CHAPTER 14
INTRODUCTION TO PROPERTY INCOME

In this chapter you will cover the rules for taxing property income including:
- types of property income;
- accruals basis;
- expenses;
- wear and tear allowances;
- losses;
- rent-a-room relief.

14.1 Property Income

In this chapter we will deal with income which is chargeable to tax as property income from a UK property business. A UK property business is a business which a person carries on for generating income from land in the UK. For example, property income from a UK property business includes rents from properties in the UK such as houses and flats. ITTOIA 2005, s.264

Property income also covers income from such sources as shooting and fishing rights. For instance, if a taxpayer owns some land which is let to a gun club for clay pigeon shooting, or if a taxpayer owns part of a river and sells fishing permits to anglers, such income is taxed as property income. ITTOIA 2005, s.266

Premiums on leases are also taxed as property income. A lease is a right to occupy land for a specified period of time. If a taxpayer owns a property and he grants a lease to another taxpayer in return for a payment of cash called a premium, that premium is chargeable to tax as property income. ITTOIA 2005, s.276; ITTOIA 2005, s.277

14.2 Accruals Basis

In order to calculate the taxable property income profit, we apply the accruals basis. This concept means that we do not simply take cash received less cash spent to give a cash profit.

The accruals basis involves taking rents receivable rather than rents received. Note the difference here. “Receivable” means the rents that relate to a tax year, which is not necessarily the same as the cash physically received.

From rents receivable we deduct any allowable expenses payable. Again note the use of the word “payable”. “Payable” means expenses that relate to the tax year, this may not necessarily be equal to the cash physically spent.

Rents receivable minus expenses payable gives the taxable property income profit (or in some cases the loss) for the year. Property income computations are always prepared for a tax year – i.e. from 6 April to 5 April.

\[
\begin{align*}
\text{Rents receivable} & \quad \times \\
\text{Less: Expenses payable} & \quad \times \left( \frac{X}{X} \right) \\
\text{Property income profit/(loss)} & \quad \times \left( \frac{X}{X} \right)
\end{align*}
\]
Illustration 1

A taxpayer starts to let out a property on 1 October 2015 and charges his tenant rents of £6,000 per annum. All of these rents are due for payment in advance on 1 October 2015. On 1 October 2015 the landlord receives £6,000.

Calculate the property income taxable in 2015/16.

The rents received in 2015/16 are £6,000, but this amount covers the period from 1 October 2015 to 30 September 2016 which is not the same as the tax year.

To work out how much of the £6,000 is taxable as property income in 2015/16, we simply do a time apportionment:

1 October 2015 – 5 April 2016
6/12 × 6,000 = £3,000

The other £3,000 will be taxed in 2016/17

14.3 Allowable Expenses

Expenses are deductible from rents only if those expenses are incurred “wholly and exclusively” for the business of the letting. Examples of deductible expenses will include agent’s fees and commissions and genuine repair expenses. ITTOIA 2005, s.272

By “genuine repairs” we mean we exclude any expenditure of a capital nature – i.e. any expenditure that improves or enhances the value of the property.

For example, if a tenant breaks a window and the landlord repairs that window, that is a genuine repair and the costs can be deducted from rents. Repairing a broken window has not enhanced the value of the property. However, if instead of simply repairing some broken roof tiles, the landlord takes the opportunity to replace his whole roof, there is obviously some degree of improvement here and the costs will not be deductible.

As technology develops over time, something that may once have been seen as an improvement may become a repair. For example replacing single glazed windows with double glazed windows counts as allowable expenditure on repairs. Changes in technology means that double glazing is now the standard and is no longer considered an improvement.

Where an item is attached to the building it becomes part of the building and therefore when the item is repaired or replaced, the expenditure is treated as a repair to the building and is therefore allowable. This includes items such as baths, toilets, washbasins and kitchen units. For example, the replacement of an old bath with a modern equivalent would be considered a repair. This is also the case where goods such as ovens and hobs fitted into units are repaired or replaced with ones of a similar standard.

However, HMRC has stated that the repair or replacement of free standing white goods, for example washing machines, fridges and freezers, is not a repair as the item has not become part of the property and therefore the expenditure is not allowable.
Even if the repairs are substantial, that does not make them capital provided that the character of the asset remains unchanged. For example, if a fitted kitchen is refurbished including replacement of base units, re-tiling, replacement of work tops etc, this will be a repair provided the kitchen is replaced with a similar standard kitchen. If additional units are fitted, the cost of these will be capital. However, if the whole kitchen is substantially upgraded, for example with standard unitse being replaced with expensive customised units then the whole of the expenditure will be capital.

Repairs to a property after it is acquired which are needed in order to make the property suitable for letting are treated as capital expenditure.

