Think Ahead

Technical factsheet

Landlord reliefs and taxes

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INTRODUCTION

The growth in the buy-to-let market over the last 20 years was fuelled, in part, by continuing government attacks on pension provision, which exposed the fact that much of the profit from pension saving came from the attached tax relief and not the expertise of the advisors controlling pension fund investment. As property prices increased over the same period, landlords looking to increase their portfolios could do so by using their existing property as security for further lending.

However, over the past 10 years the government has attacked the buy-to-let market with a raft of new provisions designed, in part, to make this activity less attractive.

There are three basic situations where taxation impacts directly on the buy-to-let landlord:

- at the time of acquisition where stamp duties become payable
- in later years as rent is received and expenses incurred
- on disposal where further tax liability can be expected.

We are not going to examine the position of those who invest overseas in the property market because that will also depend on local taxation provisions. Instead, we will concentrate on those in the UK investing as well as provisions that affect the owner overseas acquiring property in the UK.

We are going to assume that the owner of the property is going to acquire either a long lease or a freehold interest. It is possible for a person to rent property and sublet it to others provided that the interest granted is shorter than the period acquired. Special rules will apply to any element of premium that may be chargeable but we do not have sufficient time to consider this complication.

The purchase may be outright or there may be finance involved in the acquisition. Increasingly, people in the UK are using what is referred to as alternative finance in legislation – this is usually some form of financing that complies with the principles of sharia, as until this source of finance became available people had to sacrifice their religious principles to purchase property using finance. However, a person does not

need to be a member of the Islamic faith to obtain alternative financing; it is now simply one more available option.

We will be looking at the difference that residing in Scotland or Wales makes to taxes on acquisition, but we will not be looking at the difference that this can make to taxation liability on property profits. However, this can be a significant factor as Scotland continues to charge higher rates of income tax on income other than dividends and savings income, and has frozen higher tax rate bands so that a taxpayer who is liable at the basic rate in England would be liable at the higher rate in Scotland.

For example, on taxable rental profits of £49,000, an English taxpayer would be liable at the basic rate only, while a Scottish taxpayer would be liable at the higher rate and would have a liability that would be £1,331 greater than the liability of the English counterpart. This difference is likely to become more and more marked in future. It is also possible that Welsh taxpayers could see higher liabilities in future years but at present the Welsh parliament has not exercised its powers.

TAXES ON ACQUISITION

Until 2003, the tax on acquisition in the UK was stamp duty, which was charged at very modest rates. Until Gordon Brown became Chancellor, the rate on land and buildings was 1% and on shares and securities 0.5%. Liability on shares and securities remains at 0.5% but as the rates of stamp duty increased because Brown had identified it as a stealth tax which could be safely increased without irritating the majority of taxpayers. The level of avoidance activity inevitably increased and this led, in December 2003, to the creation of stamp duty land tax (SDLT).

Stamp duty had been charged on the value of a legal document that conveyed ownership. If you were making a transfer to a company you controlled, or a trust you had established, you could leave the transaction 'resting in contract' – transferring the equitable interest in the property without completing the transfer of the legal interest. Stamp duty did not have to be paid in this situation, and until 2000 there was no penalty or interest chargeable if the transaction was completed at a later date.

SDLT was to be a tax charged on the value of the transaction by which any interest in property was transferred and would be levied on completion, as before, but also on substantial performance where the equitable interest was transferred, possession was granted or the majority (90%) of the consideration was paid. It was intended not to be avoidable.

However, as rates were increased further by the coalition government, it was realised that even this tax could be avoided by placing the residential property into a company and then subsequently transferring ownership by transferring the shares of the company that owned the property. This would mean that the liability would once again be stamp duty and charged at only 0.5%.

Two measures were introduced to counter this practice. The first was an enveloping charge, where if a company acquired a residential property with a value in excess of £500,000, SDLT would be charged at 15%. There was an exception if there was a good reason for using a property development or property rental company.

The second measure charged a tax on continued ownership. This is called the annual tax on enveloped dwellings (ATED) and will be considered in the section concerning taxes on continued ownership.

Devolved taxation

The UK government agreed to allow devolved parliaments to replace SDLT with their own versions of this tax. Scotland and Wales have done so and believe that their taxes are superior to SDLT by learning from the mistakes that they claim to identify. Northern Ireland has not sought this measure and so continues to use SDLT; it does have a power to levy corporation tax at 12.5% (the rate that applies in the Republic of Ireland), which could apply to property situated in the North, but has not yet exercised this power.

Scotland introduced its equivalent of SDLT in 2016: land and buildings transaction tax (LBTT). Wales introduced its version, land transaction tax (LTT), in 2018. The rates and even the principles of charge are quite different, and significant variations

in liability can arise. For example, there is no equivalent of the enveloping charge that applies in England and Northern Ireland; however, property that would have attracted such a charge is liable to the ATED, as we shall see.

