Easthams&Co

Landlords Tax Guide

This guide runs through what you need to know - and how to ensure your buy-to-let investment retains its appeal.

Stamp duty.

To deter many would-be investors, the Chancellor announced a hefty increase to stamp duty for buy-to-let and second properties in his Autumn Statement in 2015. As a result, any additional properties will attract a 3% stamp duty surcharge.

Band	Standard rates	Additional property rates
Up to £125k	0%	3%
£125k - £250k	2%	5%
£250k - £925k	5%	8%
£925k - £1.5m	10%	13%
£1.5m+	12%	15%

As an example, take a £300,000 property.

Buy it as your main residence and you'll pay £5,000 in stamp duty.

Buy it as a buy-to-let, and as well as the £5,000 stamp duty you'll pay further stamp duty at 3% of £300,000, equal to £9,000, bringing the total bill to £14,000.

There are some exceptions. These are properties that cost less than £40,000, caravans, mobile homes and houseboats.

Tax on rental income

Rental income is subject to income tax in the same way as your salary. But it's worth understanding what expenses you can deduct as these will help to reduce your tax bill.

The taxman categorises 'allowable expenses' as things you need to spend money on in the day-to-day running of the property such as:

- letting agents' fees
- accountants' fees
- building and contents insurance
- interest on property loans (but check below for details of future changes to this)
- maintenance and repairs to the property, but not improvements
- utility bills, council tax, ground rent and service charges
- services you pay for such as cleaning or gardening

As an example, if you let a property for a year at £1500 a month, your annual rental income would be £18,000.

You pay £100 a month to a letting agent, £600 a month in mortgage interest and £300 a year to insure the property, giving you annual allowable expenses of £8,700.

Therefore you would pay income tax on £9,300 (£18,000 - £8,700).

If you make a loss on a rental property, for instance you have a void period or you need to pay for major repairs, this can be carried forward to another year and offset against a profit from your rental property.

Tax relief for finance costs

Buy-to-let investors were dealt a blow in the 2015 Summer Budget when Mr Osborne announced a reduction in the tax relief for one of the key allowable expenses - interest on property loans.

The change, which is being introduced gradually over a four year period starting in April 2017, will mean that, rather than being able to claim tax relief at their highest income tax rate, landlords will only be able to claim tax relief at the basic rate (20%).

In addition, the way rental income is calculated changes under the new rules. Under the current rules, your rental income is regarded as the rent minus any mortgage interest. But, from 2017, it will be the rent. This could push some taxpayers into a higher tax band.

As an example, the annual interest on a buy-to-let mortgage is £7,500 and you receive annual rental income of £12,000.

2016/17

Ignoring other allowable expenses, in the final year when all of your mortgage interest will be an allowable expense, you would have a net profit of £4,500.

If you were a basic rate taxpayer you would pay 20% of £4,500 = £900 in taxes.

If you were a higher rate taxpayer you would pay 40% of £4,500 = £1,800 in taxes.

2020/21

Your income would be £12,000. On this, a basic rate taxpayer would have a tax charge of £2,400 (20% of £12,000) while a higher rate taxpayer's tax charge would be £4,800 (40% of £12,000)

Both would be able to claim basic rate tax relief on the mortgage interest,
20% x £7,500 = £1,500.

The basic rate taxpayer would have a tax bill of £2,400 - £1,500 = £900.

The higher rate taxpayer would have a tax bill of £4,800 - £1,500 = £3,300

This is a considerable jump for the higher rate taxpayer and although the basic rate taxpayer's bill doesn't change, they might be caught by the income calculation if it pushes them into a higher tax band.

Wear and tear allowance

Another feature of buy-to-let that Mr Osborne has attacked is the wear and tear allowance. This allows landlords to claim 10% of the net rent as an allowable expense to cover the wear and tear of furniture and equipment you provide in a residential letting.

From April 2016, this allowance will be scrapped and landlords will only be able to deduct costs they actually incur.

Capital gains tax

Capital gain tax is charged on any profit you make when you sell a buy-to let property. Although the Chancellor announced a cut in the capital gains tax rate in his Spring 2016 Budget, this does not apply to buy-to-let properties.

Subsequently, you'll pay 18% on the gain if you're still a basic rate taxpayer once you've added the gain to your income, or 28% if your income and gains combined takes you into the higher rate tax band.

There are ways to reduce this gain. Everyone has an annual capital gains tax allowance, known as the 'Annual Exempt Amount', (£11,100 in 2016/17) and you can also deduct costs associated with the sale of the property, for example solicitor and estate agent fees as well as the stamp duty charge you will have paid when you bought the property.

If you lived in the property you may also be able to reduce your gain. Private Residence Relief gives you full relief for the time you lived in the property plus the final 18 months you owned it. Letting Relief enables you to further reduce the gain, by claiming the lower of the Private Residence Relief and £40,000.

Using a company structure

Given the changes to the way buy-to-let properties are taxed, many investors and accountants are weighing up whether or not to set up a limited company to hold these properties.

There are certainly some tax benefits. For example, a limited company is not affected by the reduction in tax relief for mortgage interest. Instead the interest would be regarded as a business expense and fully deductible against rental income.

The other key advantage is that rather than paying income tax, companies pay corporation tax at a flat rate of 20%, which is set to reduce to 19% in 2017 and 18% in 2020.

There are some negatives. If you take money out of the company as a dividend, you'll be charged tax on this once you've used up your £5,000 Dividend Allowance that's on top of the corporation tax the company will already have paid.

This may be acceptable in some instances but if you want to sell a property and take the proceeds out of the company, this could be a lengthy - or heavily taxed - process.

There can also be capital gains tax and stamp duty charges when you transfer a property into a limited company.

Given the pros and cons, the decision to set up a company is one that will vary from case to case. Taking professional advice on this is essential.

Reporting requirements

If you rent property you must tell HMRC and pay any tax that you owe. You can report property rental income on your Self Assessment tax return. If you fail to do this, you could be charged a penalty.