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Tax

Excerpt from Buy-to-Let Property Tax Handbook, Second Edition – Chapter 2 – Calculating property business profits and losses

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INTRODUCTION

2.1

The taxation of property businesses is a broad topic. As the book focuses on the buy-to-let regime, the chapter does not cover the more unusual treatments, such as for wayleaves, tied premises, shooting rights, caravan sites, hotels, rent-a-room, etc.

For information on the tax treatment of buy-to-let rental business losses, see **Chapter 7**.

What is property income?

2.2

The categorisation of income from property is mutable, depending on the circumstances.

Property is an appreciating asset; it may be held as a long-term investment, with a reasonable expectation that it will increase in value over the period of ownership. While so owned, it may be exploited for rent or similar returns, without being consumed. In that regard, it is similar to money in a deposit account, or shares in a quoted company. It may be distinguished from a trading business that hires out equipment or similar, on the basis that the latter business' customers have no substantive interest in those assets they are hiring, and those assets may be considered to deteriorate over time or with use; it could be argued that property may also deteriorate over sufficient time, but there is in turn a question of to what extent the value attaches all but irreducibly to the land, or to the property that adorns it.

Tax law categorises such returns as 'investment income' which is essentially passive in nature. Much fun can be had trying to explain to a room full of career landlords that HMRC's starting position is that rental income is a passive investment activity, allowing the landlord to sit back and watch the profits roll in!

Focus

Property can, on the other hand, be bought with a fixed intention to sell on at a profit. This approach may involve developing the land or existing property with a view to increasing the value of the asset, to assist in generating profit. Or, it may not: 'large' property developers may, for example, buy plots of bare land and consider them stock held for resale at a profit, no more or less so than a grocer buys tins of beans.

Just like a grocer, or a business that builds laptops for sale, all such property businesses would be considered trading activities on basic principles (including the so-called 'badges of trade' – see **2.35**).

It depends…

2.3

The fact that land and property may fall into either category, depending on the circumstances, has and will continue to provide some quite interesting problems as regards the appropriate categorisation and corresponding tax treatment for property owners and their tax advisers.

While it may be said that a person's intentions regarding a property at the point of acquisition are very important (see, eg, *Lionel Simmons Properties Ltd v CIR* [1980] STC 350), one's intentions may change over time – whether the property should be re-categorised as a result can sometimes be a difficult matter to resolve (the case *Taylor v Good* [1974] 1 AII ER 1137 tussled with this issue all the way to the Court of Appeal).

2.4

Having recognised that the taxation of property income is not always straightforward, the simple rule of thumb is:

- Rental income is taxable as investment 'income from a property business';
- The sale of an investment property is a capital transaction subject to capital gains tax (CGT) or corporation tax (CT) on capital gains (but see **2.58**–**2.68** below in relation to developing investment property for onward sale);
- Buying property with an intention to sell it on for a profit, and property development for the purposes of resale, are taxable as trading activities.

Priority of rental income over trading income rules

2.5

Focus

Readers may be surprised to find that the legislation gives priority to the rental income regime, over trading rules. In other words, where income, etc might reasonably be considered to fall in either rental income or trading income category, it will in fact be taxed according to the rules for property income, not trading income (*ITTOIA 2005, s 4*; *CTA 2009, s 201*).

There are exceptions to this rule, such as for overseas property businesses, where the reverse may apply.

One consequence of these rules is that rental income derived from property held for development purposes – for example, where new build homes are temporarily let out while looking for a buyer, or for the market to recover – may still be taxable as property income, despite the overwhelmingly trading nature of the overall enterprise – see HMRC's Property Income Manual at PIM4300 but note also the distinction in that section for the letting of temporarily surplus office space used in a trade or profession, where the rental receipts may be aggregated with trading income.

Assessed as a business

2.6

The income tax (IT) rules for the taxation of property investment income are to be found at *ITTOIA 2005, Pt 3* (*s 260* onwards).

The corporation tax (CT) rules for the taxation of property investment income are to be found at *CTA 2009, Pt 4* (*s 202* onwards).

For both IT and CT purposes, the *logical* starting point is that rental profits (and losses) are to be calculated in the same way as for trading profits; this is because the taxation of property businesses relies heavily on the legislation that applies to trading entities (*ITTOIA 2005, s 271E*; *CTA 2009, s 210*).

However, the introduction in April 2017 of the cash basis for property businesses subject to income tax entails a different approach – where it applies.

