property is let as furnished holiday accommodation the number of days each property is let to each tenant should be recorded (see chapter **8**).

A landlord may use his own vehicle to visit properties or tenants, and his own home to undertake paperwork concerning the property business. If the landlord is an individual he may use the fixed rate deductions to calculate the appropriate motor expenses and use of home deductions to include in the property letting accounts (see BIM75005, BIM75010).

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.

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).

3.5 Assessment of tax

3.5.1 Individuals

Individuals and trustees pay tax on their property income as part of their self-assessment. It is worth pointing out to clients who start to let property that they may have to pay 150% of the annual tax due on 31 January following the tax year in which that business commences. This is because where the taxpayer's income was previously taxed under PAYE, he or she will not make payments on-account under self-assessment within the current tax year, leaving the full amount of tax on the property income profits to be paid by 31 January following the tax year end, plus a payment on account due for the next tax year.

3.5.2 PAYE

The tax due on property income can be collected through the taxpayer's PAYE code. Income Tax (PAYE) Regulation 14(1)(f)(SI 2003/2682) allows HMRC to include non-PAYE income in a taxpayer's PAYE code, but the taxpayer can object. The PAYE regulations do not set an upper limit on the amount of non-PAYE income that can be included in a PAYE code, but HMRC use an operational cap of £10,000 per year.

The GOV.UK website advises taxpayers to report property income on a self-assessment tax return if it amounts to £2,500 or more per year (see here: https://www.gov.uk/renting-out-a-property/paying-tax). Smaller levels of property income can be reported to HMRC by telephone. In such cases, where the taxpayer is also taxed under PAYE the property income is likely to be taxed by inclusion within the taxpayer's PAYE code. However, where there is more than one let property, or frequently changing tenants, the taxpayer should be advised to complete a SA tax return each year to ensure all the eligible expenses for the property letting business are claimed.

3.5.3 Corporation tax

Where the let property business is operated by a company it will pay corporation tax on the profits from property at the same time as the tax due on other trading income received by that company. Small companies pay corporation tax nine months and one day after their accounting year end. Large companies with profits of more than £1.5 pay corporation tax by four quarterly instalments which start six months and 13 days into the accounting period.

3.6 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 **4.5.1**), or exceptionally when initial allowances are claimed under the Business Premises Renovation Allowance, that loss can be set against the taxpayer's other income for the same tax year (s 120 ITA 2007).

Profits or losses from a partnership held property 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.

3.7 Capital gains or losses

Any gain made on the disposal of a property by an individual must be declared on the capital gains pages of the SA tax return. This includes properties given to relatives, who are regarded as connected parties (s 993 ITA 2007). When a property is transferred between connected parties, the profit or loss on that transfer should be calculated as if the transfer 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. In those cases the transfer is treated as a no-gain, no-loss 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 chapter **7**).

3.8 National insurance

Currently the basis on which class 2 and class 4 national insurance contributions (NICs) are charged and collected is slightly different.

3.8.1 Class 4 NIC

Class 4 is assessed as a percentage of the self-employed profits of a trade or profession (taxed under Pt 2, ITTOIA 2005), and is collected as part of the taxpayer's self-assessment. Class 4 NIC thus cannot apply to profits from a property letting business which is not a trade. It also cannot apply to profits from a FHL business (see chapter **8**) which is deemed to be a trade, since they remain assessable as rental income meaning Class 4 NIC is not payable (see PIM4120).

3.8.2 Class 2 NIC

Class 2 NICs are currently due where there is a self-employed business, and are paid separately from the taxpayer's self-assessment. The term business relates to a wider range of activities than a "trade", but it is very difficult to draw the line between a passive investment and an active business. In the case *Rashid v Garcia* SpC 348 HMRC argued that the taxpayer was not in business when he tried to claim benefits based on the class 2 NICs he had paid in respect of profits arising from his four let properties. It was held that Mr. Rashid was not in business as a self-employed earner, so the class 2 NICs he had paid were not valid contributions.

In spite of the *Rashid* case HMRC has recently sent demands for payment of class 2 NICs for up to six prior years, to landlords who have several let properties. In some cases the landlord may want to make class 2 NICs in order to build up a qualifying year of contributions for the state pension. In cases where the taxpayer has other earnings that attract class 1 or 4 NICs, paying additional class 2 NICs will provide no benefit. A taxpayer in receipt of a demand from HMRC may want to challenge it, perhaps by quoting *Rashid* and asking for the NICs demand to be reviewed by a more senior person within HMRC.

This problem will be resolved from 6 April 2015 as from that date the basis on which class 2 NI is assessed will be aligned with Class 4 NI, i.e. charged in respect of trading profits assessed under Pt 2, ITTOIA 2005. This change allows class 2 NICs to be collected as part of the self-assessment alongside class 4 NICs. Thus for 2015/16 onwards HMRC will not be able to ask for payment of class 2 NICs in respect of profits arising from let property businesses.

4. Tax allowable expenditure

4.1 Types of costs

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

- Legal and professional fees (see **4.7**);
- 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 **4.9**);
- Ground rent and service charge for leased property;
- Wear and tear allowance (see **4.5.2**);
- Maintenance and repairs (see **4.3**);
- Buildings and contents insurance;
- Interest paid on borrowings to fund the property business (see **4.6**);
- 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 house in multiple occupation (see **4.10**) the landlord may be required to pay the council tax.

4.2 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

Jane bought a leasehold flat on the third floor of a block of flats in January 2013, and let it immediately. The flat management company asked all the owners to contribute to the cost of repairing the external fire escape. Jane's share was £3,000 payable one third up front and the balance on completion of the work, which is expected to be in the last quarter of 2013. Jane can include the full £3,000 cost for the fire escape in her property letting accounts for the year to 5 April 2013, as she is committed to paying this fee even though the final amount was not paid until 2013/14.

4.3 Repairs and improvements

The cost of repairs should be set against the rental income, but the cost of an improvement should be added to the total cost of the property and receive tax relief on its disposal.

The boundary between repairs and improvements is often fuzzy, as HMRC recognise in their Property Income manual. Where the improvement element is so small as to be incidental to a repair HMRC will treat the entire cost as a repair (see PIM2020).

HMRC are clear that where the expenditure changes the character of the thing being repaired it must be classified as a capital improvement, not a repair.

Example 4

Where a fitted kitchen is replaced with higher quality fittings, all the expenditure on the project should be treated as an improvement. If the old kitchen is replaced with similar standard items, then the entire cost can be treated as a repair.

HMRC do not accept that the costs of a large project can be apportioned between repairs and improvements to the property. Prior to April 2001 extra statutory concession B4 allowed a "notional repair" cost to be deducted from the total improvement expenses, leaving only the balance of the improvement expenditure to be disallowed. This concession was removed from April 2001, so now the cost in its entirety must be either a repair or improvement. In a large project it would be worthwhile asking the builder to invoice separately for items that can be distinguished as repairs and improvements to the property.

The boundary between a repair and an improvement can also move over time as technology and building standards advance. For example HMRC accept replacing single glazed windows with double glazed units is an allowable repair, not an improvement. Similarly a new central heating boiler may be more energy efficient than the one it replaces but it will not be an improvement as it performs the same task.

4.4 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 income.

Expenditure qualifies 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 of the property. The LESA cannot be claimed where the property is let as a FHL business (see chapter **8**), or subject to rent-a-room relief (see **3.2**).

