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“Property Tax Update”

Presented by Brian Ogilvie FCCA CTA

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Timetable:

4pm – Refreshments and registration*
4.30pm – Lecture begins
6pm – Break for refreshments*
6.30pm – Lecture begins
7.45pm - Questions
8pm – Close

CPD Hours: 3

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UK PROPERTY TAX UPDATE

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In addition to practice work, Brian is also a tax consultant for the PTP group, and a freelance tax lecturer for a number of commercial and professional organisations including leading accounting firm Chantrey Vellacott DFK LLP .He is also current chairman of the Sussex branch of the Chartered Institute of Taxation.

Brian demonstrates a lively training style, using illustrative case studies, and drawing on extensive experience of providing tax advice on various areas affecting the SME sector.

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The Finance Bill 2008 was published on 27 March. 1148 linked Explanatory Notes were published on the Treasury website, referring to the numbered clauses of the Bill, albeit the final sections of the Act may be differently numbered.

After Committee stage scrutiny and amendments the Bill received Royal Assent on 21 July 2008, running to 166 sections and 46 schedules

FINANCE ACT 2008

CGT reform

Schedule 2 FA 2008 implemented major changes to reform the CGT code for individuals, trustees and personal representatives for disposals on or after 6 April 2008, including:

Assets held at 31 March 1982

For assets owned before 31 March 1982 it was possible to elect for the original value to be used in calculating the gain instead of the value at 31 March 1982 value. This option is no longer available on or after 6 April 2008 and the 31 March 1982 value must be used for disposals of assets owned prior to that date.

Indexation relief

Indexation relief (except for companies under the separate régime for corporation tax) was withdrawn. Up to 5 April 2008, individuals trustees and personal representatives were able to claim indexation between 31 March 1982 and the introduction of taper relief on 6 April 1998. This is not possible under the new régime.

Indexation relief can more than double the base cost of an asset held at 31 March 1982, consequently the overall increase in the tax payable on a disposal may be greater than the 'headline' increase (e.g. from 10% to 18% for a higher rate taxpayer disposing of a business asset).

Taper relief

Taper relief was withdrawn for all disposals, or where a held-over gain comes into charge.

Accordingly the effective rate of tax on an asset qualifying for full BATR increased from 10% to 18% if the vendor is a higher rate taxpayer, and from 5% to 18% if a basic rate taxpayer.

CGT payable on the disposal of assets qualifying for non-business asset taper relief at the maximum rate 40% either *increased* from 12% to 18% if a basic rate taxpayer, or *decreased* from 24% to 18% if a higher rate taxpayer.

Share identification rules

When an individual sells some, but not all, of his shares, or other securities, in a company, and has acquired the shares at different times, the share identification rules match the shares disposed of with particular acquisitions, in order to determine what expenditure is taken into account in computing the gain or loss on the disposal.

In matching shares disposed of on or after 6 April 2008 with acquisitions, all shares of the same class in the same company acquired before the date of disposal will be pooled to form a single asset, described as a section 104 holding.

Example: Montgomerie acquired 4,000 shares in March 2005 for £5,000 and a further 6,000 shares of the same class in the same company in September 2006 for £26,000. He will be treated as having a section 104 holding of 10,000 shares with a cost of £31,000.

If he sells 4,000 of the shares in June 2008, then, assuming that he has not acquired more shares on the date of disposal or within the following 30 days, for CGT purposes he will be treated as disposing of part of the section 104 holding. The expenditure deductible in computing the chargeable gain or loss on the disposal in June 2008 will be £31,000 x 4,000/10,000 = £12,400 using the method of apportionment described in CG50728

Rate of CGT

A rate of CGT of 18% will apply for all disposals, and will no longer vary depending on the top slice of income.

CGT - unchanged

Capital losses brought forward and arising in the current year will still be available to offset against gains.

The CGT annual exemption continues, as do other capital gains tax reliefs in the new regime including:

- Principal private residence relief
- Business asset roll over relief
- Business asset hold over relief
- Enterprise Investment Scheme relief, and Venture Capital Trust relief.

Entrepreneurs' Relief

The announcement of the proposed reform of CGT in the PBR (9 October 2007) produced much criticism for the Chancellor. The ministerial statement which followed in January 2008 introduced a £1 million lifetime allowance in respect of qualifying chargeable gains, which forms the basis of a new CGT entrepreneurs' relief from 6 April 2008. Gains not exceeding £1 million (ignoring gains realised before 6 April 2008) will be taxed at an effective rate of 10%. Any gains in excess of £1m will be taxed at the new mainstream CGT rate of 18%.

Schedule 3 FA 2008 provides that the relief applies where certain criteria are met. The disposal must relate to:

- the whole or part of a qualifying business (excluding investment business) owned by the individual throughout the period of one year ending with the date of disposal, or;
- assets in use in a business at the time it ceased, where the individual had owned the assets for a period of one year at the date of cessation and the disposal occurs within three years of the cessation, or;
- shares or securities in a company, subject to the following criteria:
 - The shares or securities must be of a trading company (or holding company of a trading group)
 - The shareholder must be an officer or employee of a trading company (or holding company of a trading group)
 - The shareholder must own at least 5% of the ordinary share capital carrying at least 5% of the voting rights.

These conditions must be satisfied throughout the 12 months prior to the disposal, or the 12 months prior to the cessation of trade (provided disposed of within three years of cessation)

Taper relief vs. Entrepreneurs' relief

CGT due on the sale of assets before and after 6 April 2008 is shown below:

Example 1

Yardy (a higher rate tax payer) acquires property qualifying for Entrepreneurs' relief on 1 January 1999 and sells on:

| | |
|--------------------------------|-----------|
| 4 April 2008(old rules) | £ |
| Gain | 1,000,000 |
| Taper relief at 75% | (750,000) |
| Gain chargeable to CGT | 250,000 |
| Tax at 40% | 100,000 |

| | |
|--------------------------------|-----------|
| 6 April 2008(new rules) | £ |
| Gain | 1,000,000 |
| Entrepreneurs' relief* | (444,444) |
| Gain chargeable to CGT | 555,556 |
| Tax at 18% | 100,000 |

Additional tax to pay under the new rules nil

Example 2

Sales proceeds now £2.25m, not £1.25m

| | |
|--------------------------------|-------------|
| 4 April 2008(old rules) | £ |
| Gain | 2,000,000 |
| Taper relief at 75% | (1,500,000) |
| Gain chargeable to CGT | 500,000 |
| Tax at 40% | 200,000 |

| | |
|--------------------------------|-----------|
| 6 April 2008(new rules) | £ |
| Gain | 2,000,000 |
| Entrepreneurs' relief | (444,444) |
| Gain chargeable to CGT | 1,555,556 |
| Tax at 18% | 280,000 |

Increase in tax to pay under the new rules 80,000

Example 3

Purchase date now 1 January 2007

| | |
|--------------------------------|-----------|
| 4 April 2008(old rules) | £ |
| Gain | 1,000,000 |
| Taper relief at 50% | (500,000) |
| Gain chargeable to CGT | 500,000 |
| Tax at 40% | 200,000 |

| | |
|---|---------|
| 6 April 2008(new rules) | |
| Tax at 18% per example 1 above | 100,000 |
| Decrease in tax to pay under the new rules | 100,000 |

* Entrepreneurs' relief on CGT subject to new lifetime limit of £1,000,000. Amount calculated as to 4/9th of the gain.

Whole or part of a business

ER is designed for the disposal of a business rather than an asset so the sale of a single asset may not qualify. S169I (2) TCGA 1992 states that there must be the disposal of the 'whole or part of' a business for the relief to operate. This rule is derived from the retirement relief legislation on which ER is based and there are a number of cases on this area.

In **McGregor v Adcock [1977] STC 206**, it was held that a farmer selling part of his land did not qualify. There was no interference with the trading activities as a whole so that it could not be said that a part of the business had been sold. A similar principle was applied in **Atkinson v Dancer** and **Mannion v Johnston [1988] STC 758**.

The case of **Purves v Harrison [2001] STC 267** demonstrates the importance of timing. The taxpayer ran a coach and minibus service and first sold off the premises, but retained a licence to occupy them. Before this disposal the taxpayer had been in informal discussions with a separate purchaser who acquired the actual business nine months later.

It was held that the intention to sell everything together did not create a sufficient connection between the two sales and so the disposal of the premises did not qualify. To succeed with a claim, taxpayers should be extremely careful with piecemeal sales. Each sale must be of a whole business or part of a business, carrying this out in several instalments may result in the loss of ER.

The trading requirement

As noted above, the shares or securities disposed of must be in a trading company or holding company of a trading group – as defined for business asset taper relief. This means that the company must be carrying on trading activities not including to a substantial extent activities other than trading activities, thus retaining the '20% test' used for the purposes of taper relief.

The 5% rule

The shareholder must own at least 5% of the ordinary shares carrying at least 5% of voting rights. Individuals with non-voting shares may be disadvantaged. For example, a company might wish to let employees or junior members of the family participate in the income and capital of the business, but not want them to have any say in how the company is run and may have issued them with non-voting shares. These employees will not be entitled to ER.

There is nothing, however, to say that they must have voting rights pro-rata to their holdings, just that they should have at least 5%. So in this sort of situation one might consider amending the voting rights of different holdings to increase the availability of ER on any future sale. Passing voting rights to people could trigger an immediate tax charge to the extent those rights have some value, although the right to have 5% of the votes in a private company may not in fact be of little worth.

Preference shareholders will be unable to claim ER even if they can vote, as shares that 'have the right to a dividend at a fixed rate but have no other right to share in the profit of a company' (s832 (1) ICTA 1988) are excluded from the definition of 'ordinary share capital.'

New share issues will dilute existing holdings and may depress some shareholders below the crucial 5% threshold. Conversely, purchases of own shares may have the added benefit of pushing people above the 5% point and giving them a new entitlement to the relief.

Whenever changes in shareholdings take place, the entitlement to ER for new and existing shareholders should be considered.

Sole traders and Entrepreneurs' relief – example

The following example looks at the typical case of a sole trader disposing of the business with a subsequent disposal of the trading premises.

Hopkinson has traded for several years from freehold premises personally owned by him. In recent years, he has let 40% of the premises on a short lease to a third party having previously used this for the purpose of the trade.

In January 2009 he decides to retire and sell the business. A gain of £400,000 arises on the sale of the goodwill, with the premises retained and let to the purchaser.

| | |
|---------------------------|----------|
| 2008/09 | £ |
| Gain | 400,000 |
| Entrepreneur relief (4/9) | 177,778 |
| Chargeable to CGT | 222,222 |
| Tax at 18%(ignores AE) | 40,000 |

Two years later, the purchaser has traded successfully and offers to buy the premises. Hopkinson duly accepts the offer, realising a gain of £1,000,000. Can ER be claimed against the gain arising?.

Period prior to the disposal of the goodwill

ER arises to sole traders who make 'qualifying business disposals' within s 169H. In the case of a disposal of a sole trade, a relevant business asset is an asset used for the purpose of a business carried on by the individual (s 169L(3)). There is no requirement for the asset to be fully used in the business.

Period following the disposal of the goodwill

s 169I((2)(b) and (4) combine to allow the post-cessation disposal of a business asset to be treated as a material disposal - even where the asset has been let to a third party - provided (a) disposal takes place not more than three years after the business ceases and (b) the chargeable asset was in use in the business at the time the goodwill was disposed of

Use of premises after cessation of business (up to three years) is not taken into account.

| | |
|---------------------------|-----------------|
| 2010/11 | £ |
| Gain | 1,000,000 |
| Entrepreneur relief (4/9) | <u>266,666*</u> |
| Chargeable to CGT | 733,334 |
| Tax at 18%(ignores AE) | 132,000 |

* Maximum £444,444 less £177,778 already used

Losses

Where business assets qualifying for ER are disposed of at the same time with some at a gain and others at a loss (probably as a result of the winding up of a sole trader's business) the relief due is calculated on gains net of losses. ER will be calculated by reference to the lower amount, and accordingly if there is a net loss on the disposal then no relief can be claimed.

Example: Trading premises sold at a gain of £1,000,000, with the loss on disposal of goodwill £250,000. The CGT computation shows:

| | £ |
|---------------------------|------------------|
| Relevant gains | 1,000,000 |
| Relevant losses | <u>(250,000)</u> |
| | 750,000 |
| Entrepreneur relief (4/9) | <u>(333,333)</u> |
| Chargeable to CGT | 416,667 |
| | |
| CGT 18% | 75,000 |

Unused Entrepreneurs' relief £250,000.

Alternative position where the goodwill is disposed of in the previous tax year:

| | |
|---------------------------|------------------|
| Relevant gains | 1,000,000 |
| Entrepreneur relief (4/9) | <u>(444,444)</u> |
| | 555,556 |
| Losses bf | <u>(250,000)</u> |
| Chargeable to CGT | 305,556 |
| CGT 18% | 55,000 |

CGT saved £20,000, unused ER £nil

Associated disposals

Where qualifying company shares or securities are sold, associated disposals of assets owned by the disposer and used in the company's business may also be eligible for this relief. The main example will be premises occupied by the company.

A similar rule will allow relief on an 'associated disposal' by a member of a partnership who is entitled to relief on the disposal of his interest in the assets of the partnership.

In both cases above, relief may be available if 'the individual makes the disposal as part of the withdrawal of the individual from participation in the business carried on by the partnership or by the company' (s169K (3) TCGA 1992).

Associated disposals: restriction of relief

s169P TCGA 1992 states that a "just and reasonable" restriction will apply to ER due in the case of an associated disposal where:

- the asset was not wholly in business use during ownership
- only part of the asset was used the purposes of the business
- the individual disposer was concerned in the carrying on of the business for only part of the period in which the asset was used in the business
- where the availability of the asset is or has been subject to the payment of rent

Payment of rent

The "just and reasonable" restriction in s169P above in respect of the payment of rent, as originally drafted in the 2008 Finance Bill, created the prospect of the loss of substantial amounts of ER for many individuals.

