

# Property Tax Tips

*Essential tax tips and information for property  
investors!*



**2006-2007  
Edition**

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## **About Accountancy Group**

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## **1. Landlords and Income Tax**

Before we look at the different Income Tax saving strategies, it is important to understand what is meant by the term **Income Tax**, and when property landlords are liable to pay it.

### ***1.1. Properties and Income Tax***

Anybody investing in property is liable to pay Income Tax on any profitable income that is generated from their properties.

There are two main categories of people who invest in property, and both are liable to pay income tax. The characteristics of each are detailed in the following sections.

#### ***1.1.1. Property Investor***

If you invest in property for the long-term, i.e. you have buy-to-let properties, then you will be referred to as a Property Investor. This is because you are holding onto a property for the long-term.

If you are letting your investment properties then you will be liable to pay income tax annually on the rental profits.

It is also likely that you will have another source of income, unless you have a large portfolio of properties where the rental income funds your lifestyle.

#### ***1.1.2. Property Dealers/Traders***

If you are investing in property for the short-term i.e. 6-12 months, and intend to sell with the aim of generating a dealing profit, then you will be referred to as Property Dealer or Property Trader.

Property Dealers/Traders are liable to pay Income Tax when they sell the property.

You will find that most full-time property developers or renovators are classed as Property Dealers/Traders.

### ***1.2. The rates of Income Tax***

The current rates of income tax for the 2006-2007 tax years are detailed in the table below.

<b>INCOME TAX 2006–2007</b>			
<b>Rate/Allowance</b>	<b>Rate</b>	<b>Band</b>	<b>Description</b>
Single-Person Allowance	Nil	£0 to £5,035	The first £5,035 of each individual's income is Tax Free.
Starting Rate	10%	£5,036 to £7,185	The next £2,150 is taxed at 10%. This means that any income between £5,036 and £7,185 will be taxed at this rate.
Basic Rate	22%	£7,186 to £38,335	The next £31,150 is taxed at 22%. This means that any income between £7,186 and £38,335 will be taxed at this rate.
Higher Rate	40%	> £38,335	Any income received above £38,335 will be taxed at 40%.

You can use the following link to view the Income Tax rates for previous years:

<http://www.inlandrevenue.gov.uk/rates/it.htm>

### **1.3. Income Tax calculation case studies**

Here are some case studies to illustrate how the tax liability is calculated for Property Investors and Dealers/Traders.

#### **1.3.1. Income tax calculation for Property Investors**

The case study below illustrates the income tax liability for a basic rate taxpayer.

### Case study – Income Tax Calculation for Property Investor (1)

John works as a local government officer and receives an annual salary of £20,000. He buys a property close to his local hospital for £45,000. He receives a monthly rental income of £400.

The property is let for the whole 2006–2007 tax year, which means that he has received an annual rental income of £4,800.

In the tax year he has also incurred property-related expenses of £2,000. These expenditures are made up as follows:

<u>Expense</u>	<u>Amount</u>
Interest repaid on mortgage	£1,200
Plumbing (to fix water leak)	£150
Annual gas safety inspection	£100
Central heating maintenance contract	£300
Replacement door fitted	£250
<u>Total Expenditure</u>	<u>£2,000</u>

This means that John's taxable rental profit is £2,800 (i.e., £4,800 – £2,000).

On this amount he is liable to pay tax at 22%. This is because he is a basic-rate taxpayer as his £20,000 salary falls into the basic tax rate band.

This means that he will pay tax at 22% on the rental profit of £2,800.

Therefore his tax liability is **£616** on the £2,800 profit.

The following case study illustrates how the rental income from the property pushes John into the higher rate tax band.

### Case study – Income Tax Calculation for Property Investor (2)

This is the same scenario as in the previous case study. The only difference is that John has an annual salary of £36,000.

John's tax liability on the £2,800 profit is now calculated as follows.

The first £2,335 is taxed at the basic rate of 22%.

The remaining £465 is taxed at the higher rate of 40%. This is because the rental profit has taken his total income into the higher-rate tax band.

Therefore his tax liability is as follows:

$$\begin{array}{rcl} (\pounds 2,335 \times 0.22) & + & (\pounds 465 \times 0.4) \\ \pounds 513.70 & + & \pounds 186 \\ & = & \pounds 699.70 \end{array}$$

John's tax liability is **£699.70** on the £2,800 profit.

## **2. Owning properties as a sole trader**

Holding a property in a sole name can be tax beneficial under certain circumstances.

In this strategy we will get to grips with why people hold properties as a sole trader and what the tax benefits and drawbacks are of owning properties in this way.

### ***2.1. Buying properties as a sole trader***

A **sole trader** is an individual who buys properties in his or her sole name.

Although it is still a very common way to purchase properties, it is not necessarily the most tax efficient.

In most cases properties are usually purchased as a sole trader for non tax-related reasons.

Here are the two most common non tax-related reasons why you might decide to buy property as a sole trader:

- a) You don't have a partner who you can invest with.
- b) You don't want to invest with anybody else i.e. you can't trust anybody, or you want total control over your investment.

If you have invested for either of these reasons then you can still make tax savings.

### ***2.2. When is it tax efficient to buy property as a sole trader?***

The ideal scenario for buying a property as a sole trader is if you have no income.

The reason for this is because you can utilise your annual tax-free personal allowance.

However, in the unlikely case of you having no income, then it is still worthwhile owning property in a sole name if you are not a higher rate taxpayer i.e. you do not pay tax at 40%.

In simple terms, the further your income is away from the higher rate tax band, then the more you will save in income tax by having the property in your sole name. This is especially true if your partner is a higher rate taxpayer.

The following two case studies illustrate these points.

### **Case study – Sole Trader With No Income**

Joanne is a married woman but does not work. Her husband is a high-flying executive who earns £70,000 per annum.

Upon the death of a relative, Joanne is left £100,000. She uses the entirety of this inheritance to purchase an investment property.

She makes £380 rental profit per month. (Her expenditures are low as she bought the property with cash, so therefore she has no outstanding mortgage.)

This means that she makes an annual rental profit of £4,560.

She is not liable to pay any tax on this amount as it is within the annual personal income tax allowance of £5,035.

Had Joanne bought the property in joint ownership with her husband, then he would have been liable to pay tax at 40% on his share of the investment. If his share of the property was 50%, then he would have an annual tax liability of £912.