4.5 Furniture and fittings

4.5.1 Capital allowances

Equipment, fittings and furniture used inside a residential property do not qualify for capital allowances (s 35, CA 2001), unless the property qualifies as a FHL business (see chapter **8**). The cost of replacing furniture in a fully furnished property may be covered by the statutory wear and tear allowance (see **4.5.2**), and the cost of replacing fittings may count as repairs (see **4.3**). Otherwise the scope for obtaining tax relief on the contents of a let property is limited (see **4.5.4**)

The cost of equipment used for tasks performed outside of a let residential property can qualify for capital allowances. Thus where items are used within the common areas of a building that contains two or more separate dwellings, for example in the stair-well, lift or landing areas of a block of flats, capital allowances can be claimed. Equipment used to maintain the outside of the building such as ladders, a grass mower, or a vehicle used to move furniture between properties can also qualify for capital allowances. Note that not all journeys made by the landlord to the let properties will be tax deductible (see **4.9**).

4.5.2 Wear and tear allowance

Where the property is let fully furnished (see **4.5.3**), the landlord can claim a wear and tear allowance calculated as 10% of the net rents from that property (s 308A ITTOIA 2005 and s 248A CTA 2009). This claim must be made on or before the first anniversary of 31 January following the tax year end it applies to (for income tax), or within two years of the company year end (for corporation tax). There is no set form for claim, HMRC confirm a deduction in the appropriate box on the tax return will be sufficient (see PIM3215).

The net rents are calculated as the rental income received less any expenses paid by the landlord that 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 properties, where the landlord lets a mixture of furnished, unfurnished and partly furnished properties, the allowance needs to be calculated on a property by property basis.

The wear and tear allowance is designed to cover "movable" items such as furniture, furnishings, electrical goods, kitchenware, linen and white goods such as: cooker, fridge and washing machine (see PIM 3210). However, it does not cover the cost of fixtures which are integral to the building, which would not normally be removed when the property is sold such as: bathroom fittings, fitted hob, immersion heater, and central heating boiler. The cost of replacing those items would normally be classified as a repair to the building and thus be tax deductible (see **4.3**). This was confirmed by HMRC in their reply to CIOT on 7 April 2014 see http://www.tax.org.uk/NR/exeres/0148B0E1-9C6A-4494-A704-8259E48DE3CA.

Where a property is sub-let the wear and tear allowance should be claimed by the first landlord in the chain that makes the property available with sufficient furnishings to allow normal residential use (see PIM3205). The wear and tear allowance should not be claimed for properties that qualify as FHL as capital allowances can be claimed for items used in, or attached to, those properties (see **8.6**). The wear and tear allowance also does not apply to rooms let where rent-a-room relief is claimed (see **3.2**).

4.5.3 What is "fully furnished"?

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

HMRC say that to qualify as a furnished residential letting the property has to be let with sufficient furniture, furnishings and equipment for normal residential use (PIM 3205).

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 appear to consider a property as furnished when it is 'fully furnished', as opposed to 'partly furnished', because they warn in PIM 3205 that the provision of a fully fitted kitchen, carpets and curtains, is not sufficient for normal residential use and thus the wear and tear allowance cannot be claimed.

4.5.4 Renewals or tools?

The renewals basis provided tax relief for the cost of furniture and fittings replaced in let properties which were furnished, or partly furnished. This relief was applied under extra statutory concession B47, which was withdrawn from 6 April 2013 (1 April 2013 for corporation tax).

From the same date the wear and tear allowance was put on a statutory footing (see **4.5.2**), but that allowance only applies where the let property is fully furnished. The problem for landlords from 2013/14 onwards is how to obtain a tax deduction for items which are included in a partly furnished property, but are not necessarily fixed to the property such as: cooker, fridge, washing machine, carpets and curtains.

In the consultation about the withdrawal of ESC B47 HMRC stated: *"… relief will be available either under section 68 ITTIOA 2005/section 68, CTA 2009 or, for furnished property under the wear and tear allowance at sections 308A to 308C, ITTOIA 2005."* Reassured by this statement the professional bodies did not oppose the withdrawal of ESC B47.

Sections 68 in CTA 2009 and ITTOIA 2005 are both entitled "Replacement and alteration of trade tools", and have identical text:

1. This section applies if—
   (a) expenses are incurred on replacing or altering any tool used for the purposes of a trade, and
   (b) a deduction for the expenses would not otherwise be allowable in calculating the profits of the trade because (and only because) they are items of a capital nature.
2. In calculating the profits of the trade, a deduction is allowed for the expenses.
3. In this section "tool" means any implement, utensil or article.

There is a view that tax relief can be claimed under s 68 for replacing the cost of items used in partly furnished let properties, such as fridges and washing machines. Case law may provide some support for this view:

- *Odeon Associated Theatres v Jones* 48 TC 257 considered carpets to be "implements, utensils or articles";
- *Caledonian railway Company v Banks* 1 TC 487 found that rolling stock on the railway was considered to be "implements, utensils or articles".

The HMRC position is that section 68 can only apply to the replacement or alteration of *small* assets in certain limited circumstances where the expenditure would otherwise be disallowed as capital (BIM46960). Yet there is no mention in section 68 of a limit on the value of the tools used for the purposes of a trade. HMRC's view was confirmed in a letter to CIOT and ICAEW on 7 April 2014 (see http://www.tax.org.uk/NR/exeres/0148B0E1-9C6A-4494-A704-8259E48DE3CA).

Tax advisers need to take a view when advising clients about claiming relief for the cost of renewing items in let properties. If a deduction is made in the property accounts that is contrary to HMRC's guidance, full disclosure of that deduction should be given in the further information boxes on the tax return, making clear what was claimed, and why.

4.6 Interest and loans

4.6.1 Interest deduction

The principles for achieving tax relief for interest paid on loans taken out to fund a property letting business are the same as apply for any other business (BIM 45700).

Where a company takes out a loan to finance a property business, the interest and charges due on that loan are dealt with under the rules for loan relationships within the company. That can mean that relief for interest paid is given at a different time than it would be where the borrower is an individual. The loan relationship rules are complex and are not covered in this guide.

It is irrelevant whether the borrowings are short or long term, or how the loan is secured; as long as the loan is used to fund the letting business the interest and costs incurred in respect of that loan will be tax deductible (see PIM 2105, PIM2066). The loan can be used for any purposes within the property business; to buy property, fund repairs, improvements or alterations.

4.6.2 Increasing a mortgage

HMRC clearly consider 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

A 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 for the letting business.

4.6.3 Extracting capital from the property business

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 house in Inverness, which he bought ten 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 house and let it out while he works abroad. The house has a market value of £375,000 when he starts his property letting 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 secured on the house, 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 the business the interest on the mortgage loan is allowable in full because the mortgage is funding the transfer of the property to his property letting business at its open market value at the time the business started. His capital account within the business is not overdrawn so it does not matter what Alan does with the capital he withdraws from his lettings business.

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 lettings business, although FHL properties must be kept separate (see chapter **8**). 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 when determining how much capital can be extracted from that business.

4.6.4 Loan secured on landlord's own home

Many landlords will hold significant equity in their own homes and would like to borrow against that equity to fund their property letting business. This is perfectly acceptable as it does not matter which property the loan is secured on.

However, the landlord must be able to show which portion of the interest he pays on his home loan relates to funds used to buy his own residence, and which part relates to funding of the property letting business. If the interest is paid out of one account it needs to be apportioned on a just and reasonable basis. HMRC may want to see how the funds were provided from the home loan to the property letting business, and how funds from the property business flow back to the mortgage provider to pay the interest on the home loan.

When the capital of a mixed purpose home loan is repaid, great care must be taken to determine which portion of the loan is repaid first: the part used for the landlord's home, or the part used for the let property business. As with all business loans it is important to check a deduction is not claimed for the repayment of the loan capital.

Tax warning

Advice concerning mortgages is related by the Financial Conduct Authority (FCA). If you are not registered to give advice on financial products you should not advise a client to change their mortgage arrangements.

4.7 Legal and professional fees

Landlords can incur significant legal and professional fees, which are only deductible from the rental income if they are of a revenue nature rather than capital. Also fees are not deductible if they are not incurred wholly and exclusively for the purposes of the property letting business.