This proposed measure would notably affect individuals who have (particularly in recent years) incorporated an existing business, but at the same time retained individual ownership

of the trading premises and charged rent to the company.

The rent would be received free of a charge to National Insurance in the hands of the owner, while at the same time he would be able to enjoy business asset taper relief for CGT purposes on any subsequent disposal.

Following much lobbying on this point, the Government (FB Report Stage 25 June 2008) amended the draft provisions to provide for **the disregard of rent received before 6 April 2008 when assessing entitlement to ER.**

In consequence, where clients are charging their own business rent for the use of an asset, the tax position should now be revisited to ensure that the benefit obtained from charging rent outweighs potentially increased CGT liability on any future disposal.

Restriction of relief: Example

Trading premises purchased 1 June 2001, let at full market rent to personal company sold 31 May 2010.

1/3 of premises let to tenants 1 June 2001- 31 May 2004

Property sold 31 May 2010 with a chargeable gain (before ER) of £250,000

| Period | | Qualifying for ER | Non Qualifying |
|------------------------------------|---|-------------------|----------------|
| 1 June 2001 to 31 May 2004 | | | |
| $2/3 \times 36/108 \times 250,000$ | = | 55,556 | 27,778 |
| 1 June 2004 to 5 April 2008 | | | |
| $3/3 \times 46/108 \times 250,000$ | = | 106,481 | nil |
| 6 April 2008 to 31 May 2010 | | | |
| $0/3 \times 26/108 \times 250,000$ | = | nil | 60,185 |
| Totals | | 162,037 | 87,963 |

The CGT computation shows:

| | |
|--------------------------------------|-----------|
| Chargeable gain | 250,000 |
| Entrepreneur's relief (4/9*£162,037) | (72,016) |
| Chargeable to CGT | 177,984 |
| Tax at 18%(ignores AE) | 32,037 |

Withdrawal from participation

During the Finance Bill debate in May 2008, the Government was asked for clarification of what was meant by 'as part of the withdrawal of the individual from participation in the business' given that, for example, a partner may retire from business, but allow his former partners a period of time in which to raise the money to buy out his interest in the firm's trading premises. The Financial Secretary replied:

*'The expression means just what it states. **There is no specific time limit.** I will explain: there will be opportunities for a case to be made on a case-by-case basis. Asset disposal occurs as part of the overall process of withdrawal, **either before or after the material disposal of shares or partnership interests.** We have not imposed intentional barriers to entrepreneurs relief .we have deliberately focused on.....the provision of relief to individuals who withdraw from participation in a business. The eligibility criteria are not meant to replicate criteria for the old taper relief. It depends on the facts of the case, but **it is possible for someone to withdraw from a business and make an associated disposal at a later date.** If the disposal is linked to the withdrawal from participation, the individual may receive relief. We need to take a fair view of the case based on the facts*'The rules are flexible, as cases vary, so they need to cater for that. The key point, however, is that asset disposal [and] the disposal of shares or shares in a partnership, where relevant in the cessation of the business, is all part of one overall event or process. **I have accepted that the disposal does not have to take place all at one immediate moment'**. (my emphases)**

It was also stated that ER *could* be available where 'a partner withdrew and sold everything', but then 'came back as an employee or consultant'.

In November 2008,further guidance was supplied by HMRC in their updated CG Manual at 63995,which now states:

"Relief will not be due unless the disposal of an asset (held outside the partnership or company) is related to the individual's reduction of his interest in the assets of the partnership, or shareholding, as the case may be. It is not necessary for the individual to actually reduce the amount of work which they may do for the business. Example:

- G owns a shop from which he trades in partnership with his son. The asset-sharing ratio is - G 3/5ths: son 2/5ths. He wishes to reduce his involvement and the shares are then altered to - G 1/5th: son 4/5ths; G also gifts the premises to his son but continues to work full-time in the shop.
- R owns a small factory unit which is used by her "personal company", S Ltd of which she is the full-time managing director. She sells both her shares and the unit to another company in a takeover but remains managing director.

In these examples the material disposal (reduction of his interest in the assets of the Partnership/disposal of shares) together with the associated disposals (gift of premises/ sale of the unit) would represent a withdrawal from participation in the business".

Delays

Where a partnership or company ceases to trade, it is possible that there may be an interval between the material disposal and the disposal of the asset that is the subject of the associated disposal.

The legislation does not specify how long the gap can be before the disposal ceases to be associated with the material disposal, however, HMRC's CG Manual paragraph 63995 states: 'In such cases you may accept that a disposal of an asset is associated with a "material disposal" if the asset is disposed of:

- within one year of the cessation of a business; or
- within three years of the cessation of a business and the asset has not been leased or used for any other purpose at any time after the business ceased;
- where the business has not ceased, within three years of the material disposal provided the asset has not been used for any purpose other than that of the business.

'Cases which do not fall within the above guidelines will have to be considered carefully on their particular facts to see whether they meet the requirement of TCGA 1992, s 169K(3). For example if the asset has been used for any other purpose for a significant period following the material disposal, it is unlikely that the conditions for relief will be met.'

Example from CG63995

" M and S are in partnership running a chain of retail chemists. W owns one of the shops used by the business. He decides to leave the partnership and move abroad. M and S continue in partnership. W intends at the time of leaving the partnership to sell the shop, which continues to be used by the partnership, to M. However M needs time to arrange his finances to allow the sale to proceed. W disposes of the shop to M 18 months after leaving the partnership. So the sale of the shop qualifies as an 'associated disposal' under the third bullet point above as the business does not cease, the shop continued to be used in the business and the disposal of the shop takes place within 3 years of W leaving the partnership".

Claims

ER must be claimed: it is not sufficient that the conditions for the relief are met. The time limit for the claim for a disposal in a tax year is 31 January following the anniversary of the end of the tax year (in effect, 22 months following the end of the tax year).

Capital allowances from April 2008

Annual Investment Allowance

As previously announced, schedule 24 FA 2008 introduces a new 100% Annual Investment Allowance ("AIA") for the first £50,000 of a business's expenditure on most plant and machinery each year. The rules will apply to businesses regardless of size.

The new AIA will be available to:

- Any individual carrying on a qualifying activity
- Any partnership consisting only of individuals; and
- Any company, subject to the fact that groups will only be entitled to a single allowance per group.

The measure will have effect for expenditure incurred on or after 1 April 2008 for businesses within the charge to corporation tax and 6 April 2008 for businesses within the charge to income tax.

The AIA will be pro-rated if the chargeable period is more or less than a year. Where a business has a chargeable period spanning 1 or 6 April 2008 (as the case may be) the maximum allowance is calculated as if the chargeable period began on 1 or 6 April and ended at the end of the chargeable period.

Where a business spends more than £50,000 in any chargeable period any additional expenditure will be dealt with in the normal capital allowance regime.

Rate Changes

s 80 FA 2008 reduces the main rate of WDA for new and unrelieved expenditure on plant and machinery (including cars) from 25% to 20%.

Allowances on long-life assets will be increased from 6% to 10% with unrelieved expenditure in the long-life asset pool allocated to a new 10% 'special rate' pool. Again, there will be a hybrid rate for existing unrelieved expenditure in the long-life pool, although expenditure incurred after the change date will immediately be within the new special rate pool.

The measures have effect for the calculation of WDA for chargeable periods ending on or after 1 April 2008 for businesses within the charge to corporation tax and 6 April 2008 for businesses within the charge to income tax.

For businesses whose chargeable period spans 1 or 6 April 2008 a time-apportioned hybrid rate will have effect for unrelieved expenditure in any pool, including single asset pools. HMRC has provided a ready reckoner to assist businesses in calculating the hybrid rate.

Example

Prior (England) limited has a year end of 31 December 2008. The Capital allowances claim shows:

| | | |
|-------------------------------------|-------------|--------------|
| Pool brought forward 1 January 2008 | | 10000 |
| Additions after 1 April 2008 | 60000 | |
| AIA £37500 100%* | 37500 | |
| WDA £32500 21.25%** | <u>6906</u> | (44406) |
| Pool carried forward | | <u>25594</u> |

* $9/12 \times £50000 = £37500$

** $3/12 \times 25\% \text{ plus } 9/12 \times 20\% = 21.25\%$

AIA: Groups, “related” businesses, and anti avoidance

Companies within the company law definition of a group are legally and economically inter-dependent and will therefore receive a single allowance per group (to be allocated in such amounts as the group itself chooses).

Where a person, or persons together, control a singleton company, but do not control any “related” company, each such singleton company will be entitled to its own AIA, otherwise the £50,000 allowance will be apportioned among the related companies (again, allocated as chosen by the controlling person or persons).

For the purposes of the new AIA, whether one company is related to another in common control will be determined on the basis of a “similar activities” condition and/or a “shared premises” condition.

Similarly, where a person or persons control(s) an unincorporated business, but do not also control another “related” business (that is, as for companies, a business engaged in the same qualifying activity or using the same premises) each separate and distinct business will be entitled to its own AIA.

The Government has also introduced two targeted rules to defend against abuse of the AIA as follows: (a) Businesses adopting a fragmented structure for the purposes of accessing additional tax relief should be considered as part of the same economic entity for the purposes of the AIA and (b) Businesses are to be prevented from benefiting from the artificial use of unused annual allowances.

Integral Features

In addition to the above changes, s73 FA 2008(introducing new s33A CAA 2001) provides a new 10% WDA (reducing balance basis applies) on “integral features” of a building. The following assets will qualify:

- Electrical systems (including lighting systems.)
- Cold water systems
- Space or water heating systems
- Powered systems of ventilation, air-cooling or air purification (inc. floors or ceilings so comprised).
- Lifts, escalators, and moving walkways.
- External solar shading

In addition, allowances for thermal insulation will be extended to expenditure on the thermal insulation of all existing buildings, used for any qualifying business, other than residential property business. All allowances for thermal insulation will, in future, be restricted to the new 10% rate, in place of the 25% rate currently applying.

New s33A CAA 2001 provides for the amendment of the list by HM Treasury, limited to the removal of items that might otherwise qualify for plant and machinery allowances and the addition of items that would not otherwise be qualifying expenditure. This provides flexibility for HM Treasury to expand the types of asset qualifying for plant and machinery allowances generally through the introduction of previously non-qualifying items into the special rate pool. It would also potentially appear to allow reclassification of plant and machinery on the integral features list to qualify for a higher rate of allowances through the general pool.

These changes will have effect in respect of expenditure incurred on or after 1 April 2008 for businesses within the charge to Corporation Tax and 6 April 2008 for businesses within the charge to Income Tax.

Example:

Nash limited has a year end of 31 March 2009.The Capital allowances claim shows:

| | Plant & Machinery £ | Integral Features £ |
|-------------|------------------------|------------------------|
| May 2008 | | 60000 |
| Nov 2008 | 60000 | |
| AIA 100% | 50000 | |
| WDA 20%/10% | <u>2000</u> | <u>6000</u> |
| Pool c/fwd | 8000 | 54000 |

Nash Limited is in fact able to allocate the AIA against the Integral Features pool, taking advantage of the concession outlined in “Business tax reform: capital allowance changes technical note” issued in December 2007.

Para 3.9 states:” *Businesses will be free to allocate their AIA to qualifying expenditure in any way they wish; there will be no rules to restrict their freedom of choice. They will therefore be able to set their allowance against expenditure qualifying for a lower rate of allowances (such as expenditure on ‘long-life assets’ or ‘integral features’) before using any balance against their general plant and machinery expenditure.*

In this way, the AIA may be seen as a sort of de minimis provision, allowing modest amounts of annual expenditure on the new category of ‘integral features’ or on ‘long-life assets’ to be completely covered by the new 100 % allowance. This may be of particular assistance to smaller businesses”.

The claim now shows:

| | Plant & Machinery £ | Integral Features £ |
|-------------|------------------------|------------------------|
| May 2008 | | 60000 |
| Nov 2008 | 60000 | |
| AIA 100% | | 50000 |
| WDA 20%/10% | <u>12000</u> | <u>1000</u> |
| Pool c/fwd | 48000 | 9000 |

Anti avoidance

It was announced on 12 March 2008 that where more than half of any ‘integral feature’ is replaced within a twelve month period, the expenditure shall count as capital and not as revenue expenditure on repairs. The yardstick for the ‘more than half’ test will be the replacement cost of the asset, at the beginning of the relevant twelve-month period.

Example: Company with a 31 December year end

| | | |
|--|------------|----------------------------|
| Office general lighting system cost 2009 | | £100,000 (10% CAs claimed) |
| Estimated replacement cost | 2012 | £125,000 |
| Repair expenditure | Oct 2012 | £ 30,000 |
| | March 2013 | £ 40,000 |

Repair expenditure in years to 31 December 2012 and 2013 will be disallowable, but added to the IF pool of expenditure qualifying for CAs at 10%. As respects 2012, it is likely that the CT computation will need to be revised retrospectively where (initially) expenditure in 2013 was not taken into account when computing the 50% rule.

In addition, new s33B CAA 2001 does not limit this rule to expenditure on assets originally acquired after April 2008, but applies to all expenditure on assets on the list in s 33A irrespective of when purchased.

This in turn means that **all** expenditure on repairs of items on the integral features list needs to be considered in light of these new rules, regardless of when the original asset was acquired or indeed whether CAs were available at acquisition.

