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Briefing document
Taxation of residential property income

Introduction
Individuals who receive rental income are subject to income tax on the net profits of their property rental business or businesses. Broadly, net profits are calculated by deducting expenses of the rental business from the income receivable. Specific rules apply to determine the extent to which relief is available for finance costs, such as mortgage interest.

This note sets out a high-level overview of the UK taxation of residential property income and is not a comprehensive guide. Unless otherwise stated, the taxation of UK and overseas property income is the same.

Basis of calculation
Details of the income and expenses must be declared on the individual's self-assessment tax return, which needs to be filed by 31 January following the end of the tax year on 5 April. The income is the total amount of rent received (or receivable if using the accruals basis) before the deduction of any expenses, such as agents' fees. The general rule is that expenses incurred wholly and exclusively in the course of running the rental business are deductible from the income receivable on a paid basis (or when accrued if the accruals basis applies). This includes expenses such as estate agents' fees, insurance, ground rent, repairs etc.

Capital expenditure and finance costs do not follow the general rule and are discussed further later in this briefing note.

Accruals basis
Historically, property income was generally taxable on an accruals basis and calculated on a tax year basis (i.e. to 5 April each year). The accruals basis means that individuals are taxed on the income receivable for the period concerned rather than the income actually received. In some cases, tax may be payable on rental income due but not received. Where this occurs and it later becomes clear that the rent will never be paid, the individual can claim the 'bad debt' as a deduction from their rental income in the tax year that the debt becomes bad.

The accruals basis is still relevant, but the cash basis (see below) applies by default instead for certain property businesses.

Cash basis for unincorporated property businesses
From 6 April 2017, the default position for unincorporated property businesses, other than Limited Liability Partnerships (LLPs), trusts, partnerships with corporate partners or those with receipts of more than £150,000, is to calculate their taxable profits based on cash received and paid. Landlords can however opt to calculate their profits on the accruals basis. To do so, an election must be made by the first 31 January following the normal Self-Assessment filing date for the return. Returns for the 2019/20 tax year must be filed by 31 January 2021 (assuming the return is filed online), so the election must be made by 31 January 2022.

Those with both a UK and an overseas property business are able to choose separately whether to use the cash basis or accruals basis for each. Those with a trade as well as a property business both eligible for the cash basis, are able to decide separately for each of these. Spouses or civil partners who jointly own a rental property for which taxable income is split equally, other than a furnished holiday let, must calculate the profits of their respective property businesses on the same basis. Other joint owners can decide independently.

There can be timing differences when calculating gross income and expenses under the cash and accruals bases of taxation, and further complications in some circumstances.

Joint owners
Where a property is legally owned jointly by spouses/civil partners, each individual is automatically taxed on half of the rental income. It is possible to make an election so that the individuals are taxed based on their beneficial ownership of the property. The election cannot be backdated and only applies from the date it is signed. The election must be submitted to HMRC within 60 days of being signed.

Broadly, when individuals who are **not** spouses/civil partners receive rental income they are subject to tax based on their beneficial interest in the property (i.e. based on the share of rental income they are legally entitled to receive).

Capital items
Generally, no relief can be claimed for items which are considered to be capital in nature. This would include, for example, the addition of a conservatory to a rental property. Such costs would normally be taken into account in calculating the gain when the property is sold.

For several tax years prior to 2016/17 it was not possible to claim a specific deduction from rental income in respect of the costs of furniture and other moveable items in residential lets, such as white goods (e.g. fridges). Instead, landlords of furnished properties were able to claim 'wear and tear' allowance. This was, broadly, a deduction of 10% of the gross rents receivable, regardless of the actual expenditure incurred. Landlords of unfurnished or part-furnished properties were not eligible for any form of relief on expenses incurred on furnishing, fixtures or white goods.

From the 2016/17 tax year onwards, relief has been available to all landlords based on the actual expenditure on replacement of these items ('replacement domestic items relief'). This means that landlords of unfurnished and part-furnished properties are now eligible for relief which was not previously available to them. Landlords of furnished properties now need to keep more detailed records than they did previously, and the extent to which the relief is available under the new relief compared to under the old allowance has changed depends on the level of expenditure incurred.

No capital allowances or deductions are allowed for other capital items in residential property. There are special rules for furnished holiday lettings which are considered below.

Finance costs
From 6 April 2017, new rules have started to be phased in in order to restrict the tax relief associated with finance costs, such as mortgage interest. By the time the new rules are fully in force in the 2020/21 tax year, rather than claiming relief for the expense in full, individuals will be taxable on net rental income before deducting finance costs and will receive a basic rate tax reducer for the finance costs (i.e. 20% of the finance costs paid will be deducted from the income tax liability for the year). This restriction will not apply to landlords of furnished holiday lets, (see below) who will continue to be eligible for full relief.

In 2019/20, 25% of finance costs paid can be deducted from rental income in full when calculating net profits. A 20% basic rate reducer (as defined above) is available for the other 75% of finance costs.