HMRC give examples of deductible and non-deductible legal expenses in PIM2205. Examples of allowable fees include those related to:

- letting the property for less than a year;
- renewing a lease of less than 50 years;
- obtaining a property valuation required for insurance purposes;
- preparing rental accounts and calculating the tax due, but not fees for preparing a tax return or dealing with tax disputes;

- subscriptions to associations representing the interests of landlords;
- arbitration to determine the rent of a property;
- evicting tenants in order to re-let the property.

Examples of non-deductible fees include expenses connected with:

- letting or subletting the property for a period of more than a year;
- acquiring, or adding to, a property;
- planning fees and negotiating planning permission; and
- pursuing debts of a capital nature, for example the proceeds due on the sale of the property.

4.8 Cost of landlord's time

A landlord cannot make a deduction for the cost of his own time in the accounts for his unincorporated property letting business. However, a landlord may pay wages to another family member out of the property business, where that individual undertakes some real work for the property letting business

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 (and pay employer's national insurance contributions) applicable where the amount paid exceeds the PAYE threshold.

Where the property letting business is operated through a company, the landlord is likely to be the shareholder and director of that company (see **5.3**). In that case the company can pay the landlord for his time as an employee of the company.

4.9 Travelling costs

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

Many landlords run their property rental business from an office in their own home. HMRC accept that a where there is no other office from which the property business is managed, the property business will normally have its base at the landlord's home (PIM2210). It follows that in those circumstances journeys from the property business base (the landlord's home) to the rental properties can be exclusively for business purposes, and a deduction for such journeys will be allowed.

However, the guidance in the Property Income Manual has not been updated following the case: *Samadian v HMRC* [2014] UKUT 0013, which concerned the travelling expenses of a self-employed medical doctor. Although the doctor had a home office, it was considered to be only one of the bases for his business, other bases were in the private hospitals where he saw patients. Deductions for the cost of travelling between the doctor's home and the private hospitals were denied.

4.10 Houses in Multiple Occupation

The definition of a House in Multiple Occupation (HMO) is a property which is occupied by three or more persons who do not form a single household (i.e. they are not one family), and those tenants share toilet, bathroom and kitchen facilities with other tenants. A large HMO is one that contains three or more storeys and which is occupied by five or more persons forming two or more households.

The Housing Act 2004 requires large HMOs to be registered with the local authority. 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 available to tenants, fire exits etc. may also vary from area to area. Landlords can be fined up to £20,000 for letting out an unlicensed HMO.

5. How should the property be held?

5.1 Jointly by a couple

Where a let property is owned by one spouse or civil partner, a transfer of the property into joint ownership could save tax on the rental income, 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, as up to two capital gains annual exempt amounts may be available to reduce the chargeable gain.

In England and Wales, it is possible for people to own property as joint tenants where the owners hold an equal undivided interest in the whole property, or as 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 **3.1.1**).

Where a property is already held as a joint tenancy it is quite simple to change the form of ownership to a tenancy in common, but there may be an SDLT charge where the property is mortgaged and liability for the debt is assumed. 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. No CGT arises at 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 *may* argue 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 the inter-spousal transfer should be ignored as an artificial step. However, generally gifts between spouses and civil partners who are living together are not regarded as abusive tax planning (see GAAR guidance: http://www.hmrc.gov.uk/avoidance/gaar-partd-examples.pdf). In any event 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 of an interest in a property between spouses/ civil partners is exempt from inheritance tax, where both individuals have UK domicile. Where the recipient spouse/civil partner is not UK domiciled, gifts to that person are only exempt up to the IHT nil rate band (currently £325,000). In any case the transfer between the couple will be a PET that becomes fully exempt from IHT after seven years' survival.

5.2 Partnership or LLP

Where property is held jointly, the owners can form a partnership or 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 constitute a partnership (see Partnership Act 1890, s 2 and PIM1030). The nature of a partnership is discussed in the HMRC Business Income manual at BIM82005 onwards.

Where the let properties qualify as FHL (see chapter **8**), 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.

5.3 Company

5.3.1 Considerations

Where the landlord plans to acquire a number of let properties it may be worthwhile holding those properties through a limited company. Tax rates can be lower for profits arising within a company (see **5.3.2**), but the long and short term plans of the landlord should be considered (see **5.3.3**).

Where the landlord already has a trading company containing surplus funds, it is tempting to invest those funds in buy-to-let properties. However, holding significant value in the form of investment properties could cause the company to lose trading company status, which would mean entrepreneurs' relief would not be due on the disposal of the company shares (see **7.5**), and the substantial shareholding exemption may also be denied on the disposal of any subsidiary companies.

5.3.2 Compare tax rates

Before the investment decision is made the landlord needs to consider his long term plans for the property and his need to extract cash from the business, and then compare the potential tax charges for operating as a company and as an individual. This may require taking a view of the likely future tax rates, for example:

- An individual will pay income tax on the property income profits at 20%, 40% or 45%, after deduction of any available personal allowance and depending on their other income;
- A small company will pay corporation tax at 20% on all its income and gains (see below), but income extracted as dividends from the company may also create income tax charges at 32.5% or 37.5% for the individual;
- An individual will pay tax on capital gains on property disposals at 18% or 28%, after deduction of any available annual exempt amount (see **7.2**).
- The company does not have an annual exempt amount to set against capital gains arising on property disposals, but it can claim indexation allowance to reduce such chargeable gains.
- Where a FHL business is disposed of by an individual, entrepreneurs' relief may reduce the rate of CGT payable to 10% (see **7.5**).

- A company holding valuable residential property is potentially liable to ATED charges from 1 April 2013 and 28% tax on gains arising on disposal of the properties, if the properties are not fully let on a commercial basis, or another ATED exemption or relief does not apply (see chapter **11**).

Corporation tax rates are due to be aligned at 20% for all companies (except for the oil and gas industry) from 1 April 2015. For earlier periods companies with profits over £300,000 may pay tax at rates of 21% or more. That profit threshold will be lower if the landlord already controls one or more associated companies. From 1 April 2015, companies controlled by an individual will not be associated, unless the companies also form a 51% group.

5.3.3 The long or short term plan

Where the properties are to be held in the long-term a company may pay less tax on each property disposal (at 20% after indexation relief), than the individual who is likely to pay CGT at 28%. Where the plan is to hold the investment property for some years, say until retirement, using a company has some advantages and disadvantages:

- The company containing the properties can be sold as a rental business, which may be more attractive to a buyer as the stamp duty payable on the share transfer will be lower than SDLT or LBTT charges due on the property transfers.

- Shares in a company can be passed on to the next generation more easily than a share in the let properties.

- If the rental income is to be the landlord's main or only source of income, holding the properties in the landlord's own name will allow the personal allowance to cover the first £10,000 or more of the profits, whereas inside a company all the profits are taxed at 20%.

- Where the properties are acquired as a form of retirement planning for the landlord, the profits can roll-up within a company being taxed at only 20% and be extracted later when the landlord has a low personal tax rate.

If the landlord plans to turn over the investment properties frequently in the short term to release capital profits, the tax charges may be lower if the properties are held by one or more individuals as the annual exemptions will reduce the effect rate of tax (see **5.1**). However, a frequent turnover of properties can lead HMRC to view the activities as a trading rather than an investment business (see chapter 6). Also the SDLT or LBTT charges on replacing each property need to be considered (see chapter **10**).

5.3.4 Transfer to a company

Where the individual already holds the let properties in his own name the transfer of those properties to a company may well incur SDLT or LBTT charges (see chapter **10**). Capital gains are also likely to arise on such transfers, but if the entire letting business is transferred incorporation relief should apply to roll-over those gains (see **7.6**).

6. Trading or investment

6.1 Facts determine tax

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 the following activities to be trading:

(a) buying and selling properties within short periods;

(b) buying and renovating, then selling the properties within four years;

(c) managing properties owned by others, collecting rent, etc.;

(d) providing significant services connected with the property, so the letting amounts to serviced accommodation.

