LAWPACK

Tax busting tips to help boost your property profits

HOW TO AVOID LANDLORD TAXES

Arthur Weller & Amer Siddiq

This is an excerpt from Lawpack's book *How to Avoid Landlord Taxes*.

To find out more landlord tax-saving secrets, **click here**.

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How to Slash your Property 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 investors and landlords are liable to pay it.

4. Income Tax Liabilities for Investors/Traders

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.

4.1. 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** (more commonly known as a landlord). This is because you are holding on to 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.

4.2. Property Traders/Dealers

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 and 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.

4.3. Income Tax Rates

You can use the following link to view the income tax rates for previous years:

http://www.hmrc.gov.uk/rates/it.htm

The current rates of income tax for the 2012–2013 tax year are detailed in the table below:

INCOME TAX 2012–2013		
Rate	***Band***	***Description***
Nil	£0 to £8,105	The first £8,105 of each individual’s income is Tax Free.
20%	£8,106 to £42,475	The next £34,370 is taxed at 20%.
40%	£42,476 to £100,000	The next £57525 is taxed at 40%.
60%	£100,001 to £116,210	The next £16,210 is taxed at 60%. This is because of the withdrawal of the Personal Allowance.
40%	£116,210 to £150,000	The next £33,790 is taxed at 40%.
50%	> £150,000	Anything above £150,000 is taxed at 50%

The above table assumes that non savings income is more than £2,710. It also assumes the personal allowance is £8,105.

4.4. Income Tax Calculation Case Studies

Here are some case studies to illustrate how the tax liability is calculated for property investors and property dealers/traders.

4.4.1. Income Tax Calculation for Property Investors

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

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 £95,000. He receives a monthly rental income of £600. The property is let for the whole 2012–2013 tax year, which means that he has received an annual rental income of £7,200. In the tax year he has also incurred property-related expenses of £2,000.

These expenditures are made up as follows:

Expense	Amount
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
Total Expenditure	£2,000

This means that John’s taxable rental profit is £5,200 (i.e., £7,200 – £2,000).

On this amount he is liable to pay tax at 20%. This is because his £5,200 rental profit falls into the basic rate band.

Therefore his tax liability is **£1,040** on the £5,200 profit.

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

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 £42,000.

John’s tax liability on the £5,200 profit is now calculated as follows.

The first £475 is taxed at the basic rate of 20%.

The remaining £4,725 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:

(£475 × 0.2) + (£4,725 × 0.4)
£95 + £1,890

= £1,985

John’s tax liability is **£1,985** on the £5,200 profit.

4.4.2. *Income Tax Calculation for Property Developers*

It is important to remember that if you become a property dealer, then this is a new self-employed trade and you are liable for Class 4 National Insurance (NI) on the profits as well as for Class 2 NI. You must also inform HMRC within three months of starting your new business.

In order to make the case studies in this section easier to understand the NI contributions have not been calculated.

The following case study illustrates how the income tax liability is calculated for a part-time property dealer.

Income Tax Calculation for Property Dealer (1)

Bill works as a local government officer and earns a salary of £25,000. Bill wants to become a property developer, so he buys a run-down property for £50,000 in May 2005.

He spends £20,000 renovating and re-decorating the property before selling it six months later for £95,000.

This gives him a taxable profit of £25,000 (i.e., selling price – (purchase price + costs incurred on the property)).

Bill's tax liability on the £25,000 profit is made in the 2012–2013 tax year, so his tax liability is calculated as follows.

The first £17,475 is taxed at the basic rate of 20%.

The remaining £7,525 is taxed at the higher rate of 40%. This is because the property development profit has taken his total income into the higher-rate tax band.

Therefore his tax liability is as follows:

(£17,475 × 0.2)	+	(£7,525 × 0.4)
£3,495	+	£3,010
	=	£6,505

Bill's tax liability is **£6,505** on the £25,000 profit.

The following case study illustrates how the income tax liability is calculated for a full-time property dealer.

Income Tax Calculation for Property Dealer (2)

Robert, a colleague of Bill and John, resigns from his job in the local government and decides to become a full-time property dealer.

In his first year of dealing he buys two properties, renovates them, and sells them for a profit of £55,000 each. This means that he has a taxable income of £110,000. The profit is made in the 2011–2012 tax year, so his tax liability is calculated as follows.

- The first £8,105 is tax-free due to the personal allowance.
- The next £34,370 is taxed at the basic rate of 20%.
- The next £57525 is taxed at the rate of 40%.
- The remaining £10,000 is taxed at the even higher rate of 60%.

Here is the tax calculation:

Tax Rate	Amount	Tax Liability
Nil	£8,105	£0
20%	£34,370	£6,874
40%	£57,525	£23010
60%	£10,000	£6,000
	Total Tax Liability	***£35,884***

Therefore Robert has a tax liability of **£3*5,884*** on the £110,000 profit.