It can therefore be said that:

- The profits of both property investment businesses and trading businesses are derived according to the same core principles; and
- The profits for both unincorporated property investment businesses and their corporate equivalents are, likewise, derived on a similar basis, except where they do not – the most common modification being the cash basis for income tax purposes.

Note that the cash basis continues to apply trading income rules, albeit with more substantive modifications, including the abandonment of GAAP (*ITTOIA 2005, ss 271E, 272ZA*).

The more noteworthy comparisons for buy-to-let landlords are set out in this chapter.

2.7

The legislation for both IT and CT purposes sets out in some detail where property business taxation borrows from or distinguishes itself from trading principles; the more important of these, from a buy-to-let perspective, are set out below:

Detail	**Income tax – new cash basis** (*ITTOIA 2005*)	**Income tax – traditional GAAP basis** (*ITTOIA 2005*)	**Corporation tax** (*CTA 2009*)

Profits are calculated in accordance with GAAP, subject to any adjustment required or authorised by law, <u>except</u> where the business is subject to income tax and fails to meet all of the criteria *to exclude it from* the cash basis (see below). The 'cash basis' of accounting looks only at cash in and cash out in a period, rather than when income or expenditure falls due. This applies by default to property letting businesses within scope, from 6 April 2017 (see **2.10**).	*s 271D* (*s 271A*)	*s 25* (*s 271A*)	*s 46*
Losses are to be calculated in the same way as profits.	*s 26* (*s 272ZA*)	*s 26* (*s 272*)	*s 47*
Expenses *not* incurred 'wholly and exclusively' for the purposes of the activity are not allowable for tax purposes – but this does not prevent a deduction for an identifiable part or proportion of an expense that *is* incurred wholly and exclusively for such purposes. (See **2.36**.) For example, for *unincorporated* businesses, adjustments are generally required if (and to the extent that) there is any 'private use or enjoyment' of an expense, such as where a property is occupied for two weeks by the owner, on holiday – a 1/26th add-back would be appropriate for some expenses, such as council tax, while other expenses, such as pre-letting inspections costs, might be unaffected. More precise apportionments might be appropriate in some cases (see Appendix to this chapter for more on this point).	*s 34* (*s 272ZA*)	*s 34* (*s 272*)	*s 54*
Pre-trading expenses (or pre-letting expenses). Expenses incurred by the person (who ultimately carries on the business) *up to seven years prior* to the date on which the business commences may be claimed as a deduction on the day of commencement – provided the deduction would be allowable, under normal principles, while the business were actually carried on. See **Chapter 1** for more information.	*s 57* (*s 272ZA*)	*s 57* (*s 272*)	*s 61*
Capital expenditure	*s 307B* (*s 271D*)	*s 33* (*s 272*)	*s 53*

Relief for capital expenditure is generally not allowed under the accruals/GAAP basis; the new cash basis complicates matters by not adopting the general disallowance but by instead applying numerous separate measures to substantively similar effect, with minor exceptions (see **2.40**)			

Key differences between property investment income and trading income

2.8

The differences between property investment income and trading income include the following:

- A person's UK property letting business consists of 'every business the person carries on for generating income from land in the UK'. The income tax legislation does not distinguish between locations, types of occupant, or category of property – even residential and commercial lettings are part of one and the same business. While a landlord may keep each property separate in his or her own books of account, the profits and losses across all properties are pooled, resulting in a single net amount – positive or negative (*ITTOIA 2005, s 264*; *CTA 2009, s 205*). This is quite different to the position for trades, each of which is identified and streamed separately, with its own capital allowances (CAs) pool, etc.
- Along similar lines, there is a separate pool for overseas letting activity – 'rest of world' lettings (*ITTOIA 2005, s 265*; *CTA 2009, s 206*).
- For the special treatments of furnished holiday accommodation and non-commercial lettings, please see **Chapter 6** and **2.69** respectively. Note that furnished holiday accommodation remains, strictly, part of a person's overall property letting business (*ITTOIA 2005, ss 322–328A; CTA 2009, ss 264–269A*).
- HMRC considers property letting undertaken in a different capacity to be part of a separate pool, however – for example, where carried on as a Trustee, or as a partner in a partnership (see **Chapter 1**). Following that logic, a partnership has its own property business, which is excluded from any individual partner's own property business (*ITTOIA 2005, s 859(2), (3)*).
- Relief for finance costs in relation to residential lettings is restricted from April 2017 for unincorporated businesses; trading activities are not caught by the restriction (see **Chapter 3** for more detail on this point and **2.47** below for more on finance costs generally).
- For IT purposes, trades have their own 'basis period' while property investment businesses are *almost* invariably taxed on a fiscal year basis; companies adopt their own chargeable accounting periods, whether trading or investing (see also **Chapter 1**).
- Unlike ordinary trading businesses (including hotels), CAs are not available in relation to the cost of plant and machinery made available in ordinary residential lettings

themselves, although they may still be available elsewhere in that business (see **Chapter 4**).

