Starting a Property Business

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Starting a Property Business - a basic guide to the expenses you can claim against your tax bill

Let us suppose that you've been fortunate enough to have been left a substantial sum of money in your great aunt's will. You have decided not to splash out on a party to celebrate, or to spend the lot on a round the world trip. Instead, you have decided to be sensible and invest your inheritance so that you'll have a secure nest egg for your old age.

But where to invest? The banks offer pitiful interest these days, and you don't really fancy the stock market. What about property? The headlease on the local fish and chip shop is for sale, and there are some student flats on offer – you've read somewhere that these particular types of investment ought to provide you a reasonably safe home for your money.

After considerable thought, you take the plunge and become a property tycoon…

Have you thought of tax?

Highly unlikely. The vast majority of investors only think of tax as something to be sorted out at the very end – wherever the end happens to be. As long as it's as far away as possible, so that they don't have to think about it too much!

But it is important. Bear in mind that the rental yield you've been quoted isn't what you'll be left with at the end of the day. This figure doesn't take account of the expenses of running the business, including the tax that you'll have to pay.

In this article we shall look at some basic ways in which the tax burden can be minimised. Although we are looking at this in the context of an individual renting out a property, the same principles apply to corporate landlords. Accordingly, the footnotes will contain statutory references applicable to both types of investor (we exclude investors such as funds and REITs, which have their own special tax regime).

Running a UK property business

The starting point is that a person who invests in UK property is running a UK property business. This is defined in the legislation as:

> "Every business which the person carries on from generating income from land in the UK" – and income specifically includes income from rental payments[1].

Furthermore, a person is taxed on the "full amount of the profits arising in the tax year"[2].

So by simply buying and renting out a building, you're not merely an investor, but a business venture. Your property portfolio shouldn't be treated as a hobby, but must be run in a business like manner.

There are two points to note from the tax legislation:

- Firstly, it is one business. This is the case even if there are several properties in the portfolio, and even though these properties are of a disparate nature, such as a fish and chip shop and a student flat;

- It is the *profits* of the business that are taxed, not the gross payments. It is implicit from this definition that you're allowed to deduct the expenses of running the business.

A single property business

What does this mean? What does it matter whether there is a single business, or a separate one for each letting?

A single business means that when you come to calculate your profits, all the rents are lumped together and set off against all the expenses. So let us suppose that for the first year, the student flat makes £9,000, but the chippy makes a loss of £8,000.

If the businesses are separate, the loss on one property cannot automatically be set against the profit on the other. The total taxable income is therefore £9,000. The £8,000 loss on the chippy is kept separate, to be carried forward against future chippy profits. A set-off is in fact possible but only in the special case where the loss is due to excess capital allowances[3].

On the other hand, if this is a single business, the set-off is automatic. In this case, the total taxable income is £1,000 instead. A more favourable result.

	One business	**Two businesses**
Profit on student flat	£9,000	£9,000
Loss on fish and chip shop	(£8,000)	(£8,000)
Taxable profit	£1,000	£9,000

The profits of the business – what expenses are deductible?

As stated above, it is the profits of the business that are taxed, not the gross rental receipts. This means that expenses should be deductible – but what type of expenses? Are there any restrictions on what can be claimed?

There are two key principles that apply to expenses:

- Expenses must be incurred wholly and exclusively for the purpose of the letting business[4]; and

- Expenses must be of a revenue as opposed to capital nature[5].

The following types of expenses are normally deductible:

- Interest on bank loans taken out to fund the property purchase;
- Any rent required to be paid if the property constitutes a headlease rather than a freehold;
- Rates such as business and water rates, and council tax where the landlord has agreed to pay for these in the lease. However, one would hope that the tenant will be paying these charges;
- Insurance premiums in case of a disaster such as the chippy burning down;
- Professional fees paid to letting agents for managing the property;
- Legal and accounting fees for submitting your yearly tax returns.

The biggest expense of all is, of course, the purchase price of the property. Unfortunately this is not allowable, as it is a capital cost. This also means you can't claim for the incidental costs such as:

- Stamp duty (SDLT);
- Estate agent and legal fees incurred on the purchase;
- The cost of obtaining a survey or valuation;
- The cost of major renovation works (but "minor works" might be claimable – see below).

All these costs are capital and can only be deducted when calculating the capital gains tax payable on selling the property.

However, for every rule there is an exception:

- Building costs are only disallowed to the extent that they are capital in nature. Where the work is classified as revenue, they are allowable as an expense in the ordinary way;
- Certain items of capital expenditure can be set against the rental payments. This is the case for those capital assets that are subject to wear and tear and need to be replaced at the end of their useful life.

Claiming for renovation works – repair or renewal?

At some stage you will have to do some work on your property, at least to keep the building from falling down.

For example, the student flat may have been in a shabby state of disrepair before you bought it and major refurbishment works were required as a condition of obtaining a bank loan. Or

perhaps you want to turn the chippy into a more upmarket venture – a larger seating area is to be added with an ornamental fishpond.

All of this costs money, and as we've just noted, you can't claim for major renovation works. But not all work on a building is disqualified. Even when the work is substantial, it is possible to claim part of the costs.

