ACTION POINTS

Rent a room
You can earn up to £4,250 a year tax-free if you take in a lodger.

Use your losses
You can offset next year's profits by carrying forward a loss made in the previous year.

Deduct expenses
As a landlord, you can claim for some common expenses, including the interest you pay on the mortgage of the property you're letting.

Remember to fill out a tax return
Renting property means that, in most cases, you'll have to fill out a tax return and the special property income pages.

Income from property

You may have to pay tax on income you get from letting property. We explain what you have to pay as a landlord

Renting out property you own is big business nowadays. The way you're taxed on the income you make depends on your situation.

WHAT YOU PAY

In most cases, including buy-to-let, you'll be taxed on any profits you make from letting property you own. Your profit is the amount that is left once you've added up your rental income and deducted any allowable expenses. The tax you'll pay is income tax, and your rental income will be taxed in the same way as income you receive from your business or employment – 10, 22 or 40 per cent, depending on which tax band the income falls into.

SPECIAL CASES

There are some special cases where the tax treatment is different – for example, where you rent out part of your own home, let a property as a holiday home on a commercial basis or let your UK home while you live abroad. If these apply to you, skip to 'Special cases', p47.

HOW YOU PAY

You will generally need to complete a tax return each year if you receive income from letting property you own. You'll have to fill out the main return and the land and property supplementary pages. But if you're an employee, and your property income is less than £2,500 a year, you may not have to fill in a tax return. In addition, if you don't normally complete a return, you won't need to tell the Revenue & Customs about your rental income if you qualify for rent-a-room relief and if it's less than the rent-a-room exemption limit (see 'Letting part of your home', p47).

If you're classed as trading, you declare your income in the self-employment pages. If you're not sure whether or not you're classed as trading, contact your tax office.

Warning

If you run a hotel, B&B or guesthouse in your own home, you will be classed as trading and will have to declare your income in the self-employment pages.

WHEN YOU PAY

You pay tax on rental profits earned from the tenants' use of the property during a tax year, so for the current tax year, that means from 6 April 2006 to 5 April 2007. You

ALAMY

SAVE ON TAX BY DEDUCTING EXPENSES

You can reduce your rental tax liability if you claim for allowable expenses

You can deduct expenses from your rental income so long as they are 'wholly and exclusively' incurred in renting out your property to make profits. Where a definite part of an expense is incurred in this way, you can deduct that part from your income – for example, the cost of lighting and heating a property which is used partly for private purposes and partly for renting.

ALLOWABLE EXPENSES

The most common expenses that you can deduct 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
- buildings and contents insurance premiums
- 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 the wages of gardeners and cleaners
- letting or estate agent fees; 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 on capital allowances, see Revenue & Customs helpsheet IR250 *Capital allowances and balancing charges in a rental business.*

FULLY FURNISHED LETS

If the property you let out is fully furnished, you can claim for wear and tear of furnishings, such as cookers and carpets.

You can use either what's known as a renewals allowance or a wear and tear allowance to work out the amount to claim. You can choose which method to use but you must continue with it for as long as you own the property in question.

RENEWALS ALLOWANCE

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

WEAR AND TEAR ALLOWANCE

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.

The wear and tear allowance does have some potential advantages over the renewals method: 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.

Warning

You can't deduct 'capital' expenses. This means that you can't deduct the purchase price of the property you are letting or the cost of renovating a property that is rundown to make it fit enough to rent out.

must declare rental income for the tax year it's due, even if you don't receive the rent until the tax year is over.

However, when you run your home as a business or let a property on a commercial basis such as holiday lets – see p47), you are classed as running a trade. This means you pay tax on the income earned in your accounting year.

If you receive rental income, you may have to make payments on account in two instalments. For the 2006-2007 tax year, the first payment will be due by 31 January 2007 and the second by 31 July 2007. Each payment is one half of your income tax bill for 2005-2006, though you can reduce your payments if you expect your rental income to be lower. If the payments you make are less than the amount finally due for 2006-2007, you must pay the balance by 31 January 2008. See p65 for more about payments on account.

MAKING A LOSS

In an ideal world, you'll make a profit, but it is always possible that you will make a loss. In such cases, certain tax rules come into play. You can carry your loss forward to set off against next year's rental profits, provided that the profits are from the same rental business. If your profits aren't large enough to fully set off the loss, you can carry forward the unused part for as long as it takes to offset the loss in full.

TIP

In his 2006 budget report, the Chancellor confirmed the intention to reform the wear and tear allowance to encourage landlords to invest in the energy efficiency of their properties. But clear proposals are still awaited.