In a) and b) the landlord may be considered to be trading in properties, where the property is an item of stock rather than an investment. In c) the individual does not actually own the properties himself so he is trading as a property manager.

Example 7

Pam buys a dilapidated house for £100,000 and spends £40,000 over six months on repairs and modernisations, with the intention of selling the property as soon as possible for a profit. Pam repeats this pattern of buying and renovating properties for four more properties. HMRC consider Pam to be a property developer and assess the profits she makes as trading profits not capital gains.

HMRC will challenge the use of main residence relief (see **7.3**) on the basis that the purchase and renovation of a property amounts to a trade; J& S Regan v HMRC [2012UKFTT 569(TC) and Lynch v Edmonson (Inspector of Taxes) [1998] STI 968. These cases show that a repeated pattern of such sales is not required for a trade to exist.

6.2 Consequences of trading

Where a landlord is considered to be trading it has the following tax consequences:

- 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 **7.2**);
- the main residence relief and letting exemption are not available to reduce taxable gains (see **7.3**);

- National Insurance Contributions will be due on the trading profits;
- a property management business may need to register for VAT;
- the business must register with HMRC by 31 January following the tax year in which trading began;
- the value of a trading business will generally attract a 100% Business Property Relief 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 operated by the individual can be set against other income made in the same tax year subject to the £50,000 cap on sideway loss relief; and
- the shares of a trading company qualify for entrepreneurs' relief on disposal.

7. Capital gains tax

7.1 Calculating the taxable gain

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

- Professional fees for estate agents and valuers, but not fees for preparing the tax return that reports the gain or for negotiating with HMRC regarding the assessable value;
- SDLT or LBTT (see chapter **10**);
- Annual exempt amount (see **7.2**);
- Main residence relief (see **7.3**);
- Lettings exemption (see **7.4**);
- Entrepreneurs' relief (see **7.5**).

7.2 Annual exemption

Most individuals are entitled to an annual exemption for CGT, which is worth £11,000 for 2014/15. 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 or personal allowances for that tax year.

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

7.3 Main residence relief

The main residence exemption available under s 222, TCGA 1992 is very valuable, as when it applies to a property for any period, lettings relief can also apply if part or all of the property was let (see **7.4**).

Periods during which the property is occupied by the taxpayer as his or her only or main residence, or for which the taxpayer has nominated the property as their main residence, represent CGT free gains. Also, if property has been the taxpayer's main residence for any period the gain made in respect of the last 18 months of ownership is also exempt from CGT (s 223(2) TCGA 1992), for disposals made on or after 6 April 2014. This final exempt period was 36 months for disposal made before 6 April 2014, and that 36 month period will still apply if the owner or owner's spouse has moved into a care home, or is disabled, and the other conditions in s 225E TCGA 1992 are met.

An individual can only have one main residence at any one time, and this also applies to married couples and civil partners, who may only have one main residence between them. To qualify as a main residence the property must actually be occupied as a home by the taxpayer for a period. Where two or more properties are occupied as a home concurrently, the taxpayer may elect for one to be treated as the main residence. That election must be submitted to HMRC within two years of the second or subsequent property first being used as the taxpayer's home. Once made, that election can be changed to favour another property which is also used as a home, at any time. This change of election for the main residence is also known as "flipping".

The Government has proposed altering the conditions for the main residence election from 6 April 2015, when the CGT charge on gains arising on UK residential properties is extended to owners who are not resident in the UK for tax purposes. If the elected property is in a different country to the owner's country of tax residence, then it is proposed that the owner will have to be present in the property for at least 90 midnights in each tax year.

A property that is fully let cannot be the owner's main residence, while it is let. A taxpayer's assertion that CGT main residence relief applies may also be challenged on a number of other grounds such as:

- the property was acquired wholly or partly to make a gain on disposal (TCGA 1992, s 224 (3));
- there was no intention to live in the property permanently (e.g.: Goodwin v Curtis (Inspector of Taxes)[1996] STC 1146); and
- there is no evidence that the taxpayer occupied the property as a home (e.g.: Moore v Thomson (Inspector of Taxes)[1986] STC170)

Example 8

David bought a cottage in Dorset on 1 September 1999, which he used as a second home. He continued to live for the most part in his flat in London. He elected for the London property house to be his main residence with effect from 1 September 1999. David let out the Dorset property from 1 June 2002 to 31 May 2010, then occupied it himself from 1 July 2010. He changed his main residence election from that date to make the Dorset property his main residence.

David returned to live in his London flat from 1 October 2011, and changed his main residence election back to the London property at that time. David sold the Dorset property on 1 September 2014 making a capital gain of £150,000.

As the Dorset property was David's main residence for 15 months from 1 July 2010 to 30 September 2011, 15 months' worth of the gain is exempt: £12,500. The last 18 months' worth of the gain is exempt: £15,000. Of the remaining gain of £122,500, up to £27,500 will be exempt from CGT under lettings relief (see **7.4**).

If David had not made the main residence election within two years of first using the Dorset property as a home in September 1999, he would not have been able to alter that election in favour of the holiday home in July 2010 and alter it back again in October 2011. The full gain of £150,000 made on selling the Dorset property would have been subject to capital gains tax.

7.4 Lettings relief

Where a property that has been a main residence has been let as residential accommodation, either as a whole property or in part, lettings relief may apply (s 223(4) TCGA 1992). This relief cannot apply to a buy-to-let property that has not been occupied by the owner, and has not 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 taxpayer's main home including the last exempt period;
- the gain attributed to the let period; and
- £40,000 per owner.

Example 9

In Example 8 David let the property for 8 years and occupied it as his main home for 15 months. The gain is £150,000 or £10,000 per year of ownership. The taxable gain is calculated as follows:

2014/15		£
Capital gain before tax relief:		150,000
Exemption for:	a) 15 months used as main home:	12,500
	b) last 18 months of ownership:	15,000
Lettings relief restricted to lower of:	Periods a) + b) = £27,500 8 months letting = £80,000 Maximum relief = £40,000	27,500
Gross gain chargeable:		95,000

7.5 Entrepreneurs' relief

Where a claim for entrepreneurs' relief is successful in respect of a disposal, the gains subject to that claim are taxed at 10%, after deduction of losses and the annual exemption.

However, for entrepreneurs' relief to apply there must be a trading business or trading company. Where a property letting business is deemed to be a trade as the lets qualify as commercial furnished holiday lettings (see chapter **8**), entrepreneurs' relief may apply on disposal of the business, part of the business, or of the business assets after cessation of the business. Other property letting businesses cannot qualify for entrepreneurs' relief, as the key "trading" condition is not present.

For further guidance on entrepreneurs' relief see the technical guide for members: Entrepreneurs' Relief by Kevin Slevin (see the CIOT website here: http://www.tax.org.uk/members/Tax+Technical+Services/member-guides)

7.6 Incorporation relief

Gains arising on the transfer of a property letting business from the ownership of one or more individuals to a company should be sheltered from CGT by incorporation relief under s 162 TCGA 1992. This relief is automatic where the conditions are met (no claim is required), which are:

- the business must be transferred as a going concern;
- all the assets of the business must be transferred, with the possible exception of cash; and
- the transfer must be made wholly or partly in return for new shares issued by the company to the transferor.

Incorporation relief does not require a trade to be present. A property letting business is not treated as a trade (unless it is FHL) but it is a business and that should be sufficient for incorporation relief to apply as was examined in *Ramsay v HMRC* [2013] UKUT 226 (TCC).

8. Furnished holiday lettings

8.1 Location of the property

For a property lettings business to qualify for the special tax treatment available for furnished holiday lettings it must be located in the UK or in any other EEA country. The EEA countries consist of all 28 member states of the EU plus Iceland, Norway and Liechtenstein.