**Capital allowances** may be able to be claimed in respect of capital expenditure on plant and machinery used in the rental business. For example capital allowances can be claimed in respect of vehicles, computers and tools such as ladders and lawnmowers which are used in the property business.

However, capital allowances cannot be claimed in respect of furniture and household equipment provided for use in a furnished residential property. The one exception to this is if the property is a furnished holiday letting.

Any **water charges** or **Council tax** paid by the landlord are deductible expenses, as is any **interest paid on a loan** taken out to purchase the property in the first place. Many property purchases are funded by way of mortgages and if the property is subsequently let out, the mortgage interest is an allowable deduction.

**Insurance** premiums paid by the landlord are also deductible. In practice the landlord will usually be responsible for paying the buildings insurance, but any contents insurance tends to be the tenant’s responsibility.

The accruals basis applies in the same way for expenses and sometimes a landlord will incur expenses such as buildings insurance and council tax, both of which can be paid in advance to cover the forthcoming 12 months. For property income purposes, we apportion these expenses into the relevant tax year.

> **Illustration 2**

A landlord pays his buildings insurance premiums in advance. On 30 June 2014 he paid a premium of £600. One year later on 30 June 2015 he paid buildings insurance of £800.

**Calculate the expense deductible in 2015/16.**

The expenses deductible in 2015/16 will be:

**Buildings insurance:**


\[(3/12 \times 600) + (9/12 \times 800) = £750\]

Strictly an expense is not deductible unless it is **wholly and exclusively** for the purposes of the rental business. However, where an expense has both a business and a private purpose, HMRC will allow a deduction for a proportion of the expense where a definite part of it is wholly and exclusively for the rental business.

For example, if a property is let out for 11 months of the tax year and occupied by the taxpayer for the remaining 1 month, then 11/12ths of the total cost of expenses
such as council tax, insurance and utilities will be deductible, with only the 1/12th relating to private use not allowable.

14.4 Wear and Tear Allowances

We mentioned that capital allowances cannot be claimed in respect of furnishings in a residential property.

Instead, wear and tear allowances can be claimed in respect of furnished lettings. The allowances are essentially compensation given to the landlord for the dilapidation of any furniture, furnishings and equipment within the property. ITTOIA 2005, s.308A

Where an election for a wear and tear allowance is made, a deduction of 10% of the relevant rental amount is taken when calculating the profits of the property business.

The relevant rental amount is the total rental income accrued in the tax year less expenses in relation to utilities, council tax and any other expenses normally paid by the tenant which have been paid by the landlord in relation to the period when the property was let. So, if the property was available for letting for the whole year but was only actually let for 9 months in the tax year, only 9/12ths of the utilities and council tax charges would be deducted when calculating the available wear and tear allowance. The full amount for 12 months would still be deducted when calculating the taxable rental income.

Where the wear and tear allowance is claimed, no other relief is available in respect of the expenditure incurred on the furniture, furnishings and equipment. Note that a claim can still be made in respect of repairs to or replacement of fixtures which are an integral part of the building, as discussed earlier.

The election for the allowance must be made by the first anniversary of 31 January following the tax year.

Illustration 3

Roger lets out a property to a tenant, Sally for the whole of 2015/16. The property is furnished. Roger originally charged rents of £12,000 per annum payable monthly in advance, but he has increased the rents to £15,000 per annum with effect from 1 January 2016.

Roger has total expenses paid in the year of £16,950 as listed below:

<table>
<thead>
<tr>
<th>Description</th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on loan</td>
<td>4,000</td>
</tr>
<tr>
<td>Repairs to roof</td>
<td>600</td>
</tr>
<tr>
<td>New garage</td>
<td>11,000</td>
</tr>
<tr>
<td>Water charges</td>
<td>250</td>
</tr>
<tr>
<td>Council Tax</td>
<td>500</td>
</tr>
<tr>
<td>Buildings Insurance (1.10.15)</td>
<td>600</td>
</tr>
<tr>
<td>Total paid in year</td>
<td>16,950</td>
</tr>
</tbody>
</table>

The buildings insurance premium paid of £600 was a payment in advance on 1 October 2015. On 1 October 2014 Roger had paid a buildings insurance premium of £500.
Assuming that Roger makes all beneficial claims for relief, calculate his property income profit or loss for 2015/16.

<table>
<thead>
<tr>
<th>Rents receivable:</th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>12,000 × 9/12</td>
<td>9,000</td>
</tr>
<tr>
<td>15,000 × 3/12</td>
<td>3,750</td>
</tr>
</tbody>
</table>

Less: Expenses
- Loan interest 4,000
- Repairs to roof 600
- New garage (capital) -
- Water charges 250
- Council tax 500
- Buildings insurance (6/12 × 500 + 6/12 × 600) 550
- Wear and tear allowance (12,750 − 250 − 500) @ 10% 1,200

Property income profit 5,650

This property income profit of £5,650 will be taxed in 2015/16 as non-savings income.