Second homes

SDLT introduced a 3% supplement to be levied on persons buying a second residence, and a similar charge was introduced in Scotland and Wales. Scotland has recently increased its charge to 4%. Where a person buys a second home as a first step in replacing their current main residence, the supplement can be reclaimed. In Scotland, the replacement of the main residence takes place within 18 months; in England, it takes place within three years.

Part commercial, part residential

Where a property is neither one nor the other, different rules apply. In England, and now in Wales under its version of the tax, properties that are not wholly residential are treated as being commercial property where the rates of SDLT and LTT are much lower. In Scotland, however, there must be an apportionment of the purchase price with the rates applied accordingly.

Non-resident purchasers

From 1 April 2021, in England and Northern Ireland, non-resident purchasers of residential property will become liable to a further surcharge of 2%; this will even apply to companies that are liable to the enveloping charge.

TAXES ON CONTINUED OWNERSHIP

Class 2 NIC?

Obviously, income tax is expected by individuals and corporation tax by companies, but what about national insurance contributions (NIC)? A landlord providing a high level of services to tenants could be considered to be gainfully employed in the UK but not as an employed earner –the definition that establishes liability to class 2 NIC. Some owners might wish to obtain business property relief for inheritance tax (IHT) purposes on a gratuitous transfer of their property portfolio, particularly if the property qualifies as a furnished holiday letting (FHL). For IT and CGT purposes, FHLs are deemed to be a trade but not for IHT purposes. The argument in favour of the activity

not being the holding or making on investments would be strengthened if liability to class 2 NIC was established. Of course, having paid class 2, possibly on a voluntary basis, will not guarantee on death that HMRC will accept a business property relief claim.

Property business profits

The method used to establish the income assessable is broadly the same whether income tax or corporation tax applies.

HMRC is reluctant to accept joint ownership and exploitation of a property, or a property portfolio, as a business and thus as a partnership, even if a partnership is established in law under the Partnership Act 1890. However, if an LLP is used as a vehicle and is active, it is deemed to be a partnership for taxation purposes and so its members will be liable following partnership practices.

From April 2017 onwards, the profits of a property business is determined using the cash basis as a default. An accruals basis can only be applied if elected for or it becomes mandatory – for example, where the landlord is a company, or a partnership or LLP that includes a company as a member, or a joint owner is using the accruals basis. The accruals basis will be either FRS 102 or 105.

Deduction of tax at source

Where a landlord is not resident in the UK, then the person paying the rent to the non-resident – the tenant if it is paid directly, the agent if the tenant pays rent to the agent – is under an obligation to deduct tax at source from the rent paid where the rent exceeds £100 per week. Landlords can avoid the obligation by bringing themselves within self-assessment, in which case HMRC will advise the tenant or agent to cease deducting tax.

Non-resident companies

From 1 April 2020, all non-resident companies will fall within corporation tax rather than IT and should advise HMRC that they have become chargeable. However, HMRC has said that they can choose to continue to accept deduction of income tax

at source. At the moment, 20% instead of 19% is marginally unattractive but if, as rumoured, the rate of corporation tax increases, this may be the better option.

One source

Where a person owns more than one rental property they consist of a single source for taxation purposes. However, FHL profits must still be determined separately, as must overseas property business profits because of restriction on loss offset; the net is then aggregated with other profits. Travelling between properties will constitute allowable travelling and a claim can be made under the cash basis for the revenue approved mileage rates to apply: 45p per mile up to 10,000 miles and 25p thereafter.

Profit extraction

Where a company is used as a vehicle for property investment, while the rate of tax is lower if profits are extracted by way of dividend, the dividend tax will distort the position of the property owner. Salary could be taken but care would need to be exercised to ensure that it would qualify as a management expense or allowable expense of the business.

Annual tax on enveloped dwellings (ATED)

This was introduced to try to reduce the attractiveness of a company as a vehicle for investment holding of more expensive residential property enabling sale without incurring an SDLT liability, as explained above. Properties are revalued for this purpose once every five years; if they exceed one of the value bands starting at £500,000 at that time or at the date of acquisition then, for the next five years, ATED would be payable annually at the appropriate rate. ATED returns are submitted at the beginning of the tax year in question, due by 30 April or 30 days of becoming liable, and the tax is due to be paid at that time.

Until 2019, where a property had been the subject of an ATED charge at any time in the period of ownership, an ATED capital gain had to be determined by reference to the value at the beginning of the period when the ATED charge applied. Now, corporation tax without indexation will instead be applied. This reduces the effective capital gains tax (CGT) rate from 28% to 19%. ATED reliefs can mean that no tax is payable but you must submit a return to be able to make the claim.

Recent reforms – rent a room relief

This has been increased to £7,500 per annum. If rent exceeds £7,500 per annum, taxpayers can choose to be taxed on the actual profit of the excess above £7,500.

Property allowance

Where rent is less than £1,000 per annum, it is not taxable at all. If rent exceeds £1,000, a taxpayer can choose to be taxed on the excess over £1,000 or the actual profit.

Wear and tear – replacements and repairs

The former wear-and-tear allowance has been abolished. A new relief for replacement of items has been introduced but does not include fitted items. Some will still count as repairs.