However, separate accounts must be kept for the FHL business conducted in UK properties and the FHL business conducted using properties in other EEA countries, and the profits or losses from those two sources must not be combined or set-off (see **8.3**).

8.2 Required periods of letting

8.2.1 The conditions

The properties within a FHL business must be let on a commercial basis with a view to making a profit. They must also be let furnished (see **4.5.3** for the definition of furnished).

In addition, the pattern of lettings must satisfy all three conditions in ITTOIA 2005 Part 3 Chapter 6. These conditions were amended from 6 April 2012, (1 April 2012 where the FHL business is conducted through a company), and are now:

1. The property must be available for commercial letting as holiday accommodation for at least 210 days per year (previously 140);

2. It must be actually let as *holiday accommodation* for at least 105 days per year (previously 70); and

3. It must not normally be let for a continuous period of more than 31 days to the same tenant in 210 days of the year, and days include the periods in which it is actually let as holiday accommodation.

All these conditions apply on a property by property basis, but there is some flexibility introduced in condition 2 by the grace period and averaging elections (see **8.2.2** and **8.2.3**)

In condition 2 “holiday accommodation” means letting to the general public for periods which do not normally exceed a month, but the tenants don’t necessarily have to be on holiday, they could be short term business visitors.

In condition 3, the 210 days of short lettings do not have to be a continuous period. The property may be let to one tenant in the other five months of the year, but again not necessarily as a continuous period. This condition was not changed in 2012

8.2.2 Grace period

As the number of actual days of letting in condition 2 was increased significantly from April 2012 without much warning, a grace period was introduced to allow properties to remain within the FHL regime if one or two years of low occupancy were encountered.

The grace period works like this:

Where a property was not let for the required 105 days in the year, 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 condition 2 above, for that year. This grace period 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 (condition 1). The election must be made by the first anniversary of 31 January following the end of the tax year it applies to.

Example 10

Marianne lets her cottage in Cornwall as a FHL. The actual days let in each year are:

Tax year	Days let	Period of grace election?	Qualifies as FHL?
2012/13	108	Not needed	Yes
2013/14	84	Yes	Yes
2014/15	77	Yes	Yes
2015/16	91	Not permitted	No

Marianne's cottage ceases to qualify as FHL from 6 April 2015, and will be treated as a normal furnished property for 2015/16 and later years, until the FHL conditions are met once more.

8.2.3 Averaging

Where the landlord has more than one property that is let as FHL, he may average the days of actual letting across the properties, when determining whether condition 2 is met. This averaging exercise can allow all properties to qualify as FHL, where some properties easily meet the letting requirement and others do not. 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 **8.2.2** is considered for each property.

8.3 Losses

A loss made in an FHL businesses cannot be set against the landlord's other income, including against profits made from other (non-FHL) let properties. The only way a FHL loss can be relieved is to carry it forward and set it against profits from the same FHL business. As indicated in **8.1** the losses from FHL properties in the UK cannot be set against profits from FHL properties located outside the UK, or vice versa.

Where a FHL business makes a loss for a year, that may be because one or more of the properties were not fully let for the season, and thus did not meet the FHL condition 2 (see **8.2.1**). Where a property does not meet the FHL conditions, that property (including all the receipts and associated costs) should be excluded from the FHL business for the year and treated as a normal furnished property letting, unless a period of grace or averaging election is made.

The result is that the landlord has two property businesses to report: FHL and normal lettings.

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.

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. Any losses unrelieved in this way could be carried forward to set against profits 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, and as terminal loss relief where the losses were made in the final 12 months of the business.

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 a FHL business can be treated as a trade in its own right, rather than as a deemed trade.

8.4 Advantages of a deemed trade

A commercial FHL business is deemed to be a trade for many tax reliefs, although it is not actually a trade. This has the following advantages:

- 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 ;
- profits from the business are qualifying earnings for pension purposes; but
- the profits are not subject to class 4 NICs (see **3.8.1**);

Capital gains made on the disposal of FHL property may qualify for:

- roll-over relief under s 152 TCGA 1992, where the gain is invested in another FHL property or into a different business asset acquired within the specified period; or

- hold-over relief under s 165 TCGA 1992, where a FHL property is given away or sold for less than its open market value.

Also the disposal of all or part of a FHL business may attract entrepreneurs' relief if all the conditions for that relief are met (see example 11).

Example 11

Brothers William and Ben purchased flats in the same apartment block in Brighton for £150,000 in April 2000 and sold the same apartments for £400,000 each in October 2014. They both let their apartments on standard short-term tenancies of six months duration. However, from 1 April 2012 William let his apartment as furnished holiday accommodation and it qualified as FHL from 6 April 2012 to 5 September 2014, when he ceased to let it. This property comprises his entire FHL business.

The gain on William's property qualifies for entrepreneurs' relief as he operated the FHL business for at least a year, then disposed of the property within three years of ceasing the entire FHL business on 5 September 2014. The letting prior to the commencement of the FHL business in April 2012 is irrelevant, the whole gain can be subject to entrepreneurs' relief and it does not have to be apportioned between periods of business and non-business use (see **7.5**). William thus pays CGT at the entrepreneurs' relief rate of 10% on his net gain.

Ben is a higher rate taxpayer in 2014/15, so he pays CGT at 28% on all his gains. The brothers' respective capital gains tax bills are calculated as follows:

2014/15	Will's Flat	Ben's Flat
	£	£
Net sales proceeds	400,000	400,000
Less purchase cost	(150,000)	(150,000)
Less fees and SDLT on purchase	(5,000)	(5,000)
Chargeable gain	245,000	245,000
Annual exemption	(11,000)	(11,000)
Taxable gains:	234,000	234,000
CGT due at 10%/ 28%	23,400	65,520

William saved CGT of £42,120, compared to Ben, by letting his property in a flexible way so it qualified as FHL for a period of at least 12 months that ended with the cessation of the business.

8.5 Disadvantages of FHL

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

- advertising and cleaning costs are higher;
- HMRC may demand payment of class 2 NICs (see **3.8.2**)

- the relief for losses is restricted (see **8.3**)
- the landlord may have to register for VAT (see **9.2**)

8.6 Capital allowances

Where a property is part of a FHL business, capital allowances can be claimed for equipment, fixtures and fittings used in the property as well as for the FHL business generally. This can provide a significant tax deduction for a FHL business compared to a normal lettings business (see **4.5.1**).

The assets in a FHL property which may be eligible for capital allowances include all the furniture used in the property as well as rugs, carpets and white goods, and even swimming pools qualify as plant (see CA 22060). Certain fixtures attached to the property will qualify for capital allowances if they fall with the definition of integral features (see CA 22320). This will include air conditioning units as well as heating systems. Where capital allowances are due they may be claimed as part of the annual investment allowance (AIA).

Where a 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 (see **8.7**), power and water charges.

8.7 Local taxation

Residential property is normally subject to council tax, not business rates. However, the GOV.UK website (see here: https://www.gov.uk/introduction-to-business-rates/self-catering-and-holiday-let-accommodation) advises that properties in England which are available for short term letting for more than 140 days per year are rated as self-catering accommodation and should be valued for business rates.

The rules are different in Wales where the GOV.UK website (again, at https://www.gov.uk/introduction-to-business-rates/self-catering-and-holiday-let-accommodation) advises that where the property is available to let for 140 days or more a year **and** is actually let for 70 days, it will be rated as a self-catering property and valued for business rates. Note: these thresholds of days let are not the same as the qualifying conditions for FHL (see **8.1**)

In Scotland the situation is different again as the local assessor applies a price per bed space on each property, based on its type, size and location, to produce its rateable value (see the GOV.UK website here: http://www.business.scotland.gov.uk/view/guide/business-rates-the-basics#self-catering-and-guest-house-accommodation).