- Relief for the replacement/renewal of capital items was withdrawn with effect from April 2016 for trading entities but ordinary residential letting businesses (which are investment businesses) may claim replacement domestic items relief for eligible expenditure (see **Chapter 5**). In the past, furnished residential lettings (but not furnished holiday lettings) were able to claim 'wear and tear allowance'.
- Losses are relieved quite differently. From an IT perspective, the scope for relieving trading losses is generally more generous than for investment property losses. There are also different rules for CT losses (see **Chapter 7**).
- National Insurance contributions – for unincorporated businesses, property letting income profits are not 'earnings' for the purposes of NICs. HMRC has occasionally tried to argue to the contrary in relation to Class 2 contributions although they argued the opposite in *Rashid v Garcia* [2003] SSCD 36, and the realignment of earnings (in *NICA 2015*) should put the matter beyond doubt in future.
- There are specific rules for the taxation of lease premia and reverse premia (see **Chapter 1**).
- Ordinary property income arising to individuals (including in a partnership) does not comprise 'relevant earnings' for pension purposes as per *FA 2004, s 189*, so as to support pension contributions in excess of £3,600 per annum (but see **Chapter 6** and also **2.9**).
- Farmers' averaging does not apply to rental income receipts but only to trading income.

Differences in property investment businesses for income tax versus corporation tax

2.9

There are certain differences in the treatment of property investment businesses for income tax and corporation tax purposes, including the following:

- Unlike unincorporated businesses, companies claim relief for finance costs through the loan relationships regime (see **2.53**, and see **2.47**–**2.49** for further information on tax relief for finance costs more generally). This distinction applies also to bad and doubtful debts. As noted above, companies are largely saved from the new restriction of finance costs in relation to the letting of dwellings (see also **Chapter 3**).
- Property rental business losses are relieved differently, between IT and CT (see **Chapter 7** and commentary on the cash basis below).
- The private use of a property in an unincorporated business would ordinarily be dealt with by a restriction of relevant costs under the general 'wholly and exclusively' rule set out in *ITTOIA 2005, s 34* (where apportionment is of course possible, as mentioned at **2.7**). In the corporate alternative, since a buy-to-let company's owners are likely to be its directors and

therefore employees, private use may instead be caught by the 'benefit in kind' rules such as for the provision of living accommodation (*ITEPA 2003, Pt 3, Ch 5*).

- If the shareholder is not a director/employee, or not otherwise brought within the benefit in kind rules, and the company is a 'close' company, then there are provisions (at *CTA 2010, s 1064*) to treat an amount equivalent to the benefit in kind as a distribution in favour of the participator. As an aside, private overseas holiday homes (ie not used at all in a property business) owned through a corporate wrapper – such as commonly used to be required for foreign ownership of properties in the former Eastern Bloc – are safe from a benefit in kind tax charge by virtue of *ITEPA 2003, ss 100A–100B*.

- As noted above, property income arising to individuals (including in a partnership) does not constitute 'relevant earnings' (*FA 2004, s 189*), so as to support pension contributions in excess of £3,600 (gross) per annum. But a company director's (or other company employee's) salary and taxable benefits in kind *will* ordinarily qualify as relevant earnings for pension purposes, despite being derived from rental income to the company.

- From 6 April 2017, mileage allowance on vehicles (not just cars) used in a property business may be claimed by individuals operating in their own or joint names, or in partnership so long as no partner is a company; companies are not entitled to claim a mileage allowance directly, but note that there is separate and long-standing provision for a company's employees to adopt the same rates of reimbursement for the business use of their own car or other vehicle, tax-free (*ITEPA 2003, s 229* onwards).

The mileage allowance is <u>not</u> generally available where the business has already claimed capital allowances on the vehicle, and likewise a capital deduction under the cash basis (although this restriction still does <u>not</u> prevent relief for the incidental costs of a particular business journey using the vehicle in question, such as parking or tolls).

