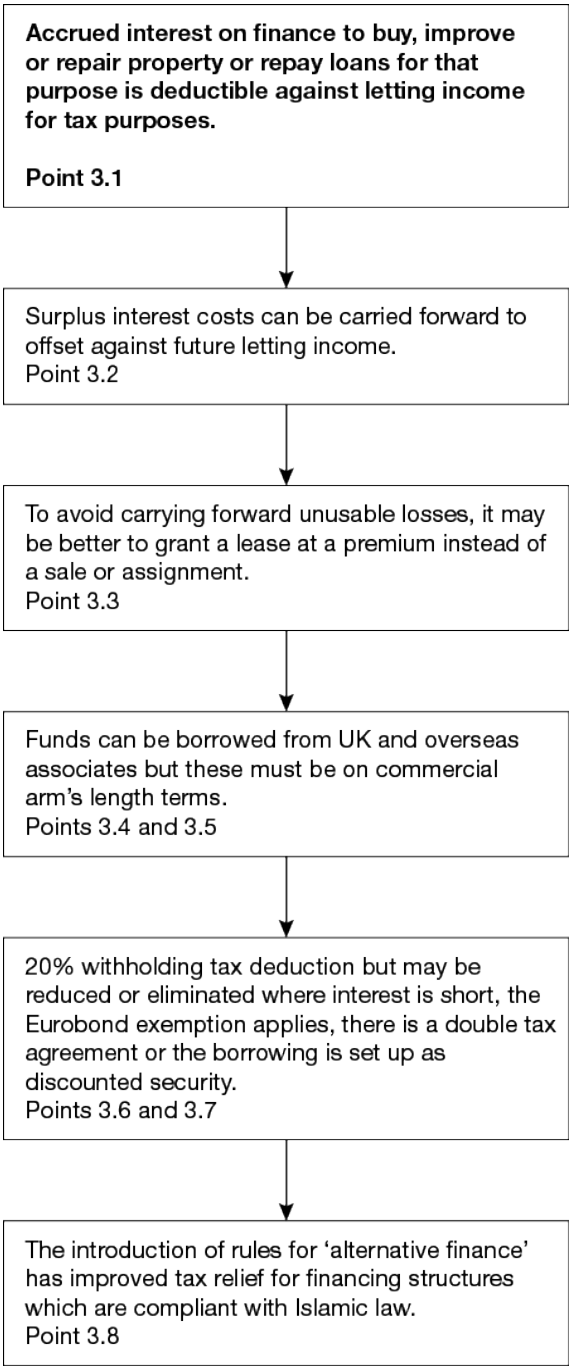
Bloomsbury Professional
Tax

Excerpt from Property Tax Planning - Chapter 3A – Relief for finance costs incurred by individuals, trustees and non-UK resident investment companies



3A Relief for finance costs incurred by individuals, trustees and non-UK resident investment companies

Point 3.1: *Accrued interest and other finance costs can be deducted from total rental income, although tax relief in respect of residential lettings is to be restricted. The position for non-UK resident investment companies will change from 6 April 2020.*

Although HMRC do not regard letting as a trading activity, taxable profits from property letting are computed as if it were a trade (*ITTOIA 2005, s 272(1)*). That means that any finance costs incurred are potentially deductible from total rents received. The deduction is for the accrued costs, calculated in accordance with generally accepted accounting practice (GAAP) (*ITTOIA 2005, s 25*), regardless of when they are actually paid.

The finance must relate to the purchase or improvement (including repairs) of the let property or the repayment of another loan that had been taken out for these purposes. Certain incidental costs of obtaining such finance are also allowable, including situations where the financing is aborted (*ITTOIA 2005, s 58*). Personal borrowings or loans for other purposes or activities would not qualify, even if secured on the let property.

These relatively generous rules will not necessarily apply to finance on residential properties or in the case of properties (commercial and residential) owned by non-resident investment companies. In the July 2015 Budget, the government announced measures to restrict tax relief on residential lettings in order to put a dampener on the buy-to-let housing market. The restriction is being phased in from 5 April 2017 when non-corporate landlords will only be entitled to offset 75% of their finance costs (including incidental finance costs such as derivative payments and lender fees). The remaining 25% will attract tax relief which is restricted to the basic rate of tax. In the following tax years, the amount deductible progressively reduces to 50%, 25% and finally nil, such that from 2020/2021 onwards, only basic rate tax relief is allowed.

Borrowings on commercial property and commercially let holiday lettings (see chapter 10) are not affected by these restrictions. Where finance covers both residential and non-residential property, the related costs need to be apportioned against the respective amounts of income when calculating the restricted relief due.

With effect from 6 April 2020, non-UK resident investment companies are likely to be affected by the proposals for the introduction of a fixed ratio rule for net interest deductions in excess of £2m – see Point 3.31 in Chapter 3B.

All UK properties let by a landlord are treated as a single business (*ITTOIA 2005, s 264*). If finance costs and other costs exceed that year's total rental income, only the loss attributable to any capital allowances can be offset against the landlord's other income or gains (*ITA 2007, s 120*). Note, however, that since 5 April 2013, there has been an annual cap on the amount of such losses and certain other deductions which can be offset against general income. This cap is the greater of £50,000 or 25% of the individual's income. The surplus costs can, however, be carried forward in full against future income from the letting activity (*ITA 2007, s 118*).

The position becomes further complicated in relation to the restrictions on residential letting finance costs mentioned above. Where finance costs exceed property income, there will be an unrelieved cost element to carry forward but only basic rate income tax relief may be available in a future year even where there is sufficient income to cover both current and brought forward losses.

Point 3.2: *If there are surplus finance costs following a property sale, these can be used against the rental income from a property owned and let subsequently.*

As mentioned in Point 3.1 above, surplus finance costs cannot be offset against other income or gains but they can be offset against future profits from the letting of UK property. Therefore, following a sale of a property, unused past finance costs can be used to shelter tax on income from another property, whether owned at the time or bought subsequently.

HMRC will allow the losses to be carried forward indefinitely whilst the UK letting business is being carried on. However, if the letting business actually ceases, the unused expenses will be forfeited.

This does not mean that losses cannot be carried forward if there is any gap in the letting activity. Where a property is sold but there is the clear intention to carry on a letting business, the costs can be carried forward. Therefore, if there is a gap in time following a sale of a property and, in that period, the investor is actively looking for a replacement investment property, the loss carry-forward should not be affected.

The offset of losses is subject to the restrictions to be introduced from 2017/2018 in respect of residential property finance costs incurred by non-corporates, referred to in 3.1 above.

Losses will be forfeited if they accrue to a non-resident company which subsequently becomes UK-resident. However, there are provisions that seek to ensure that when non-UK resident investment companies fall within the scope of UK corporation tax on rental income (ie. from 6 April 2020) any historical losses accrued under the UK income tax regime should be available to be utilised as UK corporation tax losses.

Point 3.3: *Where finance costs exceed rental profit throughout ownership, tax on a capital gain on sale can be reduced if a short lease can be granted at a premium prior to a sale of the main interest in the property.*

Unrelieved finance costs cannot be offset against a capital gain on investment properties for tax purposes. If there is to be no further rental income from this or any other properties, future relief for these costs will be forfeited.

Where there is the prospect of a capital gain that will be chargeable to UK tax, the tax liability can be reduced if the capital gain were partially converted to income for tax purposes.

This can be achieved by granting a short lease at a premium, with an option for the buyer to buy the main interest at the end of the lease period. For the reasons set out in Point 9.1, such a premium is partly treated as income, depending on the length of the lease involved. The shorter the lease, the higher the proportion of premium treated as income.

Example

Mrs Wiggins owns a freehold commercial property that she lets. The rent is £30,000 per year. Over the past few years, repairs and finance costs have given rise to an accumulated loss of £100,000.

The property is sold in November 2016 for £400,000; this will give Mrs Wiggins a capital gain of £100,000 on which she will pay 20% tax, ie £20,000. (NB the capital gains tax rate on residential property is 18% or 28% depending upon the individual's marginal rate.) Alternatively, Mrs Wiggins offers the prospective buyer a four-year lease for no rent and a premium of £107,000 together with the freehold reversion for £293,000.

As a consequence of this transaction, 94% of the premium of £107,000 – or £100,580 – on grant of the four-year lease will be treated as letting income (see Point 9.1). Against this, the £100,000 losses can be offset, leaving just £580 in charge to income tax.