Example

| | | |
|---|---------|------------------|
| Office general lighting system cost 2004 | £70,000 | (No CAs claimed) |
| Estimated replacement cost | 2009 | £90,000 |
| Anticipated repairs 2009 in excess of £45,000 ? | | |

- Disallowed in tax computation
- Added to IF pool

During the Finance Bill debates on this issue, the Opposition spokesman put forward ‘*the example of a business that owned three floors of a building and totally replaced the wiring*’

and fittings on one floor. In theory, that would not meet the 50 per cent replacement rule. However, that floor received 100 per cent replacement. Would HMRC approach that example as not meeting the 50 per cent replacement rule, as I think it would, or are there difficulties because it is a total replacement of one part of the building?’

The Exchequer Secretary replied: *‘If the company owned three floors and replaced the electrical system for one floor.... it would be classed as a repair, not replacement.’*

Summary

At the outset of any project involving repairs to a building, care must be taken in identifying expenditure on categories within s33A, and an estimated replacement cost calculated for any integral feature that will be affected by the works. This requirement will produce a further unnecessary compliance burden

Final point: the above rules will override any other rules in tax law or accounting practice on what is capital or revenue expenditure.

Overseas holiday homes

Background

Chapter 5 ITEPA 2003 applies to living accommodation provided for an employee by reason of the employment. The basic charging provision is set out in s105 which defines the cash equivalent as the difference between rental value of the accommodation and any sum made good. ‘Rental value’ for this purpose is the rent which would have been payable for that period had the property been let to the employee at an annual rent equal to the annual value.

Annual value for a property in the UK is equivalent to the gross rateable value, a historical figure that tends to undervalue the benefit which is why s 106 was brought in for properties costing more than £75,000. In the case of overseas property without a UK gross rateable value, s 105 will be based on the annual rent that the property would fetch in the open market. In these cases HMRC will not impose a charge under s 106 per ESC A91.

So in summary, a UK resident individual should be subject to a benefit-in-kind charge in respect of the availability of overseas property held through a company, on the basis that he or she is a director (or shadow director) of that company.

It is now increasingly the case that overseas holiday homes are held through a company, perhaps because the overseas jurisdiction does not allow direct purchase by foreigners or because the owners wish to sidestep local laws giving specified relatives an absolute right to inherit directly-held real property, or for other reasons.

2007 Budget announcement

In a surprise announcement in the 2007 Budget the Chancellor announced that the charge would be removed, with retrospective effect, provided the following conditions were met:

- The property is owned by a company which is owned by individuals
- The property is the company’s sole or main asset
- Sole function of the company is to hold the overseas property (and receive rents, if applicable)
- Purchase of the property is not funded by a connected company.

Detailed provisions are contained in s 45 FA 2008. Provided the conditions are met the exemption is deemed always to have had effect. HMRC have indicated that if tax has been paid in the past on such a property then a claim for a refund can now be made.

Points of practice

Companies owning more than one property are not exempted by the new rules (conversely, it would appear that an individual owning several companies, each of which may own an individual property, may fall within the exemption).

No reference is made to the position where the shares are owned by trustees or local management company

UK situated property is not covered by the new rules; there remains, potentially, a tax charge on the occupation of property in the United Kingdom owned through a company.

The property-owning company, even if within the ambit of the new rules, will still be associated with any other companies owned by the same shareholders in cases where a rental income business is held to be carried on. The significance of this is that the existence of the property-owning company may, in some circumstances, restrict the ability of a trading company to claim small companies relief, and so increase the corporation tax payable.

Claiming exemption / tax repayment

Any individual who can show that they have paid income tax for any year before 2008-09 on the benefit of living accommodation which qualifies for exemption should write to:

Michael Robinson, HMRC CPPT Directors Office
5th Floor, Trinity Bridge House
2 Dearmans Place
Salford, M3 5DT

Information to be provided:

- name, address, National Insurance number and/or UTR
- if agent acting – agent's name and address
- details of the living accommodation outside the UK – address, type, use or uses made
- details of the company through which living accommodation is provided including name, address, place of incorporation, ownership and activities
- an explanation of why they consider that the exemption applies
- the years for which tax has been paid on the benefit of this accommodation
- evidence that the benefit of the accommodation in question has been taxed for each year e.g. copies of one or more of the following documents which clearly show the benefit as taken into account as taxable income:
 - assessments/self-assessments
 - P11Ds
 - coding notices
 - correspondence with HMRC or the former Inland Revenue

Cases not covered by the exemption

For cases not covered by the exemption, an example of the approach of HMRC to the calculation of the taxable benefit arising is set out in EIM 11421, reproduced below:

“A UK company purchases a flat in a French ski resort for £200,000. It is agreed that a market rental for the property would be £500 per week during the 6 month skiing season and £100 per week during the rest of the year. A husband and wife who are both directors of the company use the flat for holidays with their children for 3 weeks during the ski season and one week in the rest of the year. Their children are neither employees nor directors of the company. The employer advises that the sole reason the property was bought was as a holiday home for the husband and wife. It has only been used by them as a holiday home. We would argue in this case that provided is equivalent to available for use. Assuming that the flat was habitable for the whole of the year we would seek a benefit measured on availability for the whole of the year. The employer may argue that the husband and wife work full time and that this prevents them using the flat for more than the 4 weeks in the year of actual use and so they are effectively only provided with it for 4 weeks. We do not accept that argument.”

HMRC insist that the reference to living accommodation being provided to an employee should be equated with ‘made available’. Accordingly, in this example, the property is available 365 days a year with the result that the individuals are assessable on the full open market rent for the year.

A less punitive approach is adopted in the example shown at EIM 11422. The same basic facts as in EIM 11421 are outlined, but with a crucial difference as below:

“The company bought the property to let as a commercial letting business. They have employed professional agents to let the property and have managed to let the property for 12 weeks of the year in addition to the period it was used by the husband and wife directors. In this case we would accept that provided is equivalent to actual use”

Summary

The new legislation provides exemption for many individuals, but these will not apply to every case and practitioners should exercise caution in advising clients considering a claim.

Clients cannot be relied upon to advise agents of purchases of holiday homes and so requests for tax return information should include suitable questions about the purchase and disposal of offshore properties.

Trading stock

Where goods are either appropriated to or from trading stock or disposed of other than in the course of the trade, for tax purposes the profits should be adjusted to replace the actual proceeds with market value.

This above rule follows the decision in **Sharkey v Wernher (1955) 36 TC 275**, which many commentators have since argued was wrongly decided, or else subsequently overtaken by the increasing reliance on generally accepted accounting practice (GAAP) for tax purposes. Under GAAP (and IAS) goods taken for own consumption could be valued at cost

Sch 15 FA 2008 introduces legislation to put Sharkey v Wernher on a statutory basis and preserve the current tax treatment, to take effect for all transactions on or after 12 March 2008.

Trading stock is defined as anything 'which is sold in the ordinary course of trade, or which would be so sold if it were mature or its manufacture, preparation or construction were complete'. It includes 'all land or other property'.

For transfers prior to 12 March 2008, the application of the *Sharkey* decision was subject to the provisions of Statement of Practice A32 which states inter alia "*The case of Sharkey v Wernher 1955 36TC 275 establishes the principle that where a trader takes stock from his business for private use or enjoyment or disposes of stock otherwise than by sale in the normal course of trade, the transfer should be dealt with for taxation purposes as if it were a sale at market value. Inspectors of Taxes have been authorised to take a reasonably broad view in applying this principle*".

There is no statutory requirement on Inspectors to adopt the same view for transfers on or after 12 March 2008

SP/A32 also states that the principle is stated not to apply in three specific circumstances:

- a) services rendered to the trader personally or to his household
- b) the value of meals provided for the proprietors of hotels, boarding houses, restaurants etc and members of their families
- c) expenditure incurred by a trader on the construction of an asset which is to be used as a fixed asset in the trade.

Current market conditions are making properties harder to sell, with builders and developers unable to find purchasers as their projects are completed. What is the tax position if a builder lets out a property he has been unable to sell?

HMRC's view is as stated in BIM 51625 'A house built and offered for sale by a builder in the ordinary course of their business is trading stock. The taking of such a house for private occupation should be treated as a sale at market value for Income Tax purposes following *Sharkey v Wernher*'. Accordingly, HMRC policy is that, if the property was originally built with a view to being sold to a member of the public, it was trading stock. A deemed sale at market value under sch 15 FA 2008 when it is transferred to private use after 12 March 2008 arises.

Despite the view of HMRC as stated above, there are in fact a number of tax cases in which it was held that, where a builder or developer built houses, let them out, and then finally sold them, they remained trading stock until they were finally sold. For example, in **J & C Oliver v Farnsworth (1956) 37 TC 51** a house that had been built in 1929 was held still to be trading stock when it was finally sold in 1953.

Conclusion

Whether the houses were stock-in-trade, or whether they were built as investments, and whether trading has ceased, are questions of fact. Houses, originally built for sale, may remain trading stock even if let out for many years, such that there is no immediate tax charge when the decision is taken to let the property to a tenant.

In these situations it is advisable to provide evidence of intention to let on a temporary basis pending sale. For companies, a suitable statement to this effect should be included in the director's report.

Chargeable gains and trading stock

s 161(1) TCGA 1992 provides that an appropriation of a capital asset into trading stock crystallises the chargeable gain, as if the asset had been disposed of on the open market at that time. s161 (3) however, allows an election whereby no gain arises under s 161(1) and the asset becomes trading stock at market value less the accrued gain i.e. at original cost.

s 173 extends the rule for groups of companies, to allow a transferee trading company to elect that a capital asset transferred from another group company be brought into trading stock at market value less the accrued gain.

The new provisions in Sch 15 FA 2008 do not mention these capital gains rules, as a result producing potential for conflicting interpretations of the tax rules applying to a transfer of stock in these situations. This is best explained by an example.

Company A transfers a chargeable asset costing £250k but now valued at £1m to Company B in the same group.

Company B brings the asset in as trading stock and elects under s173 above to produce a tax valuation of £250k(MV £1m less accrued gain £750k).

Para 6 sch 15 FA 2008 however states that the “cost of the stock is taken to be the amount which it would have realised if sold in the open market at the time it became trading stock of the trade” i.e £1m.

If we take this as a given, and Company B sells at the same market value, then the trading profit is nil and the capital gain has also fallen out of account.

During the passage of the Finance Bill committee stage hearings, amendments were proposed to ensure that a s173 election would take priority. In reply, the Government stated:

‘The amendmentsappear to be based on a concern that the legislation will override and affect the capital gains rules set out in TCGA 1992, ss 161 and 173... concern is unfounded. The schedule will have absolutely no impact on the operation of the capital gains legislation, and ss 161 and 173... will continue to apply in the same way as they do currently. Had our intention been to override those sections..., we would have explicitly amended or repealed them. We have not done so because that is not our intention.’

The statement does little or nothing to resolve the potential conflict; as a result it remains to be seen how HMRC and the courts view the matter in future.

IHT -Spousal exemption

Schedule 4 FA 2008 allows the unused nil rate band of the first of a married couple (or civil partnership) to die to be ‘inherited’ by the survivor, to increase the nil rate band ‘for the purposes of the charge to tax on the death of the survivor’ (new section 8A(3) IHTA 1984).

The rule applies where the survivor dies after 9 October 2007.

‘The charge to tax on the death of the survivor’ includes not only the charge on assets transferred on his or her death, but also any charge which crystallizes on death in respect of PETs made during the last seven years of life.

Where a valid claim to transfer unused nil-rate band is made, the nil-rate band available when the surviving spouse or civil partner dies will be increased by the proportion of the nil-rate band unused on the first death.

Example; if on the first death the chargeable estate is £150,000 and the nil-rate band is £300,000, 50% of the nil-rate band would be unused. If the nil-rate band when the survivor dies is £325,000, then that would be increased by 50% to £487,500.

Other points to note

The amount available to be transferred is restricted to the amount of the nil rate band in the year of second death. The maximum nil rate band that can then be claimed on the second death is thus twice the individual nil rate band for that year. This is intended to deal with the situation where an individual may have had more than one spouse or civil partner and therefore more than one unused nil rate band.

- The claim for transfer of unused nil rate band will be made by the personal representatives of the estate of the second spouse or civil partner on submission of the IHT return. No claim is required on the first death
- A claim must be made within two years of the second death although there are provisions to extend this in certain circumstances
- A separate claim is required for each transfer of unused nil rate band if there was more than one deceased spouse or civil partner
- The relief may equally be claimed where the first spouse died under the CTT (13 March 1975 to 18 March 1986) or Estate Duty (pre 13 March 1975) régimes.

The announcement does not help siblings living together, as they are not married or in a registered civil partnership. The elderly Burden sisters, who have lived together all their lives, lost their claim in the ECHR to have the same IHT relief as married couples and civil partners, when the first of them dies. On the first death, the other will have to sell the family home to pay the IHT due. The Court differentiated their position from married couples and civil partners and found that the UK tax system was not discriminatory **Burden & anor v UK [2008] ECHR 357**.

Examples of IHT payable under the new rules

A dies on 14 April 2007 with an estate of £400,000, which he leaves entirely to his spouse, B. B dies on 17 June 2009 leaving an estate of £600,000 equally between her two children. When B dies the nil-rate band is £325,000. As 100% of A's nil-rate band was unused, the nil-rate band on B's death is doubled to £650,000. As B's estate is £600,000 there is no IHT to pay on B's death.

J dies on 27 May 2007, with an estate of £300,000. She leaves legacies of £40,000 to each of her three children with the remainder to her spouse K. The nil-rate band when J dies is £300,000. K dies on 15 September 2009 leaving his estate of £500,000 equally to his three children; the nil-rate band when K dies is £325,000. J used up 40% of her nil-rate band when she died, which means 60% is available to transfer to K on his death. So K's nil-rate band of £325,000 is increased by 60% to £520,000. As K's estate is only £500,000 there is no IHT to pay on K's death.

R dies on 14 April 2007 with an estate of £450,000, which he leaves entirely to his spouse, S. S dies on 17 June 2009 leaving an estate of £675,000 which she leaves equally between her two children. When S dies the nil-rate band is £325,000. As 100% of R's nil-rate band was unused, the nil-rate band on S's death is doubled to £650,000. This leaves £25,000 chargeable to IHT on S's death.

X dies on 14 April 2007 with an estate of £250,000, leaving £120,000 to his son Y and the remainder to his spouse Z. The nil-rate band when X dies is £300,000 so 60% of his nil-rate band is unused. Z later marries W who dies on 14 May 2008 and also leaves 60% of his nil-rate band unused. Z dies on 14 June 2009 with an estate of £700,000 when the individual nil-rate band is £325,000. Z's nil-rate band is increased to reflect the transfer from X and W, but the amount of increase is limited to 100% of the nil-rate band in force at the time. So Z's nil-rate band is £650,000, leaving £50,000 chargeable to IHT on Z's death.

PROPERTY INVESTING AND PROPERTY DEALING

It is natural to consider the CGT consequences which arise when a property is sold, but advisable to remember that CGT is the secondary tax and that IT takes precedence. It is prudent always to consider the possibility that the transaction may be regarded as trading, however remote that possibility might be.

Investing and dealing compared

Persons who acquire property will either be classed as investor or dealer. It is important where possible to establish a classification before initial investment, as the status may have a material effect on tax liabilities.

Investor status applies to property owners not concerned in trading. With effect from 6 April 2007, s989 ITA 2007 defines a trade as including **'every venture in the nature of trade'**. (Note: this contrasts with the wider definition under s832 ICTA 1988; **'every trade, manufacture, adventure or concern in the nature of trade'**)

Badges of trade

"Trade" is not further defined in the legislation, and so as a result the question of what precisely what constitutes a trade has been left to, and determined by, the courts in many decided cases. The following **badges of trade** have been developed by the courts from the element of doubt which may exist as to whether a transaction or series of transactions fall within the statutory definition of 'trade'.

Motive for acquiring the property – profit seeking?

This is the fundamental and most significant test. Evidence that the sole object of acquiring an asset was to re-sell it at a profit, without any intention of holding it as an investment, is a pointer to the conclusion that a trade is being carried on. However, the presence of a profit-seeking motive is not necessarily a decisive pointer to the existence of a trade. It is one factor to be weighed along with all the other relevant factors. Note, it is not the existence of a profit which is important, but the motive to earn one.

The existence of a profit-seeking motive is a question of fact that is not necessarily determined by the person's professed intentions. Where appropriate it can be inferred from the surrounding circumstances.

In **Rutledge v CIR [1929] 14TC490** the Lord President said: 'It has been said, not without justice, that mere intention is not enough to invest a transaction with the character of trade. But, on the question whether the appellant entered into an adventure or speculation, the circumstances of the purchase, and also the purchaser's object or intention in making it, do enter.....into the solution of the question.'

In **Marson v Morton [1986] 1 WLR 1343**, the profit on a single transaction in land was held to be a capital, not trading, receipt. The taxpayer purchased land with the intention of retaining it as an investment for at least two years, and in order to increase the value, applied for planning permission.

Despite the fact that the application pointed towards property dealing, it was held that, as the original intention was the purchase of an investment, no trade was being carried on.

In its judgement, the court confirmed the view expressed in BIM 20205 that whether there has been an adventure in the nature of trade is a question of fact that depends on all the facts and circumstances of each particular case. In this case, documented intentions made the difference.

In **Taylor v Good [1974] 49 TC 277**, a husband purchased a property to be used as a family home. However on seeing the house, his wife refused to live in it. As a result he had no option but to sell. Despite it being a one-off transaction, the Inland Revenue considered that the badges of trade applied because the asset was only owned for a very short period of time. However, there was clearly another reason for the acquisition and subsequent sale – there was a genuine intention by the taxpayer to live in the house rather than simply to make a quick profit, and therefore the transaction was held not to be a trading transaction.

The Court of Appeal judgement stated: ‘a person who buys a property without the intention of reselling it, and who was not otherwise engaged in the purchase and sale of land by way of trade, cannot be held to have engaged in an adventure in the nature of trade merely because having decided to sell the property (they) take steps to enhance its value’.

The subject matter of the realisation

Traditionally, property investments have been purchased of a long-term income-producing nature, thereby indicating property investor status - but this is a rebuttable presumption, as shown in the prime example of **Lynch v Edmondson (SpC 164)**.

This case concerned a self-employed bricklayer, who built two flats on a plot of land, having borrowed £40000 from the bank to finance the development. He was unable to sell the properties so let them to the local council for 3 years. At the same time the taxpayer leased one of the flats to his girlfriend for 99 years at a premium of £41500 and a peppercorn rent. The transaction was financed by a mortgage in the girlfriend's name that allowed the taxpayer to repay the bank loan

The flats were eventually sold and he appealed after HMIT assessed him to income tax under Sch. D Case I in respect of the premium received for the lease. In reaching his decision, the Special Commissioner applied badges of trade principles to the particular circumstances of the case.

Most (but not all) of the badges pointed towards the lease constituting a trading transaction, resulting in the taxpayer's appeal being dismissed - the Lynch case showing that land can be the subject matter of a trade.

The badges of trade principles apply to sales of all types of assets. But with many classes of assets such isolated sales or dealings are comparatively rare. A person who wishes to buy and sell such assets is more likely to set up a regular business of doing so and this will be readily recognisable as a trade. But property lends itself less likely to occasional deals. Many of the cases relating to the badges of trade have been concerned with purchases and sales of property.

In addition, property has always been regarded as a suitable sphere for investment which has naturally led to the argument that a sale of such property is simply a change of investment and not a trading activity at all, or, at least, that any profit on the sale is capital rather than revenue.

In **Kirkham v Williams ([1991] STC 342)** a demolition contractor purchased a site and used it for office space and storage. He later obtained planning permission to build a large dwelling house on the site. He then sold the entire site and carried on his business elsewhere. HMIT raised a Sch. D Case I assessment on the profit and this assessment was upheld by the Commissioners and the High Court. This decision was, however, overturned by a majority verdict in the Court of Appeal, where it was accepted that the site was acquired and sold as a capital asset.

Again in *Marson v Morton*, already quoted, the High Court upheld a decision by the Commissioners that a gain on the purchase and resale of land by shareholders in a potato-merchandising company was a capital and not an income profit. There have been other successes achieved by taxpayers with regard to property so that it cannot be said that selling property is always to be regarded as a trade.

Length of ownership

Property purchased and subsequently sold within for a short period, typically between 1-2 years, is more likely to be regarded by HMRC as indicative of property dealing. BIM 20310 states: ‘...if you can show an intention, at the time of purchase, to sell quickly that supports the idea of trading because trading implies the idea of turning over assets for profit. And even if no such intention is admitted or demonstrable, the fact that a sale did actually take place after a short period of ownership will help the trading inference if you can find sufficient of the other badges of trade.’

Frequency or repetition of sales

An isolated transaction may be enough to constitute a trade but repetition of transactions, especially at frequent intervals is even more likely to do so. In **Pickford v Quirke (13 TC 251)** a taxpayer was a member of four different syndicates, which were engaged in successive liquidations of cotton-mill companies and the resale of their businesses. He was held to be carrying on a trade. Although a one-off transaction is capable of being a trading transaction, a lack of repetition generally points away from the existence of a trade, a view acknowledged by the Special Commissioner in the Lynch case.

What was the source and method of finance for the transaction?

Where money is borrowed, this often indicates an intention to re-sell in the short term, a fair pointer towards trading. In the Lynch case, bank borrowings financed the property construction on terms whereby the loan would be repaid out of the sales proceeds from the first flat, a factor indicating that a trade was being carried on

Was the transaction in some way related to the trade which the taxpayer otherwise carries on?

The Special Commissioner in the Lynch case noted that the construction of the flats was related to the taxpayer's trade of bricklaying, and the fact that the taxpayer was directly involved in their construction was deemed to be an indicator towards trading.

Supplementary work on or in connection with the property realised

This is one of the easier badges to identify. Anything which is done to the asset which makes it saleable is a strong indicator of trading. In the property context, obtaining planning permission for development would be an obvious change in the nature of a piece of land. Dividing the land into building plots would be another. Turning a commercial building such as an old warehouse into luxury flats would be clearly viewed as a badge of trading.

Work carried out on an asset prior to sale is a factor in determining the existence of a trade. The asset in the Lynch case was the land on which the flats were built. Their construction was considered relevant to the badge of supplementary work, and provided a further pointer towards trading.

Was the item purchased resold in one lot, or broken down into several ?

The sale of the flats separately in the Lynch case was considered to be a further indicator towards trading.

Circumstances responsible for realisation

The presence of a profit-seeking motive is not necessarily a decisive pointer to the existence of a trade. However, evidence indicating that the sole object of acquiring an asset was to re-sell at a profit, with no apparent investment motive, would normally favour trading treatment

An intention to re-sell in the short term might be a pointer towards a trading transaction, as opposed to an investment. Lynch intended to sell one of the flats at the time of purchase, as agreed under the terms of the bank loan to finance the construction work.

Conversely, a sudden emergency or necessity to quickly realise an asset is therefore likely to help dispel any argument as to the existence of a trade. In **IRC v Old Bushmills Distillery Co Ltd [1928] 12 TC 1148**, it was held that sales by a liquidator of the whisky stock of a distilling company which went into liquidation constituted the realisation of company assets, and that the liquidator was therefore not engaged in a trade

Income from the asset prior to disposal

If an asset yields an income, for example, rent or dividends, this provides prima facie evidence that it is more likely to be an investment than if it produces no income. Receipt of rent from property in the Lynch case therefore indicates that acquisition may have been for investment purposes.

Badges of trade - conclusion

Whether or not a transaction or series of transactions constitute trading will depend upon the circumstances of each individual case. No single badge of trade is conclusive evidence in itself. It is therefore necessary to critically examine the overall picture, distinguishing any unique features.

Tax Advantages of a property investment business

Gains arising on property disposals are treated as capital gains. This provides the ability to claim CGT exemptions and reliefs, including:

- Annual Exemption - available to individuals but not companies.
- Taper Relief (see below).
- Principal Private Residence relief
- Private Letting relief
- Exemption for non-UK residents.
- No National Insurance is payable on rental income.

Tax Disadvantages of a property investment business

- All business assets are fully exposed to IHT on death.
- Abortive expenditure on property purchases (e.g. surveys), or sales (e.g. advertising), may not be allowed for tax purposes
- Limited scope for loss relief (Exception: furnished holiday lets, see post)
- Accounting periods ended 5th April each year are compulsory.

Tax Advantages of a Property Trade

Greater scope for claiming indirect or abortive expenses relating to property transactions.

Long-term assets of the business attract the higher rate of taper relief for CGT purposes prior to 5 April 2008.

Losses can be set off against any other income arising in the same or previous tax year. Any date may be chosen for the accounting year-end.

The value of a property development or property management business will be exempt from IHT on death.

Tax Disadvantages of a Property Trade

Profits arising on property sales are subject to both Income Tax and NIC.

Non-UK residents are fully taxable on all profits derived from a UK based property trade.

Taper relief 1998 to 2008

Unlike sole traders and partners charged to income tax, property investors are entitled to deduct a proportion of the gain from CGT. This is known as taper relief, and the amount available will depend on the length of ownership as detailed in the table below.

| Years held after 6 April 1998 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10+ |
|-------------------------------|----|----|----|----|----|----|----|----|----|-----|
| Business assets % relief | 50 | 75 | 75 | 75 | 75 | 75 | 75 | 75 | 75 | 75 |
| Non-business assets % relief | 0 | 0 | 5 | 10 | 15 | 20 | 25 | 30 | 35 | 40 |

Note that a progressively larger portion of the gain is exempted as the property is held.

As taper relief only came into effect on 6th April 1998, it is only periods after that date which may be taken into account for taper relief purposes.

However, there is an exception to this rule, which is that, where the property was already owned on 17th March 1998 an extra "bonus year" is counted for taper relief purposes.

Note that, like the annual exemption, taper relief is not available to companies.

Business asset taper relief and qualifying property

Disposal of a property will qualify for business asset taper relief for disposals between 6 April 1998 to 5 April 2008 where wholly or partly for the purposes of a trade carried on by an individual (either alone or in partnership); or used wholly or partly for the purposes of a trade carried on by an individual's 'qualifying company'. (Note the definition of an individual's qualifying company changed in April 2000)

From 2000, the availability of Business asset taper relief was extended, and may *also* apply on the sale of property occupied by a business, for owner-occupier and landlord alike, where the tenant is as below:

From 6 April 2000 to 5 April 2008 an unlisted trading company.

From 6 April 2004 to 5 April 2008 an unincorporated trader (sole or partnership)

and used for the purpose of the trade in each case.

CGT planning points

Some points for individuals and partners to note when undertaking property transactions:

Individuals married and living together can transfer assets between themselves without having to pay CGT.

“Married” for this purpose is extended (from December 2005) to include same sex couples who have registered under the Civil Partnership Act 2005

Gifts and sales at undervalue to “connected persons” may produce CGT liabilities – even in cases where no money has been received.

On death, there is no CGT to pay on chargeable assets within the estate – however if an asset is later disposed of by a beneficiary, CGT will be payable based on the difference between the market value at the time of death and the value at the time of disposal

CGT and losses

CGT is charged on all chargeable gains, less allowable losses of the same tax year, less unused allowable losses brought forward.

A current year loss is set off in priority to losses brought forward.

Capital losses cannot be carried back, with the exception of unused allowable losses of a deceased individual in the tax year of death. Those losses can be carried against chargeable gains of the preceding 3 tax years, starting with gains of the later year

Note that time limits apply when claiming loss relief for CGT purposes.

Purchasing property in joint names

A good tax planning strategy is to hold a property in joint names, this because each joint owner can use the annual CGT allowance when the property is sold.

Also, up to 5 April 2008, holding a property in such a way is also beneficial if one is a lower rate taxpayer than the other, with the lower rate taxpayer holding a greater share.

This will help not only to reduce the CGT bill when the property is sold, but also any ongoing income tax liabilities on rental income (see further).

Note also, in the case of joint owners who occupy investment property as Principal Private Residence (PPR), the normal CGT lettings exemption of £40000 on sale is given to each joint owner (see also further)

Purchasing property in joint names will usually take one of two forms:

Joint Tenants

In this type of partnership, all owners will have an equal share of the property – most commonly seen when spouses purchase a property jointly.

The most important point about this method of ownership is that when one of the joint tenants dies, then the property automatically becomes in the ownership of the surviving tenants(s)

Tenants in common

Here, the joint owners register the existence of separate shares of ownership – most commonly seen when two or more unconnected people purchase a property together.

The most important point about this method of ownership is that when one of the tenants in common dies, then the property is not automatically transferred to the ownership of the surviving tenant(s)

Limited company: advantages and disadvantages

A property investor has to decide whether to trade personally or through the medium of a limited company. The key reason for forming a company will often be the limited liability protection provided to its owners; a company is considered a separate legal entity, the shareholders have limited liability for the company's debts, and in most cases the personal assets of shareholders are not at risk for satisfying company liabilities

Some of the other advantages and disadvantages of trading as a company are as follows:

Advantages

There is flexibility regarding share transfers. Therefore if the taxpayer wishes to spread ownership throughout the family, this can be effected relatively easily.

Stamp duty is only 0.5% on share transfers.

The advantage of lower tax rates on net rents can be gained – but note increasing CT rates.

Indexation relief is available on capital gains. This relief is designed to exempt the purely inflationary element of any capital growth, and is calculated by taking the increase in the RPI from date of purchase of the property until disposal

Income may be extracted by dividend, without national insurance payable, subject to income shifting rules after April 2010.

Company formation costs can be nominal only.

Disadvantages

Annual CGT annual exemption, taper relief, and entrepreneur relief unavailable to companies.

Cost of administration and accounts filing (annual costs can be as much as 3-4 times more expensive for a small company).

Potential double CGT charge, if dissolution of the company is contemplated at some point.

The double CGT charge disadvantage is a very real one, and combined with the lack of annual CGT exemption, taper relief (to April 2008), and entrepreneur relief (after April 2008) means that a company is only worthwhile if it is intended to form a continuing business of property investment on a long term basis.

Incorporating a rental business

If incorporation is under consideration however, tax efficiency will obviously depend on the availability of Incorporation Relief, which is itself dependant on whether the rental “business” is being transferred as a going concern when the portfolio is incorporated.

HMRC outlines its interpretation of 'business' and 'going concern', at CG 65712–65718 which states that a business includes a trade but that it is wider than that. They also mention that passive property ownership is unlikely to qualify as a business, however many landlords with substantial and/or growing portfolio may not be regarded passive in their buy to let business. If the client is involved in actively managing the properties there should be little doubt that there is a property business and consequently s.162 incorporation relief should be available.

As the properties are transferred at market value for tax purposes then chargeable capital gains will arise, to be set against the base cost of the shares under s.162 TCGA 1992.

The chargeable gain on the transfer of properties is deferred by reducing the amount otherwise chargeable, by the fraction A/B , where 'A' is the 'cost of the new assets' and 'B' is the value of the overall consideration received by the transferor in exchange for the business.

Important: Although s162 relief should be available on the transfer, the shares themselves will *not* qualify for entrepreneur reliefs on later sale or winding-up. As indicated in the case of **Patel v Maidment (SpC 383)** a taxpayer may own and operate a rental **business**, this does not mean that he can be said to be carrying on a **trade, profession or vocation** (as required for the purpose of this relief – s169S(1)(a) TCGA 1992).

Disincorporating a rental business

From April 2008, the basic rate of income tax decreased to 20% and the small companies rate for corporation tax increased to 21%. These changes, coupled with the CGT advantages conferred by individual ownership of property and the burden of administering a company will mean that some property companies may now be considering disincorporation.

Caution should be exercised in this situation – no 'disincorporation relief' exists in UK tax legislation, which means that chargeable gains will arise when the properties are transferred to the shareholders at a deemed market value for tax purposes (s17 TCGA 1992). The CGT cost of disincorporating may prove to be prohibitive, particularly if a substantial capital gain is likely to arise.

If the tax cost of transferring the property is however manageable, then it may usually be preferable to distribute it to the shareholders in specie during the winding-up. This will normally avoid any SDLT charge (para 1 sch 3 FA 2003) and rank as a capital distribution in the shareholder's hands. However, any assumption of a property loan/mortgage by the shareholders would represent consideration for the transfer with a consequent SDLT charge. If the property is sold to the shareholders on or just before the trade ceases, perhaps to access trading losses that might otherwise remain unused, then SDLT will be payable at the relevant rate (maximum of 4% for property sold for more than £500,000).

Furnished Holiday Lets (FHLs)

The letting has to satisfy s325 ITTOIA 2005 to be classed as a FHL and obtain the tax advantages. A letting is a FHL if the property is:

- available for commercial letting (with a view to the realisation of profits) to the public as holiday accommodation for 140 days in a year, and;
- actually let for 70 days in that period; and
- not let to the same tenant for a continuous period exceeding 31 days in a seven-month period.

The property must be furnished and situated in the UK. Despite the word 'holiday' in the provisions, there is no requirement for the property to be within walking distance of the seaside. A flat in a city let out to sightseers could qualify.

There are a number of tax advantages of having a FHL. Among these:

- Profits are net relevant earnings (NRE) for pension purposes.
- Relief may be due for pre-trading expenditure
- Losses on FHLs can be relieved in the same way as trading losses i.e. against general income in either the current or preceding year;
- Capital allowances (including FYA/AIA) are available on fixtures and furnishings.

PIM 4120 also states that Class IV NI contributions are not due on FHL income as 'furnished holiday letting is not a trade'.

FHLs are "business assets" for all aspects of CGT. A sale of the property after more than two years will therefore qualify for the maximum rate of business taper relief causing 75% of the gain to be tax-free. Entrepreneur's relief may also be available after April 2008. Gift relief or roll-over relief is also available if the FHL is gifted, or sold and replaced.

The commerciality of the operation is the keynote to treatment as a trade, and this also extends to a caravan lettings business. As many services as possible should be supplied, whether or not undertaken by the owner(s). Some examples:

- a. Meeting and greeting new holiday tenants.
- b. Organising car hire.
- c. Cleaning and laundry.
- d. Supply of basic food for the fridge.
- e. Arranging for the property to have details of local maps and guides and details of nearby historic attractions.
- f. Ensuring that the garden is maintained at all times.
- g. Maintenance of the property during and after the period of letting.

A contemporaneous record of these services should be maintained in case of HMRC query.

FHLs: longer-term lets and rollover relief

Many property owners in holiday areas let their properties out during the main holiday period on a short-term basis but during the quieter part of the year on a longer-term basis.

Do these longer lettings - which may be to the same person for more than 31 days - preclude a claim to roll-over relief when the property is subsequently disposed of ?

The answer is no. HMRC in Tax Bulletin 4 (Aug 1992) has stated "provided the letting during the main holiday period satisfies the requirements of ss 503 and 504, the longer lettings in any other part of the same year of assessment will not preclude relief. We regard the whole of the income derived from the property for that year as arising from commercially let furnished holiday accommodation. So roll-over relief will generally be due on the property, subject to the other conditions for the relief being satisfied".

FHLs and Entrepreneur relief

S169S TCGA 1992 confirms that entrepreneur's relief may be available on a disposal of a property comprised in a qualifying furnished holiday lettings portfolio.

FHLs and IHT

The special IT and CGT regime for FHLs does not extend to Inheritance Tax (IHT).

For IHT purposes, it was traditionally possible to secure Business Property Relief (BPR) for a business of furnished holiday lets comprising a number of properties, although more recently relief could be obtained, subject to conditions, on a single property only. The IHT manual (IHTM 25278) stated in March 2006 "You should therefore normally allow relief where:

- the lettings are short term (for example, weekly or fortnightly); and
- the owner - either himself or through an agent such as a relative or housekeeper - was substantially involved with the holidaymaker(s) in terms of their activities on and from the premises even if the lettings were for part of the year only".

This view however was amended (November 2008) and now reads:" In the past we have thought that business property relief would normally be available where:

- the lettings were short term, and
- the owner, either himself or through an agent such as a relative, was substantially involved with the holidaymakers in terms of their activities on and from the premises.

Recent advice from Solicitor's Office has caused us to reconsider our approach and it may well be that some cases that might have previously qualified should not have done so. In particular we will be looking more closely at the level and type of services, rather than who provided them.

Until further notice any case involving a claim for business property relief on a holiday let should be referred to the Technical Team (Litigation) for consideration at an early stage".

UK PROPERTY RENTAL INCOME AND EXPENSES

The rental income 'business'

Income tax is normally charged on rental and certain other income arising during the tax year, calculated as if the 'business' was a trade. This means that expenses are generally allowable if incurred 'wholly and exclusively' for business purposes.

Rents are assessed on an accruals basis, self-assessed (rents received less expenses incurred) on principles similar to trading income, for both furnished and unfurnished lettings. Profit and loss computations must be on a current, fiscal year basis. That is, the profit for the year ended 5 April 2008 is charged for 2007-08 and so on for later years. There are two exceptions.

- a property let by a trading or professional partnership using the trade basis period, and
- where the letting amounts to a trade, as in a hotel or guesthouse business.

The 'earnings basis' treatment of receipts and expenses as outlined above follows ordinary commercial accountancy methods. Accruing income and expenses in this way gives the correct measure of business profits. However, rental business profits based on cash received and paid in the tax year may not be materially different from the strict earnings basis profits where:

- rental incomings fall due at frequent intervals (say weekly or monthly),
- business expenses are paid at similarly short intervals.

In these situations, HMRC is prepared to accept the use of a 'cash basis' (profits based on the cash paid and received in the year) provided all the following conditions are met:

- the case is small; gross rental receipts less than £15000 per year
- the 'cash basis' is used consistently, and
- the result is reasonable overall and does not differ substantially from the strict 'earnings basis'.

Time apportionment

The charge for IT cases is on the full amount of the profits arising in the tax year –s270 ITTOIA 2005. HMRC (PIM 1010) accepts that this can be done either from accounts to 5 April, or by time apportionment between two sets of accounts drawn up to some other accounting date.

Time apportionment need not be the method used to arrive at the income of the year ended 5 April if a better method is available - see **Marshall Hus & Partners Ltd v Bolton [1980] STC539**. In that case the company prepared one set of accounts to cover a period of more than five years. So one period of accounts covered six accounting periods. Apportionment by reference to the actual deals in each of the accounting periods gave fairer results than time apportionment.

For CT cases, s9 ICTA88 provides that 'the amount of any income shall for the purposes of CT be computed in accordance with IT principles'.

Receipts other than rents

Receipts other than rent can form part of the rental business. Some of the main categories are:

- Rent charges, ground rents and feu duties
- Premiums and other lump sums received on the grant of certain leases
- Reverse premiums – s311 ITTOIA 2005
- Income arising from allowing waste to be buried or stored on land
- Income from letting others use land - for example, where a film crew pays to film inside a house or on land,
- Grants received towards revenue expenses, such as repairs to a property which are deductible in computing rental business income.
- Income from caravans or houseboats (but see ESCB29 and s20 ITTOIA 2005)
- Service charges received from tenants.
- Refunds or rebates of rental business expenses previously allowed for tax
- Insurance recoveries on policies providing cover against non-payment of rent

Jointly owned property

Where there is no partnership, the share of any profit or loss arising from jointly owned property will normally be the same as the share owned in the property. Joint owners can agree a *different* division and so occasionally the share of the profits or losses will be different from the share in the property

Where the joint owners are husband and wife, or civil partners, profits and losses are treated as arising to them in equal shares unless:

- Both entitlement to the income and the property are in unequal shares, and
- Both spouses, or civil partners, ask their respective tax offices for their share of profits and losses to match the share each holds in the property.

If a taxpayer's only income from land and property in the UK comes from a jointly owned property, that share alone will form the rental business. If a taxpayer has other income from land and property in the UK, whether in their name alone or owned jointly with other people, their share from the jointly owned property will form a part of their rental business along with the other income and expenses on any other properties which they own alone.

Deposits/ Bonds taken from tenants

HMRC's view of the tax position of deposits and bonds is provided at PIM 1051 which states: "deposits paid by tenants or licensees to landlords will, ordinarily, be receipts of a rental business. Deposits should be recognised in accordance with GAAP, normally by being deferred and matched with the costs of providing the services or carrying out repairs.to the extent that a deposit taken from a tenant or licensee exceeds the relevant costs, and is subsequently refunded, you may accept that it should be excluded from the receipts of the rental business.....deposits not refunded at the end of a tenancy should be included as income at that point to the extent that they have not already been recognised".

Tenancy Deposit Protection

The Tenancy Deposit Protection regime, effective from April 6 2007, provides additional powers against landlords who fail to declare UK rental income.

Deposits received by landlords after this date must be registered with one of three government approved agencies running the scheme – providing HMRC with powerful of data with which to monitor rents across the UK. In addition the agencies also have to carry out money laundering checks on landlords.

The terms and conditions of the schemes explicitly state that information given to them by clients will be passed on to regulators such as HMRC “for the purposes of fraud and money laundering prevention”. Tax evasion is regarded as both fraud and money laundering for this purpose. HMRC also has the power to order Tenancy Deposit scheme providers to hand over information about clients under TMA 1970

Landlords who fail to register deposits face a fine of three times any deposit given to them with the fine paid to the tenant.