If the rateable value of the property for business rates is less than £12,000 the property owner may qualify for small business rates relief. Different thresholds for this business rate relief apply for properties 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.

9. VAT

VAT may be due on transactions in land and buildings such as:

- Purchase or sale
- Letting or leasing
- Construction services in relation to land.

If the land is situated in the UK, it will be subject to UK VAT but if it is outside the UK, then if the foreign country has a VAT system, it may be subject to VAT in that country. This section provides only a very brief guide to the VAT implications of letting residential property in the UK.

9.1 Rates applicable

A landlord will pay VAT on the purchase of certain property assets and on services that he/she receives in relation to land and buildings for example:

Repairs to the property or contents	Generally standard rated, adaptations for the disabled may be zero rated
Construction of a new residential building	Zero-rated
Conversion or renovation of certain existing buildings to create dwellings	Reduced rate (5%)
Professional services e.g. architects, surveyors, estate agents, accountants.	Standard rated

There can be particular VAT problems with service charges. Most service charges are regarded as part of the rent and so follow the VAT liability of the rent but there can be exceptions. There can be complications where the landlord provides services such as electricity, gas or water.

The rates of VAT applicable to letting or selling residential property in the UK are:

Letting of residential property	Exempt but certain major interests are zero-rated
Letting of property as holiday accommodation	Standard rated (see **9.2**)
Sale of a residential building	Exempt unless the landlord was the “person constructing the building”
Sale of land and buildings as part of a going concern	Outside the scope of VAT

A landlord must register and account for VAT on taxable transactions if his taxable turnover exceeds the VAT registration threshold. However, as can be seen from the table above the letting of residential property is generally exempt from VAT, in which case it does not count towards the VAT registration threshold.

Tax warning

If in doubt about the VAT treatment of a property-related transaction seek advice from a member of CIOT or ATT who specialises in VAT. Do not rely on verbal assurances from the HMRC VAT helpline – always get the advice in writing.

9.2 Holiday accommodation

Standard rate VAT must be applied to income from letting holiday accommodation if the owner is, or should be, VAT registered. This covers all holiday and hotel accommodation, not just furnished holiday lettings.

A UK resident landlord must register for VAT if the rental income from his UK holiday lettings plus any other VATable sales he makes exceeds the VAT registration threshold of £81,000 (from 1 April 2014) for a 12 month period. If the landlord is already VAT registered, the amount charged for letting holiday accommodation must have VAT at the standard rate added to the basic price.

A landlord who is resident outside the UK can become liable to register for VAT in the UK when he makes any supply of holiday accommodation in the UK. Supplies relating to land (such as letting of accommodation) are always deemed to occur in the country where the land is situated.

The non-resident landlord is classified as a NETP (non-established taxable person) for VAT purposes, unless he has a fixed establishment or a business establishment in the UK. VAT Notice 741A includes guidance on these definitions. The VAT registration threshold for NETPs in the UK is zero with effect from 1 December 2012 (see VATREG37050).

The test for a fixed establishment is met if the non-resident landlord appoints a local property agent to deal with the management of the property on his behalf, in which case the landlord will not have to register for VAT in the UK (see para 9.2 of VAT Notice 700/1).

If a UK resident landlord lets holiday accommodation in other EU countries or third countries with a VAT system, that landlord may have an obligation to register for VAT in the country where the holiday accommodation is situated. The client should be advised to take local tax advice about his overseas VAT and other tax obligations.

9.3 Flat rate scheme

There is a trap for landlords of residential property who also use the flat rate VAT scheme for small businesses. Although the letting of residential property is exempt from VAT, any rental income the trader receives must be included in his gross turnover when calculating the amount of VAT to pay to HMRC under the flat rate scheme (see para 6.2 of VAT Notice 733).

This problem does not arise where the letting business is operated through a separate entity to the one that is VAT registered and in the flat rate scheme.

Example 12

Mr & Mrs Jordan jointly own several residential properties which are let on short term tenancies. Mr Jordan also runs a computer repair business as a sole-trader, and is registered under the VAT flat rate scheme for that business. His share of the letting income is not required to be included in his turnover for the flat rate scheme as the letting business is operated as a partnership (for VAT purposes) with his wife.

9.4 Reclaiming input VAT

The VAT incurred on construction services such as the repairing and improving of the let property will normally carry standard rate VAT, where those repairs are carried out by a VAT registered trader. Before 1 October 2012 approved alterations to listed buildings were zero-rated but that anomaly has now been removed.

The installation of energy saving materials in or on residential properties, such as solar panels or insulation, is subject to VAT at the reduced rate of 5% (see VAT Notice 708/6).

Where the property is let as standard-rated holiday accommodation the input VAT can be reclaimed as normal by a VAT registered landlord. Other landlords cannot generally reclaim input VAT on the costs directly relating to exempt residential lettings.

9.4.1 Partial exemption

Where a trading business contains a VATable trade as well as exempt lettings, using the de minimis rule for partially exempt businesses may allow input VAT to be reclaimed alongside VAT relating to the main trade. This can only apply where the de minimis limits for partial exemption are not exceeded. Those de minimis limits are expressed as input VAT being no more than:

- £625 per month on average, which is £7,500 a year; and
- 50% of the total VAT the business has to pay on all its purchases.

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

Warning

Great care is needed to ensure the de minimis limits are not breached, otherwise the whole business will become partially exempt. This may reduce the amount of input VAT that can be reclaimed on overheads that relate to both the main trade and the residential lettings.

10. Taxes on purchase

10.1 Who pays

When the residential properties are purchased, the purchaser will normally have to pay Stamp Duty Land Tax (SDLT). For purchases of properties located in Scotland on and after 1 April 2015 Land and Buildings Transaction Tax (LBTT) will apply instead of SDLT (see: www.revenue.scot). There are transitional rules for contracts entered into for Scottish properties on or after 1 May 2012, which determine whether SDLT or LBTT is paid on the transaction.

The purchaser is responsible for self-assessing and reporting how much SDLT or LBTT is due, but the conveyancing solicitor will normally complete and submit the land transaction forms that report the purchase to HMRC or to Revenue Scotland for land located in Scotland.

For SDLT the land transaction form must be submitted and the SDLT be paid, within 30 days of the effective date for the purchase. This is normally the completion date, the day on which the funds for the purchase are handed over. However, where the new owner takes possession of a property before the completion date, that earlier date is the effective date for tax purposes, and will advance the due date of payment of SDLT.

For acquisitions in Scotland after 1 April 2015 separate factors may affect the effective date for LBTT which will normally be payable at the time the land return is submitted, therefore you should take local advice on this point.

Penalties are imposed if the land transaction form is not submitted on time, and interest is due on any duty paid late. The property cannot be registered with the Land Registry or Keeper of the Registers (for land in Scotland) until the SDLT or LBTT is paid.

10.2 Stamp Duty Land Tax (SDLT)

The application of SDLT for residential properties was changed significantly following an announced in the Autumn Statement on 3 December 2014. For contracts completed from 22 March 2012 to 3 December 2014, SDLT was applied on a “slab system” at the rates below. Under the slab system once a SDLT threshold was reached the charge applies to the full cost of the property, not just to the slice of value above the threshold.

Purchase price	**Rate of SDLT**
Up to £125,000	nil
£125,001 to £250,000	1%
£250,001 to £500,000	3%
£500,001 to £1,000,000	4%*
£1,000,001 to £2 million	5%*
Over £2 million	7%*

*15% for enveloped properties where exemptions do not apply (see **10.4**).

For contracts to purchase residential property completed on and after 4 December 2014, SDLT is calculated on a progressive fashion such that the rate of SDLT applies only to the amount of the purchase price that falls within the SDLT band, at the follow rates:

Purchase price	Rate of SDLT
Up to £125,000	nil
£125,001 to £250,000	2%
£250,001 to £925,000	5%
£925,001 to £1,500,000	10%
£1,500,001 and over	12%

These rates do not apply to non-residential property where the SDLT is still calculated on the slab system and at different rates. Also where a residential property is acquired for more than £500,000 by a non-natural person, such as a company, a penal rate of 15% SDLT may apply (see 10.4).