The capital gain, following the reduction in the capital element of the receipt by £100,580, has now disappeared. No capital gains tax therefore arises.

Mrs Wiggins has, therefore, saved just under £20,000 tax.

There could also be a short-term benefit for a buyer who is using the property for trading premises. The premium rules allow the buyer a trading deduction against taxable profits over each of the four years of the lease of £25,145 (ie £100,580/4 – see Point 27.1).

There is exposure, in arrangements such as this, that HMRC might seek to attack the grant of a lease as an artificial step inserted in the transaction under the principle in *Furniss v Dawson* [1984] STC 153. Additionally, *Finance Act 2013* introduced a general anti-abuse rule (the so-called GAAR) to counter tax planning arrangements that are considered to be abusive. The GAAR provisions require HMRC to successfully show that the arrangements cannot reasonably be regarded as a reasonable course of action. This double reasonableness test is intended to set a high threshold in determining whether a particular arrangement is considered to be abusive and therefore liable to counteraction.

Ultimately, the dividing line between arrangements that work and those that do not is a matter for the courts to determine, rather than HMRC. It is essential in such arrangements for there to be commercial or structural features that make the pure tax avoidance aspects less significant. For instance, the lease could be granted to an entity occupying the premises for trading purposes, whilst a separate (but possibly associated) entity buys the reversion for investment purposes.

In some situations, there may be no taxable capital gain. This could be, for instance, where the gain is less than the available annual exemption for the individual or trust. In other cases, there may be unused capital losses. Where the owners are non-UK resident individuals and non-UK companies, they may not be subject to UK tax on capital gains (see Chapter 1). In cases such as this, the conversion of capital into income would not give rise to any benefit. Indeed, it may be preferable to preserve losses in case there is a resumption of letting.

As already indicated, restrictions to be introduced from 2017/2018 may mean that that surplus finance costs in relation to residential property may only be relievable at the basic rate of income tax.

Point 3.4: *Finance costs are allowable on funds borrowed from associated and connected persons. This includes lenders based abroad.*

Interest is allowable even on a loan from a connected party. Therefore, finance can be obtained from associated individuals (including spouses and relatives) and trust funds.

For the most part, there is no stipulation as to the amount of interest that is allowed, even where it is paid to a non-resident. However, excessive finance costs will be disallowed as not 'wholly and exclusively' for the purposes of the business (*ITTOIA 2005, s 34(1)(a)*). Interest relief can also be denied where the sole or main benefit of incurring the interest is to secure an income tax advantage (*ITA 2007, s 809ZG*).

There is also the possibility that transfer pricing rules may apply to adjust excessive interest to arm's-length rates where one company borrows from a lender with which it has a 'special relationship'. This will typically include situations where one company has a controlling or major interest in the other, or the same third person has such an interest in both companies.

Transfer pricing (see also Chapter 3B and Point 3.5 below) applies also to transactions wholly within the UK. In most cases, however, the transfer pricing rules now no longer apply unless the person receiving the tax advantage ('the advantaged party' – here, the borrowing company) is a 'large enterprise' (see Point 3.20 in Chapter 3B for the definition of 'large enterprise'). Even where they do apply, the 'disadvantaged party' (the lending company, which is receiving the excess interest) can claim exemption from UK taxation on the amount of interest that is disallowed for the borrower.

See also Point 3.5 below, and Points 3.20 and 3.21 in Chapter 3B.

Point 3.5: *The terms of any borrowing must be wholly arm's length to obtain a deduction for related finance costs. Where borrowings are from a foreign associate, the terms should be based on those offered by a reputable third-party lender.*

The UK's transfer pricing rules (*TIOPA 2010, Pt 4*) may apply to limit the allowability of finance costs payable by non-UK resident companies. Transfer pricing applies to non-arm's-length transactions between two persons, one of whom has a controlling or major interest in the other. It does not, therefore, apply to transactions between individuals or to non-business transactions, but can apply to business transactions between an individual and a company or partnership. The rules apply even where both parties are taxable in the UK, but there is an exemption where the advantaged party – the party whose liability to UK tax has been reduced as a result of the transaction – is a small or medium-sized enterprise (SME), unless the other party is located in a tax haven or certain other jurisdictions with which the UK does not have an appropriate double tax treaty. For transactions involving UK companies, see Point 3.4 above, and Points 3.20 and 3.21 in Chapter 3B.