Tax on premiums and similar receipts

Premiums and other lump sums received for the grant of a lease of 50 years or less are liable to tax on a special basis. (s277 ITTOIA 2005).

A premium is a sum paid on the creation of an interest in property. As such it is capital on normal principles. This led to landlords seeking premiums instead of rent to avoid IT, and so to counter this the anti-avoidance legislation in (now) Part 3 Chapter 4 ITTOIA 2005 was introduced.

A premium paid for a very long lease is a capital sum. If paid for a shorter lease it has a character more like rent paid in a lump sum not periodically. It is more akin to income, and the shorter the lease the more like income it is.

The Taxes Acts charge a proportion of a premium to tax as income, the proportion to be charged depending on the length of the lease. The shorter the lease, the greater the proportion to be charged. If the lease is for more than 50 years then none of the premium is treated as income.

If a premium is payable in instalments, it is normally taxable as if it had been paid in one lump sum. However, the recipient may claim to pay the tax by instalments over a period allowed by HMRC - s299 ITTOIA 2005.

This period cannot extend beyond the earlier of eight years from the date the payment of tax would have been due, or the time when the last instalment of the premium is payable.

Example:

Wright grants 25-year lease to Lewry on 5 June 2008, with a premium of £30000 in addition to rent of £400 a month.

| | | |
|----------------------------------|---|--------|
| Assessable 2008/09: | £ | |
| Rent 5 June 2008 to 5 April 2009 | | 4000 |
| Taxable amount of the premium. | | 15600* |
| Total | | 19600 |

*Taxable premium calculated as follows:

| | | |
|---------------------------------|---|--------------|
| | £ | |
| Premium receivable | | 30000 |
| Less: (2% of £30000) x 24 years | | <u>14400</u> |
| | | <u>15600</u> |

Relief for premiums paid

A grantee of a lease granted at a premium may also be entitled to relief against trading profits (s61 ITTOIA 2005), and treated as though they had paid a rent equal to the chargeable amount of the premium spread over the term of the lease.

The effect of this is that a trading deduction is allowed for the fraction of the chargeable amount of the premium appropriate to the period during which the property was occupied for trade purposes.

Example (cont):

| | |
|--|------|
| The annual trading deduction due to Lewry: | £ |
| Chargeable amount as above £15600 x 1/25 = | 624 |
| Rent deduction | 4800 |
| Total deduction | 5424 |

This relief also may apply to subsequent assignees where the landlord has accepted the assignment of a lease for which the original grantee paid a premium.

Lease requiring tenant to carry out work on premises

s278 ITTOIA 2005 covers situations where a lease is granted requiring the tenant to carry out work on the property. The landlord is treated as if the lease had required the payment of a premium, in addition to any actual premium.

The amount is the difference between:

- the value of the landlord's interest in the property immediately after the commencement of the lease, and
- the value of that interest if the lease had not required the tenant to do the work.

Example

Rayner lets a shop to Kirtley from 6 January 2008 for 11 years at a rent of £300 per month. He is also required to have tarmac laid on the area at the rear of the premises to be used as a new car park at a cost of £5000.

Rayner is treated as if he had received a premium equal to the extra value of his interest in the property immediately after the commencement of the lease.

The increase in value is agreed to be £3000 (not the cost of the work) to reflect the wear and tear the improvement will have suffered by the time the lease falls in and the restating of that reduced amount to present value. The rental income computation must include:

| | |
|--------------------------------|------|
| | £ |
| Deemed premium receivable | 3000 |
| Less: (2% of £3000) x 10 years | 600 |
| Chargeable amount of premium | 2400 |
| | |
| Add actual rent for 3 months | 900 |
| Total | 3300 |

Trading premises – surplus part let

A trade or profession may include rents from temporarily surplus accommodation in the profit or loss computation as a trading or professional receipt.

The advantage of this approach is that the need to apportion outgoings on accommodation that is partly used for a trade and partly let is avoided.

This can only be done in the following circumstances (s21 ITTOIA 2005):

- The accommodation must be temporarily surplus to current business requirements.

Accommodation is temporarily surplus to requirements only if (a) it has been used within the last 3 years to carry on the trade or acquired within the last 3 years, (b) the trader intends to use it to carry on the trade at a later date, and (c) the letting is for a term of not more than 3 years.

- The premises must be used partly for the business and partly let; in other words, rents from a separate property which is wholly surplus must be dealt with as property income. The treatment cannot be applied to whole buildings that are let because there is no question of any apportionment of expenses being necessary.
- The rental income must be comparatively small (since otherwise, the tax liability resulting may not approximate to the strict statutory liability).
- The rents must be in respect of the letting of surplus business accommodation only and not of land.

Receipts from the letting of surplus business accommodation are treated as trading income and will not form a part of the taxpayer's rental business (provided they meet the conditions set out above). Any expenditure on the surplus accommodation is deducted in computing taxable profits and must be excluded from their rental business.

Examples:

A company received rents of £62000 per year from the letting of property as follows:

£27000 related to the letting of premises that had formerly been in use as trade premises but were vacated on becoming surplus to requirements. No part of these premises was retained by the company for its own use.

£10000 related to surplus land at a factory site. The company still used the factory and the remainder of the site.

£25000 related to premises that the company had built 4 years previously, intending to occupy them itself, but which it found surplus to requirements before occupation and therefore let.

Treatment

£27000: premises not temporarily surplus to current trade requirements

£10000: rental income not in respect of premises

£25000: premises not intended for use in trade

Conclusion: the company did not satisfy the qualifying conditions in respect of any part of the rental income receivable, and its application to treat these rents as trading income was refused.

Property surplus to trade requirements

The taxpayer may carry on a trade in which a property becomes surplus to requirements, but able to deduct the rent and other expenses of that property in computing trading profits under normal 'wholly and exclusively' rules (**Hyett v Lennard [1940] 23TC346**).

The expenses of a former trading property would not however in the view of HMRC (PIM 4300) meet this test where, after it became surplus the taxpayer did not exercise an option to terminate the lease that was available; for example, by giving notice to the landlord.

If the taxpayer sublets the surplus property, PIM 4300 states that the position is:

- Strictly, rents receivable are taxed as rental income with no deductions for those expenses which qualify as expenses of the trade or profession, since the 'wholly and exclusively' test is not met for the rental business;
- They can however choose to deduct those expenses in the rental business instead of their trade or profession so that only the net profit is charged as property income.
- Any excess of expenses over receipts from the surplus property can be deducted in computing the profits of their trade or profession, provided the expenses meet the normal 'wholly and exclusively' test

Expenses: general rules

In calculating rental business profits a taxpayer can deduct business expenses provided incurred wholly and exclusively for business purposes and not of a capital nature.

Expenses are brought into the tax computation using normal accountancy principles and are the converse of the approach to receipts.

Dual-purpose expenditure

Strictly, if an expense is not wholly and exclusively for the purposes of the rental business it may not be deducted. In practice, though, some dual-purpose expenses include an identifiable part or proportion which is for the purposes of the business.

Losses

Profits and losses from more than one property are generally pooled, and if an overall rental business loss arises it is normally carried forward and set off against future rental income business profits.

Capital Expenditure and the 10% wear and tear rule

Capital allowances cannot be claimed for expenditure on furniture, fixtures and fittings for use in dwelling houses. However, a 'wear and tear' allowance may be claimed instead, equal to 10% of 'net rents' from furnished lettings (i.e. rents less payments that would normally be borne by the tenant, such as water rates). Alternatively, a 'renewals' basis may be claimed, i.e. no relief is given for the original cost of an asset, but a deduction is given for the cost of replacement.

Repairs to let property

HMRC guidelines confirm that landlords may deduct from rental income repair costs, which prevent the property from deteriorating. Typical costs include:

Repairs to internal/external walls
Interior/exterior painting and decorating
Roof repairs
Repairs to fixtures and equipment

Alteration or improvement is not a repair

If, instead of simply repairing the asset, the taxpayer has the asset improved or upgraded, then all the cost of the work is capital expenditure. No revenue deduction can be allowed for any part of the expenditure.

For example, if an office needs repairs to its roof and the taxpayer decides to have the roof space opened up and additional windows installed, this is an improvement and is capital expenditure. A tax deduction cannot be made for this cost.

Whether the trader has had the asset repaired or improved is a question of fact and degree. An improvement element may be sufficiently small to count as incidental to the repair. In the absence of other capital indications, the entire cost can then be regarded as revenue .

If the asset had not been improved, then the business would have had to have the asset repaired. The cost of these repairs would have been allowable – but the business does not enjoy relief for the ‘notional ’repairs it would have paid for.

Tax Bulletin 59

Tax Bulletin 59 outlines HMRC’s policy on the allowability of repair costs, and states : “if a fitted kitchen is refurbished the type of work carried out might include the stripping out and replacement of base units, wall units, sink etc., re-tiling, work top replacement, repairs to floor coverings and associated re-plastering and re-wiring.

Provided the kitchen is replaced with a similar standard kitchen then this is a repair and the expenditure is allowable. If at the same time additional cabinets are fitted increasing the storage space, or extra equipment is installed, then this addition is capital and disallowable (applying whatever apportionment basis is reasonable on the facts). But if the whole kitchen is substantially upgraded, for example if standard units are replaced by expensive customised items using high quality materials, the whole expenditure will be capital”.

Interest costs

Landlords are generally able to claim mortgage interest against rental income. This rule extends to interest on borrowings for the following:

Improvements and developments

It may be necessary to obtain finance to improve an investment property, in which case interest paid may be deducted

Former residences

Where an individual lets his residence, interest paid after the date on which the letting business commenced may be deducted.

Additional borrowings on let properties

PIM2105 states that the interest on a loan or overdraft may not be allowable, or only part may be allowable, where the borrowing is, for example, used to:

- buy non-rental business investments
- buy private assets
- provide private funds taken out from the rental business.
- fund private living expenses or other non-business expenditure.

Note however that this guidance is inconsistent with HMRC’s example at BIM 45700 which states:Ms D talks to her bank manager about how well her business is doing and the manager agrees to increase her business overdraft facility by £10000. She increases the level of her cash drawings from the business by £1000 a month, so she is withdrawing part of her capital as well as the profits being earned by the business. Her capital account does not become overdrawn. The interest payable on the increased overdraft is an allowable deduction.

Proprietors of businesses are entitled to withdraw their capital from the business, even though substitute funding then has to be provided by interest bearing loans. This is on the basis that the purpose of the additional borrowing is to provide working capital for the business. There will though be an interest restriction if the proprietor's capital account becomes overdrawn".

The key issue seems to be the balance on the proprietor's capital account - if this stays in credit the interest on the new borrowings would appear to be allowable. This has wide implications for sole traders and can be extended to buy-to-let investors who follow the same principles, as demonstrated by a buy-to-let situation also in BIM 45700 reproduced below:

Mr. A owns a flat in London, purchased 10 years ago for £125000. He has a mortgage of £80000 on the property. He has been offered a job in Holland and is moving there to live and work. He intends to come back to the UK at some time. He decides to keep his flat and rent it out while he is away. His London flat now has a market value of £375,000.

The opening balance sheet of his rental business shows:

| | | | |
|-----------------|----------------|----------------|----------------|
| Mortgage | £ 80000 | Property at MV | £375000 |
| Capital account | £295000 | | |
| | £375000 | | £375000 |

He renegotiates his mortgage on the flat to convert it to a buy to let mortgage and borrows a further £125000. He withdraws the £125000 which he then uses to buy a flat in Rotterdam.

The balance sheet at the end of Year 1 shows:

| | | | |
|---------------------|----------------|----------------|----------------|
| Mortgage | £205000 | Property at MV | £375000 |
| Capital account B/F | £295000 | | |
| Less Drawings | £(125000) | | |
| C/F | £170000 | | |
| | £375000 | | £375000 |

Although he has withdrawn capital from the business **the interest on the mortgage loan is allowable in full** because it is funding the transfer of the property to the business at its open market value at the time the business started. The capital account is not overdrawn.

Thus provided the remortgaged amount withdrawn does not exceed the credit on the capital account the interest would seem to be fully deductible, and would also indicate that Mr. A also has the ability to borrow and withdraw a further £170000 of tax deductible finance from his rental income business.

The Revenue's manuals at BIM 45700 will be extremely useful to buy-to-let investors, many have significant equity in their property portfolio and remortgaging to withdraw sums that they initially provided as equity will be attractive to many. Even if the additional funds are withdrawn and then applied for a private purpose, a full deduction should be available for interest incurred - provided the capital account remains in credit.

It would be prudent for buy-to-let investors to prepare a balance sheet on an annual basis in order to keep track on their capital account. Lenders will eventually agree to further funding which can then replace the equity originally funded from own resources.

Other expenses

Other categories of expenditure which may be deducted from rental income:

Rent

Ground rents or other forms of rent paid under a lease.

Rates and property services

Includes: council tax, water rates, electricity, and gas.

Insurance

Includes: buildings, contents, mechanical breakdown, and appliance cover.

Legal and other professional costs

Accountant's fees for preparing rental income statement.

Solicitor's fees for drawing up rental agreement – up to 12 months duration.

Agent's fees for rental collection.

Other services

Includes: Cleaning, gardening and portorage.

Travel costs

Provided expended wholly and exclusively for the purposes of the rental income business, there is no upper monetary limit for allowable travel costs.

Example: an expatriate landlord travels to the UK to manage property A and also view other prospective BTLs. The cost of the trip will be deducted against rental income.

Bad debts

It is possible to deduct debts, which are either irrecoverable, or likely to prove on critical examination, irrecoverable.

Expenses: cessation and recommencement

Rental business activities may stop and, after an interval, begin again, in which case it is necessary to decide whether the original business really continued after a period of dormancy, or whether it permanently ceased and the new activities amount to a new rental business.

The view of HMRC (to be found in PIM 2510) is that a rental income business stops where there is an interval of more than three years and different properties are let in the taxpayer's old and new activities.

