Retirement plan

Sarah Thomas explains how to frame suitable advice to a lay person wishing to use property to fund their retirement.

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I have just returned from a weekend visiting my nephew, Mikey, and his family. They live in a manor house in the middle of nowhere which they rent from the 'Estate'. Mikey runs his cabinet making business from the premises and, being so good with his hands, has done up the manor house in his spare time. I helped him when he set up his business 15 years ago and he is now confident with self assessment. But, as always, he was looking for more tax advice. He is now 40 but has not started saving for a pension – with two children and his own modest business there is little spare cash. I have previously explained the huge tax efficiency of pension saving, but he feels it is not right for him.

> "The paper 1 examiner has recently commented that candidates are not very good at explaining tax rules as compared to calculations."

He does, however, have a cunning plan. He has just had an offer accepted on a cottage in the Yorkshire Dales, not too far from home. He intends renovating the property to a high specification – it needs a new upgraded kitchen, an extra bathroom and the central heating system needs replacing. He has arranged a mortgage on the property and plans to do the work himself. His plan is to rent the cottage out, possibly as furnished holiday accommodation, with a view to selling it in a few years and then starting again with a slightly bigger property. Another option would be to add other similar properties to his property portfolio in the future.

Key points

- Tax implications of starting a property business.
- The importance of explaining the relevant tax rules as well as providing calculations.
- Rental receipts that are less than £150,000 a year can be reported using the cash basis.
- The differing tax treatment of property improvements and repairs.
- Losses from rents can be set against rental profits in future years.
- Advantages of furnished holiday letting but conditions must be met.

He asked me whether I could take him through any income tax implications of his venture as well as the possibility of capital gains tax were the property to be sold at some point. We discussed these briefly and Mikey asked me to email him a summary of the tax rules.

Property businesses feature frequently in the Association of Taxation Technicians paper 1, so I thought it would be helpful to show you my approach and my reply to Mikey, in particular how I tailored my reply to the specific circumstances. This will allow me to give a few exam technique tips as well.

Note that the paper 1 examiner has recently commented that candidates are not very good at explaining tax rules as compared to calculations. In particular, they suggest that, when applying the rules to a practical scenario, candidates should look for and interpret 'leads' or 'hints' that are given in the question.

My approach

I shall reply by email as requested. Mikey is not a tax expert so the language I use needs to be suitable for him to understand.

I will need a brief plan to ensure I cover all the issues relevant to Mikey in a structured order.

- I should explain how income tax is charged on renting out the property using the cash basis – for each tax year through self assessment – no detail is needed on self assessment.
- I should cover which expenses are allowable and which are not – he is going to install a kitchen and bathroom and replace the central heating system before it is rented out. These are specific 'leads' given by Mikey that I need to address. I shall mention other typical expenses which are allowable or not and also the rules on replacement of domestic items as the property may be furnished.
- Are there any other expenses to mention? He is likely to use his car occasionally.
- Mikey has told me he will need a mortgage – this is another 'lead' so I need to cover relief for interest.
- Should I mention losses? It is a new venture so might take time to build up the profits.

- Furnished holiday lets – Mikey has indicated that the property might be used as a holiday cottage so I need to address the rules – another 'lead':
  - conditions to qualify; and
  - any advantages.
- There will probably be capital gains tax on an eventual sale – costs will include improvements, and the rates for residential property will apply.

Exam tips

If faced with something similar in the exam here are four good tips:

- answer in the format requested;
- use suitable language for the client;
- plan what you want to include before you start to write; and
- take 'leads' from the scenario to apply the tax rules to the specific case.

The plan could be to annotate the question paper in the 15 minutes of pre-exam reading time. The annotations may be a few bullet points and perhaps highlight or link the 'leads', but they need to be enough to jog the memory. For example:

Income tax

- cash basis, self assessment – no detail needed;
- expenses wholly and exclusively, not capital – apply;
- interest relief – tax reducer; and
- furnished holiday letting – conditions, advantages.

Capital gains tax on sale – 18%/28%

Now for an answer

I will try to keep my sentences short and punchy. I shall keep my paragraphs brief with plenty of headings. This will make it easier for Mikey to follow and refer to. *[This is a good exam tip – it makes it easier for the marker to see each separate point and give credit.]* As I proceed I have inserted a few comments in brackets to help readers understand my approach.

