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How to Avoid Property Tax

By Carl Bayley BSc ACA

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About the Author

Carl Bayley is the author of a series of 'Plain English' tax guides designed specifically for the layman. Carl's particular speciality is his ability to take the weird, complex and inexplicable world of taxation and set it out in the kind of clear, straightforward language that taxpayers themselves can understand. As he often says himself, "my job is to translate 'tax' into English".

Carl enjoys his role as a tax author, as he explains: "Writing these guides gives me the opportunity to use the skills and knowledge learned over more than twenty years in the tax profession for the benefit of a wider audience. The most satisfying part of my success as an author is the chance to give the average person the same standard of advice as the 'big guys' at a price which everyone can afford."

Carl takes the same approach when speaking on taxation, a role he frequently undertakes with great enthusiasm, including his highly acclaimed annual 'Budget Breakfast' for the Institute of Chartered Accountants.

In addition to being a recognised author and speaker on the subject, Carl has often spoken on property taxation on radio and television, including the BBC's 'It's Your Money' programme and BBC Radio 2's Jeremy Vine Show.

Carl began his career as a Chartered Accountant in 1983 with one of the 'Big 4' accountancy firms. After qualifying as a double prize-winner, he immediately began specialising in taxation.

After honing his skills with several major international firms, Carl began the new millennium by launching his own tax and accounting practice, Bayley Miller Limited, through which he provides advice on a wide variety of taxation issues; especially property taxation, Inheritance Tax and tax planning for small and medium-sized businesses.

Carl is a member of the governing Council of the Institute of Chartered Accountants in England and Wales and a former Chairman of the Institute Members in Scotland group. He has co-organised the annual Peebles Tax Conference for the last seven years.

When he isn't working, Carl takes on the equally taxing challenges of hill walking and writing poetry and fiction. Carl lives in Scotland with his partner Isabel and has four children.

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Introduction

This guide was first published in 2002, as a response to the huge demand for advice on property taxation issues which we had been experiencing at Taxcafe.co.uk. That demand continued to grow at a phenomenal pace and is responsible for the fact that this guide is already in its twelfth edition, just seven years later, and has expanded to the nine chapters which you have here.

People in the UK have invested in property for centuries, but substantial increases in personal wealth and disposable income over the last few decades have combined with recent difficulties in other areas of investment and the pensions industry to make this an increasingly important area of personal financial planning.

The first few years of this century, in particular, saw phenomenal growth in the property sector, not just in the amount of property investment activity but also in the sheer numbers of people entering the property market as investors, developers and dealers. Whilst the big flotations of the 1980s acted to spread investment in stocks and shares into all sectors of society, the late 1990s and early years of this century witnessed a similar spreading of property investment.

'Property Investment' itself is a very wide term. A few years ago, the majority of new investors tended to be purely interested in the 'Buy-to-Let' market. As the property sector grew larger and more sophisticated, however, many other types of activity began to proliferate more widely, including 'Buy-to-Sell', 'Let-to-Buy' and, of course, a great deal of renovation, conversion and development activity. Beyond these, there also lie the fields of property trading and management.

When increasing property prices raised the barrier to entry, people found other ways to invest in property, such as investing abroad, or clubbing together to invest through syndicates or special purpose vehicles (often called 'SPVs').

All of these different types of activity are subject to different tax regimes and establishing the correct tax classification for each property business can be quite tortuous. One of our first tasks in this guide is therefore to help you understand how your own business will be treated for tax purposes and this is something which we will consider in depth in Chapter 2.

There are also many different reasons for becoming a property investor. Some fall into it by accident, finding themselves with a second property through marriage, inheritance or other changes in personal circumstances.

Others move into the property sector quite deliberately, seeing it as a safe haven providing long-term security and perhaps an income in retirement. Still others see the property market as a means to generate a second income during their working life. Some even enter the property business as a professional career. This 'new breed' of property investor is entering the market with a much higher degree of sophistication and is prepared to devote substantial time and resources to their business.

The last couple of years have, of course, seen enormous changes in the property market and in the economy as a whole and previously held views on the certainty of capital growth and the whole philosophy of 'you can't lose' have been questioned and found wanting.

Whilst these changes have been disastrous for some, they have created opportunities for others and the current unprecedentedly low level of interest rates means that, for many, rental profits are making up for the current lack of capital growth.

In effect, the current recession can be seen as part of an evolutionary process. The fittest property businesses will survive to become part of a stronger property sector in the future.

So, despite current difficulties, I personally believe that the property investment sector as we know it today is here to stay. Naturally, the sector will have its ups and downs, as any other business sector does, but the philosophy of property investment as a 'career move' is now so well entrenched that it has become impossible to imagine that it could ever disappear altogether.