This means that over a 10-year period, Joanne will see a minimum tax savings of £9,120 by owning the property in her sole name.

### **Case study – Property Investor With No Income, but Partner Works**

Lisa is a married woman and earns £15,000 per annum as a store sales assistant. Her husband is a hotel manager and earns £45,000 per annum.

They decide that they want to start investing in property and purchase a property for £45,000.

They take tax advice before investing and are told that they will pay less annual income tax if the property is purchased in Lisa's sole name.

This is because she is not a higher-rate taxpayer.

## **2.3. When is it NOT tax efficient to buy property as a sole trader?**

Try not to buy a property as a sole trader if you are a higher rate taxpayer, especially if you can invest with a partner who is a lower rate taxpayer.

If you are a higher rate taxpayer then you will also have to pay income tax on any rental income at the higher rate as well.

Now, it would be very poor tax planning on your behalf if you ended up paying 40% tax on all rental income, especially if you had a partner who was a lower rate taxpayer.

#### ***2.4. A note about selling properties when operating as a sole trader***

You now know when it is beneficial to buy properties as a sole trader.

However, it is generally better to have a property in a joint name when you come to sell the property. The main exception to this rule is if the property has been your Principal Private Residence.

### 3. Property Partnerships

There is no doubt that owning properties in a partnership can be an excellent income tax saving strategy.

In this strategy you will learn how owning properties in partnerships can significantly reduce your income tax bill.

#### 3.1. *What is a property partnership?*

To put it simply, a property partnership exists when two or more people own a property in joint names.

When a property is held as a partnership then it is usually held in either of the following ways:

##### 3.1.1. *Joint Tenants*

This type of partnership is used when all owners have **equal** share of the property. This is the most common method used when a husband and wife purchase a property together.

The most important point about this method of ownership is that when one of the joint tenants dies, then the property becomes the ownership of the surviving tenants.

##### **Case study – Owning properties as Joint Tenants**

Lisa and Alex are husband and wife and own a property as joint tenants. Unfortunately Lisa passes away due to ill health.

The property now becomes the sole ownership of Alex.

##### 3.1.2. *Tenants in Common*

This method is used when the owners of the property want to register the fact that they have separate ownership. This method is most commonly used when two or more unconnected people purchase a property together.

The most important point to note about this method is that when one of the 'tenants in common' dies, then the property does not necessarily become the ownership of the surviving tenants.

### **Case study – Owning properties as ‘Tenants in Common’**

Jack and Bill are two long-term friends who decide to start investing in properties together.

They are also both married.

Jack is the wealthier of the two, so when they decide to purchase a property and he funds 60% of the deposit. Therefore it is agreed that the property will be a 60:40 split in Jack’s favour.

They purchase the property as ‘tenants in common’ where they specify that the property will be passed to their estate should either party die.

Jack is the first to pass away. Upon his death, his 60% ownership in the property is passed to his wife.

### **3.2. When to consider buying in a partnership**

As we saw in Strategy 2, you should generally try to avoid owning a property as a sole trader if you are a higher rate taxpayer. This is purely because you will be liable to pay tax at the higher rate on any profitable rental income.

The two most important conditions that must be satisfied before investing with a partner are that:

- a) Your partner must be a lower rate taxpayer than yourself i.e. if you pay tax at 40% then your partner should pay tax at 22% or less.
- b) You **MUST** be able to trust your partner(s)

Let’s look at both these points in more detail in the following sections.

### **3.3. Saving tax using Partnerships**

The biggest income tax saving occurs when you pay tax at 40% and your partner is a nil rate taxpayer. In this scenario it really does make sense to have a partnership.

This is because you will be passing on a portion of the rental profit to your partner who will be able to use his/her annual income tax personal allowance.

### Case study – Income Tax Savings Using a Partnership

Jack is a bachelor and earns £50,000 in a well-paid city job. He meets Joanne, the girl of his dreams, and eventually, they both decide to get married.

Joanne gives up work shortly after the marriage.

They can no longer live in Jack's one-bedroom city apartment, so they buy a new house, and at the same time they decide to rent out the existing apartment.

Jack moves the apartment into joint ownership with his wife.

The annual rental profit on the apartment is £4,000 per annum. This means that each is liable to pay tax on £2,000.

Joanne has no tax liability as her £2,000 profit is consumed by her personal tax allowance, whereas Jack has an £800 tax liability on his share of the profits.

This means that by transferring the property, they will have an annual tax savings of £800 per annum.

Over a 10-year period, this is a tax savings of £8,000!

**PLEASE NOTE:** An even greater tax savings could be had if Jack transferred the entire property into his wife's name. However, Jack does not want to lose ownership rights on a property that was originally his. Therefore he only transfers half of the ownership to his wife.

#### TAX TIP

If you are already a nil rate taxpayer then don't seek out a partner who is a higher rate taxpayer.

This is because you will be unnecessarily passing on an income tax liability to your partner.

Instead consider keeping the property in your sole name until your rental profits lead you to incur a tax liability at a rate that is equal to or greater than that of your partner.

### 3.4. *Partners must be trustworthy*

If you buy property in a partnership then you **MUST** make sure that the partners who you are purchasing with are people who you **implicitly** trust i.e. spouse, mother, father etc.

This is not just for tax reasons, but is just simply **GOOD BUSINESS PRACTICE**.

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### **3.5. Partnerships between Husband and Wife**

**TAX TIP**

The Inland Revenue will treat all properties purchased between husband and wife as a 50:50 split, unless otherwise stated.

In fact the Inland Revenue treats all jointly owned property between husband and wife as an equal 50:50 split unless it is otherwise stated.

This means that unless you tell the Inland Revenue otherwise, you will both be taxed 50:50 on any property rental profits.

A considerable amount of tax can be saved by having a property jointly owned by husband and wife, especially if one or the other is a nil or a lower rate taxpayer. It is important to note that if you intend to have a property between husband and wife as a non 50:50 split, then you must have an agreement between the two of you to say that this is the case.

It is not enough to just make a declaration to the Inland Revenue stating that a property is owned in unequal shares. It must actually be owned in this manner and documentary evidence must be made available if requested by the Inland Revenue.