The question of whether a tax deduction is available boils down to whether the works constitute a repair or a renewal. You can claim for the costs of repairs but not for renewals. The distinction is found in case law:

> "Repair is restoration by renewal or replacement of subsidiary parts of a whole. Renewal, as distinguished from repair, is reconstruction of the entirety, meaning by the entirety, not necessarily the whole, but substantially the whole subject matter under discussion"[6]

In short:

- Repairs can be claimed because they constitute an income expense. The purpose of the work is of a maintenance nature – replacing faulty light bulbs, fixing a broken window or a leaky roof, whitewashing the walls, making the student flat less shabby. This is the type of work necessary to keep the building in a "useable" state;

- On the other hand, renewal costs cannot be claimed because they are capital[7]. The effect is to change the nature of the building, or a substantial part of it – a transformation that gives rise to a totally new look to the property. So taking the fish and chip shop and transforming it into a gourmet restaurant – building an extension to the property or adding that fish pond– this sort of work is more likely to be capital.

Claiming capital allowances

Capital allowances are an exception to the rule that capital expenses are not deductible[8].

Broadly, allowances are available for certain items of a one-off nature – capital items that, while they are not required to be replaced on a regular basis, nevertheless are subject to wear and tear as the years go by. In short, the deduction is an allowance for depreciation.

Items normally deductible in a property business are fixtures and fittings, electrical systems for heating, lighting and ventilation, or fire and burglar alarms. Although the costs of installing these necessary items are capital, they can be deducted against the rent.

The way it works is as follows:

- Every one is entitled to an annual allowance. The current allowance is set at £500,000 until 31 December 2015, after which it goes down to £25,000[9]. For any qualifying capital expenditure falling within this figure, the full cost can be claimed;

- Any further capital costs incurred over this figure must be claimed at the writing down rate relevant to the item in question;

- Those items that are long life assets or labelled as integral fixtures attract a rate of 8% on a reducing balance. Integral fixtures are those features that are a key part of the building. This would be the electrical power and lighting systems, fire and burglar alarms, ventilation systems[10];

- Other non-integral items with a shorter life – such as the ornamental fish pond – attract a more favourable rate of 18%, again on a reducing balance[11].

Capital allowances are relevant in two situations:

- Firstly, when actually buying the property. We have noted that you can't claim a deduction for the purchase price, being a capital expense. However, part of the price may be attributed to the building's fixtures if there are any. In these circumstances, the relevant amount qualifies for an allowance[12];

- Secondly, when doing subsequent refurbishment works. Even if the expenses are capital in nature, there may still be some items that qualify for an allowance, such as the fish pond.

The importance of claiming capital allowances cannot be stressed too highly. As well as the obvious advantage of a lower tax bill, the effect is to reduce the purchase price of the property. This in turn leads to a higher rental yield and therefore a higher rate of return on your investment.

It should be noted that capital allowances are not generally available where the property is rented out for residential use[13]. So at first, it would appear that the student flat cannot benefit from tax relief on any capital items. However, there are a number of caveats:

- Firstly, for residential landlords, there is an alternative relief. This is the wear and tear allowance in respect of any furniture provided with the lease – the current rate is 10% and is based on the rental receipts of the property[14];

- Secondly the restriction on claiming allowances only covers those items that are for use in the dwelling part of the property – the place where people are going to live. So, although a block of flats clearly constitutes residential property, the cost of certain items such as the lifts or the central heating system may still be eligible for allowances[15];

- Finally, the restriction does not extend to furnished holiday lettings[16].

Conclusion

That brings us to the end of this introductory article on property investing. There are of course, other topics relevant to buying a property, such as stamp taxes and VAT. However, in this article we concentrated on the type of expenses likely to be incurred and the issue of whether these expenses are tax deductible.

It is important to claim your expenses as far as possible. Remember that not all of the rent goes into your pocket – if you don't claim, you end up getting taxed on more money than you've actually earned.

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This article was first published on the website Tax Notes (taxnotes.co.uk) and can be viewed at the following link: http://taxnotes.co.uk/starting-a-property-business/

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[1] ITTOIA 2005 ss 264, 266; CTA 2009 ss 205, 207.
[2] ITTOIA 2005 s 270; CTA 2009 s 209.
[3] ITA 2007 s 120 – claiming a loss against general income. This restriction does not however apply to corporate landlords – CTA 2010 s 62.
[4] ITTOIA 2005 ss 272, 34; CTA 2009 ss 210, 54.
[5] ITTOIA 2005 s 33; CTA 2009 s 53.
[6] Lurcott v Wakely v Wheeler [1911] 1 KB 905 per Buckley LJ at 923-924.
[7] See Auckland Gas Co Ltd v CIR [2000] 1 WLR 1783 at 1788B-1789G for a full statement of the principles.
[8] ITTOIA 2005 s 28(b); CTA 2009 s 49(a).
[9] CAA 2001 s 51A(5), FA 2014 s 10(1).
[10] CAA 2001 ss 33A, 104A, 104D.
[11] CAA 2001 s 56.
[12] There are special rules for claiming allowances on fixtures. Where the seller has also been claiming, it is sometimes necessary to jointly elect the amount for which one can claim
[13] CAA 2001 s 35.
[14] ITTOIA 2005 ss 308A – 308C; CTA 2009 ss 248A – 248C.
[15] See HMRC Manual at CA20020 http://www.hmrc.gov.uk/manuals/camanual/CA20020.htm.
[16] See HMRC Manual at PIM 4105, http://www.hmrc.gov.uk/manuals/pimmanual/PIM4105.htm. This is on the basis that the restriction in CAA 2001 s 35 covers an ordinary UK or overseas property business – however, furnished holiday lettings are a completely separate category – CAA 2001 s 15(1)(b), (c) and (d).