14.5 Property Business Losses

Where expenses exceed income, a property business loss will arise. All profits and losses in the year are pooled together for these purposes to give an overall profit or loss for the year. A landlord renting out a number of properties has one UK property business and the net profit is taxable as non-savings income.

However, where the overall result is a loss, we insert a figure of nil in the property income line in the income tax computation. We should never insert a negative figure in the “income” part of our tax computation. A loss is effectively a profit of zero.

If a taxpayer has a property business loss, that loss can only be carried forward and set against property income from a UK property business in future tax years. The taxpayer cannot set a property business loss against non rental income. It must be carried forward and set against future rental profits. Neither is there any possibility of carrying the loss back to a previous tax year. ITA 2007, s.118

14.6 Nominal Leases

An exception to the general rule for losses concerns nominal or non-commercial leases. A nominal lease is one where the landlord does not charge the tenant a full market rent for the use of the property. So if a landlord lets out a property to a member of his family, this is likely to be a nominal or non-commercial lease.

In these instances, the rents received under the lease are taxable, but the expenses incurred in relation to the non-commercial let are only allowable up to a maximum of the rents received. In essence, the expenses will cancel out the rent leaving a nil profit, but no loss will arise.

14.7 Rent-a-Room Relief

If a landlord is letting out a room to a tenant in his home (i.e. his only or main residence), a special relief is available. Note here that the landlord and tenant will
be living in the same property, so the tenant is a “lodger” of the landlord. ITTOIA 2005, ss.784 - 802

If the tenant pays the landlord a rent of, say, £100 per week, this is chargeable to tax as property income. The landlord has two choices of method for calculating his property income profit for the year. His first choice is to prepare a normal property income computation by taking annual rents of £5,200 and deducting any expenses to give him a profit or loss.

The problem with this method is that it is difficult for the landlord to determine his deductible expenses, as he will have to take all of the expenses relating to the property and do some sort of apportionment. Remember that only part of the property is being let out – the remainder is the landlord's own home. This is a fiddly and time-consuming process. The legislation has therefore simplified the computation by using the rent-a-room scheme.

Again we start with the rental income of £5,200. This time in order to arrive at the taxable profit, we simply deduct the rent-a-room limit, which for the current tax year is £4,250. The excess of rents over the threshold is the taxable profit. Here it is £950. The amount of any allowable expenses is irrelevant.

Where gross rents are not more than £4,250, rent-a-room relief applies automatically and the rental income is exempt from tax. If allowable expenses exceed gross rents, a claim can be made for the relief not to apply in order to crystallise a loss.

Where gross rents exceed £4,250 a claim must be made for rent-a-room relief to apply. The relief will then continue to apply each year until the claim is withdrawn.

A few more small points about the rent-a-room scheme:

a. The landlord and the tenant must be sharing the landlord's home for the scheme to be applied, so it will not apply to normal commercial leases.

b. The £4,250 threshold applies per property and not per tenant. So if a landlord takes in 2 tenants, each paying rents of £100 a week, only one amount of £4,250 can be deducted.

c. If a property is jointly owned, half the rent-a-room limit is given to each joint owner (even if the rents are apportioned differently).

d. If rent-a-room relief applies, it does not affect the availability of Principal Private Residence relief when the owner comes to sell the property.

14.8 Interest Relief – Withdrawals of Capital

We have seen that the owner of a property business is allowed to claim interest relief on a loan to purchase the property (or properties) which he lets out.

Interest on the loan will be allowable in full - even where capital is withdrawn from the business - provided that the loan does not exceed the amount of the capital employed in the business. So, additional borrowings could be made in respect of a property with the funds being used for non-business purposes without there being a restriction in the interest relief available.
The “capital” employed in the business is equal to:

a. The value of the property (or properties) used in the business at commencement; plus

b. Any other capital used in the business at commencement (such as white goods, furniture, plant & machinery etc).

**Illustration 4**

Mr Hoylett owns a house in Colchester, which he bought 15 years ago for £125,000. He has a mortgage of £80,000 on the property.

Mr Hoylett has been offered a job in Sweden and is moving there to live and work. He intends to come back to the UK at some time. He has therefore decided to keep his UK house and rent it out while he is away.

His house in Colchester now has a market value of £375,000 (inclusive of furniture and fixtures).

Therefore, the opening balance sheet of his property business shows:

<table>
<thead>
<tr>
<th>£</th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td><strong>Liabilities:</strong></td>
</tr>
<tr>
<td>Property</td>
<td>375,000</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>375,000</td>
</tr>
</tbody>
</table>

Mr Hoylett locates a suitable apartment in Stockholm which will cost him £250,000. He renegotiates his mortgage on the house in Colchester to convert it to a buy-to-let mortgage and borrows a further £250,000 to buy the apartment in Stockholm. The bank also lends him a further £30,000 to buy a new car to use in Sweden.