The following case study illustrates this scenario along with a considerable tax saving:

### **Case study – Potential tax savings between husband and wife**

After 5 years of marriage bliss, John and Lisa decide to buy an investment property.

John is a higher rate taxpayer, whereas Lisa is a housewife and therefore has no income.

They buy a two-bedroom terraced house for £80,000. They decide to have the property as a 90:10 split between the two of them in favour of Lisa and produce documentary evidence to support this. They also inform the Inland Revenue of this split.

(The property is split in this manner to take advantage of Lisa's personal income tax allowance - in other words they want to reduce their tax bill!)

They make £4,000 rental profit on the property on an annual basis. This means that the profit is split as follows:

Lisa's share of the profit is £3,600

John's share of the profit is £400

Lisa has no tax liability as her profit is within her tax allowance and John pays £160 tax his £400 profit.

If the property had remained as a 50:50 split then the total joint tax liability would have been £800.

Therefore they make an annual saving of £640! Over 10 years this gives a tax saving of at least £6,400.

### **3.6. Partnerships between non-husband and wife.**

#### **TAX TIP**

If a property is purchased as a partnership between non-husband and wife, then you **MUST** inform the Inland revenue of the split.

In this type of partnership the Inland Revenue does not make any assumptions as to how the property is split. It is the taxpayer's duty to tell the Inland Revenue how the property has been split and it must be based on fact.

For example if you buy a property in a partnership with a friend, where he/she provides 70% of the deposit and you provide 30% of the deposit, then you must also inform the Inland Revenue of the 70:30 split also.

## 4. When to offset interest charges

In this strategy you will learn about the different types of interest repayments. Property Investors come across.

More importantly you will understand when each of these types of interest can and cannot be offset against your rental income.

### 4.1. Interest on mortgages

It is probably fair to say that this is the most common type of interest that is associated with Property Investors.

This interest relates to the amount you pay back to your mortgage lender that is above and beyond the initial amount that you borrowed.

#### **TAX TIP**

It does not matter if the mortgage is a 'repayment' or an 'interest only' mortgage. The fact that interest repayments have been made means that they can be offset.

This is illustrated through the following case study:

#### **Case study – Interest on mortgages**

John buys an investment property for £100,000.

The finance for the property is made up from a £20,000 deposit, (provided from his personal savings), and an £80,000 buy-to-let mortgage, (provided by a high street bank).

In the first year of the mortgage he pays £2,500 in mortgage interest. This entire amount can be offset against his income from the property.

This means that if he received £5,500 income from his property then he would only be liable to pay tax on £3,000.

### 4.2. Interest on personal loans

#### **TAX TIP**

If you take out a personal loan that is used 'wholly and exclusively' for the purpose of the property, then the interest charged on this loan can also be offset.

The important point to note here is that personal loans **MUST** be used in connection with the property.

Here are some typical property investment scenarios detailing when the interest charged on a personal loan **CAN** be offset against the property income:

#### **a) Loan used for providing deposit**

Most buy-to-let mortgage lenders require you to provide a 20% deposit before they will lend you the remaining 80% in the form of a mortgage.

If you don't have the 20% deposit then it is likely that you may well need to finance the deposit by getting a personal loan.

If you do take out a personal loan for the 20% deposit the interest charged on this loan can be offset against the property income.

If you are considering doing this, or have already done this, then what this means is that you have a 100% financed investment property where interest charged on both the mortgage and the personal loan can be offset against the rental income.

#### **b) Loan used for refurbishments/developments**

Periodically, you will need to refurbish or even develop a property.

Imagine that you have just purchased a property that needs totally re-decorating and modernising. If you take out a loan for carrying out this work then the interest charged on the loan can be offset against the property income.

Alternatively, you might decide to embark on a more expensive property extension i.e. to build a conservatory.

Again the same rule applies here - the interest charged on the loan can be offset.

#### **c) Loans used for purchasing products**

If you purchase goods from retailers where finance is available, and these goods are used in your property, then the interest charged can also be offset.

This is more likely to happen if you are providing a fully furnished property i.e. a luxury apartment.

If this is the case then you may decide to buy the more expensive items on finance.

Such items are likely to include:

- Sofas, dining table & chairs, beds
- Cooker, washing machine, fridge freezer
- Carpets, flooring etc.

If you are paying for these products over a period of time (i.e. 6, 12 or 18 months), then any interest charged by your creditor can be offset against your rental income.

### **4.3. When you cannot offset the interest charged on personal loans**

You now have a good understanding about when interest charged on loans can be offset against the property rental income.

Now consider the following:

- a) Loan used for paying for a family holiday
- b) Loan used for buying a new car
- c) Loan used for paying children's tuition fees, etc.

It is clear from the above examples that all these scenarios have one common characteristic:

**They have ABSOLUTELY NOTHING to do with the property investment!**

So, it is suffice to say that if the loan has nothing to do with your property investment, then any interest repayments cannot be offset.

To help you decide if an interest repayment on a loan can be offset, always ask yourself 'Is the loan being used for the sole purpose of my property?'

If the answer is **YES**, then you can generally offset the interest.

If the answer is **NO**, then you cannot offset the interest.

## 5. 10% Wear and Tear or renewals?

In this strategy you will learn about two very important methods that can be used to reduce your income tax bill.

These two methods are known as:

- The 10% Wear & Tear Rule and
- The Renewals Basis method

They are relatively simple strategies to understand and they both relate to the furnishings provided in a property.

However, so many investors get confused by not knowing which method they can use, and how it will affect their annual property income tax bill.

Choosing the right one can have a significant bearing on your income tax liability.

### 5.1. *What is the 10% Wear & Tear Allowance?*

The 10% Wear & Tear Allowance is an allowance that the Inland Revenue has introduced to make the lives of Property Investors easier, when they complete their tax returns.

In a nutshell - it allows you to offset 10% of your annual rental income against your property income tax bill.

This sounds straight forward, and in principle it is. However, there are some important points to note:

- a) The Inland Revenue states that:

**‘The Wear and Tear Allowance is calculated by taking 10 percent of the next rental received for the furnished residential accommodation. To find the ‘net rent’ you deduct charges and services that would normally be borne by a tenant but are, in fact, borne by you (for example, council tax, water and sewerage rates etc)’**

In most cases it is very straightforward to calculate.