10.3 Land and Buildings Transaction Tax (LBTT)

LBTT is expected to apply to purchases of residential properties located in Scotland from 1 April 2015 at the following rates:

Purchase price	LBTT rate
Up to £145,000	0%
£145,001 to £250,000	2%
£250,001 to 325,000	5%
£325,001 to £750,000	10%
Above 750,000	12%

These rates are provisional and are due to be confirmed or changed by the Scottish Parliament.

The LBTT will be applied in a progressive fashion, such that each slice of the consideration is subject to the tax rate for the band it covers, in the same manner as the new SDLT imposed from 4 December 2014. This will mean purchasers of lower valued residential properties will pay less tax in Scotland, but the tax due on higher valued properties could be considerably more than in the rest of the UK.

Example 13

A residential property costing £500,000 will create a SDLT liability for the purchasers of £3,000. The SDLT is calculated as follows:

(250,000 - 125,000) x 2%	£2,500
(500,000 - 250,000) x 5%	£12,500
	£15,000

Where a residential property located in Scotland and sold after 31 March 2015 for £500,000 the LBTT is calculated as:

(250,000 - 145,000) x 2%	£2,100
(325,000 - 250,000) x 5%	£3,750
(500,000 - 325,000) x 10%	£17,500
	£23,350

10.4 Enveloped properties

A penal rate of SDLT of 15% was introduced from 22 March 2012 on purchases of enveloped residential properties in the UK. "Enveloped" means purchased by a non-natural person rather than directly by an individual. A non-natural person is a company, a partnership where one or more partners is a company, or a collective investment scheme such as a unit trust.

At first the 15% rate of SDLT was restricted to residential properties costing over £2 million, but from 20 March 2014 this rate can apply to residential properties worth over £500,000, potentially within the reach of buy-to-let landlords. The 15% rate applies to the entire purchase price of the property, i.e. under the "slab system", even when the transaction occurred on or after 4 December 2014.

The 15% rate does not apply where the company is acting as a trustee of any settlement or of a bare trust whose beneficiaries are individuals who are absolutely entitled to the property. Where the 15% rate does not apply, the SDLT is levied at the normal rates (see **10.1**)

There are also a number of specific exemptions from the 15% rate for commercial property trades including businesses of letting, trading in or developing properties (Sch. 4A FA 2003).

For the exemption to apply the property must be acquired for the exclusive use in the commercial property business. This requirement will not be met if it is intended that the property will be occupied by a non-qualifying individual such as persons connected with the owner of the property: company directors, shareholders, or their associates. Also if the conditions for the exclusion cease to apply within three years of the purchase date, the 15% rate of SDLT will be re-applied.

The exemptions from the 15% rate of SDLT are similar to, but not identical to, the exemptions from the annual tax on enveloped dwellings (see chapter **11**). If the purchase of the let property was not subject to 15% SDLT by reason of timing or exemption, it does not necessarily follow that the ATED reliefs will also apply.

Note: there are currently no penal rates of LBTT for enveloped purchases of residential properties in Scotland that mirror the 15% rate of SDLT. However, the ATED will continue to apply to enveloped properties in Scotland after 31 March 2015, where one of the ATED reliefs or exemptions does not apply.

10.5 SDLT avoidance schemes

Many SDLT avoidance schemes have been shut down with effect from 21 March 2012. The use of SDLT tax avoidance schemes must be reported under the SDLT DOTAS rules. The Solicitors Regulation Authority has published a warning regarding SDLT schemes which should be consulted if any professional involved in the property purchase suggests that SDLT or LBTT can be avoided:

http://www.sra.org.uk/solicitors/code-of-conduct/guidance/warning-notices/stamp-duty-land-tax-schemes--warning-notice.page

10.6 Gifts

Where the property is transferred as a gift there is no SDLT payable on the value of that property, as there is no chargeable consideration. If the property has a mortgage attached, liability for which is assumed by the new owner, the value of the debt assumed is taken to be the consideration for the transfer, so the value of that debt is subject to SDLT.

Example 14

Lionel gives a property worth £283,000 to his civil partner Kevin on 2 March 2015. The property is subject to a mortgage of £183,000. Kevin assumes liability for the mortgage. SDLT of £1160 is payable being 2% of the debt transferred that exceeds £125,000.

11. Annual tax on enveloped dwellings (ATED)

11.1 What ATED applies to

This tax was introduced from 1 April 2013 to discourage individuals from holding high value residential properties indirectly within envelopes. The definition of "enveloped" for the ATED is the same as for SDLT (see **10.4**). For guidance on ATED see: https://www.gov.uk/annual-tax-on-enveloped-dwellings-the-basics

ATED initially applied to enveloped UK residential properties valued at over £2 million, the same starting threshold for the 15% rate of SDLT. However, ATED can apply where the property was acquired many years ago, as the value point for the ATED is the open market value of the property as at 1 April 2012, or the value when it first became subject to ATED if later. This valuation point will be revised every five years, so the next valuation point will be 1 April 2017, to apply for the ATED charge payable for 2018/19 to 2023/24.

As the threshold for the 15% rate of SDLT has moved down, so the threshold for ATED will follow to £1 million from 1 April 2015 and £500,000 from 1 April 2016 (see **11.2**).

11.2 ATED rates

The ATED charge is revised every year in line with inflation, but the bands in which the ATED applies are not revised, so as property values rise more properties could potentially become subject to ATED.

The bands and rates that apply for 2013/14 to 2016/17, as already announced are:

Property value:	**2013/14** **£**	**2014/15** **£**	**2015/16** **£**	**2016/17** **£**
Over £500,000 to £1m	Nil	Nil	Nil	3,500
Over 1m to £2m	Nil	Nil	7,000	TBC
Over £2m to £5m	15,000	15,400	23,350	TBC
Over £5m to £10m	35,000	35,900	54,450	TBC
Over £10m to £20m	70,000	71,850	109,050	TBC
Over £20m	140,000	143,750	218,200	TBC

TBC = to be confirmed.

11.3 ATED exemptions and reliefs

Hotels, guest houses, boarding school accommodation, hospitals, student halls of residence, military accommodation, care homes and prisons are not dwellings, so are not subject to the ATED (see s 112(4) FA 2013)

Properties exploited in a commercial property rental business as a source of rents or other receipts are exempt from the ATED, but that exemption must be claimed on the annual ATED return (see **11.4**).

This exemption is removed for up to five years if a non-qualifying individual is permitted to occupy the property. A non-qualifying person is someone who is entitled to an interest in the property, or someone connected with the owner of the property. Similar reliefs (that must be claimed) apply for commercial property traders, property developers, farmhouses occupied by farm workers, houses open to the public, and properties held for charitable purposes.

11.4 Paying ATED

The ATED charge must be paid by 30 April **within the chargeable year**, which runs for 12 months from 1 April. A separate ATED return must be submitted by the same date for every property subject to the ATED. However, the Government is consulting on how to reduce the administration burden of the ATED, so this may change. Where the ATED does not apply for part of a year, the relevant relief due must be claimed by submitting an amended ATED return to claim a refund.

For the first year of the ATED (2013/14), the charge was payable by 31 October 2013 and the ATED return was due by 1 October 2013. Those delayed filing and payment dates are likely to apply to the properties first brought into ATED by the introduction of the lower ATED bands on 1 April 2015 and 1 April 2016.

