INCOME FROM PROPERTY

Are you a landlord? Unsure about what tax you should be paying? Find out what you have to pay if you receive income from letting property

Whether you're a property tycoon, a landlady with a lodger, or simply one of the many people these days who has caught the buy-to-let bug, you need to understand how you may be taxed on the money you make. Different rules and exemptions apply, depending on your situation. We explain them here.

HOW RENTAL INCOME IS TAXED

In most cases, including buy-to-lets, you'll be taxed on any profits you make from letting property you own. Put simply, your profit is the sum left once you've added together your rental income and deducted any allowable expenses.

You'll be taxed on profits you make from letting property

The tax you'll pay is income tax, and your rental income will be taxed at the same rates as income you receive from your business or employment – 10, 22 or 40 per cent depending on which tax band the income falls into.

But there are some special cases where the tax treatment is different – for example, where you let a room or rooms in your own home, let a property as a holiday home or let your UK home while you live abroad. If these apply to you, skip to 'Special cases', opposite.

GLOSSARY

Rental income Primarily the rent you receive, but also other receipts you earn from letting. For example, it covers separate sums you get from the tenant for the use of furniture, as well as charges for services normally provided by a landlord, such as cleaning of communal areas and the provision of hot water and heating.

Trading income Income from services not usually offered by a landlord, such as cleaning, laundry and meals. Your entire income is likely to be trading income if you run a B&B, a guesthouse or hotel from your home. Trading income is calculated in a similar way to rental profits. You declare trading income on the self-employed supplementary pages.

ALLOWABLE EXPENSES

You can deduct expenses from your rental income so long as they are wholly and exclusively incurred for business purposes (that is, as part of renting out your property). For example, if you travel to your holiday cottage for a three-week holiday, your travel expenses are unlikely to pass the 'wholly and exclusively' test, even if you use the time to check the property and get it ready for a booking. But where a definite part of an expense is wholly and exclusively incurred for business purposes, you can deduct that part from your income – for example, the cost of lighting and heating a property which is partly used for private purposes as well as renting. If you let only part of your home, or let it out for only part of each year, you have to apportion your expenses and be prepared to justify how you have done so.

The expenses you deduct must also not be of a capital nature. This means you can't deduct the cost, for example, of the property you are letting or the cost of renovating a property that you bought in a run-down state in order to make it fit to let.

Common allowable expenses

The most common allowable expenses are:

- water rates, ground rents and council tax (unless the tenant pays)
- gas and electricity bills (again, unless the tenant pays)

- normal repairs and decoration, but not the cost of improvements or additions to the property
- the interest (but not the capital) you pay on a mortgage for the purchase of the property
- what you pay for services you provide, including cleaners'/gardeners' wages
- buildings and contents insurance premiums
- letting or estate agent fees and the cost of advertising for a new tenant
- legal and professional fees when you renew a tenancy agreement
- wear and tear for furniture and equipment supplied with a furnished property (but not for furnished holiday lets if you're claiming capital allowances instead)
- capital allowances for items such as vehicles, tools, business equipment and computers. For more details, see Revenue helpsheet IR250.

Wear and tear

If the property you let out is fully furnished, you can claim for wear and tear of furnishings, such as cookers and carpets. This can be calculated using a renewals allowance or a wear and tear allowance. You can choose which method you want to use but you must stick to the one you opt for for all your furnishings.

With the renewals allowance, you can claim the cost of furniture or furnishings when you replace them. But you have to deduct any money you make when disposing of them and the cost of any improvements (for example, if you replace a washing machine with a washer-drier).

The wear and tear allowance allows you to claim 10 per cent of the annual rent less any council tax, water rates and other services you pay that would usually be paid by a tenant.

You can claim for wear and tear of carpets in fully-furnished lets

Possible advantages of the wear and tear allowance are that it's simple to calculate; you get a deduction each year; and you might save tax if it comes to more than your actual expenditure on furnishings.

MAKING A LOSS

Certain rules apply if you make a loss (that is, your expenses exceed your income). You can carry forward the loss and set it off against your next year's rental profits (provided the profits are from the same rental business). If your profits aren't large enough to set off the loss, you can carry forward the unused part of the loss to the next year and so on indefinitely until you have offset the full loss. Losses on property abroad cannot be offset against rental income from the UK, and you generally can't set off your rental losses against your general income. However, if you have made a loss and capital allowances are due (these are deductions you can make, when calculating your profits, for the cost of capital items such as vehicles, tools, computers and business equipment), you may be able to set part or all of the capital allowances loss against your general income. You can also set off losses from furnished holiday lettings against your general income.

BETTER OFF WITH RENT A ROOM

Bill charges his lodger, Ben, £450 a month rent to share his house. As the annual rent of £5,400 is more than the rent-a-room allowance (£4,250), Bill has to decide how to deal with the income.

If he stays in the rent-a-room scheme, over a year £4,250 of Ben's rent will be tax-free. That leaves £1,150 to be taxed at Bill's top rate of tax, which is 22 per cent. So he pays tax of £253 on Ben's rent for the year.