- b) It does not matter how much you, as a landlord, spend on furnishing your property. You can only offset 10% of your net rental income.
- c) If you use this allowance, then it **MUST** be used for the duration of the property ownership (unless it becomes a part-furnished or unfurnished property).
- d) The allowance can be used from the day that your property becomes furnished.

## 5.2. Understanding when the allowance can be used

### TAX TIP

The 10% Wear and Tear Allowance can ONLY be claimed when a property is FULLY FURNISHED.

Before we go any further, it is worthwhile understanding what is meant by a **fully furnished** property.

Here is the Inland Revenue's definition:

**'A furnished property is one which is capable of normal occupation without the tenant having to provide their own beds, chairs, tables, sofas and other furnishings, cooker etc.'**

What this means is that a tenant can start living out of the property as soon as they move in. The only accessories that the tenant needs to provide are his/her own personal belongings.

More importantly this means that the 10% Wear and Tear allowance cannot be used for part-furnished or unfurnished properties.

Here are a couple of case studies to illustrate the use of this rule.

### Case study – Simple calculation of Wear and Tear Allowance.

John rents out a fully furnished property.

He receives a monthly rent of £500.

The tenant is responsible for all property bills (i.e. utility bills) and services provided to the property (i.e. gardening).

The annual income for the property is therefore £6,000.

This means that John can offset £600 when he calculates his rental profits.

### **Case study – Complex calculation of Wear and Tear Allowance.**

Same scenario as above, but this time, John is charging £600 monthly rent. He charges an extra £100 because John himself pays the utility bills and gardening services.

The annual income is now therefore £7,200.

John **cannot** offset 10% of £7,200 against his rental profits.

He firstly has to deduct the costs that would normally be borne by the tenant, which in this case is £100 per month.

Therefore he can only claim 10% on £6,000 (£7,200 - £1,200), which equates to £600.

### **5.3. Understanding the ‘Renewals Basis’ method**

#### **TAX TIP**

The ‘Renewals Basis’ method can be used for either a furnished, part-furnished or even an unfurnished property.

The renewals method allows you to offset the cost of ‘renewing’ or ‘replacing’ an item in a property.

Unlike the 10% Wear and Tear Allowance, there are no restrictions as to when this rule can be used.

However, there are some important points to note if you decide to use this method:

**a) You cannot offset the initial cost of an item**

This is a VERY IMPORTANT point, which many landlords get caught out with.

If you purchase a property and decide to fully furnish it with new or even second hand items, then you CANNOT offset the cost of providing these furnishings.

You can only offset the costs of these furnishings when you renew them.

**b) If you use this allowance, then it MUST be used for the duration of the property ownership.**

In the case of a furnished property you cannot move to the 10% Wear and Tear Allowance at a later date.

Here are a couple of case studies to illustrate the use of this rule.

### **Case study – Renewing and offsetting the costs**

Roy buys a new house and decides to let out his previous main residence.

He leaves the existing furniture in his old house, and decides to use the Renewals Basis method to reduce his income tax liability.

Two years later, he spends £4,000 renewing all the furniture in the property.

This whole amount can be offset against his annual property income tax bill.

More importantly, if by offsetting this whole amount it means that he has made a loss on his property, then the loss can be carried forward into the next tax year.

### **Case study – Be careful of initial costs**

Alex buys a brand new luxury apartment in the city centre.

He decides to fully furnish the property and spends £7,000 on ‘kitting it out’ with the best furniture and appliances.

He considers using the ‘renewals’ method, but quickly changes his mind after he realises that the initial cost of furnishing can not be offset against his rental income.

This last case study illustrates the need to **carefully** consider which method you should use. If John had decided to use the Renewals method then he would have been committed to using this for the duration of his property ownership.

### Selling items and receiving an income

If you decide to replace an old item, and receive some income by either selling it or scrapping it, then the amount received must be taken into account when calculating your tax liability.

You must deduct the amount received (when disposing of the old item) from the amount spent on the new item.

The case study below illustrates this important point.

**Case study – Considering the cost of disposing of the old item**

Robert decides to replace the sofa in his luxury apartment.

Although the sofa is not in a poor state, he feels that it no longer fits in with the high standards of the apartment.

He advertises the sofa and receives £200 from a buyer.

The replacement sofa costs £1,000.

This means that he can only offset the amount of £800 from his rental income. This is because the income received by selling the old sofa must be deducted from the cost of the new replacement.

## 6. Getting to grips with the term ‘Wholly and Exclusively’

This strategy will address the term ‘wholly and exclusively’.

If you have ever read and tried to digest the 145 page ‘IR150 – Taxation of Rents’ document, then you will have noticed that this phrase is consistently mentioned in the guide.

By the time you have finished this strategy you will know how to test if an expense satisfies this rule and whether it can be offset against your property rental income.

### 6.1. *Understanding the term ‘wholly and exclusively’*

#### **TAX TIP**

The Inland Revenue states that:

**‘You can’t deduct expenses unless they are incurred wholly and exclusively for business purposes’**

To put it simply, this statement means that if you incurred an expense that was not used for the purpose of your property, in any way at all, then you cannot offset the cost.

Whenever you incur a cost for your investment property, always ask yourself:

**‘Has the cost been incurred wholly and exclusively for the property?’**

If you can answer **YES** to this question, then it is highly likely you will be able to offset the cost against your property rental income.

### 6.2. *What if the cost is not wholly and exclusively incurred for the property?*

Sometimes you may incur a cost that is not used ‘wholly and exclusively’ for your property. However, a portion of the cost has been incurred for your property.

For such situations, the Inland Revenue provides the following guideline:

**‘Where a definite part or proportion of an expense is wholly and exclusively incurred for the purposes of the business, you can deduct that part or proportion.’**

What this effectively means is that you need to determine what part or proportion of the cost is attributed to your investment property. This is because you cannot offset the entire cost.

The following case study will help to illustrate this guideline.

**Case study – Where costs are not wholly and exclusively incurred for the property.**

Bill has an investment property.

The bathroom is looking rather ‘tired’ so he decides to re-tile it completely. He goes to a local tile shop where they have an offer of 12sqm of tiles for £240.

However he only requires 7sqm for his investment property.

After some serious head scratching he appreciates that the deal is excellent value for money and too good to miss. He therefore purchases the tiles.

He decides to use the extra 5sqm of tiles in his own house.

