Tax Treatment of Refurbishments

By specialist property accountant **Stephen Fay** ACA

The standard of rental property these days is much higher than has historically been the case. To stay ahead of the game, many investors are refurbishing their property, often before the first let, to a high standard, and so refurbishment costs are often big money. So, it's vital that investors appreciate the tax consequences of their refurbishment spending, so that they factor this into their financial plans. This article looks at how refurbishment costs are treated for tax purposes.

Understanding what a repair is

Most day-to-day maintenance works are simple repairs and replacements of assets within a property. These costs are therefore treated as 'revenue' costs, as they are deducted from revenue (income) to arrive at a rental profit. Examples include: replacing kitchens & bathrooms, re-wiring, decorating, repairing roofs and gutterings etc.

'Capital' costs include the cost of the land & building itself, plus any refurb spend that isn't a simple repair. Relief for capital costs is provided when the property is sold. For example, converting a loft in a HMO to create another letting room is capital, even if the roof needed repair in any case.

Most investors prefer costs to be 'revenue' because there is an immediate tax deduction, whereas relief for capital costs might come 20+ years later when a property is sold.

The above applies to companies as well as individuals.

Refurbishment before the first tenant

Often, investors will complete a significant refurb before the first tenant moves into a property. Some investors think that the pre-first-let timing of the refurb automatically makes the spend capital - it does not. The mere fact that repairs are undertaken not long after the property is acquired does not, in itself, make the cost capital. However, the most likely timing of any capital works is before first let, so it is essential to ensure costs are claimable as revenue.

Only the costs of bringing a derelict or very run-down property up to an acceptable standard for letting are capital (the purchase price often indicates this).

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'Modern equivalents' works

Sometimes it is uneconomic to repair an asset, or, modernisation is better. Examples include replacing single glazing with double glazing windows, or wooden gutterings with modern plastic. Where such 'modern equivalent' replacements are used, even if there is some improvement, the costs are treated as revenue. The 'improvement' element would need to be substantial, for the costs to be treated as capital - for example, replacing an old conservatory with a new brick-built extension.

In my experience of dealing with hundreds of landlords, it's rare for general works to be treated as capital, and where that is the case, it is usually beyond any doubt. Again, this is an area where many investors are too cautious in their view of capital vs revenue - seek professional advice as often the sums involved are significant!

Proving that works are repairs

If mortgaged, the property will have been surveyed by the lender. On the survey report, the surveyor will have indicated if the property was in suitable condition to be let. If 'yes', this is good evidence that costs incurred after purchase but before first let were general repairs and so revenue costs.

If a retention is placed on the mortgage offer, again, this provides good evidence as to the proportion of the works that is capital vs revenue. Surveyors often state that 'floorings, kitchen and electrical fittings need updating' - so, in the event of a £3k retention (say), we might treat £3k of the refurb costs as capital, and the remaining £4k as revenue.

Other useful proof is video or photographic evidence - to show that the property was fit for let before works. If the property was bought already-let, again this is good evidence of condition.

Finally, be sure to have tradesmen describe the works carefully on their invoices. HMRC will only ever conduct a 'desktop' check of the tax treatment of costs - they won't visit your property - so we need to make it easy for an Inspector to agree with us - evidence helps to do this.

Projects with a mix of capital and revenue works

Often, landlords will delay repair works as there are planned substantial capital works. These works will therefore comprise part-revenue repairs, and part-capital. We ▶

therefore need to, at a detailed level, split the spend between capital and revenue, to find the revenue costs to be included in the rental accounts. Usually, this detailed work results in a higher revenue deduction than the investor expects.

Capital works - examples

It is usually HMO landlords that do capital works to properties - since they are trying to add rooms to let to their property. So, works such as new lofts / basements / extensions / en-suites / new walls, are all capital works.

By contrast, it is rare for single-let landlords to do capital works as there is usually little incentive in terms of extra rent. For example - few landlords will add a garage to a property (capital works), because the £5-10k cost is not justified by the £25-50pm rent increase (or, no rent increase!).

Minor refurbishment works

Often, there is a small degree of 'improvement', which strictly should be split out and treated as capital. However, by HMRC concession, such works are treated as fully revenue spend, since the capital element is small and incidental. I often see investors agonising over small amounts of spend, or producing elaborate breakdowns to support a revenue treatment - this isn't necessary!

Provisions - useful!

A 'provision' allows an investor to include the cost of refurb works into their accounts and tax return for the year, even if the work has not yet been completed, or, if it has been completed but the invoice has not been received or paid by year-end. To do this, the investor must have actually incurred the liability - for example, the works have been ordered by the freeholder, or the works have been done but are not invoiced.

Note - insurance proceeds, or grants received, must be offset against the cost of the works i.e. these are taxable.

To sum up...

Many landlords spend big money on maintaining their property, ensuring a high standard which translates into better rents and occupancy i.e. it makes business sense! Care needs to be taken to ensure that the maximum amount of spend is treated as revenue, and so available for immediate tax deduction, as this is often one of the main areas that is looked at in a HMRC Tax Investigation.

Given the harsh HMRC penalty regime, errors that are picked up can result in substantial penalties, plus additional tax and interest. So, it's worth spending some time, and taking good advice, to get the maximum legitimate tax deduction! PIN