Losses on property you own abroad can't be set off against UK rental income, and you generally can't set off rental losses against the rest of your income. But if you have made a loss and capital allowances become due, you may be able to set part or all of the capital allowances loss against general income. You can set off losses from furnished holiday lets against general income (p47).

SPECIAL CASES

How you're taxed if you have a lodger, rent your home and live abroad or run a business

So far we've looked at the usual way rental income is taxed. This covers most property income, including buy-to-let. But there are situations where the tax treatment is different.

EXAMPLE

Bill has chosen to be in the rent-a-room scheme. He charges his lodger, Ben, £400 a month rent to share his house. This brings in rent of £4,800 a year. Since Bill has chosen to be in the rent-a-room scheme, £4,250 of Ben's yearly rent is tax-free, leaving £550 to be taxed at Bill's top rate of tax. Bill is a basic-rate taxpayer so he pays tax of £121 on Ben's rent for the year.

RENT A ROOM – BILL	
Bill's rental income	£4,800
Rent-a-room allowance	-£4,250
Total profit	£550
Amount of tax Bill pays = £550 x 22% =	£121

Jack has chosen not to be in the rent-a-room scheme. He charges Jo £400 a month to share his house. As Jack has chosen not to be in the scheme, the whole £4,800 is treated as ordinary rental income, so Jack can deduct relevant expenses and have only the 'profit' taxed. The expenses he can claim come to £2,000 for the year, leaving £2,800 profit. As a basic-rate taxpayer, Jack pays tax of £616.

RENTAL INCOME – JACK	
Jack's rental income	£4,800
Total of expenses	-£2,000
Total profit	£2,800
Amount of tax Jack pays = £2,800x22% =	£616

LETTING PART OF YOUR HOME

If you take in a lodger, the rent-a-room scheme allows you to get a certain amount of income tax-free. To qualify, you must let furnished accommodation in your only or main home.

Under the scheme, you can receive up to £4,250 gross (before expenses) income a year tax-free. If you let your house jointly with one or more people, each person gets an allowance of £2,125. Anything you charge 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 the limit, you can either pay tax on your rental income less expenses in the normal way, or continue with the rent-a-room scheme and pay tax only on the amount of your gross rental income that is over the £4,250 limit (or £2,125 if shared). However, with this option you can't make any deductions for expenses.

If you don't choose rent-a-room relief, Revenue & Customs will automatically tax your profits in the normal way. You can change methods yearly but each time you do so you must tell Revenue & Customs by 31 January, 22 months after the end of the tax year.

If you fill in a tax return, you claim rent-a-room relief by answering 'yes' to the relevant question on the land and property supplementary pages. If you don't fill in a tax return, you don't need to disclose rental income as long as it's £4,250 (or £2,125 if shared) or less.

Warning

The rent-a-room scheme doesn't protect you from losing private residence relief from capital gains tax if you have more than one lodger (see p49).

TIP

If your expenses are less than £4,250 you'll be better off sticking with the rent-a-room scheme, and vice versa; see our example, above.

LETTING WHILE YOU LIVE ABROAD

While you're abroad you can let out your home in the UK. When it comes to paying tax, you have two options. Under the first option, your letting agent or tenant deducts basic-rate tax from your rental income each quarter and pays it to the Revenue & Customs. Tenants paying less than £100 a week rent don't have to do this unless told to do so by the Revenue & Customs. You then set off the tax paid against your personal tax bill when you complete your tax return.

The second option involves you, as a non-resident landlord, applying for approval to receive your rental income with no tax deducted. In return the Revenue & Customs may ask you to complete a self-assessment return once a year.

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.

For further help, contact the Centre for Non-Residents – phone 0845 070 0040 ((44)151 210 2222 if you live outside the UK) or go to www.hmrc.gov.uk/menus/helpline.htm to contact the centre by email.