Under the rules, 'excessive' interest payable to an associated lender abroad will be disallowed. This does not just apply to situations where the rate of interest is too high. It also applies where the amount of the loan is greater than would have been supplied by a third party.

In a situation where a third party might normally lend up to, say, 65% of the value of a property on purchase, finance higher than this may be considered excessive. The loan does not have to be between two associates for the rule to apply. Interest will also be disallowed where a third party lends a higher than normal amount on the strength of the security of a guarantee or deposit provided by the borrower's associate. So-called 'back to back' arrangements are, therefore, caught.

If the interest payable under the arrangements is greater than would have applied in an arm's-length transaction, a deduction for the excess will not be allowed. If the entire loan is not on an arm's - length basis – for instance, where a top-up loan is required in addition to a normal secured loan – the whole of the top-up interest can be disallowed, unless it is on the same terms as subordinated debt available from third-party lenders.

Companies which borrow with the direct or indirect assistance of a foreign associate must be prepared to justify the loan arrangements as arm's length. It is advisable to approach a bank or other lender for a loan quote which ignores any security from associates. If a reputable third-party lender can be found which is prepared to take a greater than usual risk, any loan arrangement with an associate which replicates those terms should be acceptable as arm's length. Whilst a number of specialist lenders are now well established in the market for 'top-up' property finance, HMRC may be sceptical of terms apparently quoted by third-party lenders where they feel that these were obtained without any real commitment by the lender at that stage to lend on those terms.

UK property businesses to which the transfer pricing rules apply, for example those undertaken by non-UK resident property investment companies, may be able to apply to HMRC for an advance thin capitalisation agreement (ATCA), where the availability of related-party finance relief has a significant commercial impact on an enterprise's profits or losses. If successful, an ATCA ruling from HMRC can be binding for up to five years (HMRC SP 1/12).

As has already been noted, however, if the advantaged party (here, the borrower paying an excessive interest rate or in receipt of an advantageous loan) is an SME, the transfer pricing rules are of no application, with three exceptions where:

(a) the lender is located in a tax haven etc;

(b) the borrower is a medium-sized enterprise and HMRC direct that the transfer pricing rules shall apply after an inquiry into the borrower's tax return; or

(c) the borrower irrevocably elects to be subject to the transfer pricing rules.

(*TIOPA 2010, ss 166–168*)

Point 3.6: *If interest is paid to a non-UK resident lender, there is a requirement to deduct income tax at the time of payment unless the loan is from a non-UK source.*

Any person paying interest to a foreign lender on a long-term loan is required to deduct tax at a current rate of 20% unless the loan interest does not have a UK source (*ITA 2007, s 874*).

There is no statutory definition of UK source. HMRC generally regard any loan interest as UK source where the borrower is UK resident. In other cases, they will be looking to designate loans as UK source, and will take into account factors such as:

(a) whether the loan is secured on UK property;

(b) whether the interest is paid out of UK source rents;

(c) if the interest is paid in the UK; and

(d) if the loan agreement is governed by UK law.

(HMRC Savings and Investment Manual SAIM9090).

If any of the above features apply, there is a potential withholding problem, although, in each case, whether the loan has a UK source will be determined by looking at each of the factors to determine on which side of the fence the indicators fall. The application of these factors (and indeed others) must be interpreted alongside more recent case law that has followed the *Westminster Bank Executor and Trustee Co (Channel Islands) Limited v The National Bank of Greece* SA 46 TC 472 (1970). The key cases in this regard are, most recently, *Ardmore Construction v HMRC* [2018] EWCA 1438 and *Ardmore Construction and Perrin v HMRC* [2015] UKUT 633. It remains unclear whether HMRC will update their guidance to take account of this case law.

Practitioners previously regarded the long-established practice of executing and retaining so-called specialty debt agreements outside the UK as sufficient to ensure that the corresponding interest could be regarded as arising outside the UK. This would involve the debt being evidenced by deed with no UK property used as security. HMRC disputed this practice and took the opportunity in *Finance Act 2013* to introduce blocking legislation. In determining whether interest arises in the UK, no account is to be taken of any deed recording the obligation to pay interest.

