



# maidment judd

Chartered Accountants

## Tax Free Income Anyone?



The idea of tax free income is always appealing and there are a number of legitimate sources by which such income can be obtained. Individuals wanting to earn some extra cash and who have a spare room in their home can take advantage of the rent-a-room scheme and make up to £4,250 tax-free a year.

The rent-a room scheme was introduced in 1992 in a bid to increase the supply of private residential accommodation. To encourage people to let out spare rooms in their home, the rental income received is tax-free up to certain limits.

### Main Residence

The scheme applies to rent received from letting a room in the individual's main residence. This is essentially the home in which they live. It does not have to be a home that they own. The scheme applies equally to a room let in rented properties as it does to owner-occupied properties, although those in rental accommodation are advised to check the terms of the lease to ensure that sub-letting is permitted.

The range of properties that qualify is also wide. The room made available for letting does not have to be in a house. The scheme applies equally to flats, caravans, houseboats, etc. The only condition is that the property is the individual's main residence.

In the event that the individual has more

than one home, the relief only applies to a room let in the property which is the individual's main residence, in which he or she lives. Essentially, to qualify for the tax-free income the individual must share his or her home with a lodger. The relief does not apply to a room let in another property, the rent from which would be taxed under the normal property income rules.

Care must also be taken not to overstep the mark if the property has been divided into more than one residence, for example where a house has been split into flats or where the property has a granny annex. The rent-a-room relief is only available if the individual lets out the room in his or her own home. This means that if an individual divides his or her home into two separate flats, lives in one and lets the other out, rent-a-room relief will not be available. By contrast, if a room is let in the individual's own flat, it will.

### Tax Free Amount

The concept of the rent-a room scheme is simple. An individual lets out a room in his or her main residence and the rental income received is tax-free up to the exempt amount.

The exempt amount is £4,250 per tax year. The exempt amount is halved if someone else receives income from letting accommodation in the same property in the same tax year.

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## Maidment Judd

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However, it is not further reduced if more people obtain rental income in respect of the same property. This means that where three or more people obtain income from letting accommodation in the same property, it is possible to receive tax-free income in excess of £4,250. For three people the exempt amount is £6,375, for four people, £8,500 etc.

The exempt amount is also reduced to £2,125 if the period of letting is less than 12 months and another person lets accommodation in the same residence at any time in a 12-month period that includes the short basis period.

The relief applies to gross receipts from furnished lettings in the individual's home in the tax year. It not only covers rent but also payments made by the lodger for provision of goods and services in connection with the let, such as meals, laundry etc.

### Example

Kirsty has just moved house and needs to earn some extra money to meet the additional costs. She lets out her spare room to a lodger. The lodger pays £300 a month.

The room is let out throughout 2007-08. Kirsty receives rental income of £3,600. As this is less than the exempt amount of £4,250, the income is tax-free under the rent-a-room scheme.

Under the rent-a-room scheme, no additional relief is given for expenses.

### Complications

The rent-a-room scheme is simple provided that the rent received does not exceed the exempt amount. However, as the limit of £4,250 has not been increased since the introduction of the scheme some 15 years ago, it no longer covers commercial rents charged in some parts of the country.

The rent-a-room relief only applies automatically where the rent does not exceed the exempt amount. Once the rental income exceeds this amount, normal rules apply to work out the profit or loss arising. The profit or loss is found by deducting deductible expenses from the rent received for the tax year. If the individual has a property income business and lets other properties, the rent and expenses from the room let in the main residence simply goes into the pot when calculating the profits and losses for the property rental business.

However, there is an alternative. The individual can instead elect for the simplified basis to apply in respect of the let room. This simply taxes rent in excess of the exempt amount and ignores any expenses. The simplified basis is considerably simpler from an administrative viewpoint than working out the actual profit or loss. However, whether it is financially worthwhile will depend on the numbers.

# Q&A

**Q.1** In August 2000, I purchased £35,500 worth of Shares. If I sell them now, I will receive £5,500, making a loss of £30,000. Can I offset the loss now against a £100,000 profit on my property?