RUNNING A COMMERCIAL HOLIDAY LETTING

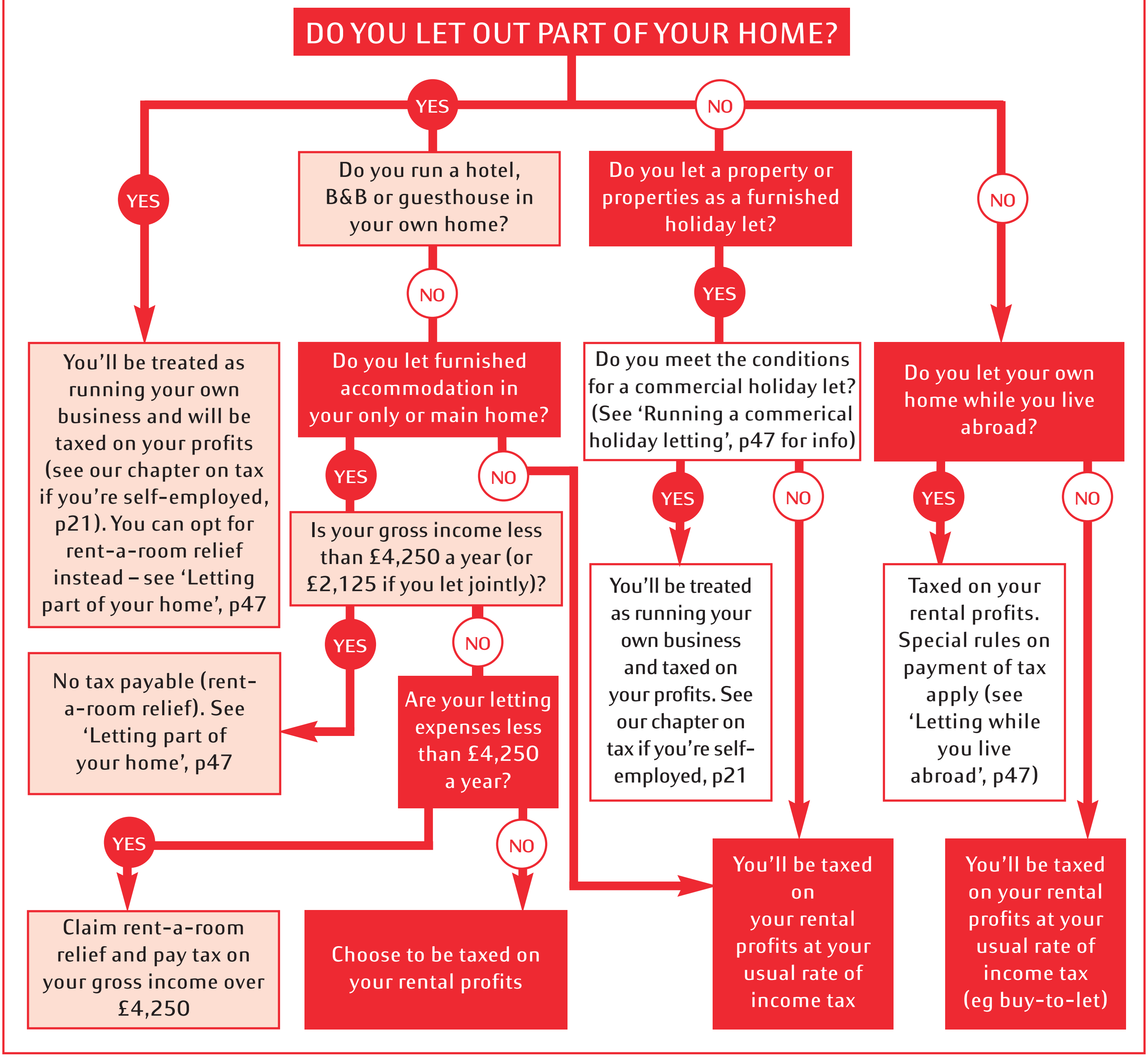
If you let a property (other than your main home) as a furnished holiday let, you'll be taxed in the usual way on your rental profits. But there are advantages to letting to the public on a commercial basis.

First, the lets are treated as a trade, so you can set your losses against general income rather than just rental income. You can use capital allowances on furnishings and furniture in the property as well as on machinery and equipment used outside it (for example, vans and tools). See p22 for more on capital allowances.

The second advantage is that your property is treated at the more generous business asset rate for capital gains tax. In addition, your letting income for 2005-2006 counts as 'net relevant earnings' for pensions.

To qualify for commercial letting, the property must be available for letting for at least 140 days during each 12-month period and must 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 days at a time don't count towards the 70-day total. For each 12-month period there's an overall

HOW YOU'RE TAXED: A QUICK GUIDE



limit of 155 days that can be taken up with lets of 31 or more continuous days.

USING 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 – read the chapter on self-employment on p21. But your profits will generally be calculated in the same way as rental profits, with the following main differences:

- you can set off trading losses against general income (rental losses can usually be set off only against rental income)
- you can claim capital allowances for more things
- you can benefit from the more generous business assets relief on capital gains tax
- your income for 2005-2006 counts as 'net relevant earnings' for pensions.

You can choose to claim rent-a-room relief rather than be taxed on your trading profits; see helpsheet IR223 *Rent a room for traders*.

MORE HELP

HMRC booklets and helpsheets

- IR223 Rent a room for traders
- IR250 Capital allowances and balancing charges in a rental business