A cessation is particularly important where the old activity had unrelieved losses because losses can only be carried forward and set against future profits of the same business. Therefore, where one rental business ceases and a new rental business starts at a later date, losses from the first business cannot be set against profits of the second.

TAX PLANNING AND THE PPR EXEMPTION

PPR (Principal Private Residence): introduction

For CGT purposes, the gain (or loss) on disposal of an individual's PPR including garden or grounds within the permitted area (in the UK or abroad) may be wholly or partly exempt. A gain is completely exempt if the property has been the individual's only or main residence throughout the period of ownership (or since 31 March 1982, if shorter).

So, the PPR relief is from CGT, but a gain on (for example) a quick resale of a dwelling house treated as a trading profit is not within the scope of the tax and therefore cannot be exempted by the relief.

Mere intention to reside in a property is not sufficient for it to qualify as the PPR – actual occupation as a residence is required.

However, mere occupation of a property does not of itself establish it as a residence. A farmhouse occupied by the taxpayer for only 32 days was not eligible for relief as a residence (**Goodwin v Curtis [1998] STC 475**). To qualify for the relief, the property must be occupied with some degree of permanence in mind, but how long is not specified.

Common reasons for HMRC restriction of PPR relief

Garden or grounds exceed 0.5 hectares

The sale price may indicate that the property sold was substantial and so may have had garden or grounds larger than the permitted area. If so relief may be restricted

Property not only used as a home.

Property partly been used as business premises or for other non-qualifying use.

Period of non-residential use by the owner.

This would cover situations where the property has not been wholly used as the owner's residence throughout ownership, for example, it may have been let for a time or the owner may have been working overseas for a period.

Second home

If at some period during ownership the owner had two or homes, PPR relief may not be due.

Maximising PPR relief using 2 or more properties

If a taxpayer owns two properties that both qualify as residences, it is necessary to ensure that care is taken to maximize the potential savings available in respect of PPR. He has the right under s222 (5) TCGA 1992 to nominate which is to be treated as PPR for any period. The main residence will attract relief for that period

Giving notice

The taxpayer has right 'to determine which of two or more residences is his PPR for any period ... by notice to an officer of the Board given within two years from the beginning of that period ...'. If a dwelling house is indeed a residence of the taxpayer, a valid notice overrides the requirement that it should actually be his PPR.

Notice time limit

Note that the two years' period for the giving of a s 222(5) notice starts with 'the beginning of that period'. What period? The answer is the period, which begins when it becomes necessary to determine which of two or more properties is the PPR.

Example: Wells purchased a holiday cottage on 1 November 2005. When his accountant first heard about the cottage – when preparing the tax return for 2006-07 in January 2008 – he thought his client was out of time for a s 222(5) notice. But it was confirmed that the first six months of ownership were spent in refurbishing the property. Wells only began to use the cottage in May 2006. It was only then that it could be said that he resided in two dwelling houses. A notice given in January 2008 was well within time. The lesson? The two years' clock begins to tick not from the date of purchase, but the date of first occupation of a new residence.

Change of residence

The case of **Griffin v Craig-Harvey [1994] STC 54** confirms that if there is a change in a person's combination of residences, then he has a new opportunity to submit a s 222(5) notice within two years from the date of that change.

Example: Dexter lives in Bristol (where he resides in house A) and has a flat B in Oxford (where he works for part of the week). He has never submitted any notice under s 222(5). He then buys a holiday cottage in Devon. He is thereby enabled to determine that flat B has become his PPR from the date of his occupation of the Devon cottage.

The effect of a tenancy

To continue the example above, because Dexter rents the Oxford flat under a tenancy, he has 'an interest' in that residence. So the commencement of the tenancy triggers a new starting point for the two years in which to give a s 222(5) notice, e.g. on the Devon cottage. This can be very useful if he is about to sell the cottage because it makes possible a PPR claim for the last three years of ownership and – if he has ever let the cottage as well as occupying it himself – a claim to the special lettings relief subject to the £40,000 maximum; see s 223(1) and s 223(4).

ESC D21

As above, occupation of a flat or other dwelling house under a tenancy offers an opportunity for a s 222(5) notice on another property. ESC D21 applies in such cases (i.e. where the taxpayer's interest 'is such as to have no more than a negligible capital value on the open market') and the two-years' time limit is extended to enable the nomination to 'be made within a reasonable time by the individual first becoming aware of the possibility of making a nomination, and it will be regarded as effective from the date on which the individual first had more than one residence'.

Varying a notice

A change in a taxpayer's combination of residences is not the only means of obtaining an opportunity to nominate a new property as his only or main residence.

If a s 222(5) notice is given, then it remains effective until either there is a change in the combination of residences (e.g. the purchase of a new property or the sale of an old property or the taking on or surrendering of a tenancy) or there is a variation of a s 222(5) nomination.

On this point it is stated in that subsection that a notice is 'subject to a right to vary that notice by a further notice to an officer of the Board'. The variation can only be effective for the two years prior to the giving of the notice, but not before.

Varying a notice - example

Assume that, since 1990, Snow has lived in London and has been using his holiday cottage in Devon since 1999. He sells (on 1 July 2005) the cottage for a substantial capital gain. It is too late to submit a s 222(5) notice to nominate the cottage as his PPR.

However, if he had given a s 222(5) notice to HMRC in 2000 (i.e. within two years of first using the cottage) nominating his London home (even though it was self-evidently his PPR), then the submission of the notice would have enabled its variation at any time with two years' backdated effect.

He can now submit a variation notice determining the cottage as his PPR from, say, 16 June 2005, i.e. for the last couple of weeks of his ownership.

This triggers: (a) PPR relief for the last three years of ownership; and (b) if ever he has let the cottage for rent, the further special lettings relief.

The price? – the loss of two weeks' relief on the main house (when eventually sold) out of the total period of ownership.

The PPR election: summary and other planning points

An election for a second home to be treated as the PPR can sometimes offer substantial tax savings

The election to choose which is a PPR for CGT purposes has to be made within 2 years of the period to which the election is to apply. Usually (but not always) this means within 2 years of the acquisition of the second property

If too late to make the election, it can sometimes be a good idea deliberately to take a course of action, which triggers a fresh opportunity to make the election. For example, if one out of a portfolio of properties is rented out, the departure of a tenant could provide such an opportunity.

Once an election has been made, it can be varied at any time. Again the variation will be effective from a date no earlier than 2 years before the notice of variation.

Switching the election to the second home for a short period of time may unlock the door to exemption for the last three years' ownership and any available special letting relief when calculating the CGT bill

The nominated main home does not have to be the property in which the taxpayer actually spends the most time in, so a valid election may be made for a property which is occupied for only a few weeks each year, but which may generate the higher gain when disposed of.

An election lasts only as long as the number of homes remains unaltered. So an election made to treat the London home as PPR will lapse when the seaside flat is replaced (or indeed supplemented) by, for example, a weekend home in the country.

A final reminder.....the election can only apply to a property in which the taxpayer actually resides, not to a property which is owned but never occupied.

PPR and lettings relief

PPR relief is also available on the sale of a property where this is at different times occupied as a residence, and also let.

Residence for a period establishes the private residence relief claim. The gain on sale would then be time-tested over the period of ownership, also taking into account exemption for the final 36 months. In addition special lettings relief of up to £40000 per owner or joint owner would be available.

Example 1

Giddens purchases a property for £200,000 on 1 July 1998. He lives in it for two years, and then lets it for seven years until it is sold for £600,000 on 1 July 2007. Incidental costs of purchase and sale, and improvements, are ignored.

| | |
|-------------------------------|-----------------------------------|
| | £ |
| Sale price | 600000 |
| Cost | <u>(200000)</u> |
| Gain | <u>400000</u> |
| Period of ownership | 9 Years |
| Occupied as private residence | 5 years (2 actual, plus 3 deemed) |
| Exempt gain 5/9 x £400000 | 222222 |
| Taxable gain | 177778 |
| Lettings exemption | (40000) |
| Gain before reliefs | 137778 |
| *Taper relief 35% | <u>(48222)</u> |
| Tapered Gain | 89556 |
| Annual exemption | <u>(9200)</u> |
| Chargeable Gain | 80356 |
| Tax due at 40% say | <u>32142</u> |

*Nb No Entrepreneur's relief available if disposed of after 6 April 2008.

Example 2 - Property Owned jointly with Mrs Giddens

| | Mr £ | Mrs £ |
|--------------------------|----------------|----------------|
| Taxable gain | 88889 | 88889 |
| Lettings exemption | <u>(40000)</u> | <u>(40000)</u> |
| Gain before reliefs | 48889 | 48889 |
| Taper relief 35% | <u>(17111)</u> | <u>(17111)</u> |
| Tapered Gain | 31778 | 31778 |
| Annual Exemption | <u>(9200)</u> | <u>(9200)</u> |
| Chargeable Gain | 22578 | 22578 |
| Tax due (assumed at 40%) | <u>9031</u> | <u>9031</u> |

There is therefore a total tax bill of about £18062, a saving of more than £14000 compared with single ownership. In actual fact, if either party had not been liable to tax at the higher rate, then the tax would have been less.

There are other variations of the PPR claim. These include the situation where part of a property is or has been occupied by the owners, with the remainder let. It should be remembered that in the case of **Owen v Elliott [1990] STC 469** the owner of a private hotel was able to establish a proportionate private residence relief claim, having occupied personally different parts of the hotel at different times.

PPR and other reliefs

Last 36 months

In any event, the last 36 months of ownership are always treated as a period of deemed occupation, regardless of whether the taxpayer is living there or not, s.223 (2) a TCGA 1992.

The only condition here is that the taxpayer must have occupied the property as his home at some stage, even if that was before 1 April 1982.

Periods of deemed occupation

Three periods of absence may also qualify as deemed occupation:

Any period of absence up to a maximum of three years - s.223 (3)(a) TCGA 1992.

Where the owner is abroad by reason of his employment - s.223 (3)(b) TCGA 1992 (this period is unlimited)

Where the owner was absent from the property due to working elsewhere – either employee or self-employed. Here the period of deemed occupation is limited to a maximum of four years - s.223 (3)(c) TCGA 1992.

These three periods of deemed occupation can apply cumulatively. This means that a longer period of absence may all qualify as deemed occupation, as certain periods can be added together.

To qualify as a period of deemed occupation, the individual must have no other residence eligible for PPR relief at that time have **and have resided in the property at some point before and after the period(s) of absence.**

Example

| | | Years | |
|-----------------------|-----------------------------|---------|----|
| Purchased | 1 May 1982 | | |
| Occupied as PPR | 1 May 1982 to 30 April 1985 | actual | 3 |
| Let (working abroad) | 1 May 1985 to 30 April 1990 | deemed | 5 |
| Occupied as PPR | 1 May 1990 to 30 April 1995 | actual | 5 |
| Let (relocated UK) | 1 May 1995 to 30 April 2002 | absence | 7 |
| | 1 May 2002 to 30 April 2005 | deemed | 3 |
| Total years ownership | | | 23 |

The property was sold on 30 April 2005, at a capital gain of £172500.

The period of ownership are divided into periods of occupation (actual and deemed) and absence.

1 May 1982 to 30 April 1985 –3 years

This period is one of actual occupation.

1 May 1985 to 30 April 1990 – 5 years

Between these dates the taxpayer was working abroad by reason of his employment.

1 May 1990 to 30 April 1995– 5 years

The taxpayer did return to the property and lived there thereby creating another five years of actual occupation – and as the period whilst working abroad was preceded and followed by actual occupation, the five years between 1 May 1985 and 30 April 1990 can now be treated as deemed occupation.

1 May 1995 to 30 April 2005 – 10 years

On 1 May 1995 the taxpayer was relocated by his employer to work in the UK. The taxpayer never returned to the property. The final period of deemed occupation will therefore be the last three years of ownership, between 1 May 2002 and 30 April 2005. Therefore the period from 1 May 1995 until 30 April 2002 will not be covered by any of the deemed occupation rules, and will be treated as 7 years of absence.

Therefore looking at the period of ownership from 1 May 1982 until 30 April 2005, we have 16 years of occupation and 7 years of absence. This will enable us to determine the PPR relief. In addition, we must consider lettings relief.

CGT calculation:

| | | | |
|-----------------------------|--------------|---------------|--|
| | | £ | |
| Indexed gain | | 172500 | |
| Less: PPR relief | | | |
| £172500 x16/23 | | (120000) | |
| Gain before lettings relief | | 52500 | |
| Less: Lettings relief | | | |
| Lower of | £ | | |
| i) PPR relief | 120000 | | |
| ii) Letting gain | 52500 | | |
| iii) Maximum | <u>40000</u> | (40000) | |
| Gain before taper relief | | <u>£12500</u> | |

“Rent a room” relief

Special rules are in place for the taxation of income under the rent a room scheme. The scheme allows homeowners to let part of the PPR and generate a tax-free income of up to £4250 per year. If more than this level of income is generated, tax is charged on the gross rent in excess of £4250.

Landlords within the rent a room scheme lose the right to deduct expenses from rental income, as it is not considered a commercial venture, which means in turn that there are circumstances where landlords are better off being outside the scheme.

If ownership of the home is joint but only one co-owner receives rental income from letting part of it, then the whole income tax exemption is allocated to the person receiving the rent. If let jointly or each lets a separate room then each receives half the £4250 income tax free allowance.

Income for ancillary services such as providing meals or washing can be added to rental income and incorporated into the rent a room scheme.

PPR occupied by a dependant relative

In September 2007 HMRC announced a change in their view on the availability of lettings relief in a dependent relative relieved case, and amended the guidance in the CG Manual accordingly.

A private residence occupied by a dependent relative before 6th April 1988 may qualify for private residence relief for CGT purposes: see CG 65550 onwards.