> "If you use your vehicle for your property business I suggest you keep a record of the 'business miles'."

Email to Mikey

From: Auntie Sarah
To: My favourite nephew – Mikey
Subject: Tax implications of your rental property.

Hi Mikey,

Great weekend – thank you. As promised, following our discussions I have summarised the tax implications below.

Income tax on rental profits

Rental profits are calculated by taking gross rental receipts and deducting allowable expenses. Profits are calculated each tax year. As your gross receipts from letting out the property will not exceed £150,000 in a tax year, your taxable profit will be calculated using the cash basis. [*Mikey is clearly unlikely to have receipts of more than £150,000 so I decided not to explain the alternative accruals basis here but keep things simple and relevant.*]

Each tax year, you will be taxed on rents actually received less allowable expenses actually paid in the tax year. For example, assume the rent is paid monthly in arrears. If a payment due on 31 March 2020 (in the 2019-20 tax year) is not received until 20 April 2020 (in the 2020-21 tax year), it will be taxable in 2020-21, even though it actually relates to the previous tax year.

Expenses are deductible from rents only if they are 'wholly and exclusively' for the business of the letting. Examples of deductible expenses include the fees of a letting agent if you use one, buildings insurance, advertising, cleaning, council tax (if paid by you) and the cost of repairs.

Your rental profits will be disclosed on the same self-assessment return as your business profits and the tax will fall due in a similar way. *[I have not explained the self-assessment process because Mikey is already well versed in it – a 'lead' taken from the scenario. In the exam, if the examiner states that the client is already familiar with something, this is a clue to spend no time on the issue and no marks would be available for it.]*

The property income profit will be taxed at 20% if you have any basic rate band remaining and then at 40% in the higher rate band (and 45% above the higher rate limit).

> "The annotations may be a few bullet points and perhaps highlight or link the 'leads' but they need to be enough to jog the memory."

Improvements versus repairs

You suggest the property will need some money spending on it before you let it, including replacing the central heating system, putting in an upgraded kitchen and adding an extra bathroom. *[I have ensured I pick up the specific items of expense Mikey mentioned and will deal with each in turn, but have also given him some general guidance.]*

Expenditure will generally need to be split between 'genuine repairs' and improvements. Broadly, improvements are any expenditure that improves or enhances the value of the property. A record of such expenditure should be kept because such enhancement costs will be deductible on an eventual sale of the property (see later).

The replacement of the central heating will normally be regarded as an allowable expense as a repair to the property. Fixtures are deemed to be part of the building, so replacing a fixture will be a repair to the building. However, if the replacement amounts to an improvement, this will not be an allowable expense. Using new technology as part of the repair does not necessarily mean the repair is an improvement.

The additional bathroom will be regarded as an improvement. It is also likely that the upgraded kitchen will be classed as an improvement unless you can demonstrate that it is being replaced to a similar standard as previously. As a result, these will not be allowable expenses that can be set against rental income.

Furnishings

If you let the property furnished, you cannot normally claim relief for the initial cost of the furnishings, furniture, household appliances and kitchenware. However, you can claim the costs of replacing domestic items in the future. If there is an upgrade when replacing, a deduction is still allowed for replacement cost on a like-for-like basis with the balance disallowed. (These rules do not apply to fixtures, where a replacement is treated as a repair to the building.)

Motor expenses

If you use your vehicle for your property business I suggest you keep a record of the 'business miles'. You can then claim a deduction at a flat rate of 45p per business mile (for the first 10,000 miles and then at 25p per mile). This flat rate covers the cost of buying, running and maintaining the vehicle. Alternatively, you can choose to deduct a proportion of actual motor expenses (including capital allowances) but this will involve more record keeping.

Interest on a loan

Interest paid on a loan to acquire or enhance a property which is subsequently let will be eligible for some tax relief. However. from 2020-21 onwards, relief for interest paid will not be available as a deduction from rental receipts when calculating the taxable rental profits. Instead, it will be relieved as a tax reducer in your income tax computation. The reducer is given at the basic rate only – currently 20%. *[For 2019-20 remember that 25% of the interest will be deducted in arriving at taxable rental profits, with the remaining 75% interest eligible for relief at a rate of 20% as a tax reducer. I could include more detail on further restrictions here, but needed to make a decision about the detail. In the exam the marks and time available will be the guide as to how much detail to include.]*

Property allowance

A property allowance of £1,000 can be deducted instead of taking a deduction for your allowable expenses and claiming relief for mortgage interest. This is a simplification measure primarily aimed at taxpayers with small amounts of rental income. I expect this will not be beneficial for you so have not discussed it further here.