Finance costs

This is the most far-reaching reform. A new system was phased in so that interest and other finance costs will no longer count as an expense in calculating business profit but will instead give tax relief as a tax reducer relief at the basic rate. This restriction does not apply to financing FHLs or commercial property ownership. Companies are not affected. Some taxpayers will now become higher rate taxpayers as a consequence – especially in Scotland – and may also suffer from child benefit clawback, loss of allowances or liability at the additional rate (in Scotland, the top rate) as a consequence.

Mitigation could be sought through additional pension contributions or gift aid relief; the latter can be carried back to an earlier year, which is helpful from a planning perspective.

If the tax reduced relief exceeds the liability for the year, the excess can be carried forward and added to the relief available in the later year. No other tax reducer relief shares this characteristic.

Alternative financing – sharia compliant

This is where sums are charged in excess of the purchase price, such as a murubaha contract; this is where the financier buys the property and sells it immediately to the intended purchaser at an inflated price paid by instalments over the deferred purchase period. This avoids interest being charged on the purchase arrangement. The excess is treated as a finance charge for the purpose of the restriction outlined above.

Making Tax Digital (MTD)

From 1 April 2022, all persons registered for VAT will enter MTD. From 6 April 2023, it will apply to the first accounting period for IT purposes commencing on or after that date where the gross rental income (not the profit) exceeds £10,000.

Capital allowances

These are not available inside residential units but are available in common areas and commercial property lettings as well as FHLs.

TAXES ON DISPOSAL

Recent changes cause problems

Companies can only claim indexation allowance for periods up to 31 December 2017. The amount available at that date is now frozen and cannot be increased. Transferring property between group companies takes place at no-gain/no-loss price, which preserves the benefit of the indexation allowance should it be abolished in future years.

This happened to individuals in 2008; if a married couple owned property before that date, they should check whether they transferred ownership at that time to preserve the indexation allowance then available as part of the cost under the no-gain/no-loss rules.

From April 2015, non-resident owners of residential property became chargeable to CGT; in April 2019, this was extended to all forms of UK property – residential and commercial. For residential property, the base price will be April 2015. For commercial property, this will be the value in April 2019.

ATED gain separate calculations were abolished from April 2019 onwards. Now, only normal gains will arise on disposal to include as part of a corporation tax calculation.

Main residence relief (s222 TCGA) is subject to attack on two sides. HMRC is challenging owners who claim that they resided in a property as a main residence on the facts of each case through the tribunal service and statutory restrictions on relief availability.

Taxpayers owning more than one residence may consider electing to determine which is the main residence as this is rarely challenged. Where a property is not subject to election, it may be in danger of attack.

Where a property has been a main residence at any time the last 36 months of ownership, this used to be treated as exempt in any event. This was reduced to the last 18 months in 2013 and from 2020 onwards is now the last nine months of ownership. People with disabilities and those moving to a care-home setting can still claim the last 36 months as before.

Letting relief of a maximum of £40,000 used to be available where a property had been a main residence at any time and was then or had previously been let. From April 2020 onwards, it will only apply to a gain arising in respect of a period where the owner occupied the property as a main residence at the same time as the tenant.

From July 2020, it is necessary to notify HMRC of the disposal of any residential property within 30 days of completion even if the gain arises in a previous tax year. An estimate of the CGT payable will be due at the same time. Only if delayed completion is so late that 30 days after completion is later than the due date for the submission of the return containing the gain will the obligation not apply. If the gain is less than available reliefs, such as the main residence relief and the annual exemption, no return will be required.

HMRC has an online facility for returning these gains at bit.ly/hmrc-cgt.

INCORPORATION ISSUES

Transferring property to a company owned by the taxpayer will trigger an SDLT/LBTT/LTT liability based on the value of the property at the date of the transfer. It will also be necessary to pay the 3%-4% surcharge as well, as this applies to any acquisition by a company.

If the company was not resident in the UK, it would also attract the further 2% surcharge in England and Northern Ireland.

If the property had a value in excess of £500,000, in England and Northern Ireland this would also attract the enveloping SDLT charge of 15% instead.

Where property is transferred from a partnership to a company, there is an SDLT relief, and so using a partnership – especially an LLP – as a precursor vehicle may enable the liability to be mitigated. In Wales, this could cause the relief available to be tainted by avoidance of a principality tax.

There would be a disposal for CGT purposes at open-market value, being a transaction with a connected person. If a loss arose, it would be ‘clogged’ and only available on future transactions with the same connected person.

Incorporation relief under s162 might be available but only if the level of services provided implied that this would be a trade in its own right.

Gifting to the company could enable s165 relief if a trade was carried on, but could be available under s260 if a potential IHT liability would arise on the transfer. This would be a lifetime liability at 20%, to the extent that the value transferred was in excess of the nil-rate band, currently £325,000. As a gratuitous transfer, there would be no SDLT liability.

Extraction of profit would attract a further liability to the dividend tax, as explained above.

If the intention is to reinvest profits in the long-term back into the assets of the company, then this may be more attractive than direct ownership.

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