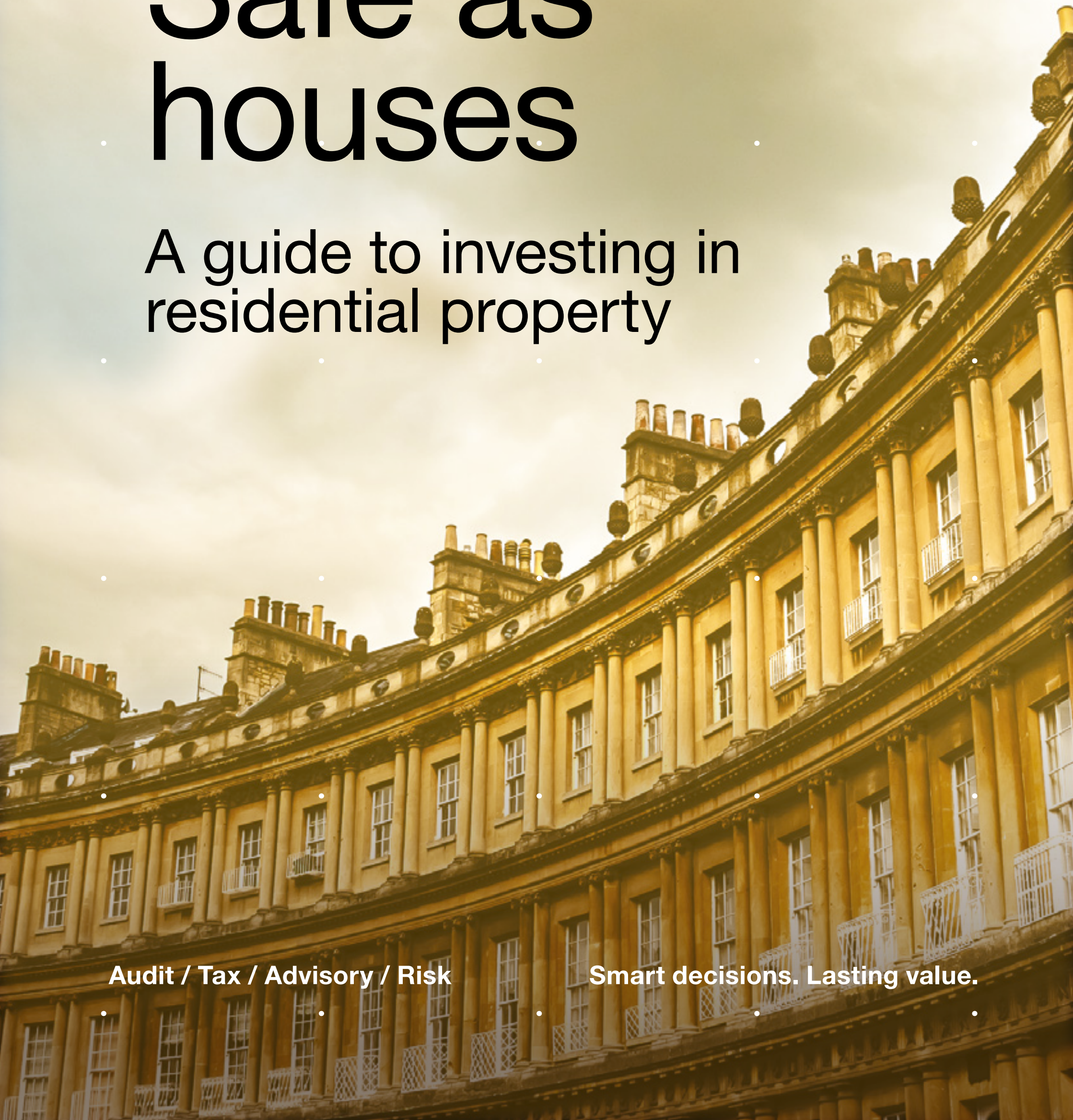
# Safe as houses

## A guide to investing in residential property



Audit / Tax / Advisory / Risk

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# Property investment

The tax position surrounding owning property, either to live in or as an investment, can be complex. One of the best ways to protect your investment is to make sure you pay tax on income or gains as efficiently as possible. This guide explains some of the tax issues surrounding property investment to illustrate how making small changes could save you money.