He could, however, opt out of the rent-a-room scheme and have the whole lot treated as ordinary rental income, which means he can deduct relevant expenses and have only the 'profit' taxed. The expenses Bill could claim against the rent come to about £2,500 for the year. When deducted from the total rent received, this would leave him with a profit of just £2,900 and a larger tax bill of £638 (22 per cent of £2,900).

RENT A ROOM

Rental income	£5,400
Rent-a-room allowance	- £4,250
Profit	£1,150
Tax payable= £1,150 x 22% = £253	

RENTAL INCOME

Rental income	£5,400
Expenses	-£2,500
Profit	£2,900
Tax payable=£2,900 x 22% =£638	

YOUR TAX RETURN

You will generally need to complete a tax return each year if you have income from letting property you own. But if you're an employee, with income of less than £2,500 a year, you may not need to fill in a tax return. In addition, if you don't normally complete a return, you won't need to tell the Revenue about your rental income if you qualify for rent-a-room relief and if it's less than the rent-a-room exemption limit of £4,250 (or £2,125).

You need to complete the land and property pages if you receive rental income. But if you're classed as trading, you declare your income in the self-employment pages. Check with your tax office.

SPECIAL CASES

So far we've looked at the usual way in which your rental income is taxed. There are some special cases where the tax treatment differs.

Letting a room in your home

If you take in a lodger, you may be able to opt for rent-a-room relief. To qualify you must let furnished accommodation in your only or main home (that is, the property which is the family home most of the time).

Under the rent-a-room scheme, you can receive up to £4,250 gross income (that is, before expenses) a year tax-free. If you let your house jointly with one or more people, each person receives an allowance of £2,125 instead. Anything you charge your tenants for meals, cleaning, laundry and so on must be included as part of the gross income.

If the total rent you receive for the tax year exceeds this limit, you can choose whether to pay

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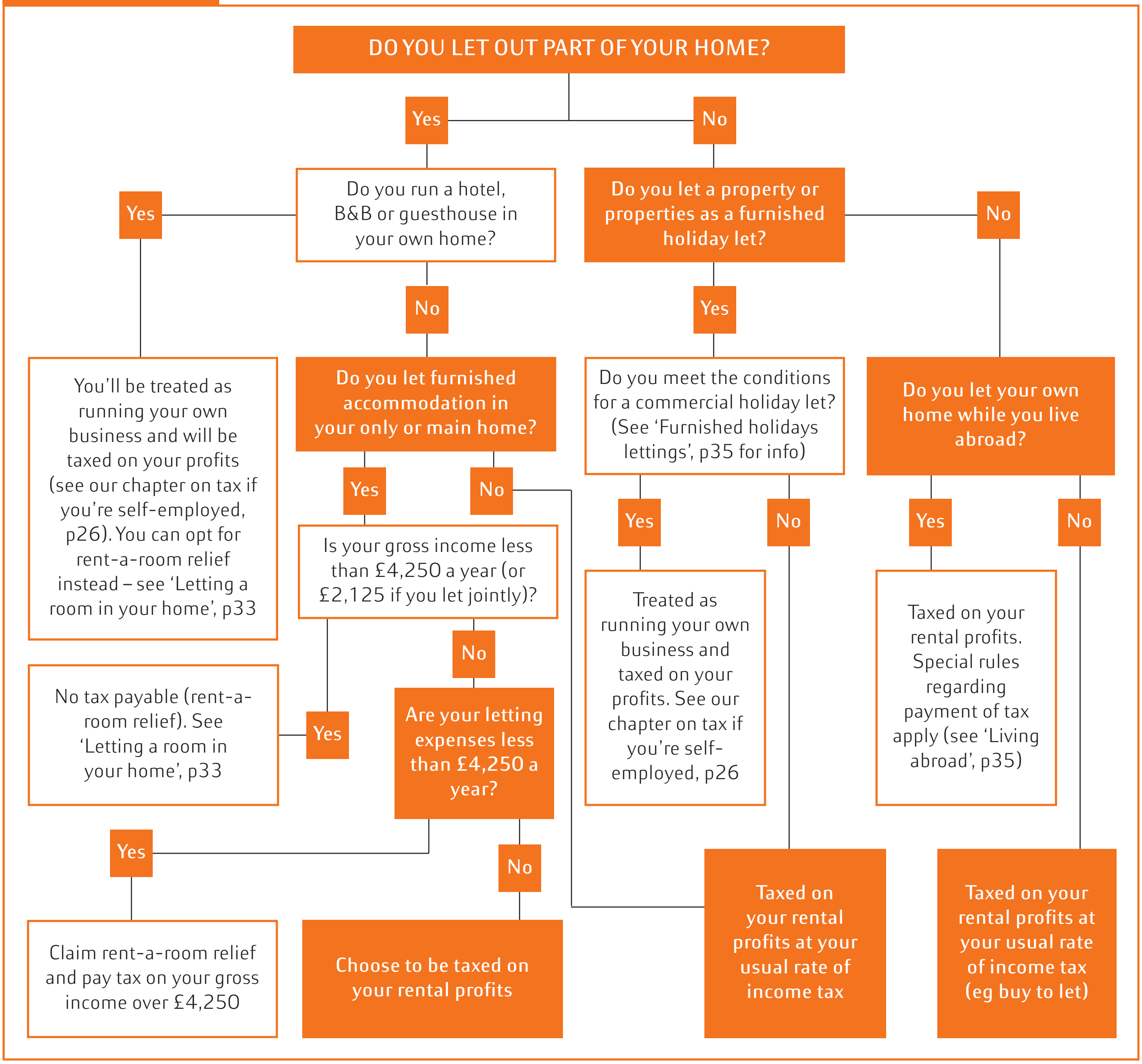

