AF1 Income Tax 2021/22
Part 6: Property Income

In part 1 we found that profits from property are classed as non-savings income This part will look at the details of how this is calculated together with some of the tax breaks available to direct property investment.

The milestones to understand are:

- How profits from “buy to let” residential property are calculated.
- The qualifications and benefits of property being classed as Furnished Holiday Lettings
- The Rent a Room allowance
- The £1,000 property exemption
- Income tax on Woodlands

Letting residential properties

Landlords pay tax on the **profits** they make rather than the rental income itself.

The profit is gross rental income less allowable expenses. These will include:

- Insurance, managing agent's fees.
- General maintenance but not improvements which can be offset against CGT

Costs of furnishing a property cannot be deducted from rental income although costs of replacing furniture and equipment are allowable expenses.

Tobias buys a property which he plans to let on a furnished basis. He spends £15,000 buying furniture and equipment. This cannot be deducted from the rental income.

Five years later the cooker breaks down and he replaces it with one that cost £300. This can be offset as an expense.

Property income (unless it is from furnished holiday lettings) is not classed as income from a “trade, profession or vocation” which means that any losses made in a tax year can only be offset against rental profits in a later one and not against the investor’s other income.

Landlords cannot select a trading year that is different to the tax year. Accounts must be drawn up on a year ending 31 March or April 5 basis.

Offsetting Mortgage Interest

Prior to 2017/18 all the interest payable on a mortgage was an allowable expense. This relief was phased out and from 2020/21 is no longer available. Mortgage interest can now only be offset as a tax reducer at basic rate.

Tom has a Pension income of £30,000. He has two rental properties with a gross rental income of £65,000. He pays mortgage interest of £30,000 and other expenses of £7,000

Pension		£30,000	
Gross rentals	£65,000		
Less expenses	£7,000		
	£58,000	£58,000	
		£88,000	
Less PA		£12,570	
		£75,430	
		£37,700 @ 20%	£7,540
		£37,730 @ 40%	£15,092
			£22,632
Less £30,000 @ 20%			£6,000
Total tax liability			£16,632

It might seem that a 20% rate tax payer will not be affected by these changes but this is not the case. Not being able to deduct mortgage interest may put individuals into a higher tax bracket, since the tax credit does not reduce their income. It could also result in the loss of child benefit or increasing their ANI above £100,000 resulting in a reduction in their personal allowance.

The reduction in tax relief had increased interest in switching to a corporate structure where tax relief is still available. The advantages and disadvantages can be summarised as follows.

Advantages

- Mortgage interest can be offset against rental income.
- Corporation tax at 19% would be taxed on profits and capital gains.
- Capital gain can be reduced through indexation but restricted to gains made up to 31 December 2017.
- Any dividends paid would benefit from the Dividend Allowance.

Disadvantages

- Switching from private holding would be a disposal for CGT.
- Dividends come from taxed profits.
- Greater costs for accountancy fees.
- May be more difficult for a company to raise a mortgage

Furnished Holiday Lettings (FHL)

A furnished holiday lettings property is let for a series of short periods. Whilst it doesn't need to be in a holiday resort the lettings mimic the typical holiday pattern in that there is a high turnover of tenants. The principle benefit is that the profit is treated as trading income rather than property income.

To qualify the property:

- Must be in the European Economic Area (I have been unable to confirm whether property outside the UK can use this concession now that the UK is no longer in the EU)
- Must be furnished and let on a commercial basis
- It must be available for 210 days a year
- It should be let for 105 days a year (if more than one property this can be averaged)
- It should not normally be let for more than 31 days at a time. Letting for longer than 31 days does not disqualify its holiday lettings status but any such let will not count towards the 105/210 day requirement

The tax benefits are:

- It is treated as a trade for the purposes of loss relief. Any losses can be offset against future profits from the same holiday lettings business or the investor's other income.
- Mortgage interest can be offset against rental income.
- Capital Allowances can be used.
- Profits are considered as relevant earnings for pension contributions.
- If a property is sold and reinvested in another one, holdover relief on CGT applies.
- Entrepreneur relief is available
- It may qualify for IHT Business Property Relief.

Rent a room scheme

The Rent a Room allows individuals who let out a room or rooms in their house a tax-free income (not profit) of £7,500 per house per year. If the ownership is in joint names the allowance is split equally between the couple. The income can also include any amounts received for meals and services such as cleaning and laundry.

To qualify the property:

- Must be part of the resident landlord's main home.
- must be in the UK
- must be let as a residence. A part that is let out as an office would not qualify. However, the scheme can be used if the lodger works at home in the evening or at the weekend or is a student who is provided with study facilities.

- The area let out cannot be self-contained. It could not be claimed if there was a flat with its own separate entrance.
- must be furnished.
- It cannot be used for homes converted into separate flats.
- The owners must be resident in the property whilst the room is let.

Jack and Jill own a flat in Wimbledon. They let it out during the championships and go away on holiday. Prior to 2019/20 they could claim Rent a Room but they will no longer qualify.

The tax exemption is automatic if the total income is less than £7,500. If the income is more the owner must complete a tax return, opt into the scheme and claim the allowance. Any income over £7,500 will be taxed as the owner's non-savings income.

If the scheme is used the landlord cannot offset any expenses against the rental income.

Theresa takes in paying guests into her home and in 2020/21 the total income is £12,500. Her expenses are £4,000.

Opting into rent a room means that £5,000 of her income will be taxable (£12,500 less £7,500).

If she keeps to the "normal" basis £8,500 of her income will be taxable (£12,500 less £4,000)

The £1,000 property exemption

- If property **income** is less than £1,000 this is exempt from tax and does not need to be declared.
- This could include letting out a driveway for parking.
- If the income is higher than £1,000 an individual can offset £1,000 but cannot claim any other expenses.
- The election to take the £1,000 exemption can be taken on a year by year basis
- If the house is jointly owned both owners can have the full £1,000 exemption
- It cannot be combined with Rent a Room relief.

John and Mary own a property near a Wembley stadium. They let out their driveway for parking on match days bringing in an income of £50 on each event. The total income over the year is £2,000. As the property is owned jointly this can be split between them and no tax is payable.

As with the Trading exemption this does not need to be declared but records should be kept.

Woodlands

There is no income tax liability on profits from commercial woodlands, that is where the main purpose is the growing of timber for commercial sale. If the woodland is used primarily for leisure purposes, e.g. camping or sports activities, the profits are taxable.

Whilst profits generated from commercial woodlands are free from income tax the owner cannot offset any expenses nor will it qualify for loss relief.

You should now understand:

- The taxation of “buy to let” residential property
- The qualifications and benefits of being classed as Furnished Holiday Lettings
- The Rent a Room exemption
- The £1,000 property exemption
- The taxation of income from woodlands

Sources and further reading

https://www.gov.uk/government/news/changes-to-tax-relief-for-residential-landlords

https://www.which.co.uk/money/tax/income-tax/tax-on-property-and-rental-income/allowable-expenses-and-allowances-atdn93l9wyqp

https://www.gov.uk/government/publications/furnished-holiday-lettings-hs253-self-assessment-helpsheet/hs253-furnished-holiday-lettings-2018

https://www.accountancyage.com/2017/12/19/new-property-allowance-useful-not-simple/#newsletter-modal