This means that the entire cost has not been incurred wholly and exclusively for the property. However, a portion of the cost i.e. 7/12ths has been incurred wholly and exclusively for the property.

He may therefore offset £140 (i.e. 7/12ths of £240) against his rental income.

### **6.3. Costs of Maintenance and Repairs**

**TAX TIP**

Once you have purchased and successfully let your property, then any maintenance costs incurred that help prevent the property from deteriorating can be offset against your rental income.

It is very likely that at some point you will have to carry out some maintenance work to keep your property in an acceptable state of repair.

When this happens you will be able to offset the cost against your property income as long as it does not satisfy both of the following conditions:

**a) It is not an initial cost**

An initial cost is one that is incurred after the property is purchased but before a tenant has taken up occupation of it.

**b) It is not a capital improvement**

A capital improvement is when work is carried out that increases the value of the property.

If the cost incurred satisfies any of the above criteria, then it **cannot** be offset against the rental income from the property.

### **Case study – Maintenance cost**

John is informed by his tenants that water is leaking from the upstairs bathroom into the downstairs living room.

He calls a plumber round to repair the damaged bathroom water pipe and also hires a painter/decorator to redecorate the damaged ceiling.

The entire cost of the work is £300 and it can be offset against the rental income.

### **6.3.1. Typical maintenance/repair costs**

The following list details typical maintenance/repair costs that you are likely to incur and which you can offset against your rental income.

- Repairing water/gas leaks, burst pipes etc.
- Repairing electrical faults.
- Fixing broken windows, doors, gutters, roof slates/tiles, etc.
- Repairing internal/external walls, roofs, floors, etc.
- Painting and re-decorating the property.
- Treating damp/rot.
- Re-pointing, stone cleaning, etc.
- Hiring equipment to carry out necessary repair work.
- Repairing existing fixtures and fittings i.e. radiators, boilers, water tanks, bathroom suites, electrical/gas appliances, furniture and furnishings etc.

### **6.3.2. Initial cost of maintenance/repair**

If you carry out maintenance work on a property before you first let it out, then the cost of incurred cannot be offset against your rental income.

### **Case study – Initial maintenance cost**

Fred buys a run-down investment property and spends £5,000 getting the property ready so that is in a habitable condition.

This cost cannot be offset against the rental income, as it has been incurred **before** the property has been let.

However, the cost can be offset against any capital gain that he makes when he sells the property.

If you know that your property needs some maintenance work that is not essential, then consider making it after the property has been occupied by a tenant.

By doing this you will be able to offset the whole cost against the rental income.

#### **Case study – Waiting to make non essential repairs**

Fred buys an investment property.

Ideally he would like to re-decorate the whole property as he feels it is rather out-dated. However, he decides to wait till the property has been occupied by tenants before he carries out this work.

The first tenant moves out after a year of occupation.

He then spends £2,000 re-decorating the whole property.

This whole cost can now be offset against the property income. Had he decided to do this work straight after buying the property then he would have not been able to offset the costs in this way.

### **6.3.3. Capital improvements**

If you carry out a capital improvement that increases the value of the property then you **cannot** offset this cost against your rental income.

This is because it is not classed as maintenance or repair work.

#### **Case study – Capital improvements**

After years of owning his investment property Fred applies for, and gets approval to add, a conservatory.

The cost of the conservatory is £20,000.

Because the conservatory has increased the value of the house by £30,000 it cannot be offset against the rental income.

Again the cost will be offset against any capital gain that he makes when he sells the property.

#### **TAX TIP**

**REMEMBER:** If you have incurred an initial cost or made a capital improvement, then these costs can be claimed when you sell your property.

## 7. Replacing your Fixtures and Fittings

This strategy will help you to understand what is meant by the term ‘**fixtures and fittings**’, and when you can offset the replacement of them against your income tax.

### **7.1. What are fixtures and fittings?**

These are items that are classed as being an integral part of the property. If a new tenant moves into a property then they will expect these items to be in the property.

Examples of fixtures and fittings include:

- Windows, doors, light fittings
- Kitchen units
- Bathroom suites
- Gas central heating systems and radiators, or hot water supply tanks
- Gas fires, etc.

The most important point to understand about fixtures and fittings is that any cost incurred in repairing them (see section 6.3) or replacing them with a like-for-like product can be offset against the property rental income. This is regardless of whether the property is unfurnished, part-furnished or fully furnished.

**For the remainder of this strategy we will focus on the replacement of fixtures and fittings.**

Two important conditions must be satisfied before you can offset the cost of replacing fixtures and fittings. These are:

- a) The cost must be a ‘replacement’ cost. In other words it cannot be for the installation of fixtures and fittings that were not previously in the property.
- b) The cost must be for a similar, like-for-like product i.e.

If both these conditions are met then the cost can be deducted from the rental profits.

### **7.2. Replacing fixtures and fittings**

Whenever you decide to replace existing fixtures and fittings, then it is likely to fall into one of the following three categories:

- a) Like-for-like replacement
- b) Like-for-like replacement but with capital improvements
- c) Replacement with superior fixtures and fittings

Each of the above scenarios is treated differently when it comes to calculating your income tax bill, and each is illustrated in the following sections.

### **7.2.1. Like-for-like replacement**

If you replace existing fixtures and fittings with similar like-for-like products then the entire cost can be offset against the income tax bill.

#### **Case study – Replacing with like-for-like (1)**

Alex has been renting out his buy-to-let property for 7 years and decides that it is now time to change the bathroom suite.

He finds a similar bathroom suite of comparable quality that costs £500. The cost of having the old suite removed and the new one fitted is also £500.

This means that the entire project costs £1,000.

This whole amount can be offset against the annual rental income.

### **7.2.2. What if it is not possible to replace with like-for-like?**

The Inland Revenue appreciates that it is not possible to replace with a like-for-like product in all instances. This is especially true if you are replacing something that is several years old, as a like-for-like product may no longer be available.

In such circumstances it is possible to replace with a superior item, especially if it is of a similar cost.

#### **Case study – Replacing with like-for-like (2)**

Alex also decides to replace the single wooden glazed windows as they are starting to rot. The windows are more than 10 years old.

The cost of replacing with similar single glazed windows is £3,500, and this includes fitting and removal of the old rotten windows.

