The Chartered Institute of Taxation

Application and Professional Skills

Taxation of Individuals

May 2021

Suggested answer

INTRODUCTION

This report has been prepared for Julia Anderson to consider the tax and National Insurance implications relating to:

1) 2 Orchard Road, Bournemouth (2 Orchard Road), including its use as a holiday let, the tax treatment of mortgage interest, and tax on the eventual sale of the property;

2) 7 High Street, Coventry (7 High Street), including an assessment of whether Julia should live there while working in Coventry;

It should not be relied on for any other purposes or by any other persons.

It is based on information provided by you in your email of 30 April 2021 and information held in our files and is based on legislation in force on today's date. If there is a delay in implementing our recommendations, a significant fiscal event (such as a Budget), or a change in circumstances, confirmation should be sought as to whether this affects the conclusions and recommendations in this report.

Chartered Tax Advisers

6 May 2021

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EXECUTIVE SUMMARY

2 Orchard Road, Bournemouth

Letting this property as a Furnished Holiday Let (FHL) rather than a long-term let will bring tax advantages, provided the specific conditions to qualify as an FHL are met.

Mortgage interest is tax deductible if you borrow for the purpose of the FHL business. Due to the expected level of profit, you will only get tax relief for interest on a loan up to around £140,000. By borrowing this amount to refurbish 2 Orchard Road you will save approximately £1,500 each year compared to if the funds are borrowed to purchase 7 High Street.

If 2 Orchard Road is run as an FHL for two years it may qualify for Business Asset Disposal Relief when it is sold. This will reduce the tax rate on the gain from 28% to 10% and save Capital Gains Tax on the disposal of approximately £43,000, based on a projected gain on sale of £250,000.

Therefore, it is recommended that 2 Orchard Road should be let as an FHL for at least two years, and that £140,000 of the £200,000 borrowed should be put towards the refurbishment of 2 Orchard Road and secured against the property before it starts to be used as an FHL.

7 High Street, Coventry

Interest on a loan to purchase this property will qualify for a 20% tax credit. It is therefore recommended that £60,000 out of the £200,000 loan is put towards the purchase 7 High Street.

The annual receipt of either a £6,000 allowance from your employer, or an additional £6,000 of rental income, will both be taxable at the same income tax rate. However, an additional £720 per annum in National Insurance is payable if the £6,000 is received from your employer and paid monthly, which will be reduced to £203 if the amount is paid in one annual lump sum.

Staying at 7 High Street would enable you to elect for the property to be treated as your main residence, exempting part of any gain on the property from Capital Gains Tax if you sell it in the future. Gains accruing during the time the property is your main residence are likely to be exempt, saving tax at 28%. If the gains are large, the saving could be significant.

A Main Residence Election can be delayed for up to two years following a change in your combination of residences. Therefore, it is recommended that you should stay at 7 High Street and accept the additional National Insurance expense, because this will give you the option to make a main residence election when you have more information about any changes in the value of 7 High Street. This should be reviewed in 18 months' time to ensure that an election is made within the two year time limit if beneficial.

MAIN REPORT

2 Orchard Road, Bournemouth

Furnished Holiday Lets

If you let 2 Orchard Road short-term to holidaymakers, as you are planning to do, it can potentially qualify as a Furnished Holiday Let (FHL).

The conditions to meet for 2 Orchard Road to qualify as an FHL are as follows:

- The property must be furnished
- The property must be available for commercial letting to the public for at least 210 days in the relevant 12-month period (usually the tax year)
- Out of those 210 days the property must be actually let out for 105 days or more
- Any longer periods of occupation over 31 days do not count towards either the 210 or the 105 day thresholds,
- Such longer periods must not constitute more than 155 days in the relevant 12-month period

There are several tax advantages available for FHLs which are not given to normal lettings. They include the following, which will be particularly relevant to you:

- Mortgage interest costs can be offset against income
- FHLs can qualify for certain reliefs against Capital Gains Tax

Given that your intention is to let the property furnished for short periods to holidaymakers, provided you manage to let the property for the required number of days, you should be able to meet the conditions to qualify as an FHL.