**A.1** Yes you can offset the loss now against a £100,000 profit on a property, provided that you realise the profit on the property in the same tax year as the loss on the shares, or in a later year. A capital loss can be set against a capital gain in the same tax year or a later year, but not against a capital gain in a previous tax year.

**Q.2** Ten years ago my husband and I bought a semi detached bungalow which we have lived in ever since. Three years ago we bought the other half of the semi and have rented that out for the whole of this time. We now propose to make the properties into one residence ( we have buildings consent). We would ideally like to let part of the property in future, and wonder if this will affect our PRR Relief.

**A.2** Once a piece of property becomes the taxpayer's legitimate qualifying principal private residence (ppr), it becomes eligible for ppr relief. This will be the case when it has been used by the taxpayer as their main

residence. However, the capital gains on separate parts of the property need to be calculated separately. If a part of the property is let out and is effectively a separate dwelling, such as a self contained flat with its own access, and has always been so, then ppr relief (and letting exemption) will not be available on that section, even if the main part of the building is eligible for ppr relief. Therefore, in your case, since you are using the other half of the semi now for your own use, it will be eligible for ppr relief, but the gains on that half will need to be calculated separately from the gains on the original half.

**Q.3** We have nine flats which we wish to leave one each to our grandchildren but we don't want them to have to find the money for death duties. How can we go about this? We need the income from the flats to keep us in our retirement. Is there anyway we could gift the houses to them now and still keep the income until we die.

**A.3** It is not possible to give the flats away but continue to enjoy the income - if you do this, it will be a "reservation of benefit" and the gift will not be effective for inheritance tax purposes. Inheritance tax is a complicated subject and you need to take professional advice before taking any action. The good news is that where inheritance tax is payable on land and buildings, it can be paid in ten

### Example

Phil lets out a room in his main residence. He charges rent of £400 per month. The room is let throughout 2007-08.

His expenses in connection with the let during the tax year are £500.

Rent received in the tax year is £4,800 (12 x £400). As this exceeds the exempt amount under the rent-a-room scheme of £4,250 rent-a-room relief is not given automatically. Therefore, Phil's income would be assessed on the normal basis.

His taxable profit for 2007-08 would be £4,300 (£4,800 - £500).

However, if Phil elects for the simplified basis to apply, he will instead be taxed on ££550 (rent of £4,800 less the exempt amount of £4,250).

This is clearly beneficial, not to mention simpler, and Phil should elect for the simplified basis to apply.

An election for the simplified basis must be made in writing within one year from 31 January following the end of the tax. Thus an election for 2007-08 must be made by 31 January 2010. Once made the election

continues in force for subsequent years until withdrawn. The same time limit applies for withdrawing the election.

As, once made, the election continues to apply until withdrawn, it is necessary to review the position each year to ensure that the best result is achieved. The simplified profit calculation is desirable where it produces a smaller profit than derived from the normal method. As a rule of thumb, the simplified basis is beneficial where expenses are less than the exempt amount.

The other side of the equation is where the expenses are high and the rents are less than the exempt amount, such that rent-a-room relief is applied automatically. As no account is taken of expenses where rent-a-room relief is given, any loss arising in connection with the let cannot be relieved. This means that if rents are less than the exempt amount and expenses exceed the rent, it is beneficial to elect for the relief to be disapplied in order to obtain relief for the loss.

The rent-a-room scheme provides a simple way to earn tax-free income from letting a room in one's home. However, some number crunching is advised to ensure that the scheme gives the best possible result.

## Keeping it in the Family - Wages for Spouses and Family Members

Many of those running a business employ their spouse or children. This article looks at the reasons for doing this and some of the pitfalls that must be avoided. It concentrates on the position of a sole trader - slightly different considerations apply to companies.

### Why Employ your Spouse or Child?

Provided you bear the points below in mind, the cost of wages paid to them will be an allowable deduction from the profits of the business, so it makes sense to employ them if:

- You pay tax on the profits of the business and they do not have any other taxable income

OR

- You pay tax at the 40% rate and they only pay at 22%

### Commercial Justification

This is the most essential point - you must not charge wages to the business unless there is a real commercial justification for doing so. The work they do must justify the pay they get - though as we shall see, they probably need not do much work to justify the amounts I suggest they should be paid.