5. Owning Properties as a Sole Trader

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

In this section we will get to grips with why people hold properties as a sole trader and will learn about some of the tax benefits and drawbacks of owning properties in this way.

5.1. 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; that is, 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.

5.2. 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.

In simple terms, the further your income is from the higher-rate tax bands, 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.

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 £600 rental profit per month. (She bought the property with cash, so therefore she has no outstanding mortgage or other costs in the 2012-13 tax year).

This means that she makes an annual rental profit of £7,200.

She is not liable to pay any tax on this amount as it is within the annual personal income tax allowance of £8,105.

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 £1,440.

This means that over a 10-year period, Joanne will see a minimum tax saving of £14,400 by owning the property in her sole name.

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.

5.3. When is it NOT Tax Efficient to Buy Property as a Sole Trader?

Try not to buy property as a sole trader if you are a higher-rate taxpayer i.e. paying tax at 40%, 50% or even 60%, especially if you can invest with a partner who is a lower-rate taxpayer.

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

It would be very poor tax planning on your end if you ended up paying 40%, 50% or 60% tax on all rental income, especially if you had a partner who could make use of the nil rate band or the 20% tax band.

5.4. How Do I Get a Mortgage If I Have No Income?

This is a very commonly asked question, especially by those families in which one partner does not work.

After all, if the other partner is a taxpayer (especially a higher-rate one), then it makes sense to buy investment property in the name of the non-working partner. This is to make use of their annual personal allowance.

In today's flexible mortgage market you can get a mortgage if you have little or even no income at all. However, you will probably have to pay a higher rate of interest and will have fewer lenders to choose from.

The banks may well ask for a guarantor just in case you fail to make mortgage repayments.

So, if you either inherit or are given a lump sum of money and you can find somebody who has faith in your property investment ideas—who is willing to act as a guarantor—then you can invest in the property market and start making use of that annual tax-free personal allowance!

There is no shortage of mortgage lending companies and Web sites where you can browse the products that are available.

You might find the following two sites particularly useful:

http://www.moneyextra.com;
http://www.paragon-mortgages.co.uk.

PLEASE NOTE: As with any financial decision, it is important that you speak to a regulated financial advisor before deciding on a particular product.

5.5. 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 PPR; see section 22 for further details.

6. Income Tax & Property Partnerships

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

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

6.1. 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, it is usually held in either of the following two ways.

6.1.1. Joint tenants

This method is most commonly 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, the surviving tenant becomes the sole owner.

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 automatically becomes the sole ownership of Alex, without the need to wait for grant of probate or administration.

6.1.2. 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, the property does not necessarily become the ownership of the surviving tenants.

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, 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.

6.2. When to Consider Buying in a Partnership

As we saw in section 5, 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; that is, if you pay tax at 40%. 50% or 60%, then your partner should pay tax at 20% or less;

b) you MUST be able to trust your partner(s).

If you are already a nil-rate taxpayer, then don't go looking for 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.

6.3. Partners Must Be TRUSTWORTHY

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

This is not just for tax reasons; it is simply good **BUSINESS PRACTICE**.

6.4. Partnerships between Husband and Wife

HMRC will treat all properties purchased between husband and wife (other than shares in a close company) as a 50:50 split, unless otherwise stated.

In fact, HMRC treat all jointly owned property between husband and wife as an equal 50:50 split, unless otherwise stated.

This means that unless you tell HMRC 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 HMRC 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 HMRC.

The following case study illustrates this scenario along with considerable tax savings.

Potential Tax Savings Between Husband and Wife

After five years of marital bliss, John and Lisa decide to buy an investment property.

John is a 40% tax payer, whereas Lisa is a homemaker 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 HMRC 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 £6,000 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 £5,400;
- John's share of the profit is £600.

Lisa has no tax liability as her profit is within her tax allowance, and John pays £240 tax his £600 profit.

If the property had remained as a 50:50 split, then the total joint tax liability would have been £1,200 (i.e. 40% of John's £3,000 share).

Therefore they have an annual savings of £960! Over 10 years, this gives tax savings of at least £9,600.

6.5. Partnerships between Those Other Than a Husband and Wife

If a property is purchased as a partnership between those other than a husband and wife, you **MUST** inform HMRC of the split.

In this type of partnership HMRC do not make any assumptions as to how the property is split. It is the taxpayer's duty to tell HMRC 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, in which he or she provides 70% of the deposit and you provide 30% of the deposit, then you must also inform HMRC of the 70:30 split.

6.6. How to Declare a Partnership Split to HMRC

If you are a husband and wife wanting an unequal split, then you must make a declaration to HMRC about the ownership split.

Such a declaration takes effect from the date it is made, providing notice of the declaration is given to HMRC via Form 17 within 60 days.

If you would like to download a copy of Form 17, please visit the following link:

>> http://www.hmrc.gov.uk/forms/form17.pdf

It is important to note that the form only covers the assets listed on it. This means that if you have other properties, they must also be listed to make HMRC aware of split.