Note that, where the withholding of tax is required of the borrower, it is only on payment of the interest. It is quite separate from the tax deductibility of the interest from profit, which is on an accrued – rather than a paid – basis.

Withholding tax will still, in principle, apply even if the interest is not allowable for tax purposes (for instance, where it is disallowable under Point 3.4 above). However, if excess interest is disallowed under the transfer pricing rules (see Point 3.5 above), the recipient of the interest can claim exemption from withholding tax for the excess (*TIOPA 2010, s 187*).

Point 3.7: *Where a deduction of tax might otherwise apply, it can be exempted or reduced in a number of situations. These are where the lender is in a country with a suitable tax treaty with the UK or where the EC Interest and Royalties Directive applies. Exemptions are also available where the interest is short interest, where the quoted Eurobond exemption applies or where discount is payable on the redemption of a deeply discounted security.*

There will be no tax withholding requirement where the lender is resident in one of a number of foreign countries with which the UK has a suitable double tax agreement eg Switzerland or the USA. In that case, however, it is still necessary for the lender to obtain advance clearance from CNR that the interest can be paid without tax deduction.

It is possible to pay or receive interest without deducting or suffering a tax withholding where the payment is made between a lender and borrower and both are associated companies resident in different member states within the European Union (Council Directive 2003/49/EC and *ITTOIA 2005, ss 757–767*), although this is likely to be affected by the future cessation of the UK's membership of the EU. The entitlement to an income tax exemption must be established by making a claim to

HMRC. HMRC's commentary on the claims process is set out in their International Manual (INTM 367000), with further guidance at INTM 400000.

At present, it is also possible to avert a UK withholding requirement where any of the following apply:

- Where the loan is not capable of exceeding 12 months, any interest paid is referred to as 'short' as opposed to 'yearly' interest. Deduction of tax only applies to 'yearly' interest (*ITA 2007, s 874*). Therefore, no tax withholding is necessary on interest on short-term facilities from a foreign lender.
- Where interest arises on a quoted Eurobond, there is a withholding tax exemption (*ITA 2007, s 882*), provided the borrower is a company and it lists the bond on a recognised stock exchange (eg London, Luxembourg or the Channel Islands). See Point 3.28 below.

Discount payable on the redemption of a deeply discounted security (ie one that is issued at a discount to redemption price) is not regarded as interest for the purposes of the withholding rules. These securities typically have a low or zero interest rate, but the borrower must repay a specific sum over and above the original sum borrowed. However, a First-tier Tribunal case (*Nicholas Pike* TC O1151) considered that a discount may be regarded as interest where debts are redeemable at a premium calculated by reference to a rate of interest. The taxpayer lost his subsequent appeal to the Upper Tribunal, which was heard during May 2013. (See Point 3.28 below for further details regarding deeply discounted securities.)

HMRC undertook a consultation during 2012 covering income tax rules in relation to interest. The proposals included a number of measures to increase the situations where income tax withholding would be required, including removing the distinction for short interest and restricting the quoted Eurobond exemption. Following strong representations, HMRC concluded that no changes to the rules affecting short interest and quoted Eurobonds would be made in the foreseeable future.

Point 3.8: *The introduction of rules for 'alternative finance' has enabled tax relief to be obtained for costs incurred in relation to financing structures that are compliant with Islamic law.*

See Point 3.29 in Chapter 3B for an outline of the typical structures that have been accommodated by changes in the UK tax rules introduced since *Finance Act 2005*.

This 'alternative finance arrangements' legislation has subsequently been consolidated into *ITA 2007* for income tax and capital gains tax purposes (*ITA 2007, Pt 10A*).

For alternative finance costs related to residential property lettings, the new restrictions referred to earlier will apply as with conventional finance costs.

For more information about Property Tax Planning:

Visit: www.bloomsburyprofessional.com/propertytaxplanning

Call: 01444 416119

Email: bptax@bloomsbury.com

You can also find this extract on Bloomsbury Professional Tax Online:

https://www.bloomsburyprofessionalonline.com/view/property-tax-planning/PTP-chapter3A.xml