Tax relief on mortgage interest

You will borrow £200,000 to fund either the purchase of 7 High Street, or the refurbishment of 2 Orchard Road. The mortgage could be secured against either property. At an interest rate of 5% you will be paying interest of £10,000 per year on a mortgage of £200,000.

The letting of standard rental property, and the letting of an FHL are treated as separate businesses and tax relief on mortgage interest is treated differently depending on the type of rental it relates to. For a standard rental property, mortgage interest is not allowable as a deduction when calculating taxable profit. Instead, you are given a credit of 20% of the mortgage interest. This is how the interest will be treated if you borrow against 7 High Street, and it will therefore reduce your tax bill by a maximum of £2,000.

The restriction on the deduction of mortgage interest does not apply to an FHL. If 2 Orchard Road qualifies as an FHL, loan interest can be brought into account in calculating profit relating to this property, which will result in lower taxable profit, provided that the interest relates to a loan taken out wholly and exclusively for the purpose of providing this property for rental. A loan to pay for the refurbishment of 2 Orchard Road would meet this criterion.

In reducing your taxable profit, loan interest borrowed against an FHL also reduces your income for the purpose of calculating the High Income Child Benefit Charge (HICBC). You are subject to the HICBC on income between £50,000 to £60,000. Child benefit is effectively withdrawn progressively by means of a tax charge at the rate of 1% of child benefit for every £100 of adjusted net income over £50,000, until you reach £60,000 when the charge is equal to the full amount of the child benefit received. Over the next two years, you will be receiving child benefit of £1,820 pa for two children. This means that you suffer an effective tax rate of 58% (40% + 18%) on your income between £50,000 - £60,000. Interest payable on 2 Orchard Road is deducted from your income before the HICBC is applied, therefore the HICBC can potentially be reduced by interest payments if you borrow to refurbish 2 Orchard Road, but not if you borrow to purchase 7 High Street.

Although the interest is all allowable, the expected profit on 2 Orchard Road of £7,000 is less than the interest you will pay. Assuming similar income in future years, after interest is taken into account 2 Orchard Road will be producing a loss. This loss cannot be set against any income other than from the FHL, and as you intend to sell 2 Orchard Road it is unlikely that the loss will ever be used. Therefore, you will effectively only be getting tax relief on £7,000 of the interest paid, which will bring the profit on 2 Orchard Road to zero. Tax relief on £7,000 at 40% is £2,800, which is higher than the £2,000 maximum relief available if the mortgage is set against 7 High Street. When the HICBC is taken into account, you will save £1,474 per year by borrowing against 2 Orchard Road rather than 7 High Street, based on your current income and the projected profit from 2 Orchard Road (**Appendix 1**).

If your income from 2 Orchard Road were to fall, the saving would decrease, because only the interest which brings profit down to zero saves you tax. If your income was higher, there would be a greater saving as more interest would be allowable.

If you were to borrow against 7 High Street, finance costs allowable if borrowed against this property would be further restricted by any portion of the borrowing which does not relate to the rental, being the portion relating to you if you stay at the property, and your son if he is not charged rent.

If you are able to split the mortgage , with 70% (£140,000) borrowed to fund the work on 2 Orchard Road and 30% (£60,000) borrowed to fund the purchase of 7 High Street, this would be likely to give the highest amount of tax relief. Otherwise, it appears that you will save the most tax by borrowing against 2 Orchard Road. It is recommended that you check with your mortgage adviser whether the mortgage can be split without incurring additional expenses. If it can't, you should fund the purchase of 7 High Street from your savings, and pay for the refurbishment of 2 Orchard Road using the £200,000 mortgage, which you should secure against this property. To obtain the most favourable tax treatment of your interest payments, you should ensure that the letting of 2 Orchard Road meets the conditions to qualify as an FHL.