However, the cost of replacing the windows with UPVC double glazed windows is actually cheaper and costs £3,400. This price also includes fitting and removal of the old windows.

Although the UPVC double glazed windows are of a superior quality, the Inland Revenue accepts that these types of windows are the 'standard' in all new build properties.

Therefore it is possible to use these as replacements and offset the entire cost incurred.

### **7.2.3. Like-for-like replacement but with capital improvements**

If you replace the existing fixtures and fittings with a like-for-like product but also make a capital improvement, then you can only offset the cost of the like-for-like replacement.

#### **Case study – Replacing with like-for-like but with capital improvement**

Alex also decides to replace the kitchen units.

The cost of replacing the kitchen units with like-for-like replacements is £1,600. However, he has some additional space that he wishes to utilise, so he orders an additional three units at a cost £600.

Alex is able to offset the cost of the £1,600 like-for-like replacement against his rental income.

However, the additional three units are treated as a capital improvement and this cost cannot be offset against the rental income.

Instead the cost of the additional units can be offset against any capital gain arising when the property is sold.

### **7.2.4. Replacement with superior fixtures and fittings**

If you decide to replace existing fixtures and fittings with totally superior ones, then the cost of these cannot be offset against the rental income. Instead they will be offset against any capital gain arising when the property is sold.

#### **Case study – Replacing with superior fixtures and fittings**

John also decides to replace the bathroom suite in his investment property.

Replacing with a like-for-like suite would cost £1,300. However, he decides that in the future he will move into this property himself, so he buys a much more superior and expensive bathroom. At the same time he also decides to re-tile the bathroom.

The cost of this mini-project is £4,000 and it adds approximately £6,000 to the value of the house.

Because this replacement is of a capital nature, it cannot be offset against the rental income. It can only be offset when the property is sold.

## 8. Beware of the Capital Gains Tax Trap

Given the property boom over recent years, a huge number of investors have quickly and successfully grown portfolios by using a very simple investment strategy. This strategy involves withdrawing equity from an existing property to fund the next purchase.

Though this strategy has been successfully used to quickly grow portfolios and increase the number of millionaires in the country, it has already caused and continues to cause severe CGT implications for a growing number of investors.

**We will now share a case study with you. It is a story about a woman called Aleesha – The multi-millionaire property investor who couldn't afford to sell a property.**

### 8.1. *Starting to Grow the Portfolio*

#### **Case Study - Aleesha takes her first steps on the property investment ladder**

Aleesha buys her first two-bed terraced investment property in January 1996 for £60,000.

This is funded by a £12,000 deposit and a £48,000 buy-to-let mortgage. In January 2000, the property is valued at £100,000, so she decides to fund her next investment property by releasing equity from the existing one.

Her mortgage lender allows her to increase her mortgage borrowing to £80,000 (i.e. 80% of the property value) and therefore she is able to buy a £150,000 three bedroom detached property with the 20% deposit funded by the equity release.

Now there is one very important point to note about the above case study. This is that there is no capital gains tax (CGT) liability due when the property is remortgaged. CGT is only due when the property is sold or transferred. So what this effectively means is that Aleesha is able to extract large sums of money from her property without paying a single penny in tax. In fact, even if she had used the equity release proceeds for a cruise around the world then still no CGT liability would have been triggered.

However, this is a very risky strategy as we are about to realise.

### 8.2. *Remortgaging to Continue the Portfolio the Growth*

### **Case Study - Aleesha continues her portfolio growth**

In 2002, Aleesha's first property is worth £150,000 and the second property is worth £200,000. Again she decides to grow her property portfolio and remortgages the existing properties. She again releases equity to fund FIVE new apartment purchases at £125,000 in the North of England.

Due to the competitive buy-to-let market she is now able to remortgage the properties to 85% of the property value. This means that on her first property she is able to increase her borrowing to £127,500 – more than twice what she originally purchased the property for.

So Aleesha now has FIVE properties with a market value of £125,000, one at £150,000 and another at £200,000. Her total portfolio is worth £975,000 – almost a property millionaire!

## **8.3. The Property Millionaire**

### **Case Study - Aleesha becomes a property millionaire**

By 2004, the north has had two years of excellent property capital growth and the apartments purchased at £125,000 are now worth £175,000 each, her two bed terraced property is now valued at £175,000 and three bed detached property is valued at £250,000.

She is now a property millionaire!

Again, Aleesha is keen to continue the growth of her property portfolio and once again takes advantage of the 85% equity release available and remortgages all the properties to 85% loan to value and invests in three Villas one in each of Spain, France and Cyprus for £250,000 each.

So to summarise this is the current state of Aleesha's property portfolio:

- Two bed terraced property: Purchased for £60,000. Current value of £175,000 with outstanding mortgage of £148,750
- Three bed detached property: Purchased for £150,000. Current value of £250,000 with outstanding mortgage of £212,500
- FIVE Apartments: Purchased for £125,000 each. Current value of £175,000 each with an outstanding mortgage of £148,750.
- THREE villas in non-UK countries valued at a total of £750,000.

So in total here portfolio is now worth over £2million and she has become a multi-millionaire.

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## **8.4. *The Multi-Millionaire Who Can't Afford to Sell a Property***

Aleesha, has grown a very sizeable portfolio in a few years and has indeed become a property millionaire (well on paper anyway!).

However, she has never considered her capital gains tax position during her continued investment, and this means that on each of her UK owned properties she actually now owes more than what she originally paid for the property.

This in turn means that unless she has a considerable amount of savings she is unlikely to be able to pay the CGT bill on the sale of the property from the actual sales proceeds.

Lets take the example of her very first investment property, which she purchased in 1996 for £60,000. If she sells at the current market value of £175,000 then she has made a £115,000 capital gain (minus her annual CGT exemption of £8,200) and could be liable to pay tax of 40% (i.e. £42,720) of this amount (ignoring the deductions for indexation and taper relief and costs).

However, given that she only has £26,500 of equity in the property she will be required to find an extra £16,220 just to pay the taxman, thus meaning she has made no actual profit and could incur additional debt paying the taxman. She may think that she can sell another of her properties to fund the required £16,220, but again she will face the same problem, where the sale of the property will not cover its own CGT liability.

Now, if for some reason she needed to sell all her properties then you could see how she could end up paying the taxman quite a considerable amount of money, and have nothing to show for it herself at the end of it.