The recent changes in both the economy and in tax legislation have dramatically altered the tax planning landscape for property investors. A few years ago, Capital Gains Tax was most investors' biggest concern. Today, Income Tax is becoming increasingly important.

In overall terms, however, tax remains as important to the property sector as ever; perhaps even more so. With the Government forecasting massive levels of national debt in a few years' time which we, the UK taxpayer, will have to repay, tax and tax planning are set to become a vital part of every business's strategy. Property businesses are no exception.

Significant future tax increases seem inevitable and it would be wrong to assume that taxes which currently seem relatively benevolent, such as Capital Gains Tax at 18%, will not increase massively within a few years. There may never have been another time when planning ahead to save tax in the future was as crucial as it is now.

Whatever reasons you may have for entering the property investment market, and whatever type of property business you may have, my aim in this guide is to give you a better understanding of how the UK tax system affects you and to show you how to minimise or eliminate your potential tax liabilities.

In the first two chapters of the guide, we will set the scene by looking at the different UK taxes which you will meet as a property investor and then looking at how they apply to the various different kinds of property business.

Chapters 3 to 7 are then devoted to explaining in detail how the UK tax rules currently apply to property investment and other types of property business and how you can minimise your own tax burden.

In Chapters 8 and 9 we will examine some more advanced tax planning strategies which you, the investor, can employ to reduce your tax burden. Chapter 8 is devoted to strategies available to individuals investing directly in property themselves. Chapter 9 then goes on to cover some of the other main investment structures and techniques available.

There are plenty of **'Tax Tips'** along the way to help you minimise or delay your tax bills, as well as **'Wealth Warnings'** designed to keep you away from some of the more treacherous pitfalls awaiting the unwary taxpayer and **'Practical Pointers'** which will make the whole process of meeting your obligations as a taxpayer as painless as possible.

I believe that this guide is now comprehensive enough to meet the needs of almost every property investor based or investing in the UK and I hope that, with its help, you will be able to enjoy a much larger proportion of the fruits of your endeavours.

Finally, I would just like to thank you for buying this guide and wish you every success with your property investments.

Scope of this Guide

This guide aims to help you understand the current UK tax system applying to property and also to help you plan for the future.

Some readers may, however, have capital gains on property disposals which took place on or before 5th April 2008 when the old, and rather more complex, Capital Gains Tax regime applied.

If you would like details of the old Capital Gains Tax regime applying to disposals made before 6th April 2008, please contact us at team@taxcafe.co.uk and we will be happy to provide you with a complimentary copy of an earlier edition of this guide in PDF format, which includes full details of that regime.

If you would like further help in computing your Capital Gains Tax position on any property sales taking place at any time, we would also recommend that you purchase a copy of the *Taxcafe.co.uk Property Capital Gains Tax Calculator*.

In this guide, we aim to cover as much as possible of the UK tax implications of investing in property, or running some other kind of property business. There are three different types of property investor for whom UK tax will be an issue. These three types of investor may be summarised as follows:

(i) UK residents investing in UK property.
(ii) UK residents investing in overseas property.
(iii) Non-UK residents investing in UK property.

Obviously, the same person might have investments falling under both (i) and (ii) and we will cater for that situation also.

Non-UK residents may also have overseas property investments, but these should generally be outside the scope of UK taxation.

For tax purposes, the UK does not include the Channel Islands or the Isle of Man, but comprises only England, Scotland, Wales and Northern Ireland.

Wealth Warning

It is important to remember that both UK residents investing in property overseas and non-UK residents investing in UK property may also face foreign tax liabilities on their property income and capital gains. Each country has its own tax system, and income or gains which are exempt in the UK may nevertheless still be liable to tax elsewhere.

Additionally, in some cases, citizens of another country who are resident in the UK for tax purposes may nevertheless still have obligations and liabilities under their own country's tax system. The USA, for example, imposes this type of obligation on its expatriate citizens.

It is only when talking about taxpayers who are both UK residents and UK citizens, and who are investing exclusively in UK property, that we can be absolutely certain that no other country has any right to tax the income or gains arising.

The tax-planning strategies outlined in this guide represent a reasonably comprehensive list of the main techniques available to all classes of property investor with UK tax obligations. More detailed information on the taxation issues encountered when investing in property overseas, including foreign taxation, is provided in the Taxcafe.co.uk guide *How to Avoid Tax on Foreign Property*.

Most of this guide is aimed primarily at those who are running a property business personally, jointly with another individual, or through a partnership. In Chapter 9, however, we will be looking at some of the tax advantages, disadvantages and other implications of investing in property through other investment vehicles, such as limited companies, limited liability partnerships, property trusts or pension schemes. A great deal more detailed guidance on the implications of using a property company is contained in the Taxcafe.co.uk guide *Using a Property Company to Save Tax*.

Those who have the benefit of being non-UK resident or non-UK domiciled may be able to employ some more specialised tax-planning techniques which are covered in further detail in the Taxcafe.co.uk guide *Non-Resident & Offshore Tax Planning*.

Finally, the reader must bear in mind the general nature of this guide. Individual circumstances vary and the tax implications of an individual's actions will vary with them. For this reason, it is always vital to get professional advice before undertaking any tax planning or other transactions which may have tax implications. The author cannot accept any responsibility for any loss which may arise as a consequence of any action taken, or any decision to refrain from action taken, as a result of reading this guide.

A Word about the Examples in this Guide

This guide is illustrated throughout by a number of examples.

Unless specifically stated to the contrary, all persons described in the examples in this guide are UK resident, ordinarily resident and domiciled for tax purposes.

In preparing the examples in this guide, we have assumed that the UK tax regime will remain unchanged in the future except to the extent of any announcements already made at the time of publication, including the Budget on 22nd April 2009.

Whilst it is probable that proposals announced in the Budget will become law, it is nevertheless worth bearing in mind that some of these proposals are not yet law and may undergo some alteration before they are formally enacted.

If there is one thing which we can predict with any certainty it is the fact that change **will** occur. The reader must bear this in mind when reviewing the results of our examples.

All persons described in the examples in this guide are entirely fictional characters created specifically for the purposes of this guide. Any similarities to actual persons, living or dead, or to fictional characters created by any other author, are entirely coincidental.

Chapter 1

What is Property Tax?

1.1 KNOWING YOUR ENEMY

We will begin this guide with an explanation of how the UK tax system applies to property investment and other types of property business.

This is essential because you cannot begin to consider how to avoid property tax until you actually understand what property tax is. In other words, you must 'know your enemy' in order to be able to combat it effectively.

It is important to understand that there is no single 'property tax', but rather a whole range of taxes which can apply to property. There is no point in avoiding one of these taxes only to find yourself paying even more of another!

Horror stories of this nature happen all too frequently, such as the taxpayer who managed to avoid 1% Stamp Duty on part of his new house, only to find that he was stuck with a 17.5% VAT charge instead!

Worse still was the taxpayer who undertook some Inheritance Tax planning on the advice of his lawyer only to find himself with a £20,000 Capital Gains Tax bill without any cash sale proceeds from which to pay it.

If only they'd spoken to a <u>real</u> tax expert first!

In this introductory chapter we will therefore take a brief look at the taxes which can affect the property investor and give some consideration to the relative importance of each.

Later, when we begin to consider tax-planning strategies, it is vital to bear in mind that it is the overall outcome which matters most, not simply saving or deferring any single type of tax.

In fact, I would go even further than that…

> ***Bayley's Law***
>
> *The truly wise investor does not seek merely to minimise the amount of tax payable, but rather to maximise the amount of wealth remaining after all taxes have been accounted for.*

If this seems like no more than simple common sense to you, then all well and good. However, in practice, I am constantly amazed at how often people lose sight of this simple fact and, in trying to save tax at any price, actually end up making themselves worse off in the long run!

1.2 WHAT TAXES FACE A PROPERTY INVESTOR?

The only UK taxes which are specific to property are Council Tax (for residential property), Business Rates (for commercial property) and Stamp Duty Land Tax.

However, the investor should not for a moment think this means that property investment gets off lightly under the UK tax system.

Far from it! Property investment is exposed to a huge range of UK taxes.

Tax is levied when property is purchased (Stamp Duty Land Tax), rented out (Income Tax) and sold (Capital Gains Tax). Property investors have to pay tax when they need to buy goods or services (VAT), when they make their investments through a company (Corporation Tax) and even when they die (Inheritance Tax).

Those who are classed as property developers or property traders will pay Income Tax and National Insurance on the profits derived from their property sales (or Corporation Tax if they use a company). Property developers must also operate and account for tax under the Construction Industry Scheme when using sub-contractors for even the most routine building work.

When the successful investor needs to employ help in the business, he or she will have to pay PAYE and employer's National Insurance. Doubtless, the investor will also be paying Insurance Premium Tax, as well as Road Tax and duty on the petrol they buy as they travel in their business. They may even be paying Air Passenger Duty if their business takes them far.

Faced with this horrifying list, investors might be excused for turning to drink, only to find themselves paying yet more tax!

1.3 WHICH TAXES ARE MOST IMPORTANT?

For most property investors, two taxes comprise the vast majority of the actual or potential tax burden which they will face during their lifetime. These are Income Tax and Capital Gains Tax and they are covered in detail in Chapters 3 to 6.

The exact way in which these two very important taxes will actually be applied to your property business will depend on exactly what type of property investor you are.

