

Buy-to-let property

According to the insurer Direct Line, there are already 3.2 million ‘second homes’ in the UK, an increase of 30% since the millennium. On top of that, approximately 800,000 Britons own holiday homes abroad, according to research by Mintel.

When considering tax issues on second properties we need to think about both income tax and capital gains tax.

Income tax

If you’ve bought buy-to-let property, the rents you earn are treated as taxable investment income. You’ll be taxed on the rent received minus what you pay out in various costs so, as a starting point, you need to keep records of all your income and outgoings. The following can be offset against rent:

Mortgage interest.

You cannot deduct the ‘principal’ – the amount of capital borrowed to fund your purchase, but you can offset the interest you pay on the debt. An interest-only mortgage costs less each month than a repayment mortgage (where, as well as paying interest, you’re also repaying capital each month).

In order to be able to offset the interest against rent, you must be using the mortgage wholly and exclusively for the property-letting business. You couldn’t, for example, take out a mortgage on a buy-to-let property that was originally bought for cash, and then treat the interest as tax-deductible. The only exception is where you’re borrowing against a property in order to buy a second one, because the Inland Revenue looks at your portfolio as a whole rather than individual properties.

The interest-offsetting opportunities extend to interest on any personal loan you have used “wholly and exclusively” on the property. So, if you raised the initial deposit through a personal loan, you could deduct the interest on that from your taxable rental income. Similarly, interest on a loan to upgrade the property – for example, to finance a new bathroom, double glazing or white goods – would be tax-deductible against rent (see below). Other tax-deductible expenses include:

Legal costs.

Legal fees for lets of a year or less, plus any other legal expenses, such as that of taking a tenant to court, are all tax deductible, as are accountancy fees.

Council tax, ground rents, service charges, utility bills.

If you pay any of these costs, then you can deduct them from tax.

Letting and management.

Any advertising expenses you incur in the process of finding a new tenant, as well as the costs of using a letting and management agent, can be offset against rent.

Repairs, maintenance and insurance.

The cost of any kind of work done, from window cleaning to sweeping the chimneys or sorting out the central heating, can be charged against rental income. Insurance

includes regular boiler or other maintenance contracts, as well as the usual buildings and contents cover. Maintenance is one thing, but upgrading is quite another when it comes to tax deductions. If you put in a smart new bathroom to replace the tatty one, or build a conservatory, you cannot deduct the costs against rental income, although you can offset the interest on any loan you take out to do the work.

What about furnished let's? In general, furnished properties are treated in the same way as unfurnished ones, but you can't deduct the cost of capital costs such as furniture or fittings. Instead, you have a choice of allowances to set against your rental profits: either an annual wear-and tear allowance of 10 per cent of the net rent (which is the rent less any costs you pay that the tenant would usually pay, such as council tax) to cover depreciation, or a renewals allowance, which is the net cost of replacing an item as and when that becomes necessary.

Most people choose the annual 10 per cent option, but once you have nominated the allowance you prefer, you have to stick with that.

Capital gains tax

Only your main home is exempt from capital gains tax (CGT) when you sell it. But you can take steps to reduce the amount of CGT payable on a second property. For a start, couples can use both partners' CGT annual exemptions (currently £10,600 per person) by registering the property in both names. Spouses can transfer assets to each other without any restrictions, so ownership of a second property could be split between them in the most tax-efficient way – not necessarily 50/50,

It may make sense for the lower-rate taxpayer to have the larger share of the property. Both partners would have their annual CGT exemption, and then they'd each be taxed at their marginal rate, 18 per cent for basic rate taxpayers and 28 per cent tax rates for higher rate taxpayers or 28 per cent for trustees or for personal representatives of someone who has died.

Bear in mind:

If you plan to keep the property to generate income in your retirement, you will need to set up some kind of repayment investment – such as an individual savings account (ISA) – that will repay the principal at the end of the mortgage term. Contributions to the investment cannot be offset against rental income.

Furnished holiday lettings have different (more generous) allowances, but there are strict rules about what counts as a holiday let.

If you're a UK resident, income from overseas property rentals is taxable in the UK, whether or not you bring it into the country. It's treated in the same way as UK buy-to-let properties (although the property will probably also be taxable in the country where it is located). Double-taxation agreements provide for various tax reliefs on a country-by-country basis where these are in existence.

If you lived in the property as your principal private residence (PPR) before renting it out, there may still be no CGT to pay, provided you sell within the first three years of moving out yourself. Finally, don't forget "flipping". If you have lived in a rented property at any time there is partial PPR and letting relief available.