So, although Aleesha is a millionaire property investor, she could up without a penny to her name and with significant debts if she decides to sell.

Her foreign properties do not help her either, as there is local CGT (often a compulsory withholding of a percentage of the sale proceeds) and the balance due to the taxman here after deducting the foreign tax she has had to pay.

## **8.5. *How to avoid and overcome the 'Capital Gains Tax Trap Problem'***

There are a number of ways to tackle this tax problem and these are outlined below by Daniel Feingold:

### **8.5.1. *Hold the properties and don't sell***

Firstly, she could decide not to purchase anymore properties and continue to just hold the properties and wait till they have increased in value, or if purchased with repayment mortgages, enough of the loans have been repaid;

that the sales proceeds could cover any tax liability quite comfortably. However this may take 5, 10, or 20 more years!

One tax advantage of waiting is that after 10 years of ownership of each property; by virtue of taper relief the CGT rate will reduce from 40% to 24%.

### **8.5.2.     *Emigrate***

Secondly, she could leave the UK for 5 complete tax years and then sell the properties in either the tax year following her year of departure and any of the next 4 tax years. By doing this she would wipe-out any UK CGT liability.

Given that six million UK residents are expected to emigrate by the year 2020 this could be her chosen option. Also, she may quite fancy living in one of her foreign properties. She would also have to consider local CGT in her new Country of residence, on her UK property sales. This would be 15% in Spain. In France, she would at present have no CGT on her UK properties (this may change!) and in Cyprus she would have to pay 20%.

### **8.5.3.     *Transferring to a company***

Thirdly, she could avoid CGT, if her properties taken together were considered to be a "Business".

She could then transfer them into a Company and claim Incorporation Relief. This would have the effect of enabling the Company to sell the properties with little or no CGT liability.

## 9. Can a Limited Company improve YOUR tax position?

In this strategy you will learn whether holding your properties through a company will benefit your tax position.

### 9.1. *The most commonly asked tax question*

‘Should I buy my property through a Limited Company?’

‘Should I move my properties into a Limited Company?’

‘Is it true I can save tax by holding my properties in a Limited Company?’

I am sure, like most investors, you will have either asked, or been involved in a discussion where these questions have been debated.

In all fairness, the answer to this question depends on the following three **key factors**:

- a) What your chosen investment strategy is.
- b) What your personal and financial circumstances/ambitions are.
- c) How long you intend to hold onto the properties.

However, before you even decide whether a Limited Company will improve your tax position, there are some very basic rules and guidelines that must be understood.

### 9.2. *Transferring properties into a Limited Company*

**Do you already own investment properties?**

**Are you already on the Buy-to-let investment ladder?**

If the answer is yes, and you are now considering whether moving your properties into a Limited company will save you tax, then consider the following **FACT**:

**Properties must be transferred into a Limited Company at market value, unless a portfolio exists that is deemed to constitute a ‘business’.**

Yes that’s right!

Moving properties into a company is treated in the same way as if you were selling the properties.

If you bought your investment property 5 years ago, and you would now like to move it into a Limited Company, then you are likely to have to pay an **IMMEDIATE** capital gains tax liability.

This is due to the fact that property prices have significantly increased over the past few years.

The exception to this rule is if the property is your Principal Private Residence.

#### **Case study – Transferring properties into a Limited Company**

Alex bought 5 investment properties between 1992 and 1996.

Their combined purchase value was £250,000.

In 2004 they are worth a combined total of £550,000 i.e. the combined value of his portfolio has more than doubled!

This means that his capital gain is £300,000.

By transferring the properties into a company he may be liable to pay 40% tax on this amount, which means that he will have an immediate tax liability of £120,000 (excluding any Reliefs), if he is a higher rate taxpayer.

#### **TAX TIP**

**Do not** start to form a Limited Company before you know what your tax liability will be if you are thinking about transferring your properties in this way.

### **9.3. Understanding ‘Limited Liability’**

There is a common misunderstanding by many Property Investors who believe that if they hold their properties in a Limited Company, then they will escape from the banks/creditors if anything goes wrong.

As a separate legal entity, the company is in theory responsible for its own debts and liabilities. However, it is **very likely** that any lender will insist on a personal guarantee from the directors or shareholders when lending to the company. This means that if the company fails the directors **will be liable!**

Consider the following case study:

#### **Case study – When Limited Liability will not help you**

Mr & Mrs Prone form the limited company ‘ABC Ltd’. They borrow 75% of the purchase price and proceed to rent out the property through the company. They withdraw every penny of rent received without considering any tax consequences.

At the end of the first year, the mortgage company decide to repossess the property as the mortgage has not been paid for six months.

In the above case study, the directors will be held responsible for paying:

- the outstanding mortgage
- corporation tax on the profits,
- any tax due on the money they have withdrawn

**This is because the liabilities have arisen as a direct result of their actions.**

In law, directors are largely responsible for the actions of the company and hence if it all goes wrong there is a fair chance that the directors will find themselves personally liable for any debts arising as a result of their decisions.

However, having the cover of Limited Liability can still be useful if the business incurs unexpected (i.e. outside the control of the directors) losses or liabilities.

Such losses and liabilities can occur when:

- A property development goes horribly wrong
- Tenants refuse to move out and the company runs out of cash to pay the mortgage
- Interest rates suddenly double
- The housing market crashes (let's hope this doesn't happen!)
- A tenant is injured in your property and successfully sues the company for personal injury.

**This last pointer is a very good reason for ensuring that you have the correct landlords insurance in place.**

Let's look at another case study to illustrate the point:

### **Case study – Using Limited Liability to your advantage**

Mr & Mrs Prone decide to enter the buy-to-let market and set up a limited company to hold the property. The property costs £100,000 and a loan is obtained from the bank for 85% of the purchase price.

Tenants are found and a rental agreement signed. No insurance is taken out as it is not considered a priority.

Three months later a solicitor's letter arrives claiming that the tenant has fallen down the stairs as a result of improper maintenance of the stairways (there is a hole in one of the stairs).

After much debate and a court case, compensation is set at £150,000. The directors are cleared of any responsibility in the case by the Judge. Clearly the company cannot pay this amount of money and the company is put into liquidation.

In the above case study, the owners have been successful in that the Limited Liability of the company has saved them from being personally responsible for the costs.