For tax purposes, there are a number of different categories into which a property business might fall and it is crucial that you understand how your business is likely to be classified before you can attempt to plan your tax affairs. I will return to this question in more detail in Chapter 2.

For some classes of investor, National Insurance will form what is effectively an additional layer of Income Tax and we will examine this extra tax burden in Chapter 5.

Other taxes which may also have a significant impact include Stamp Duty Land Tax and VAT. These are covered in Chapter 7.

For those investors using a company, Corporation Tax will become of equal, if not greater, importance to the two main taxes and Inheritance Tax is also likely to be a major concern for most property investors. These two important taxes are covered in the Taxcafe guides *'Using a Property Company to Save Tax'* and *'How to Avoid Inheritance Tax'*.

1.4 HOW DOES PROPERTY TAX COMPARE WITH TAX ON OTHER TYPES OF INCOME?

Property income might reasonably be described as 'middle-ranking' in terms of the level of tax which is levied on it in the UK. On the one hand, property income is treated less favourably than dividends – basic rate taxpayers have no liability on most dividends and higher rate taxpayers usually suffer an effective rate of only 25%.

On the other hand, however, one saving grace is that property rental income is not regarded as 'earnings'. This means that most property rental income does not give rise to any liability for National Insurance. This, in turn, means that the effective tax burden on rental income received is usually much less than for:

a) Self-employment or partnership trading income – most taxpayers have to pay an additional 8% in Class 4 National Insurance on the majority of their profits, plus £2.40 a week in Class 2 National Insurance. (The Class 4 rate drops to 1% for annual profits over £43,875, giving an overall effective 'top-rate' of 41% in combined Income Tax and National Insurance on this income.)
b) Employment income – the combined National Insurance burden for employers and employees on most earnings is 23.8%, giving an overall effective rate of 43.8% in combined Income Tax and National Insurance on most employment income. (The effective 'top-rate' of combined Income Tax and National Insurance is currently 53.8%!)

One can therefore readily see the massive advantage which rental income has over employment income with a lesser, but still significant, advantage over other forms of self-employment. Consider the following by way of illustration:

For a basic rate taxpayer with annual income of less than £43,875 to get an extra £100 in his or her pocket net of all taxes will require:

a) Their tenants to pay an extra £125.00 in rent (as a landlord),
b) Their customers to pay an extra £138.89 (as a self-employed trader), or
c) Their employer to pay an extra £163.48 in salary and National Insurance (as an employee).

Similarly, for a higher rate taxpayer to get an extra £100 in his or her pocket net of all taxes will require:

a) Their tenants to pay an extra £166.67 in rent (as a landlord),
b) Their customers to pay an extra £169.49 (as a self-employed trader), or
c) Their employer to pay an extra £191.19 in salary and National Insurance (as an employee).

Furthermore, most self-employed traders with gross annual sales income over £68,000 will also need to charge VAT on the figure given at (b) above, bringing the total extra charge required up to £194.91 (or £199.15 from 1st January 2010).

Naturally, however, the property market is not just about rental income and there are other forms of property income to be considered. The profit which property dealers or property developers make on the sale of their investments is treated as trading income and is subject to National Insurance as described above, just like any other trade.

Property management fees will also generally be treated as trading income subject to both Class 2 and 4 National Insurance.

1.5 WHAT ABOUT CAPITAL TAXES?

Unfortunately, this is where property investment really can suffer in comparison to other forms of investment.

The rates of Stamp Duty Land Tax on property are quite prohibitive (see Section 7.2), especially when compared with the single 0.5% rate of Stamp Duty which still applies to shares and securities.

In Chapter 6 we will be looking at the current system of Capital Gains Tax reliefs and exemptions. These can work well for the wiser and better prepared property investor, but it is nevertheless somewhat disappointing to note that the most popular forms of property investment fail to attract many important reliefs, including entrepreneurs' relief and rollover relief.

Worse still, if you are classified as a property dealer or property developer, the profits arising on the sale of your properties will be taxed as income, rather than capital gains. Generally speaking, this will be highly disadvantageous, although, as with most things in tax, there are exceptions (as we shall see later in the guide).

Finally (in more ways than one), there is the fact that Inheritance Tax will most likely be payable in full on most property investments if the investor fails to plan effectively during his or her lifetime.

1.6 DEALING WITH REVENUE AND CUSTOMS

At various points in this guide, you will see me refer to your 'Tax Office'. This is the HM Revenue and Customs office which sends you your tax return or, if you are not yet in the self-assessment system, the office which your employer deals with. Failing either of these, it will be the local HM Revenue and Customs office for the area where you live and can be found in the telephone directory.

Details of HM Revenue and Customs contact numbers can be found at: www.hmrc.gov.uk/menus/contactus.shtml

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