<u>Tax on Sale of 2 Orchard Road</u>

The costs of repairs to a rental property would usually be deductible against rent received, whereas making significant improvements or alterations is not allowable against income, and is instead included as part of the cost of the property, deductible against capital gains on sale. If some of the expense is revenue in nature, it may be possible to set it against income from 2 Orchard Road, once the FHL business commences. However, it appears that the significant work being carried out will be capital in nature, and will be reflected in the value of the property when it is sold. Therefore, for the purpose of this report it has been assumed that the entire £200,000 refurbishment expense is capital and will form part of the allowable cost on disposal of the property. A detailed breakdown of costs will be needed once the work has been completed to establish to what extent this is the case.

Based on the expected market value of £550,000 and cost of £300,000 (100,000 + 200,000), 2 Orchard Road will be standing at a gain of £250,000. Capital Gains Tax (CGT) is charged on residential property at 18% on gains which fall within the basic rate tax band, and 28% on gains above the basic rate. Based on current rates, CGT on the gain will be a maximum of £66,556 (£250,000 - £12,300 = £237,700 x 28%) if the entire gain falls within the higher rate tax band, or a minimum of £65,686 (£8,700 x 18% + £229,000 x 28%) if you have no rental income at all in the year of sale.

FHLs can qualify for Business Asset Disposal Relief (BADR). This is a relief which reduces the tax rate on the eligible gains to 10% (up to a lifetime limit of £1 million of eligible gains). If the sale of 2 Orchard Road were to qualify for BADR, tax on the gain would be £23,770 (£250,000 – £12,300 x 10%), a saving of £42,786 over the amount payable if the gain is all taxed at 28%.

To be able to claim BADR when you sell the property, you must ensure that it qualifies as an FHL for at least two years prior to the sale, and that it is sold within three years of the FHL business ceasing.

Therefore, it is recommended that 2 Orchard Road should be let as an FHL for at least two years prior to sale, and that the mortgage to buy 7 High Street should be secured against 2 Orchard Road before the property starts to be used as an FHL.

7 High Street, Coventry

Employment Expenses

You work for one week each month in Coventry, but your normal workplace is 100 miles away in Bristol. Because you spend less than 40% of your work days in Coventry, it is classed as a "temporary workplace", so you are not taxed on the travel and accommodation costs which your employer currently pays to enable you to work there.

If you stay at 7 High Street, the additional allowance your employer pays you will form part of your salary and will be subject to tax and National Insurance, because it is not reimbursing any specific allowable expenses.

Employment expenses are allowable if you are obliged to incur them as holder of the employment and they are incurred "wholly, exclusively and necessarily" in the performance of your employment duties. You can claim a deduction from your salary for any costs you meet out of your own pocket which meet this rule, or which form part of your travel and accommodation costs and are not reimbursed by your employer.

The allowable costs of travel include accommodation and meals while staying away on business. Therefore, if you stay at 7 High Street, you should keep records of the amounts you spend on meals and also of any additional household expenses incurred during the time you have to stay at the property for your employment, as these will form part of your accommodation expenses. Expenses which are allowable will include any additional costs you incur due to staying at 7 High Street because of your employment, such as your portion of utility bills. However any mortgage interest relating to your own accommodation at 7 High Street, which is not deductible as a rental expense (discussed above), is also not likely to be deductible as a work expense because the amount payable is not directly affected by your employment.

The mileage allowance paid by your employer for travel relating to your work in Coventry is not taxable based on business travel of up to 10,000 miles per year. If you travel more than 10,000 miles any amounts reimbursed over 25p per mile (for mileage over 10,000 miles) are taxable.

If you do not live at 7 High Street, you will instead be able to let an additional room, for which you will also receive £500 per month (£6,000 per year). Although this is the same amount as your employer will pay you if you stay at 7 High Street, and subject to income tax at the same rates, there is an advantage to getting £6,000 of rental income if you let the room rather than stay there as compared to receiving additional employment income. This is because your employment income is subject to National Insurance (NI), at 12% on income between the primary threshold and the upper earnings limit of £4,167 per month, and 2% above.

