I'VE MADE A PROPERTY RENTAL LOSS – WHAT CAN I DO WITH IT?

Making a tax loss is fairly typical during the initial 'portfolio build' phase of a property investor's journey. This article considers how losses can be used, and how maximum benefit can be derived from any tax loss.

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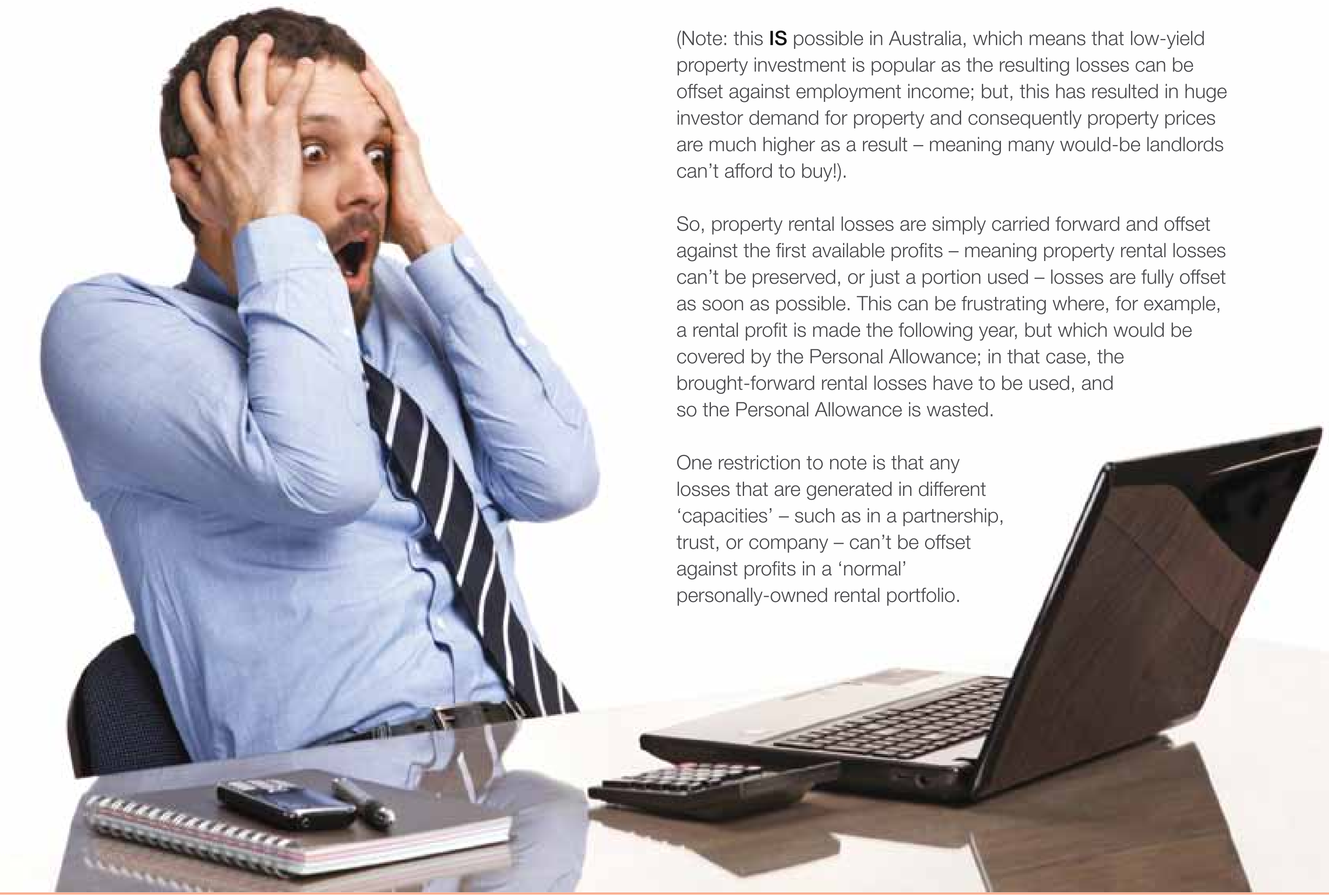
HOW DOES AN INCOME TAX LOSS ARISE?

An income tax loss occurs when allowable property expenses are greater than property income in a given year.

Typically, in the early years of portfolio growth, income tax losses will be generated, often despite positive cashflow. It often puzzles investors why they have cash in the bank yet a loss on their tax return – the reason is usually because in the first year of owning a property only a part-year of income is received, and there may be significant costs in setting up a property (initial refurbishment, mortgage / valuation fees etc.) for first let.



Of course, part of the reason that an income tax loss may occur is because of the various reliefs and allowances that may be legitimately claimed, but which are paid out by the investor, such as home office allowances and the 10% wear and tear allowance. Hence, it may be perfectly possible to have a positively cash-flowing portfolio and incur an income tax loss.

WHAT CAN I DO WITH AN INCOME TAX LOSS ON MY RENTAL PORTFOLIO?

Property rental losses are 'relieved' (used) against future property rental profits. Sadly, it isn't possible to offset property rental losses against other income, for example a PAYE day-job, to obtain a tax repayment.

(Note: this **IS** possible in Australia, which means that low-yield property investment is popular as the resulting losses can be offset against employment income; but, this has resulted in huge investor demand for property and consequently property prices are much higher as a result – meaning many would-be landlords can't afford to buy!).

So, property rental losses are simply carried forward and offset against the first available profits – meaning property rental losses can't be preserved, or just a portion used – losses are fully offset as soon as possible. This can be frustrating where, for example, a rental profit is made the following year, but which would be covered by the Personal Allowance; in that case, the brought-forward rental losses have to be used, and so the Personal Allowance is wasted.

One restriction to note is that any losses that are generated in different 'capacities' – such as in a partnership, trust, or company – can't be offset against profits in a 'normal' personally-owned rental portfolio.

This makes it very important when preparing property accounts to ensure that allowances and claims are made as beneficially as possible by the different entities.

THE EXCEPTION – LOSSES ARISING FROM CAPITAL ALLOWANCES CLAIMS

A very useful exception to the 'carry forward' loss relief rule for rental losses relates to capital allowances. To the extent that a rental loss relates to capital allowances, that element of a loss can be offset against non-rental income, to generate an immediate tax repayment.

For example, let's say a £2,000 loss was made by a person with a PAYE income on which they pay 40% income tax, and that half of the loss resulted from capital allowances (e.g. purchase of a new computer). That person could claim £1,000 of the loss against their PAYE income, and receive a tax repayment of £400 – rather than just carrying forward the loss. Note that the maximum amount of loss must be relieved if this option is chosen.

Obviously, generally the preference is to get tax relief for losses as soon as possible, and so offsetting the capital allowances element of the loss against income in the same year is the common strategy. However it is possible to apply the income-offset in the following year, which could be useful for example if the person's next-year income tax rate increases, say, to the 60% effective income tax rate paid on income between £100,000-120,000.

THE RULES ABOUT USING RENTAL LOSSES SEEM VERY RESTRICTIVE – WHY IS THAT?

A property rental business is treated by HMRC as an 'investment', rather than as a 'trade'. On the positive side, this means that profits from renting residential property are not subject to National Insurance – unlike PAYE income, for example – which can add as much as half again to tax bills. The down-side of this is that losses aren't as flexible as when incurred by a 'trade', i.e. a 'normal' non-property business (plumber, florist, shop etc.).

WHAT IF I MAKE A RENTAL LOSS EVERY YEAR?

Consider whether you are in the right business! Joking aside – losses are simply added to the total, and carried forward. However, there is a serious point here: many investors carry loss-making properties for long periods, rather than dealing with the underlying issue of a lack of profits. Remember, the aim is to make profits, even if a tax bill results.

HOW LONG DO RENTAL LOSSES LAST FOR?

Property rental losses are carried forward year-on-year until fully utilised – so, until death potentially! On death, any rental losses are lost, as rental losses can't be transferred from one person to another, or 'inherited' on the death of an individual.

One tax-planning point to therefore consider is that where a portfolio is owned by several people, it may be better for older owners to allow younger owners to take more of the general business expenses, so that any loss is taken more by the younger owners.

This may sound a macabre – even ruthless – point, but we have recently taken over a family rental portfolio where the father had died. As little care had been taken by the former accountant, much of the initial rental loss was in the father's name, rather than his children. The family are therefore facing income tax bills much earlier than they should be, as the father's losses were lost when he died.

However, generally, losses are lost after 3 years if a landlord sells his last rental property; so, it always makes sense wherever possible to ensure that all rental losses are utilised before selling the last property.

CAN PROPERTY RENTAL LOSSES BE BOUGHT OR GIFTED?

Sadly, no. It isn't possible for a person to buy rental losses from another person, nor can a person give away their losses. Rental losses are incurred and 'booked' to a person, and stay with that person.

However, this does give rise to a useful tax-planning point: if property investors are buying a high-yield property together, it makes sense wherever possible for any person with rental losses to be the 'beneficial' owner of that property. The beneficial owner accounts for the rental profits, and would then offset the profit against their losses, meaning no tax is payable. This benefit can then be shared with the group to minimise the tax paid by the group. (Note: a simple deed of trust arrangement can be used to make a person the beneficial owner of a property if s/he is not the legal owner).

SUMMARY

No property investor sets out to make rental losses.

But, rental losses are useful, as they can be used to reduce future income tax bills. Therefore, having an appreciation of how losses arise, and are used, and possible tax-planning and accounts options available, should allow the canny property investor to make best use of any losses, and so ultimately save tax as a result.