Where the cash basis applies, there may be a further restriction in the amount of finance costs considered for the purpose of the deductions and the basic rate tax reducer. The rules are complex, but generally they should only take effect where the outstanding loan exceeds the value of the property at the time that it was first let.

Property income allowance
An income tax allowance of £1,000 applies to property income, such that individuals with property income (before expenses) of less than £1,000 in a tax year will no longer need to declare or pay tax on that income. By default, expenses are disregarded, but individuals can opt out of the allowance and claim expenses instead. If income exceeds £1,000, the £1,000 allowance can be claimed instead of expenses if this is beneficial.

Furnished Holiday Lets (FHL)
There are different rules which apply to the taxation of income derived from an FHL. In order to be an FHL, the property must be in the UK or European Economic Area (EEA), be fully-furnished and let on a commercial basis. The property must usually have been available to let for 210 days and actually let for short-term periods (maximum 31 days per let) totalling at least 105 days in the tax year in order to be a FHL. If the availability and occupancy requirements are not met there are other, more limited circumstances in which the property may be considered to be an FHL.

The main differences in terms of calculation and taxation of FHL profits are:

- Where the accruals basis applies, capital allowances are available to be claimed against the rental income. Capital allowances can be claimed for items such as furniture and fixtures and fittings.
- Where the cash basis applies, expenditure on furniture etc. will generally be deductible as an expense of the property business.
- In addition, as noted above, landlords of FHLs are unaffected by the replacement of finance cost deductions with a basic rate tax reducer, which only applies to non-FHL residential lets.
- A beneficial capital gains tax rate may apply to capital gains realised on the disposal of FHLs as entrepreneurs' relief may apply.

There are potential VAT considerations which need to be taken into account and full advice should be sought in this regard.

Rent-a-room

Rent-a-room relief is available when individuals rent a part of their home to a lodger. The relief applies so that if £7,500 or less of rent is receivable, the rental income is not taxable. If the rent receivable exceeds £7,500, only amounts in excess of this amount are taxable. The £1,000 property allowance cannot be applied to income which is eligible for rent-a-room relief.

Alternatively, it is possible to elect out of rent-a-room relief, and instead pay tax on the full net rental income receivable, after deduction of a proportion of actual household running expenses on a just and reasonable basis.

Losses

UK non-FHL property business

All UK rental properties are considered to be part of a single rental property business and if, for example, a loss is incurred on one UK property this is automatically offset against the rental profits of any other UK properties, including profits from properties that qualify as UK FHLs. To the extent that losses are in excess of profits in the tax year, the losses carry forward to be set against future UK rental profits. The losses carry forward until the rental business ceases.

Non-UK non-FHL property business

Similarly, all overseas rental properties are considered to be a single overseas rental property business. For example, if rental profits on a Spanish property arise and rental losses on an American property arise, the losses incurred on the American property will be automatically offset against the profits from the Spanish property. Such losses may also be set against non-UK, EEA FHL profits. To the extent that losses are in excess of profits in the tax year, the losses carry forward to be set against future overseas rental profits, until the overseas rental business ceases.

There will be taxation considerations in each overseas jurisdiction in addition to the UK.

FHLs

All UK FHLs are considered to be one business and losses from FHLs in the UK can only be offset against profits from UK FHLs in the same or future tax years. Similarly, all FHLs situated elsewhere in the EEA are considered as one separate, non-UK, business and overseas losses can only be relieved against overseas FHL profits.

The Non-Resident Landlord (NRL) scheme

The NRL scheme may apply where a UK property is rented out by a person whose usual place of abode is outside the UK. This often, but not always, corresponds to being non-UK resident for tax purposes.

If the NRL scheme applies, 20% income tax should be deducted at source by the tenant or letting agent. The collecting tenant or agent may deduct certain expenses they have paid on the landlord's behalf from the gross income before calculating the tax due. However, the landlord may instead be able to register with HMRC under the NRL scheme to receive rents gross. Annual tax returns would then need to be completed to declare the tax due, in the same way as for UK residents.

Indirect property interests

This note is written on the basis that rental properties are owned personally by individuals. The position is more complicated if a UK resident individual has an interest in a non-UK resident entity that receives rental income, such as a UK resident who owns shares in a non-UK resident company that receives UK source rental income. In such cases, the individual may be taxable personally on rental income received by the company, even if the individual has not received any funds from the company.

The position will be further complicated from April 2020, as companies will be brought within the scope of corporation tax on UK property income from then onwards, rather than income tax as is currently the case. This is a complicated area, and you should contact your advisor for specific advice if this is relevant to your affairs.

Find out more…

This note reflects the law in force as at 2 August 2019. Please be aware that it does not cover all aspects of this subject. To find out more about any aspect of the above, please discuss with your usual Deloitte contact. If you do not have a usual contact, please contact Patricia Mock (pmock@deloitte.co.uk).

For further information visit our website at www.deloitte.co.uk