Losses

If your expenses exceed your rental income in a tax year, you will have no liability to income tax on the letting in that year. The loss arising can be carried forward and set against your rental income in future years. You cannot use the loss against other types of income nor can the loss be carried back against rental income of previous years.

Capital gains tax

Eventually the property will be sold. You mention you might sell it and buy a bigger property. I assume you are hoping for some capital growth. This capital growth will be not be taxed until disposal of the property when a capital gain (or loss) is calculated by comparing the proceeds of sale with the original cost.

This cost will include incidental costs of purchase such as stamp duty land tax, solicitors' fees and the like. It will also include any enhancements or improvements you have made to the property while you owned it. It is therefore important to keep records of such costs on an ongoing basis.

Assuming you have not lived in the property yourself, any gain (disposal proceeds in excess of costs) is potentially chargeable to capital gains tax on sale. The capital gains rates on residential properties are currently 18% in your basic rate band and 28% in the higher rate band.

Furnished holiday accommodation

I understand you are considering using the property as a holiday cottage. There are some advantageous tax rules which apply to furnished holiday lettings (FHLs), but also some conditions that need to be satisfied in order for the property to qualify.

Advantages of an FHL

- The interest paid on the loan can be deducted in full from the rental receipts to arrive at the taxable rental profits. This means that if you are paying 40% income tax, relief will not be restricted to 20% as it is for other property rental profits.
- Relief is available for capital expenditure incurred in respect of the initial cost of the furniture, fixtures and equipment used in the property (as a deduction from income under the cash basis). This could be very useful if you are intending to furnish the property from scratch.
- There are also some capital gains tax reliefs relating to business assets which may be available on the disposal of an FHL property. These could be very useful to reduce or defer any capital gains tax on a future disposal. *[These are gift relief, replacement of business asset relief and entrepreneurs' relief – replacement of business assets might be useful if Mikey sells a furnished holiday let and buys another – but this relief is not examinable at ATT paper 1.]*
- Having FHL income means you could put more into your personal pension each year, because the income is treated as 'earned' income. I understand this is not something you are currently interested in.

Conditions for an FHL

To qualify as an FHL, the property must be furnished, and, during the tax year:

- the property must be situated in the UK or the European Economic Area – which it is;
- the property must be available for commercial letting as holiday accommodation to the public generally for at least 210 days;
- out of those 210 days, the property must actually be let out for at least 105 days (excluding periods of longer term occupation); and
- if occupied by the same person for more than 31 days (longer term occupation), have a total of no more than 155 days of such occupation

Planning point

Do clients with furnished holiday lettings understand the conditions for the property to be treated as such for tax purposes? Make sure they know how many days it must be available for letting and actually be let.

Summary

As you can see, there's plenty to think about. Exciting times – but don't forget that you will need to declare the profits on your self-assessment return, pay income tax on rental profits if applicable and, in the future, pay capital gains tax on the capital growth on the sale of the property.

While purchasing and refurbishing please ensure you keep detailed records of all your costs so they can be analysed carefully and tax relief claimed where possible either against the rental income or on an eventual sale of the property.

Please do let me know if you want any further assistance.

Good luck and best wishes,

Auntie Sarah.

"There are also some capital gains tax reliefs relating to business assets which may be available on the disposal of an FHL property."

Conclusion

I have now followed my plan and covered all the relevant points; I like to tick off each item as I deal with it. I just need to reread my email and ensure that I have covered all the points as intended before I press 'send'.

For the ATT exams property income is frequently examined in paper 1, so be prepared to explain the rules as well as doing the calculations. Remember that the examiner has recently commented that candidates are less comfortable with explanations than calculations. A particularly weak area is candidates failing to pick up the 'leads' in a question which enable a candidate to apply their knowledge to the facts of a scenario and also exclude irrelevant information for which there are no marks.

That just leaves me now to ponder whether I might get a 'free' holiday in the Yorkshire Dales for my troubles after Mikey gets everything up and running.

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