The tax inspector may well ask questions about wages paid to family members, so it is important to be clear about the hours worked, the rate per hour and the duties involved.

### National Minimum Wage

The NMW (currently £5.35p per hour for those over 22 years old) does not apply to members of a family working in the family business if they live in the same household, so you are free to work out the most tax efficient rate of pay for your spouse or child.

This depends on a number of factors:

- PAYE - if your spouse (for the rest of this article, I shall use the word spouse, but the advice applies to other members of the family as well) has no other employment income then you can pay them up to £100 per week without having to deduct any tax or NIC - but make sure they sign a P46 to certify they have no other employment income.
- If your spouse has another paid job, it is unlikely to be worthwhile employing them because you will have to deduct basic rate tax from all their wages, no matter how small.
- If you are self employed, even if you pay tax on your profits at 41% (this includes your Class 4 NIC at 1%) it is hardly worthwhile paying your spouse wages that produce a charge on them at the basic rate of tax:

## Tax Tips

- Company cars are generally not a tax efficient idea, but there are exceptions. If your teenage son or daughter is clamouring for their first car, get the family company to provide them with one of those ultra-green cars with CO2 emissions of under 120 g/km. It works out like this:

The car cost (say) £10K. The company gets 100% capital allowances, so if it pays CT at 20% that reduces the cost by £2K.

You (not your child) will be taxed on the benefit at 15% of the cost, so a benefit of £1,500 means tax at 40% of £600 (and in 2008/09, the benefit will go down to 10% meaning tax payable of only £400). The company pays Class 1A NIC on this benefit at 12.8%, so after the 20% deduction for corporation tax that will cost £154 (£102 in 2008/09)

The company pays all the running costs, can recover the VAT on them and treat the cost net of VAT as an allowable expense for CT.

There's one other advantage - those "green" cars are so slow that your child is unlikely to come to any harm in it!

- **Another scam, this time by post** - HMRC have issued a warning about fake Forms P86 that are being sent to people coming to the UK for the first time or returning after an absence. The fake form asks for details of your bank account - the real one does not. If you receive one of these forms don't fill it in and return it - take it to the police!

- **Are you selling your business?**

As well as the tax planning for the sale itself, remember that you need to consider inheritance tax - your business probably benefited from 100% Business Property Relief for inheritance tax, but once you have sold it, you need to consider planning to mitigate inheritance tax on the sale proceeds - which do not qualify for Business Property Relief.

- **£40K "letting relief"**

Do you own (or have you recently sold) a house that was occupied by an elderly relative before 5 April 1988? Did they pay you rent, or has it been let since? HMRC have recently announced a change in their interpretation of the rules for the £40K "letting relief" - they now accept that this is due on "dependent relative" properties as well as on properties that have been your own main residence.

Wages Paid per £1,000	Tax Saved on Profits	Cost	Total Saving/(cost)
Tax on profits saved	410		410
Employers NIC 12.8%	52.48	(128)	(75.52)
Employee's NIC 11%		(110)	(110)
Income tax 22%		(220)	(220)
<b>Total</b>	<b>462.48</b>	<b>(458)</b>	<b>4.48</b>

Of course, if the trader is only paying basic rate tax on the profits the position is even worse as the saving will only be £338 (tax £248 plus Class 4 NIC of £90) but the costs will be the same, so in this case the family actually loses money.

The rule of thumb, therefore, is that it is only tax efficient for a sole trader to pay his spouse a wage if:

- The spouse has no other income of any kind,

OR

- The trader is paying tax at the 40% rate, and the spouse is a basic rate taxpayer and has no other employment income ("employment income" includes a pension)

AND

- In both cases, there will be little or no tax saving if the spouse is paid more than £100 per week

### Actual Payment

It is not enough simply to make an entry in the books for the spouse's wages - they must actually be paid to them, preferably by cheque or direct debit, so that there is an audit trail if the inspector comes looking for it.

Note that the wages should not be paid into a joint account, as it could be argued that the trader has not really paid them as he still has access.

If wages are paid in cash it is good practice to get the spouse to sign a receipt.