Your salary is currently £3,333 per month. As the allowance would be paid to you monthly, the full £500 would fall below the upper earnings limit and would be subject to National Insurance at 12%, which amounts to an additional £720 each year, paid through deduction from your salary by your employer. Any employment expenses you meet personally for which tax relief is claimed will not reduce your income for National Insurance purposes. If your employer is willing to pay you the £6,000 as one annual amount, National Insurance will be reduced to £203 (being £834 x 12 % plus £5,166 x 2%) as any amount which falls above the upper earnings limit for that pay period will be subject to NI at the reduced rate of 2%.

Expenses such as the hire of furniture or accountancy will not be deductible from your employment income, but they will be deductible when calculating the rental profit provided they are wholly and exclusively for the rental business. You expect these expenses to amount to £3,000 each year, regardless of whether you are living at the property or not. Although this may well be the case, if you live in the property expenses such as repairs or insurance may need to be apportioned because any portion which relates to your own occupation of the property (or your son's if he is not being charged rent) cannot be deducted from rental profit. You may instead be able to claim a deduction against employment income, as already outlined. For the purpose of forecasting your taxable income, it has been assumed that the entire £3,000 of expenses will be deductible, either against rental or against employment income.

Rent paid by your son

Any rent your son pays will be taxable on you as part of your rental income. As already outlined, your effective tax rate on this income could be as high as 58% when the HICBC is taken into account. As you intend to give the money back to your son, it is recommended that to avoid this tax charge you should not charge your son rent, and instead look at other ways to encourage him to save money. All calculations in this report assume that you will not receive any rent from your son. Any expenses relating to Steven will not be tax deductible if he does not pay any rent.

High Income Child Benefit Charge

The allowance from your employer and the additional rental income will increase your income above £50,000, so that your child benefit is withdrawn resulting in a high effective tax rate, as outlined above. Pension contributions are deducted when your income for the purpose of the HICBC is calculated, therefore you may wish to consider making additional contributions in order to reduce the HICBC clawback further.

Rent-a-room Relief

Even though you would be living at 7 High Street for one week each month, you would not be able to claim rent-a-room relief, because this only applies to the letting of rooms in your only or main home. Your main home remains your residence in Bristol, as that is where you spend most of your time and is where your other children will be living.

Main Residence Election

For Capital Gains Tax (CGT) purposes, you can make an election to nominate any property which you actually reside in as your main residence. Whichever property is your main residence benefits from Principal Private Residence (PPR) relief, which exempts gains accruing during the time it is your main residence from Capital Gains Tax.

Unlike under the rent-a-room scheme, the property nominated does not have to be the residence you spend the most time in, or the residence you use as your main address for everyday purposes. It does have to be a property you reside in some of the time, and your residence there must have a level of permanence. If you were to live at 7 High Street for one week each month, you would meet these conditions and could elect for this property to be treated as your PPR for CGT purposes.

This may be advantageous because you are expecting 7 High Street to increase in value substantially. Without a main residence election, when you come to sell the property, the increase in value will be subject to CGT. CGT is charged on residential property at 18% where gains fall within the basic rate tax band, and 28% above that. Based on your current circumstances, you would pay tax at 28%.

Currently, 15 Round Road is your PPR and has been since you purchased it in 2004. Without an election, your PPR is determined based on a combination of factors including where you spend the most time, where your children stay, and which address is used for registrations such as car and doctor. You can only have one main residence at a time, so while Round Road is your main residence, any gains accruing on 7 High Street will be subject to CGT when the property is sold.

The flip side of this is that if 7 High Street becomes your PPR, during the time 7 High Street is your PPR, 15 Round Road will not be. When you sell Round Road, any capital gain will be time apportioned between time that the property was your main residence, and time that it was not. Gains made during the time it was your main residence will remain exempt. The last nine months of ownership are given as a deemed period of occupation, so are also exempt, for any property which has been your main residence at some time.

A PPR election can be made at any time within two years of a change in your residences. After an election has been made, it can be varied at a later time by giving fresh notice to HMRC. Currently, 15

Round Road is standing at a gain of £250,000, which is all exempt due to PPR. If you nominate 7 High Street as your PPR you can then vary the election so that 15 Round Road is reinstated as PPR at a later point.