# Types of property investment

Property investment can be in many forms, from buying a house to live in, let out or use as a furnished holiday home for extra income. Ensuring tax is minimised for each can be very different.

## 1. Buy-to-let

Whether you have a single property or large portfolio, with direct ownership the tax treatment is generally the same. The following are the main taxes that affect buy-to-lets.

### Income tax

Any rental income after most expenses will be charged to income tax at your marginal rate.

With the rate of income tax now as high as 45%, you should aim to ensure that all personal allowances and lower rate bands of tax are used in full.

Any losses arising from the rented property have to be carried forward and offset against any future profits arising from your rental business and cannot be offset against other income.

Ownership structure is important. It is possible to own property jointly or in partnership with other family members. This means that income can be shared to minimise tax rates.

### Interest relief

As a buy-to-let landlord, many of the expenses incurred in the course of letting your property are allowable for tax purposes.

Landlords are also able to deduct the costs incurred in purchasing replacement furnishings, including white goods, when calculating their taxable profit.

As part of an ongoing clampdown on the buy-to-let market, from 6 April 2017 relief for finance costs incurred on residential properties, such as interest and mortgage costs, has been restricted to the basic rate of income tax of 20%.

The restriction was phased in over four years, with the full interest restriction taking effect from 6 April 2020.

These changes will not apply to furnished holiday lets. Where the property is owned by a company rather than an individual, finance costs will be allowable in full.

| | With Restriction | Without Restriction |
|---|---|---|
| Gross Rents | £10,000 | £10,000 |
| Unrestricted Interest Costs | -£7,500 | N/A |
| Other Rental Costs | -£2000 | -£2000 |
| | | |
| Taxable Profit | £500 | £8,000 |
| Above £1.5 millon | -£200 | -£3200 |

## Capital Gains Tax

The sale of a residential investment property is usually charged to Capital Gains Tax (CGT) at 18% or 28%. CGT rates on the sale of assets were reduced to 10% or 20% but these rates do not apply to residential property. Each person is entitled to an annual exemption, which for 2020/21 is £12,300.

If a property is bought simply to be renovated and sold at a profit, this is deemed to be trading income and charged at income tax rates.

Qualifying for Business Asset Disposal Relief (formerly known as Entrepreneurs' Relief) by making the property a business asset can secure a lower 10% rate of tax on a capital gain.

This usually only applies to furnished holiday lets, or very large portfolios. HMRC has to be satisfied that you are genuinely running a trading business rather than simply collecting rents for this to apply.

## Inheritance Tax

Inheritance Tax (IHT) reliefs on investment property are limited. However, there are some simple steps which may help reduce the tax burden.

IHT is charged on assets in your estate at 40% over and above the nil rate band, currently £325,000. This band has not kept pace with inflation or the increase in property prices, so many people find that there are hefty tax bills arising on death.

An additional nil rate band of £175,000 is being phased in from April 2017. This only applies to properties that have been your main residence at some point and which are left to one or more direct descendants on death.

- One way of reducing IHT is minimising the value of property in your estate.

To work properly, not only does this mean gifting the capital asset, but also the entitlement to any income generated.
- Any gift of property you make will fall out of your estate for IHT purposes provided you survive for seven years from the date of the gift. Reduced rates can apply from four years.

It is important to note that CGT charges can arise to the donor on the gift, other than on gifts between spouses and civil partners.

## 2. Furnished holiday lets

Furnished holiday lets, can be treated as business assets and attract some preferential tax reliefs. The property must meet specific criteria in order to qualify. Essentially they must be let on a commercial basis, for example the property must:

- be available for letting for at least 210 days of the year
- be actually let for at least 105 days
- continuous periods of over 31 days are excluded.

## Income tax

Most of the income tax benefits have been removed from furnished holiday lettings in recent years, and they are now charged to income tax in much the same way as other rental property.

## Capital Gains Tax and Inheritance Tax

Significant CGT and IHT savings can be made if the furnished holiday let conditions are met.