### Payment Dates

In theory, if the wages are included in the accounts and are paid within nine months of the accounts year end, they are an allowable deduction but I strongly recommend you do not rely on this - pay them weekly or monthly.

### PAYE

Although you do not have to deduct PAYE if the spouse has signed a P46 and their wages are £100 per week, you do have to make an annual PAYE return if the wages are more than £87 per week. A rate of pay between £87 and £100 has the added merit of enabling the spouse to qualify for State Benefits.

### Children

Be careful about employing children under 16 - there is legislation restricting this which is beyond the scope of this article.

Inheritance Tax is charged at 40% on the value of your estate (above £300,000) when you die, and that value includes any gifts you have made in the previous seven years.

There are various exemptions for lifetime gifts, such as for small gifts (under £250 per person per year), and an annual exemption of £3,000, but any other gifts remain part of your estate for IHT purposes for seven years after they were given away.

There is another important exemption, however, which more people should be aware of. Section 21 of the Inheritance Tax Act 1984 says that a gift to another person is not to be included in the seven year total if it passes all three of these tests:

- It was part of your "normal expenditure"
- It was made out of your income
- Making it did not affect your normal standard of living

Each of these three tests must be passed, and none of them is as simple as it appears at first:

## "Normal Expenditure"

In order to be considered "normal", the gift must be shown to be part of a pattern. If you have given £5,000 to each of your children every year for the last three or four years then this test is clearly passed, but it is possible to establish a pattern in less time than this. This is one case where a deed of covenant can be useful as it is a binding legal promise to pay a certain sum at specified intervals.

The gifts do not have to be given every year, but they do have to form part of a regular pattern. When starting a sequence of such gifts, it is normal practice (if a deed of covenant is not used) to write a letter saying something to the effect that you intend to make similar gifts in future years, though this is not essential - and it will not help if in fact you do not make the future gifts.

The gifts do not have to be to the same person, but they do have to be to the same class of people. For example, you might have three children and give £10,000 to one of them in one year, £10,000 to another the next year, and so on. That would qualify, but if instead you gave £10,000 to charity every year, you could not in one year give £10,000 to a child instead and claim that was part of the annual pattern of a gift of £10,000 - a child is not the same as a charity.

The sums given must be roughly the same every year - this does not have to be precisely accurate, but each gift must fit the pattern and not be an exception to it.

# Give What You Can Afford - IHT and "Normal Expenditure Out of Income"



## "Out of income"

This means made out of the income for the year in question, not out of savings from previous years' income, but the legislation does say the test is to be done "taking one year with another", so if you have established a pattern of "normal" giving that came from your income, the fact that in one year it came out of last year's income (because, for example, your business had a bad year, or because you were between jobs) will not spoil the pattern.

Because the gifts must be "out of income", a gift of a capital item, such as a painting or some shares, would not qualify unless you can show that you bought it with income in that year for the purpose of giving it as a gift. In other words, if you use income to buy a gift that you then give away, that will qualify, but if you give (say) a painting you have owned for some time to your nephew, that would not count because it was not given "out of income". Be careful here - unless you regularly give things rather than cash, you may still fail the "normal" test - it is safer to stick to cash.

## "Usual standard of living"

The final test is the hardest and the one that calls for some good record keeping. You must be able to show that after making the gift, you had enough income to maintain your usual standard of living. Notice that you must have enough income; having to live on capital after

making the gift will lose you the exemption.

Once again, there is a "taking one year with another" tolerance, so just because you have a bad year, you will not lose the exemption if things subsequently improve and you are able to continue to make the gifts out of income in future.

## Looking Back

Although this exemption is usually deliberately achieved as a result of tax planning advice, anyone dealing with the estate of a deceased person who had a good income should check to see if some or all of the gifts given in the final seven years of their life might benefit from this exemption. Whether it is due or not is a question of fact, and if the gifts pass the three tests described above, the exemption is due, even if the deceased did not deliberately set out to achieve it.

## Health Warning

If you want to try to qualify for this exemption, make sure you take advice before starting. This article has only scratched the surface of the subject and there are many pitfalls. To take just one example, capital repayments from certain bonds and payments to nursing homes out of "lifetime care plans" are not income for the purposes of this exemption.

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