tax on your profits in the normal way or whether to pay tax only on your gross rental income over the £4,250 limit (or £2,125 if shared). If you choose the second option you can't make any deductions for expenses. The Revenue will automatically tax your profits in the normal way unless you ask for the other method to apply.

To work out which method is best for you, you need to calculate your expenses. If they are less than £4,250 you'll be better off sticking with the rent-a-room scheme, and vice versa – 'Better off with rent a room', p33, shows how this works.

You can change methods from year to year, but each time you want to change you must tell the Revenue by 31 January, 22 months after the end of the tax year. You claim rent-a-room relief by answering 'yes' to the relevant question on the supplementary pages of the tax return relating to land and property. If you don't normally complete a tax return, you don't need to tell your tax office you receive rental income as long as it's £4,250 (or £2,125 if shared) or less.

Finally, it's worth noting that the rent-a-room scheme does not protect you from losing private residence relief from capital gains tax if you have more than one lodger.

Your home as a business

If you run a hotel, guesthouse or B&B in your own home, you will normally be treated as running a

business. Instead of the rules described here, read the self-employment chapter on p26. However, the profits of your business will generally be calculated in the same way as rental profits. The main differences are that you can claim capital allowances for more things; trading losses can be set off against general income whereas rental losses can usually only be set against rental income; you can benefit from capital gains tax reliefs on business assets; and your income counts as 'net relevant earnings' for the purpose of pensions (see p46).

You can instead claim rent-a-room relief if you own this type of business rather than being taxed on your trading profits – see Inland Revenue helpsheet IR223 *Rent a room for traders*.

Furnished holiday lettings

If you let a property (other than your main home) as a furnished holiday let, you'll be taxed in the usual way on your rental profits. But there are some advantages to this type of letting if you let to the public on a commercial basis.

These commercial holiday lets are treated as a trade, which means you can set your losses against general income rather than just rental income. You can also benefit from deductions for capital allowances on furnishings and furniture in the property as well as on machinery and plant used outside the property (for example, vans and tools). In addition, you can benefit from capital gains tax relief on business assets, and your income also counts as 'net relevant earnings' for the purpose of pensions (see p46).

To qualify, the property must be available for letting for at least 140 days during each 12-month period and must actually be let for 70 or more of those days (this can be an average of the total letting days if you have more than one property). Lets of more than 31 continuous days do not count towards the 70-day total. There's an overall limit of 155 days in each 12-month period for lets of 31 or more continuous days.

Living abroad

If you choose to let out the house you live in in the UK while you live abroad, you'll have to pay income tax on the rent. The reliefs and allowances you are due are calculated in broadly the same way as if you still lived in the UK.

When it comes to paying the tax, your letting agent or tenant must deduct tax from your rental income at the basic rate (22 per cent, currently) each quarter and pay it to the Revenue (although tenants who pay less than £100 a week rent don't have to do this unless the Revenue asks them to). You can then set off the tax paid against your personal tax bill when you complete your tax return.

Alternatively, as a non-resident landlord, you can apply to the Inland Revenue for approval to receive your rental income with no tax deducted. In return the Revenue will ask you to complete a self-assessment return once a year to work out whether any tax is due.

These rules apply only if your usual home is abroad. You won't be judged as a non-resident landlord if you're temporarily living outside the UK for, say, six months or less.

You pay tax on rent if you let your UK home and live abroad

For further help, contact the Centre for Non-residents. Call 0845 070 0040 or go to www.inlandrevenue.gov.uk/cnr/email.htm to contact the centre by email.

PAYING YOUR TAX

For the 2005-2006 tax year, you pay tax on rental profits earned from the tenants' use of the property between 6 April 2005 and 5 April 2006. (You must declare rental income for the tax year it's due, even if you're not paid until the tax year is over.) However, if you're treated as trading, you pay tax on the income earned in your accounting year.

If you receive rental income, you may have to make payments on account (see our chapter on payments on account, p36). For the 2005-2006 tax year, you'll have to make two payments on account, the first by 31 January 2006 and the second by 31 July 2006. Each payment on account is one half of the income tax bill for 2004-2005. But you can reduce your payments if you know your rental income will be lower. If the payments are less than the amount finally due for 2005-2006, you must pay the balance by 31 January 2007. ■

MORE HELP

Inland Revenue booklets & helpsheets

- IR87 Letting and your home
- IR140 Non-resident landlords, their agents and tenants
- IR223 Rent a room for traders
- IR250 Capital allowances and balancing charges in a rental business