The property could qualify as a business asset for Entrepreneurs' Relief, meaning any capital gain on sale would be taxed at a reduced rate of 10%, rather than 28%.

Qualifying as a business asset also has benefits for IHT. Business assets may qualify for 100% Business Relief (formerly known as Business Property Relief or BPR) which means that no liability to IHT arises on the property. This also applies to lifetime gifts of these assets, the property could be settled on a discretionary trust to be protected for future generations with no charge to IHT.

The income could then be used as a tax efficient way of paying grandchildren's school fees. The transfer can generate a charge to CGT, but in these circumstances, any gain can be held over until the eventual sale.

It should be noted that it has become more difficult for holiday letting businesses to qualify for Business Relief. HMRC is paying closer attention to the services that are provided to establish whether a genuine business is being run and several cases have lost in the courts. The more additional facilities and services that can be provided i.e. over and above those which would be expected of a landlord, the better the chances of a successful claim.

## 3. Second homes

Most people know that the sale of their home is exempt from CGT, but what is less commonly known is that if you own two properties and live in both, the exemption does not automatically extend to the second home. A common misconception is that married couples can have an exemption each, which is not the case.

While income tax is not generally an issue in these circumstances, CGT and IHT can often prove expensive — but there are ways to make some savings.

### Capital Gains Tax

The CGT exemption on your main residence is known as Principal Private Residence Relief (PPR).

If you are a UK resident and have two or more homes, it is possible to nominate one of your properties to be your main home and it would then qualify for relief. This would generally be the property with the highest increase in value.

The rules for PPR are complex, there are separates rules if one of the properties you own is overseas, or you are a non-UK resident but spend a significant amount of time in the UK.

### Inheritance Tax

The value of a second home forms part of your estate for IHT. Complex planning arrangements, using trust structures and debt arrangements were introduced to mitigate IHT on family homes. Most of these planning opportunities have now been removed by HMRC.

If the property is gifted, but the donor still wants to use the property, such as for a weekend retreat, this would impact IHT relief due to the reservation of benefits rule. The simplest way of mitigating this would be for the donor to pay full market rent for the use of the property. The income would be taxed on the recipient after expenses. The rental payments would also help to reduce the value of the estate of the donor.

However, care must be taken to ensure that an undivided share of the whole property is given away rather than specific parts, as this will negate the tax saving. Similarly, all associated outgoings on the property must be shared equally.

Shared ownership allows you to give away part of the value of the property.

# Ownership structure

There are various ways to structure ownership of your property investments to mitigate your tax liability. The main ones are: direct ownership, joint venture, partnership and limited company.

The tax position for direct ownership, joint ventures and partnerships is very similar. In each case, profits are taxed at your marginal rate and capital gains charged on sale. The difference with a partnership is that there is the opportunity to utilise the personal allowances and lower rate bands of all partners, who can be other family members.

**Limited companies**

Holding property within a limited company can help to save tax as the rate of corporation tax is currently 19%, reducing to 17% in 2020. Whether this is beneficial largely depends on whether the income needs to then be drawn out of the company. If this is the case, there is likely to be a double tax charge, removing the saving.

As with partnerships, it is possible to bring other lower earning family members in as shareholders. These arrangements are commonly known as family investment companies. Provided the shareholdings are structured correctly, dividends can be paid to utilise the dividend allowance and lower rate tax bands of the shareholders and extract profits efficiently.

This can often assist families with the funding of university fees, or first homes for young adult children.

There can also be significant IHT savings as the value of property or capital invested in the company is passed to other family members when they become shareholders in the company.

A double tax charge can also arise when properties are sold, as the gain is charged within the company and then tax may be due on the distribution to shareholders. This type of structure is not always beneficial for those requiring an income stream which would be taxed at higher rates or with the prospect of an impending sale.

Company ownership can be advantageous for the most part where it is not necessary to extract all the profits. If profits and gains are to be retained for investment, or to be protected for future generations, then they can be an extremely tax efficient way of owning property.

This also depends on whether the property owned is a higher value residential property. The consequences of this are covered later in this guide.