11.5 CGT on ATED- related gains

Where a property has been subject to the ATED, a special capital gains tax charge at 28% can also apply when that property is sold or otherwise disposed of (TCGA 2992, Sch 4ZZA). The ATED-related CGT (also referred to as "ARCGT") only applies to the gain accrued from 6 April 2013 onwards, so the base value of the property must be determined as at 6 April 2013. Where the ARCGT applies to a gain, that portion of the gain is not also subject to corporation tax.

Where the property has qualified from relief from the ATED the gain subject to ARCGT is reduced in proportion to the period for which ATED relief was given.

Note that ARCGT can apply to non-resident owners, such as off-shore companies or unit trusts. The Government has made it clear that the ARCGT charge will take priority over the proposed CGT charge for non-resident owners (individuals and companies) who dispose of UK dwellings on or after 6 April 2015.

12. Overseas issues

12.1 Letting overseas property

A UK resident who lets property located abroad must report the income and expenses from that let property on the foreign pages of his UK tax return. That is unless he is also non-domiciled and claims the remittance basis for that particular tax year (see **12.2.3**).

The overseas letting business is treated as a separate business from any UK lettings. This applies for both long term lettings and accommodation qualifying as furnished holiday lets (FHL). Any losses arising from the overseas property cannot be off-set against UK property income, but can only be used in the same year against profits from other overseas property or carried forward to set against future overseas letting income.

The rental income from the overseas property is also likely to be subject to tax 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 a 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. If a local property agent is employed to manage the overseas property that agent may be required to deduct withholding tax from the rental income. Income tax paid in the country where the rent arises can normally be set-off against the UK tax liability on the same income, as foreign tax credit relief (see HMRC helpsheet HS263). The landlord cannot reclaim any excess foreign tax paid which exceeds the UK tax due on the rental income.

12.2 Gains on overseas property

12.2.1 UK domiciled landlords

Gains made on the disposal of overseas properties should be reported on the UK tax return, but the amounts in the CGT computation must be converted into sterling at the exchange rate that applies at the time the transactions (purchase and sale) occurred (see CG25391). This will mean that part of the gain assessed in the UK may be attributable to the movement between the two currencies involved in the computation, see example 15.

Example 15

Colin is resident and domiciled in the UK. He purchased a cottage in France in April 1999 for €120,000 to use as a holiday home for his family. It was also let to third parties but did not met the letting requirements to qualify as furnished holiday lets.

Colin sold the cottage on 20 June 2014 for €320,000, making capital gain of €200,000, which is be subject to capital gains tax in France, subject to the computational deductions due under French law.

In the UK Colin is taxed on the equivalent of €200,000 (£176,271), although some of the French CGT he pays should be available to set-off against his UK liability (see **12.2.2**). Up to £16,271 of the gain assessed in the UK is attributable to the movement in exchange rates between the euro and the pound between 1999 and 2014.

2014/15	**€**	**£**
Proceeds (€1.25:£1)	320,000	256,000
Less cost in 1999 (€1.5051:£1)	(120,000)	(79,729)
Gain before reliefs and exemptions	200,000	176,271

12.2.2 Double tax relief

A double taxation treaty may allow the UK resident landlord to off-set foreign capital gains tax against the UK capital gains tax 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 may be able to elect for it to be his main residence for UK tax purposes, which will protect a proportion of the gain from UK capital gains tax on sale (see **7.3**). However, the ability to make the main residence (PPR) election for a foreign property will be restricted from 6 April 2015. The Government has proposed that to be eligible for the PPR election the individual must either be tax resident in the same country in which the property is situated, or he/she must spend at least 90 midnights in that property in that tax year (see https://www.gov.uk/government/consultations/implementing-a-capital-gains-tax-charge-on-non-residents).

12.2.3 Non-domiciled landlords

Where the landlord is not domiciled in the UK, he or she may be able to claim the remittance basis, such that only income and gains remitted to UK, or which arise in the UK, are taxed in the UK (see HMRC Helpsheet HS264). However, non-domiciled landlords who have been resident in the UK for seven years or more, must pay the remittance basis charge (RBC) for any tax year for which they wish to use the remittance basis. This charge applies at two rates:

- £30,000 per year for those resident in the UK for at least seven out of the previous nine tax years;
- £50,000 per year for those resident in the UK for at least 12 years out of the preceding 14 tax years.

A proposal has been announced to increase from 6th April 2015 the £50,000 rate to £60,000 and to introduce a third rate of RBC at £90,000 per annum once UK residence for 17 out of the preceding 20 tax years is reached.

The RBC does not apply in the follow circumstances:

- The individual has unremitted foreign income and gains of £2,000 or less for the tax year;
- the individual is aged under 18 in the entire tax year; or
- 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 the HMRC guidance note RDR1: Residence, domicile and the remittance basis.

12.3 Let property held through a company

Holding the overseas property in a foreign registered company will not necessarily remove the capital gain from UK tax charges. Where the overseas company would be a close company if it was resident in the UK, gains made by the overseas company (excluding ATED related gains) can be treated as accruing to the UK tax residents who are participators in that company (s 13, TCGA 1992).

12.4 UK Property owned by non-resident landlords

12.4.1 Non-resident landlord scheme

The non-resident landlord scheme applies where a UK property is let and the landlord is not resident in the UK for tax purposes.

The 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, who pays more than £100 per week in rent to a non-resident landlord must withhold the basic rate of income tax from that rent and pay over the tax deducted to HMRC on a quarterly basis.

12.4.2 Landlords

The landlord may apply to HMRC for approval to receive the rent with no tax deducted if it can be shown that:

- the landlord's UK tax affairs are up to date; or
- the landlord has not had any UK tax obligations before they applied; or
- the landlord does not expect to be liable to UK income tax for the year in which they apply; or
- the landlord is not liable to pay UK tax because has sovereign immunity.

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

12.4.3 Agents

Where a UK resident letting agent or property manager has the power to collect rents on behalf of a non-resident landlord, that agent must register with HMRC within 30 days of taking rent for the UK property. The agent must complete an annual information return (form NRLY) 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.

Some letting agents are not aware of their obligations under the non-resident landlord scheme. To help them understand their obligations HMRC has produced a guide for letting agents and tenants: http://www.hmrc.gov.uk/cnr/nrl_guide_notes.pdf

13. Inheritance Tax

13.1 Basic position

The value of let property, less any debt secured on the property, must be included in the total value of the deceased's estate on death. Similarly where a let property is given away within seven years of the death it will also have to be valued as at the time of the gift and be brought into account as a failed PET for IHT purposes.

Any investment property should be valued by a professional valuer, as HMRC will challenge valuations that they believe to be too low. Where a property is let on a tenancy of six months or more HMRC may accept that a discount can be applied to the market value of up to 50%. However, most let properties will be held on short-term tenancies of no more than six months.

Where the property is jointly owned with someone who is not the deceased's spouse or civil partner, HMRC will generally agree to a discount on the value of up to 15% to reflect the difficulty in selling a share in a jointly owned property.

13.2 Reliefs

There are no special reliefs from inheritance tax for let property.

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) IHTA 1984).

Although a furnished holiday lettings (FHL) business is a deemed trade, it is unlikely to qualify for BPR. To qualify for BPR the FHL business needs to provide a level of services over and above that which would be expected from a landlord. This was explored in *Pawson (dec) v HMRC* [2012] UKFTT 51 (TC) where the executors of the estate won the argument for BPR to be given at the First-tier Tribunal, but this was overturned at the Upper Tribunal, and leave to appeal was refused.

The level and type of services needed to make holiday accommodation into a business qualifying for BPR may be achieved in the case of a caravan park or seasonal short lets where catering, entertainment and other services are also provided. However, HMRC are very uneasy about granting such relief and will refer any case concerning FHL property to their technical team (litigation).

Where the accommodation is merely furnished and no other services are provided to the tenants, HMRC conclude in their inheritance manual: "In most cases the level of services provided will not be sufficient to weigh the balance away from 'investment'" (IHTM 25276).