His total borrowings are now £360,000.

The revised balance sheet of his property business shows:

<table>
<thead>
<tr>
<th>£</th>
<th>£</th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td><strong>Liabilities:</strong></td>
<td></td>
</tr>
<tr>
<td>Property</td>
<td>375,000</td>
<td>Mortgage</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Capital a/c b/fwd</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Less: Withdrawn</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Capital a/c c/fwd</td>
</tr>
<tr>
<td></td>
<td>375,000</td>
<td>375,000</td>
</tr>
</tbody>
</table>

**Explain the allowable deduction for the interest on the mortgage.**

Although Mr Hoylett has withdrawn capital from the business by using the additional mortgage funds for non-business purposes, the interest on the mortgage of £360,000 is still allowable in full against the rental income from the house in Colchester. It does not matter what the borrowings are actually used for provided the capital account is not overdrawn.

If the capital account becomes overdrawn, part of the interest is disallowable.
Illustration 5

Continuing our previous illustration, Mr Hoylett finds living in Sweden to be more expensive than he anticipated, so he borrows a further £25,000 to cover additional living costs.

The revised balance sheet of his property business shows:

<table>
<thead>
<tr>
<th>£</th>
<th>£</th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets:</td>
<td>Liabilities:</td>
<td></td>
</tr>
<tr>
<td>Property</td>
<td>375,000</td>
<td>Mortgage</td>
</tr>
<tr>
<td>Capital a/c b/fwd</td>
<td>15,000</td>
<td>Capital a/c o/d</td>
</tr>
<tr>
<td>Less: Withdrawn</td>
<td>(25,000)</td>
<td></td>
</tr>
<tr>
<td>_______</td>
<td>_______</td>
<td>_______</td>
</tr>
<tr>
<td>375,000</td>
<td>375,000</td>
<td>375,000</td>
</tr>
</tbody>
</table>

He now pays interest on a loan of £385,000.

Explain the allowable deduction for the interest on the mortgage.

Only interest on the loan up to the amount of the capital employed in the business is deductible from rental income (being £375,000). Therefore 10/385 of the mortgage interest will be disallowed. The £10,000 represents an overdrawn capital account which is being used to fund personal expenses.
EXAMPLES

Example 1

Mark lets out two furnished properties in the UK:

- Rent on Property X: £24,000 p.a. (started 1.9.2015)
- Rent on Property Y: £200 per month
- Loan interest 2015/16: £7,200 for X and £3,000 for Y

All the other expenses are paid by the tenants.

Calculate Mark’s UK property business income, assuming all beneficial claims for relief are made.

Example 2

Julian lives in a 3 bedroom house. He lets 2 rooms to students, each of whom pays rent of £80 per week.

Julian also owns a small flat which he leases to his grandfather for £10 a week. Expenses in the year relating to this flat were £2,000.

Calculate Julian’s UK property business income.
ANSWERS

Answer 1

<table>
<thead>
<tr>
<th></th>
<th>X</th>
<th>Y</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>£</td>
<td>£</td>
</tr>
<tr>
<td>Rents receivable:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>24,000 × 7/12</td>
<td>14,000</td>
<td></td>
</tr>
<tr>
<td>200 × 12</td>
<td>2,400</td>
<td></td>
</tr>
<tr>
<td>Less: Loan interest</td>
<td>(7,200)</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Less: Wear and tear allowance:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>– 10% × 14,000</td>
<td>(1,400)</td>
<td></td>
</tr>
<tr>
<td>– 10% × 2,400</td>
<td></td>
<td>(240)</td>
</tr>
<tr>
<td>Profit/(loss)</td>
<td>5,400</td>
<td>(840)</td>
</tr>
</tbody>
</table>

Overall UK property business income (5,400 – 840) 4,560

Answer 2

<table>
<thead>
<tr>
<th></th>
<th>£</th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>House:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rent receivable (160 × 52)</td>
<td>8,320</td>
<td></td>
</tr>
<tr>
<td>Less: Rent a room limit</td>
<td>(4,250)</td>
<td></td>
</tr>
<tr>
<td>Taxable Profit</td>
<td>4,070</td>
<td></td>
</tr>
<tr>
<td>Flat:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rents receivable (10 × 52)</td>
<td>520</td>
<td></td>
</tr>
<tr>
<td>Less: Expenses - limited to rents as nominal lease</td>
<td>(520)</td>
<td></td>
</tr>
<tr>
<td>Profit/loss</td>
<td></td>
<td>Nil</td>
</tr>
<tr>
<td>Profit for year</td>
<td></td>
<td>4,070</td>
</tr>
</tbody>
</table>