If this had not been in place then the costs would have fallen on them, which would have resulted in them having to sell their own houses to meet the claim.

## **9.4. Two major tax benefits of using a Limited Company**

### **TAX TIP**

As a general rule, if you intend to re-invest the money you have made through your property investments, i.e. you want to continue re-investing the profits into acquiring more properties, then it will be beneficial to invest through a Limited Company.

There are two *significant* tax benefits of growing a property portfolio through a company. These are explained below.

a) Lower-rate tax savings.

As a higher-rate taxpayer, you pay 40% on your profit and gains. For a limited company the tax rates are between 19% and 30% — a considerable savings.

b) Stamp duty savings.

You only pay stamp duty at a rate of 0.5% when purchasing company shares<sup>1</sup>.

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<sup>1</sup> This only applies when purchasing a company that already owns the property. It does not apply when a company purchases a property.

## 10. How to Avoid Inheritance Tax on Your Family Home

The following article written by James Bailey ([taxinsider.co.uk](http://taxinsider.co.uk)) explains how to successfully avoid Inheritance Tax on your family home.

For most people, the family home is their most valuable asset. Unfortunately, it is also often the asset that admits them to what was once a very exclusive club – the Inheritance Tax club.

Inheritance Tax (“IHT”) is charged on a person’s “estate” (broadly, assets less liabilities) when they die. The first £285,000 is free of charge (the “nil rate band”) and all the rest is charged at 40%. The nil rate band will rise to £325,000 in 2009-10.

Because the nil rate band has not kept pace with house prices, more and more people find themselves in line for what used to be a tax on the rich. Transfers between married couples (or civil partners) are exempt from IHT, so if the home is left to the surviving spouse there is no IHT cost on the first death, but when the survivor dies, the house may well have to be sold to pay the IHT.

Much ingenuity has therefore gone into schemes to avoid IHT on the family home, and these have been countered with much legislation. There was a time when the ageing parent could simply “put the house in the children’s names” and continue to live there – this has not been effective for many years, though sadly I still come across situations where people have thought it was, and get an unpleasant surprise when the parent dies and is still taxed on the value of the house.

The three biggest obstacles to IHT planning for the family home are:

- **“Reservation of benefit”** – If you give the house away, but carry on living there, you will be treated as if you still owned it for IHT purposes
- **“Life interests”** – If you do not own the property, but have the right to live there for the rest of your life, you are treated as if you owned it for IHT purposes
- **“Pre-owned Assets Tax”** – This is an annual charge to income tax on the “benefit” of using assets that you once owned in the past, or assets that you have never owned but which were bought by their owners with money that you gave them.

The tax on pre-owned assets began in 2005, but it catches arrangements made as long ago as 1986. Any future IHT planning might be similarly attacked with retrospective effect, so this is not a planning area for the faint-hearted!

Any IHT planning involving the family home needs expert advice, both to ensure that it works for tax purposes, and also that other vital factors are considered:

- Security for the person living in the house – some schemes rely on the generosity of the children in letting the parent occupy “their” house, but what happens if the children go bankrupt?

- The ability to move house in the future
- The potential problems if nursing home care becomes necessary (the rules on “deliberate deprivation” can deny local authority funding to those who have given assets away)

There are two sorts of planning to consider – lifetime planning, and “first death” planning.

### **10.1. Lifetime planning**

The scope here is very limited – but the following can be considered:

- **Give away the home, then pay a full market rent to live there** - but the rent will be taxable income for the new owners of the home
- **Give a share in the home to (say) a child, who then lives there with you and shares the running costs** – but if the child moves out, the value of their share will be included in your estate again
- **Give cash to the children, wait seven years, then sell the house and move into one they buy with the cash** – this works, but only if you have that kind of cash available in the first place
- **Mortgage the house, and invest the money in assets that do not attract IHT, such as shares in unlisted trading companies (perhaps the children run such a company?), or agricultural land which is let out** – after two years, the investments described will qualify for 100% relief from IHT, and the mortgage will reduce the value of the house for IHT purposes – but you have to pay the mortgage interest. I have seen this work, but only because the parent concerned wanted to invest in the children’s company anyway.

### **10.2. “First death” planning**

If you are a married couple (or a civil partnership), there is some opportunity to pass the home down to the children when the first of you dies – a dead person cannot “reserve a benefit”.

The first essential step is to ensure that you own the home as “tenants in common” rather than as “joint tenants”. This is because a joint tenant inherits the other joint tenant’s share automatically on their death, whereas a tenant in common can leave their share to whomever they wish. If you are joint tenants, it is a simple legal procedure to convert to being tenants in common.

Some planning possibilities on the first death are:

- **Leave your share of the house to the children** – this is the “low-tech” form of planning, and crucially, it relies on the children’s generosity in allowing the surviving partner to live there undisturbed (they cannot evict him/her, but they

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could put a tenant in or force a sale of the property), and on them not going bankrupt. If the survivor wants to sell up and move, there will be capital gains tax to pay on the sale of the house.

- **Leave your share of the house to a “discretionary trust” with your partner and your children as beneficiaries** – assuming that your half of the property is worth less than the “nil rate band” there is no IHT to pay, and when your partner dies they can leave their share to the children as well. If, however, your partner wants to move, there may be CGT to pay when the house is sold, and there is a danger that the Revenue will say that your partner has a “life interest” in the other half of the house. A more sophisticated scheme is:
- **Leave a cash legacy equal to the “nil rate band” to a discretionary trust, and empower that trust to take an index-linked charge over the house instead of cash** – this needs careful drafting to ensure that your partner does not have a “life interest” as before, and it is essential that the trustees of the trust know how to manage things to avoid this problem. The main advantage of this arrangement is that if the survivor wants to move house, they can do so without any CGT being payable on the sale of the old property.

It may be possible to deal with this planning after the first death, by using a “deed of variation” within two years of the death. This effectively rewrites the will, providing that the beneficiaries agree.

IHT planning is a complicated business, and it is **essential** to get proper professional help. I will leave you with two pieces of advice:

- **MAKE A WILL**
- **If someone tells you they know a “simple” way to avoid IHT, they do not understand how IHT works!**



## End of Free Guide

This free guide cannot offer guidance specific to your circumstances. Please contact us now to see how we can help you.

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