However, since the new mileage allowance for landlord businesses is meant to replace a similar facility previously provided by way of an extra-statutory concession which lapsed in 2013, unusually, the legislation permits taxpayers to adopt the mileage allowance even if capital allowances were claimed on the vehicle between 2013/14 and 2016/17. More general restrictions will nevertheless continue to apply so that unrelieved capital allowances qualifying expenditure may not be carried forward on adopting the mileage allowance regime.

Kind of vehicle	**Rate per business mile**
Car or goods vehicle (eg, van)	45p for the first 10,000 miles 25p after that
Motor cycle	24p

(*ITTOIA 2005, ss 94B–94G*, as updated by *FA 2018*)

- The property allowance, which took effect from April 2017, applies only for income tax purposes and, while it basically ignores the first £1,000 of gross rental receipts in a tax year, it also ignores any other deductions, so will be of little use to any but the most casual of landlords (see **2.71**–**2.73**).

Cash basis for property letting businesses (income tax only)

2.10

Historically (ie, for many years up to and including 2016/17), support for the cash basis approach to taxing rental income has been rather slight; HMRC guidance at PIM1101 confirms that it was permitted only for businesses with gross income not exceeding £15,000 a year, where applied consistently and where the outcome did not differ, to any significant degree, to that which would have been derived using the 'correct' accruals basis.

Focus

The new 'simplified cash basis for unincorporated property businesses' represents a complete overhaul. It is important to note that it applied automatically from 6 April 2017 – one has to elect *out* of the regime, not opt *in*. The new cash basis – we shall soon dispense with the pretence that it is 'simple' (at least for landlords or their agents) – therefore applies automatically to such businesses from the tax year 2017/18 onwards.

HMRC believes that the new cash basis is so widely drawn that it will apply to the vast majority of BTL landlords. HMRC guidance, such as it is, may be found at PIM1090–PIM1098. The guidance is brief, and light on detail.

The legislation was introduced in *F(No 2)A 2017, Sch 2, Pt 2* (ie, several months after it was due to take effect), which brought in a raft of changes to *ITTOIA 2005 Pt 3*, primarily *ss 271A–271E, 272ZA, 276A, 307A–F*, and numerous further additions and amendments equating, all in all, to twenty pages of updating legislation.

What is the cash basis? an introduction for non-accountants

2.11

Accountants tend by default to work on the 'accruals basis' – that is, simply, to allocate and apportion income by reference to the activity or period for which it is earned, and likewise to recognise expenses by reference to the income they were incurred to derive.

For example, it may have cost 14 grommets to make seven widgets, in the year in question, even though 25 grommets were bought in one batch in that year, and not all seven widgets have yet been sold: whatever the money laid out and received in that scenario, the accruals basis employs adjustments to the likes of closing stocks of raw materials and finished goods, debtors, creditors, etc, to work out the real net profit for that period of activity.

2.12

In contrast, the cash basis simply recognises cash (in whatever form – notes, bank transfers or card payments) as it is received and paid out. Over the life of a business, and ignoring any withdrawals of profit, the aggregate of the business' net profits should equate to the net cash inflow over that same period; the point of the accruals basis is that it attempts to be a more accurate measure of the net

profit for a given period (the better to assist the business owner in understanding how the business performs, and how it might be made more profitable).

Example 2.1 – Accruals basis vs cash basis

Jennifer has a single property, which she starts to let for £1,000 a month, in April 2019. Her only expenses are mortgage interest (interest-only, at £500 a month, paid at the end of each month) and insurance, which is £800 and was first paid in September 2019.

Unfortunately, her tenant is a little behind with the payments and has not paid for March 2020, by the end of the 2019/20 tax year. For simplicity, take 31 March as being the end of the 2019/20 tax year.

Accruals basis

Jennifer's property has 'earned' £1,000 a month for the entire year, even though the tenant has not paid the final month's rent by the end of the tax year it is still recognised as income 'belonging' to 2019/20, so £12,000 in total; the expenses of £500 a month for mortgage interest totalling £6,000 are straightforward and require no adjustment but the insurance cost of £800 should be cut in half because it runs 6 months beyond the tax year to the end of September 2020, so only £400 of insurance 'belongs' in 2019/20.

For more information about Buy-to-Let Property Tax Handbook, 2nd Edition: