# SPENDING MONEY ON PROPERTY REPAIRS …

## … TO OFFSET THE IMPACT OF 'SECTION 24' MORTGAGE INTEREST RELIEF RESTRICTIONS

By specialist property accountant **Stephen Fay** FCA

**The single biggest tax issue facing many landlords who own mortgaged residential rental property is the introduction of the new (as of tax year 2018) mortgage interest relief restrictions known as 'Section 24'. This article looks how landlords can spend money on property repairs to help to mitigate the impact of this significant worsening of the tax regime for private landlords (meaning, landlords who own their property in their own personal name or in a partnership).**

## SECTION 24 – A QUICK RECAP

The Section 24 mortgage interest restrictions mean that between tax years 2018-2021, claiming mortgage interest as an expense will be progressively phased out, and instead replaced with a tax credit at a fixed rate of 20%, regardless of the tax rate of the individual. The impact of this in many cases can convert a Basic Rate (20%) taxpayer into a Higher Rate taxpayer, without any change to the underlying property rental profits.

| | £ |
|---|---|
| Rental profit EXCLUDING finance costs | 60,000 |
| Interest payable | 30,000 |

| | No Section 24 | | Full-impact Section 24 (no repairs) | | Full-impact Section 24 (extra £10k of repairs) | |
|---|---|---|---|---|---|---|
| **Income calculation** | **£** | **£** | **£** | **£** | **£** | **£** |
| Non-property income | 0 | | 0 | | 0 | |
| Rental profit EXCLUDING interest | 60,000 | | 60,000 | | 50,000 | |
| Interest payable | -30,000 | | | | | |
| Total income | 30,000 | | 60,000 | | 50,000 | |
| **Tax calculation** | | | | | | |
| Personal Allowance | 12,500 | 0 | 12,500 | 0 | 12,500 | 0 |
| Basic Rate tax band (20%) | 17,500 | 3,500 | 37,500 | 7,500 | 37,500 | 7,500 |
| Higher Rate tax band (40%) | 0 | 0 | 10,000 | 4,000 | 0 | 0 |
| | 30,000 | 3,500 | 60,000 | 11,500 | 50,000 | 7,500 |
| **Interest tax relief (20%)** | | | 30,000 | -6,000 | 30,000 | -6,000 |
| **Final tax bill** | | **3,500** | | **5,500** | | **1,500** |

**OK, so how can spending money on repairs help from a tax and Section 24 view?**

Property repairs are of course a legitimate business expense for a landlord, and so will reduce taxable profits on a £ for £ basis. Therefore now more than ever there is a significant tax benefit in spending money on repairs which maintain and improve the value of a rental property.

For a Basic Rate taxpayer in the example above, the tax benefit of a £10k refurb **BEFORE** Section 24 was £2k (20%), however with Section 24 fully in force the tax benefit of the same £10k refurb **DOUBLES** to £4k (40%).

**OK, that sounds like a good deal – but aren't I in business to make money? If I spend all my profits on repairs how does that make overall sense?**

Fundamentally, of course, repairs have to be necessary and value for money in order to make overall business sense (so, no gold taps and marble bathrooms just to get a tax benefit!).

But sensible money spent on maintaining a rental property to the right standard to attract and retain good tenants is usually money well spent – and translates into better rent levels and occupancy.

Spending money on repairs isn't a case of all or nothing – in the example above just £10k of extra repairs would have completely eliminated the impact of Section 24, and so there wasn't a need to go further than that (from a tax-planning view) once the Higher Rate tax exposure had been eliminated.

Example of routine regular repairs and renewals that almost all properties require are:

- **Replacement kitchens and bathrooms**
- **Decoration and replacement carpets**
- **Upgrade of single-glazing windows to double-glazing**
- **Upgrade of electrics and plumbing to modern-day standards**

Less regular but nonetheless important repairs and renewals include:

- **External pointing and brickwork to improve kerb appeal and ensure a watertight property**
- **Replacing boiler and water tanks**
- **Internal plastering and skimming**
- **Replace damp proof course and external flashings, repair chimneys and flues, etc**
- **Roof tile / felt / battens repairs and replacements**

**What is a 'repair' for tax purposes?**

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 – the following provides further guidance:

**1. PRE-FIRST-LET REFURBS**

Often, residential landlords will complete a refurb before the first tenant moves into a property. 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 by carefully detailing all works and allocating between capital / revenue.

**2. 'MODERN EQUIVALENTS' REFURBS**

Sometimes it is uneconomic to repair an asset, or, modernisation is better. Examples include replacing single-glazing with double-glazing windows, or iron guttering 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.

**3. HOW TO PROVE YOUR REPAIRS ARE REVENUE**

If mortgaged, the property will have been surveyed by the lender. On the survey report, the surveyor will have indicated if the property was currently lettable. 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 only need to treat £3k of the refurb costs as capital.

"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.

**4. 'INCIDENTAL' IMPROVEMENT**

Often, there is a small degree of incidental improvement when completing a refurb, which strictly should be split out and treated as capital. However, by HMRC concession, such works are treated as fully revenue spend, where the capital element is modest and incidental.

**5. REPAIR PROVISIONS**

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 yet invoiced.

## TIMING OF EXTRA REPAIRS – PHASING OF SECTION 24

Spending more on property repairs and maintenance makes tax sense for landlords who are Higher Rate taxpayers, given HMRC are effectively paying 40% of the cost via tax relief. But, bear in mind that Section 24 phases in over four tax years (2018, 2019, 2020, 2021), with 25% / 50% / 75% / 100% of finance costs in those years being replaced by a flat-rate 20% tax credit.

So there is some tax sense in spreading additional (non-emergency) repairs into future years, to ensure a Higher Rate (40%) tax benefit, rather than embarking on a single-year very significant repairs programme, which may mean that some of the spend is only tax-deductible at the Basic Rate (20%) rather than the Higher Rate (40%) of income tax.

## BALANCING TAX-PLANNING WITH OTHER CONSIDERATIONS

Spending more on property repairs and maintenance makes tax sense for landlords who are Higher Rate taxpayers, given HMRC are effectively paying 40% of the cost via tax relief.

However, as mentioned earlier, it is only beneficial to make necessary and value-for-money repairs, even with the tax benefit. For my own portfolio, there is always a property that could do with a new boiler / kitchen / bathroom / some tiling or flooring / external works / decorating, etc – I would be surprised if the average portfolio landlord ever runs out of repairs to pay for.

Also, it's tempting as a landlord to only ever spend money on repairs between tenancies, but keeping repairs ticking over can make for happy tenants and avoid the void in the first place.

Often tenants will also chip inwith labour and pay towards mid-tenancy repairs, which can keep tenant satisfaction high and maintain rent and occupancy levels (don't forget the fundamentals of renting property haven't changed with the introductions of Section 24 – this is a 'fixed cost' business where the big costs are largely fixed and income rate and occupancy levels determine overall profits, like hotels and airlines for example).

## IN SUMMARY …

Spending money on necessary and value-for-money repairs can mitigate the impact of Section 24 mortgage interest relief for 'private landlords' (ie those not operating via a company) who are pushed into being Higher Rate (40%) taxpayers as a result. Most landlords can see the sense in spending money on minimal repairs, but there is also now a substantial tax benefit in many cases in spending more on water-proofing, weather-proofing, kerb-appeal improvements, as well as the more usual kitchens / bathrooms / decoration. And, keeping paying tenants happy with sensible and business-savvy repairs that HMRC chips in 40% for sounds like a good way to operate a successful property rental business.

Visit our website (www.fyldetaxaccountants.co.uk) for useful tools, tax tips and free reports.