# Stamp Duty Land Tax

Stamp Duty Land Tax (SDLT) is ordinarily due on all residential property purchases over £125,000.

For purchases of second and additional properties a further 3% is added to existing rates. This applies to property purchases over £40,000.

The additional 3% will not be charged where the purchase is replacing your main residence. The transaction must occur on the same day (or before in certain circumstances), otherwise SDLT must be paid and reclaimed once the original property is sold.

There is a 36 month window in which to do this. Trusts and companies will pay the additional 3% regardless of the number of properties they own. These SDLT rules can be complicated, particularly in cases of separation and divorce. Our team can help you get it right.

In addition to this HMRC have implemented an SDLT 'Holiday' for transactions completing between 8 July 2020 and 31 March 2021. The impact of this holiday is to increase the initial £125,000 band to £500,000 temporarily.

The current rates of residential SDLT are shown below (surcharged rates shown in brackets):

| Value of property | Residential (before and after Holiday | Residential (During Holiday) |
|---|---|---|
| £1 - £125,000 | Nil (3%) | Nil (3%) |
| £125,001 - £250,000 | 2% (5%) | Nil (3%) |
| £250,001 - £925,000 | 5% (8%) | Nil (3%) |
| £925,001 - £1.5 million | 10% (13%) | 10% (13%) |
| Above £1.5 millon | 12% (15%) | 12% (15%) |

## Higher value residential property

Annual charges now apply on high value residential property, owned by a non-natural person, which includes companies. These charges, which apply to properties valued at over £500,000, start at a rate of £3,700 per year in 2020/21 and are intended to encourage investors to de-envelope and bring the property back into the ordinary SDLT regime.

To discourage enveloping further, the rate of SDLT for properties worth over £500,000 bought by a non-natural person was set at 15%. Many exemptions are available against these additional charges including those properties let out commercially but the exemptions must be claimed.

The Annual Tax on Enveloped Dwellings (ATED) rates from 1 April 2020 to 31 March 2021 are outlined below.

| Residential property value | 2018/19 |
|---|---|
| £500,000 - £1 million | £3,600 |
| £1 - £2 million | £7,250 |
| £2 - £5 million | £24,250 |
| £5 - £10 million | £56,550 |
| £10 - £20 million | £113,400 |
| Above £20 million | £226,950 |

# How we can help

How a property investment is structured can be one of the key factors in determining the return. Our team has extensive experience of working with investors from the UK and overseas to advise on how best to invest, hold and dispose of UK real estate.

**Our services include:**

- calculating rental profits and losses
- reviewing income levels to balance rates and allowances between spouses and family members
- assessing your compliance with furnished holiday lettings rules
- developing an efficient ownership structure
- calculating Capital Gains Tax liabilities, including all allowances and reliefs
- assessing the availability of Business Asset Disposal Relief (formerly known as Entrepreneurs' Relief)
- mitigating Inheritance Tax and advising on wealth planning
- advising on Stamp Duty Land Tax and assistance with de-enveloping.

**This guide covers issues that affect property investors, outlining where savings can be made. It should be noted that the content is written with UK resident and domiciled property investors in mind. If this does not apply to you, take specific advice for your circumstances.**

## Start the conversation

**Rebecca Durrant**
Head of Private Clients
Manchester
rebecca.durrant@crowe.co.uk
+44 (0)161 214 7500

**Tom Elliott**
London
tom.elliott@crowe.co.uk
+44 (0)20 7842 7100

**Nick Latimer**
Cheltenham
nick.latimer@crowe.co.uk
+44 (0)1242 234421

**Simon Warne**
Kent
simon.warne@crowe.co.uk
+44 (0)1622 767676

**Richard Bull**
Midlands
richard.bull@crowe.co.uk
+44 (0)121 543 1900

**Mark Stemp**
Thames Valley
mark.stemp@crowe.co.uk
+44 (0)118 959 7222

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We are trusted by thousands of clients for our specialist advice, our ability to make smart decisions and our readiness to provide lasting value. Our broad technical expertise and deep market knowledge means we are well placed to offer insight and pragmatic advice to all the organisations and individuals with whom we work. Close working relationships are at the heart of our effective service delivery.

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