Evidence of the ownership of the asset should also be provided to HMRC together with Form 17.

Please note that different HMRC offices differ with regards to what evidence is required to prove the ownership split for a property.

There are two common ways to prove the split.

a) Provide a signed declaration by the two parties concerned detailing that ownership of the joint property is split in a specific way.

This is acceptable to some HMRC officers.

However, other officers will want more formal proof.

b) Provide more formal property documents that include the following:
   i. the deeds of conveyance;
   ii. bank accounts (to see letters to and from the bank confirming the change).

The best thing is just to send in (a), but be prepared to send in (b) if HMRC requires it or asks any further questions.

6.7. Moving Properties into Joint Ownership to Avoid Income Tax

If you have realised from this strategy that you can save tax by holding your property in a partnership, then you may well be thinking about how to transfer to joint ownership.

Well, it is actually very easy to do, and you will incur *no* capital gains tax liability if you are transferring part ownership to your spouse, i.e., your husband or wife.

PLEASE NOTE: If part ownership of the property is to be transferred to anybody other than your spouse, then there may be a capital gains tax liability triggered.

6.7.1. Three simple steps to follow

The following three steps will show you how you can transfer the property into joint ownership.

<u>STEP 1. Contact your mortgage lender.</u>

Tell your mortgage lender that you want to transfer the property into joint ownership, and explain why you want to do this.

Your mortgage lender will then send you a new mortgage application form for you to complete in order to move the property into joint ownership.

Unfortunately, lenders will treat transferring an existing property into joint ownership as though you are applying for a new mortgage. Therefore it is very likely that you will have to submit the same paperwork again and effectively apply for a new mortgage.

It is likely that the property will be put into joint names on the same terms as the original contract; that is, if the original mortgage was fixed at 4.99% and had four years left to run on the fixed period, then the new mortgage will also be the same.

However, if mortgage rates have reduced, then be cheeky and ask if you can also have it at the new reduced interest rate!

<u>STEP 2. Contact a solicitor.</u>

Once your mortgage application has been approved, your solicitor can have all relevant documents changed into joint names pretty quickly. It usually takes about four weeks to complete all the legal paperwork.

Also, tell your solicitor whether you want the property to be owned as 'Joint tenants' or as 'Tenants in common', and how you want to split the ownership of the property. For example you may want to hold the property in the majority of the lower rate tax payer, so that you pay less tax.

Whenever a property is being purchased by more than one person or transferred into multiple ownership you solicitor should always ask you how you wish to hold the property.

STEP 3. Notify HMRC.

If you decide to have an unequal ownership split, then tell HMRC of this split as soon as possible.

Don't delay in notifying HMRC as it could well cost you in tax penalties.

6.7.2. Typical costs incurred when transferring

The costs that you are likely to incur when transferring the property will include the following:

- **Solicitor costs:** These are normally between £300 and £400. However, they will be less than the amount charged when buying a new house as searches will not need to be carried out again.

- **Mortgage lender fees:** The mortgage lender may or may not charge a fee for re-issuing the mortgage in joint names. Try hard to negotiate with them and see if they will waive it.

- **Stamp duty:** This may be payable dependent upon the mortgage amount that is being transferred. For example, if you are transferring more than £125,000 of the mortgage amount to your partner, then stamp duty will be payable at a minimum rate of 1%.

- **A valuation fee may also be incurred, especially if you are using the mortgage re-application** as an opportunity to release some equity from the property.

Please see section 17 to learn more about stamp duty.

It is important that you consider the tax savings you will make before you decide to transfer a property into joint names.

Ideally, you should calculate the cost of transferring the property into joint names and then consider how much income tax you will save on an annual basis.

The case study below demonstrates the importance of making such considerations.

Saving Tax When Moving a Property Into Joint Ownership

Alex has an investment property in his sole name and is a 40% taxpayer.

His wife, Lisa, is unemployed and has no intention of working.

Alex has an outstanding mortgage of £50,000 on the property, which is now worth £100,000.

He gifts 75% of the property to his wife and re-mortgages the property in joint names, with a 75:25 split in favour of his wife.

The cost of transferring into joint ownership is as follows:

- Solicitor costs	£500 approx.
- Mortgage lender fees	£variable
- Stamp duty	N/A. This is because 75% of the £50,000 mortgage is £37,500, and this amount is below the stamp duty threshold value.

He also calculates what the tax savings will be on an annual basis on a property income of £6,000.

Alex's tax liability	➔ 40% on £1,500 = £600	(based on 25% ownership)
Lisa's tax liability	➔ 0% on £4,500 = £0	(based on 75% ownership)

By having a 75:25 split, the combined tax liability is £600.

If Alex had kept the property in his sole ownership, then his tax liability would have been £2,400 (40% on £6,000 taxable property income) on an annual basis.

This means that both Alex and Lisa are making an annual income tax savings of £1,800.