Tax planning for residential landlords

A guide for clients

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Planning to take advantage of low interest rates?

After a challenging year for the UK's residential landlords, you might have read about improvements to the buy-to-let mortgage market in recent weeks.

In the three months to 31 May 2021, the average interest rates for residential landlords had declined. A two-year fixed-rate buy-to-let mortgage fell 0.10 percentage points to 2.95%, while a five-year fixed dropped 0.11 percentage points to 3.30%.

For higher loan-to-value (LTV) ratios, the drop was even more significant and as you would expect, it is vice versa for lower LTV. This may partly be down to increased competition.

By April 2021, there were 2,333 buy-to-let mortgage products on offer – more than at any point since the onset of the pandemic.

It all adds up to good news for investors seeking to expand their property portfolio or buy a second home, and this is further enhanced by the fact rental incomes grew 5.9% in April – the fastest growth since January 2015.

If these favourable borrowing conditions appeal to you and you are considering buying a holiday home or further rental properties, here's a useful overview of the tax landscape and how you can best manage it.

Taxes have significantly shifted for landlords over the past five years and it's not as attractive as it once was to borrow money to fund your purchase.

However, by talking to us you can make sure you are set up in the most efficient way to enjoy your rental income and any capital gains.

Stamp duty land tax taper

Let's start with a note on the stamp duty land tax holiday. The temporary £500,000 tax-free threshold in England and Northern Ireland no longer applies.

Until 30 September 2021, no stamp duty will be paid on the first £250,000 of residential purchases in England and Northern Ireland. Landlords and second-home buyers can benefit from this, albeit with a 3% surcharge.

To qualify, the deal must be completed before the end of September. So if you were just starting out now, you should be able to benefit assuming you've got everything ready to go and the process runs smoothly.

Tax liabilities on rental income

You probably know about your rental income tax obligations if you are an experienced landlord, although it is surprising how many do not. Or you may be getting into property investment for the first time. Either way, much has changed recently.

Rental income is subject to income tax. It is added on to any other taxable income and taxed at the relevant rate. Rental income includes rent, non-refundable deposits, additional costs (such as charges for the cleaning of communal areas in flats), and any refundable deposit you retain.

Everyone has a personal allowance of £12,570 in 2021/22. For those whose gross property income is less than £1,000, the property allowance (an extra £1,000 tax exemption).

Rental income which does not see you exceed these limits is not taxable, assuming you have no other source of taxable income, but you might still need to make a declaration.

Generally speaking, after that your tranche of rental profits falling between:

- £12,571 and £50,270 is taxed at 20%
- £50,271 and £150,000 is taxed at 40%
- above £150,000 is taxed at 45%.

If you are married, as with other assets, it can be worth exploring holding properties in your spouse's name if they are in a lower income tax bracket to you.

Income tax deductions

You can deduct certain costs from your rental income associated with your day-to-day expenses.

These include a range of expenditures from letting agent's and accountant's fees, to property maintenance and repair (although not improvement works).

The big change in recent years concerns the rules for buy-to-let mortgage repayments. Prior to 2017, the interest component of these was classed as a deductible expense, often representing a significant saving on income tax.

However, the Government brought in new rules to end this. Between 2017 and 2020, there was a phased regime but mortgage interest payments are no longer deductible.

Instead, 20% tax relief can be claimed on your interest payments, subject to certain limits. This is neutral if you pay tax at 20%.

However, if you pay tax at a higher rate it could add a significant cost burden to you and change the dynamics of investing in rental property.

Bear in mind that if you extend your property portfolio now, taking advantage of lower interest rates, it might push you into a higher tax bracket.

Property companies

One potential mitigation is to hold your investments in a limited company. Many people do this. Then, rental income is taxed like any business income, with loan interest a deductible expense, currently at a corporation tax rate of 19%. However, there are several knock-on effects.

For example, in addition to the company paying corporation tax, you will probably face personal tax liabilities when withdrawing the money from the company.

It is very important to go into such an arrangement fully aware of the implications. We can help you understand the pros and cons.

Capital gains tax considerations

Capital gains tax is a tax levied on any gain you make when you dispose of assets that have gone up in value.

Like income tax, the rate you pay depends on the tax brackets that you are in. For residential property, these are:

- 18% of the gain within the basic-rate band
- 28% of the gain within the higher and additional-rate bands*.

**Uniquely, these are higher capital gains tax rates than for most other asset classes, where the rates are 10% and 20% respectively.*

Your primary residence is generally exempt from capital gains tax. But when you own more than one property, such automatic protection is not granted on the additional properties.

It is important to emphasise that capital gains tax is only paid on the profit made on an asset, not the sale price.

You can deduct certain costs; offset some losses on other assets from other years against gains; and everyone has an annual capital gains tax exemption which currently protects the first £12,300 of gains made. This can be arranged to be combined with that of a spouse on joint assets to provide £24,600 annual protection.

Letting relief can reduce the capital gains tax you may pay on a property. However, this is only applicable to people who let out part or all of their own home while residing in it.

Specifically this tax relief is not available to buy-to-let investors who let out property having never lived in it.

Various factors go into working out letting relief, and overall it is capped at £40,000, or £80,000 for married couples.

Holiday lets

If you are interested in taking advantage of low interest rates to buy a holiday home, these come with their own unique tax rules which can be advantageous.

Strict criteria must be met for a property to qualify as a holiday let, though. These are to do with how often it is made available for hire in the year, who stays in it, and its occupancy rate.

If these are met, there are a range of capital gains and income tax allowances that become available.

Optimise your position

If you are attracted by the current low borrowing rates for and are considering buying another property, talk to us first.

The tax rules might have tightened, but we can optimise your returns by compliantly using the appropriate tax allowances.

Get in touch for tax-planning advice.

FOR GENERAL INFORMATION ONLY

Please note that this guide is not intended to give specific technical advice and it should not be construed as doing so. It is designed to alert clients to some of the issues. It is not intended to give exhaustive coverage of the topic.

Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein.

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