PPR Relief is not given for any parts of the house which are let out and which your tenants have exclusive access to. Presumably this would apply to each of your tenants' bedrooms at 7 High Street. However, if gains which accrue on the let parts of the house during the time it is your PPR are not more than £40,000, they are instead covered by Lettings Relief, which works in the same way as PPR relief.

Even if 7 High Street is your PPR for just a short period of time, this will be advantageous because it will exempt gains during the last 9 months of ownership from CGT, in addition to gains during the period it is nominated as your PPR. Any gain arising in 15 Round Road during this period is likely to be below the annual exempt amount, so no tax will be payable provided there are no other gains made in the same tax year.

Any saving through making a PPR election would only be realised when you sell 7 High Street. The amount of the saving would depend on how much the value of the property increases, but could be significant at 28% of the gain if you are a higher rate taxpayer at the time of the sale.

The two-year time limit for making a PPR election starts from the date you first use the property as a residence, rather than when you purchase it, so you could wait to move into 7 High Street until after you know with more certainty whether its value is likely to rise. However, if you don't live at 7 High Street now your circumstances in future may change so that you no longer have the option of living there, and any gain which accrues during the time you do not live there will eventually be taxed on sale.

Therefore, on the basis that you expect the property to increase in value substantially, it is recommended that you should live at 7 High Street. This will give you the option to make the election for it to be your main residence. The election can be delayed for just under two years from the date you move in, by which time you will have more information about the respective values of 7 High Street and 15 Round Road. We feel that the potential large CGT saving will outweigh the modest annual NI costs. We appreciate that you and your son may also wish to factor in any commercial considerations such as the pros and cons of living together before making a final decision.

<u>Stamp Duty Land Tax (SDLT)</u>

You will be liable to the 3% SDLT surcharge on the purchase of 7 High Street, because you already own other property. It would make no difference if you sold Coventry Road before buying 7 High Street, because you also have your home in Bristol. Therefore, there is no way to avoid the SDLT surcharge.

SDLT due on the purchase will be £10,000 (£125,000 x 3% + £125,000 x 5%).

<u>Inheritance Tax</u>

None of the transactions considered in this report would directly affect your potential Inheritance Tax (IHT) liability, which is calculated based on net assets. The value of your properties will be included in your estate for IHT purposes, regardless of whether they are let long-term, short-term, or used as a residence. Equally, any loans will reduce the value of your estate.

When you die, your estate will be shared equally between your children if you have no will in place, but will be liable to IHT at 40% on the value of assets over £500,000 (assuming you qualify for the Residential Nil Rate Band and leave your home to direct descendants). If the value of your assets at that time is £950,000 (15 Round Road £350,000 + 2 Orchard Road £550,000 + 7 High Street £250,000 minus mortgage £200,000, based on the assets you currently hold) IHT payable will be £180,000. You may wish to seek further advice in relation to your IHT position, including ensuring that you have a will in place.

APPENDIX 1 – comparison of tax due if £200,000 mortgage is borrowed against 2 Orchard Rd, Bournemouth or 7 High Street, Coventry (based on a full year's rental income)

Income source	Mortgage on 7 High St, Coventry	Mortgage on 2 Orchard Rd, Bournemouth
	£	£
Employment income	40,000	40,000
Employment benefits	1,300	1,300
2 Orchard Rd profit	7,000	-
7 High street profit (£12k – £3k)	9,000	9,000
Round sum allowance or additional rent	6,000	6,000
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Total income	63,300	56,300
Minus Personal Allowance	(12,500)	(12,500)
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Total income on which tax is due	50,800	43,800
	======	======
Basic rate £37,500 x 20%	7,500	7,500
Higher rate £13,300 x 40%	5,320	
Higher rate £6,300 x 40%		2,520
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Tax due	12,820	10,020
Less relief for finance costs	(2,000)	-
Plus HICBC (100% of CB and 63% of CB)	1,820	1,146
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Tax payable	12,640	11,166
	=======	=======
Difference		£1,474
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