CG 64718 previously stated that in such cases the further relief provided for by TCGA 1992, s 223(4) where the residence has also been wholly or partly let out as residential accommodation ('lettings relief') will not be due.

CG 64718 has been amended to reflect HMRC's change of view that lettings relief may be due. HMRC have also withdrawn CG 65562 which said that lettings relief is not due where private residence relief is given on a residence occupied by a dependent relative.

The change in practice may reduce the CGT payable on the sale of a dwelling once occupied by a dependent relative – however error or mistake relief claims for closed years will not be accepted, on the grounds that HMRC's 'previous published view was widely accepted'.

RECENT CHANGES AND OTHER POINTS

Temporary SDLT exemption

On 3 September 2008 the Chancellor of the Exchequer announced a temporary exemption from SDLT for acquisitions of residential property worth not more than £175,000. The exemption will be available for the acquisition of major interests in land (other than grants of leases for less than 21 years or the assignment of leases with less than 21 years to run).

In order that for the exemption to apply the acquisition must:

- consist entirely of residential property
- be for a chargeable consideration of not more than £175,000

The exemption will be available where the effective date of the land transaction (normally the date of completion) is on or after 3 September 2008 and before 3 September 2009.

Business Premises Renovation Allowance (BPRA)

First announced in 2004, BPRA came into effect on 11 April 2007, with 100% tax relief available for expenditure incurred on the conversion or renovation of qualifying business premises in “assisted” areas. The property must have been empty or disused for at least 12 months to be eligible for relief. The scheme will provide tax relief to any individual or company who incurs capital expenditure on bringing qualifying business premises (whether owned or let) back into productive use.

The scheme is due to finish in April 2012.

Conversion of parts of business premises into flats

100% CAs are available for expenditure incurred from 11 May 2001 on renovating or converting space above shops and other commercial premises into flats for letting.

The scheme enables property owners and occupiers to obtain up-front tax relief for their capital expenditure on recycling former residential space over shops. Under the old rules, tax relief was only given against the computation of any capital gain on the disposal of the property.

The scheme includes all normal conversion expenditure and is based on provisions for IBAs but there are differences. No balancing allowances or charges are made provided that, throughout a period of seven years from the flat being completed it is either let or available for letting and there is no disposal event.

Qualifying expenditure

This is defined as capital expenditure incurred on:

- conversion of part of a qualifying building into a qualifying flat;
- renovation of a qualifying flat in a qualifying building
- repairs to a qualifying building if they are incidental to the above

Expenditure must relate to a part of the building which was either unused or used only for storage throughout the period of one year before conversion or renovation work began.

Qualifying building

All or most of the ground floor must be authorised for business use. This is done by reference to specific uses designated in the relevant ratings rules - within classes A1, A2, A3, B1 or D1 (a).

At the time the building was constructed the floors above the ground floor were for residential use.

The building must not have more than four storeys above the ground floor.

The original construction of the building must have been completed before 1 January 1980 although extensions completed by 31 December 2000 are acceptable.

Qualifying flat

The flat must be suitable for letting as a dwelling. It must:

- be held for the purpose of short-term letting.
- have external access separate from the ground floor premises.
- have not have more than four rooms (excluding kitchen and bathroom).
- not be a high value flat.
- not be let to a person connected with the person who incurred the expenditure on conversion.

High value flats

A flat is a high value flat if the notional rent - i.e. as expected if the flat was let furnished on an assured short hold tenancy - exceeds the limits set out below.

| Number of rooms | Greater London | Elsewhere |
|-----------------|----------------|---------------|
| 1 or 2 | £350 per week | £150 per week |
| 3 | £425 per week | £225 per week |
| 4 | £480 per week | £300 per week |

Sales of overseas holiday homes

In these uncertain times many UK residents are deciding to sell their foreign holiday homes, many located in Cyprus, France, Italy and Spain.

As such properties invariably do not qualify as the individual's sole or main residence for CGT purposes, any gain made will be subject to tax.

The important point to note is that the UK CGT charge is computed in sterling and not the relevant local currency. Thus, even though on a given sale a capital loss arises as measured in the local currency, this does not mean that a capital loss arises as measured in sterling terms; it may well be a gain, considering the current position due to sterling's devaluation against other currencies including the euro.

Thus, before effecting any sale it is strongly advisable to check the position from the UK sterling perspective .

Where a sale precipitates a capital gain when measured in local currency then it is likely local CGT (or sometimes income tax) will be payable. The local tax paid will generally be available for offset against any UK CGT payable; thus, in effect the tax charge is higher of the two tax regimes.

Landlord's Energy-Saving Allowance(LESA)

LESA allows landlords within the charge to income tax to deduct, as a revenue expense, the cost of installing a range of energy-saving measures, such as loft and cavity wall insulation, in let residential properties.

The Allowance was extended, with effect from 6 April 2007, so that:

- It may be claimed by landlords within the charge to corporation tax
- It may additionally be claimed on the installation of floor insulation
- The £1,500 cap on qualifying expenditure will apply to each let property, rather than to each building owned by the landlord

The Allowance, which was to have expired on 5 April 2009, has now been extended to 2015.

Business rates relief on empty property

Gordon Brown used his last Budget as Chancellor to include the abolition of empty property relief from April 2008, after which full business rates are due on empty shops and offices, and on industrial properties after six months.

Until then, un-let workshops were exempt from business rates and the tax only became payable on office and retail space after three months and then at only half the normal rate.

The Rating (Empty Properties) Act 2007 applies only to non-domestic rates for business premises in England and Wales.

The Pre-Budget Report (24 November) announced a temporary increase in the threshold at which an empty property becomes liable for business rates. For financial year 2009/10 empty properties with a rateable value of less than £15,000 will be exempt from business rates.

CGT and partnerships – Brief 03/08

SP D12 first published in 1975 sets out how CGT rules are to apply to partnerships. HMRC in January 2008 decided that the statement was deficient, and issued Brief 03/08 to “clarify” the position.

The specific point at issue relates to assets transferred to a partnership by means of a capital contribution. Previously, where no cash or money’s worth was received, the partner would not be treated as having disposed of their asset. HMRC now consider this to be incorrect.

Their current view is that there will be a partial disposal equal to the fractional share in the asset, which passes to the other partners, and that a sum credited to the partner’s capital account represents consideration for the partial disposal.

This “clarification” represents a major change for partnerships and needs to be considered carefully. In light of Brief 03/08, any partner contributing assets to a partnership should consider whether he has sufficient cash to fund any resulting tax liability and the availability of tax reliefs on the contribution such as losses to set against the gain. Alternatively, partners may wish to reduce the amount of exposure to any chargeable gain by leasing the asset to the partnership rather than making a contribution.

HMRC has stated that they will not re-open settled cases where calculations were based on the earlier interpretation, but will apply the “correct treatment” to all other cases.

Recent IHT cases

DWC Piercy’s Executors v HMRC 2008 SpC 687

Can land that is let out continue to qualify as trading stock for the purposes of BPR? The subject matter was a taxpayer being “landed with various unsaleable interests”, which in the current property market might apply to a number of clients now and in the future.

Facts

Mr Piercy had been managing director and major shareholder of a trading and property development company. The company had developed and sold 256 flats in North London between the 1950s and early 1970's. In the 1970's, the nature of the trade moved into the activity of small community shopping centre developments. The key here is developments.

However, one development ran into problems planning permission so as a temporary measure the company constructed low-quality industrial workshops and let them on short-term leases. The idea was that the workshops would be demolished when the development could achieve planning permission and could go ahead.

HMRC argued that BPR under s105 (3) IHTA 1984 would not apply to the deceased's shares in the company as the business was the making or holding of investments.

Significant receipt of rents

Part of HMRC's grounds for rejecting the claim for BPR was that the company received significant rental income. The executors appealed on the grounds that the company still wished to develop the land in North London for residential purposes but had been unable to do so because of uncertainty about proposals for a new railway line.

The holding of trading stock

The Special Commissioner accepted evidence presented by the executors and allowed the appeal, finding that the company continued to hold its land as trading stock and ruled that it was not an investment company for the purposes of s105. The Commissioner also held that the only type of land-dealing company whose shares fail to qualify for the relief is some sort of dealing or speculative trader that does not actively develop or actually build on land.

He also noted that if a company is to be said to be conducting the business of holding investments, then the company must actually have some investments; in this case the Company held land as trading stock. The company had never bought land as an investment. It was not an investment company.

The Special Commissioner stated: *"it has long been accepted that a building company (that generally of course buys land, builds on it, and sells it off in a trading or dealing manner) is not for this purpose 'a land-dealing company'. Equally it follows from that fact that the Respondents have specifically confirmed that they are not contending here that the company was, at the date of the relevant death, a 'land-dealing company', that a company whose business it is to acquire land with a view to promoting a development, and then realising the developed land once sub-contracted building work has been completed, is also not a 'land-dealing company' for the purposes of the section 105(3) definition. The only type of land-dealing company whose shares fail to qualify for the relief is thus some sort of dealing or speculative trader that does not actively develop or actually build on land. At no stage in this case was it contended that the shares in the company here forfeited business property relief on this alternative ground. The only question was accordingly whether the company was, at the date of death 'a company whose business consisted wholly or mainly in the making or holding of investments'. "and concludes:" the rather self-evident point is then that a company with stock, but not investments, can hardly be treated as conducting the business of acquiring and holding investments."*

Proactive protection for clients

The proactive tax advisor must consider the scope for IHT planning and protection. In the current property climate where potential development land cannot be sold and has to be let then ensure the asset is always correctly shown as stock not investment in the Balance

Sheet where possible. Obviously where the Special Commissioners question “motive” there must also be a review of company/partnership minutes to ensure that the motive to build and develop is reflected.

Clearly the activity of building and property development is very different from those if holding investment land or trading in investment land but circumstances can lead to a potential development site being held longer than desired.

If the death of the shareholder, sole trader, partner etc., should intervene then it is likely that HMRC will challenge the claim for BPR. The taxpayer and adviser must ensure the correct and clear treatment of trading stock.

Action Plan

Review Balance Sheets and minutes of property trading/building businesses. Review contemporaneous correspondence, e.g. dealing with the bank for loans to support the stated motive.

Trustees of Nelson Dance Family Settlement v HMRC [2009] EWHC 71

In January 2009, the High Court upheld the decision of a Special Commissioner (SpC 682) that, for purposes of claiming BPR pursuant to s104 IHTA 1984, all that was required was that the value transferred by the transfer of value was attributable to the net value of the business. There was no implication that the transfer had to be of a business rather than merely business assets.

Facts

Mr Dance, a farmer, transferred into trust part of the farm's land and buildings. Following his death the trustees claimed that the value transferred was attributable to the farming business being relevant business property and thus qualifying for BPR.

HMRC argued that on proper application of s104 IHTA 1984 a choice has to be made whether the value transferred by the transfer of value is attributable to the value of the farming business or, as contended by HMRC, is attributable to the value of the land and thus not qualifying for BPR.

The trustees argued that the value transferred by the transfer of value might be regarded both as attributable to the value of the farming business carried on immediately before the transfer and as attributable to the value of the land transferred. They submitted that it did not matter that the attribution could be to the value of the land transferred, so long as it could also be said that the attribution could also be to the value of the business.

The Court held in favour of the trustees and HMRC's appeal was dismissed – affirming the principle in IHT that of taxing the loss to the donor rather than the subject matter of the gift.

Note: judgement was delivered in December 2008 and may be subject to HMRC appeal.

Extra statutory Concessions

In February 2009 HMRC issued draft legislation intended to give statutory effect (from 6 April 2009) to a number of ESCs following the House of Lords' decision in the *Wilkinson* case.

Among the ESCs which will be given statutory effect are the following:

ESC D3

This extends the relief in respect of periods of job-related absence to cases where an individual is absent from the house because he or she lives with a spouse or civil partner and the absence is caused because of the requirements of the employment of the spouse or civil partner, rather than the individual's own employment.

ESC D4

Like ESC D3 above, this concession is concerned with the rules that provide for certain periods of job-related absence from a house to be treated as periods during which the house was an individual's only or main residence, so that PPR relief is available in respect of any capital gain relating to such periods of absence.

The rules that provide for such treatment require that the house should be the individual's only or main residence both before and after the period of job-related absence. The concession allows the rules to apply where the individual does not occupy the house between the end of a period of job-related absence and its disposal, provided the nonoccupation is because the individual's employment requires him to live elsewhere.

ESC D6

This concession applies in cases of the breakdown of a marriage or civil partnership. An individual may leave a house in which he or she lived with his or her spouse or civil partner, while the spouse or civil partner continues to live there. Later, as part of a financial settlement relating to the termination of the relationship, the individual may transfer his or her interest in the house to the other partner who continues to live in it.

The transfer of his or her interest in the house to the other partner is a disposal that could result in the individual realising a capital gain. Between the time he or she left the house and the transfer of the interest in the house to the partner, the house will not have been the individual's residence. So PPR relief might not be due in relation to the whole of that period. As a result, the individual may be liable to CGT on a part of the gain.

The concession allows the individual to choose that he or she should be treated as continuing to occupy the house between leaving it and transferring his or her interest to the other partner, so that PPR relief is available to cover the gain relating to that period.

The concession applies only if—

- the other partner has continued to live in the house throughout that period, and
- the partner who left has not made a nomination that another property should be treated as his or her main residence in any part of that period.

ESC D37

An employee may have to move house because his employer requires him to work elsewhere. To ease the move, some employers provide arrangements whereby they, or a designated company, will purchase the employee's house at an agreed price. If the house is then sold on at a profit, part of that profit is payable to the employee.

The employee's share of this later profit is a gain which is chargeable to CGT. Although it arises as a result of the sale of the house which was previously the employee's home, this gain is not covered by PPR, because, in law, it arises not from the disposal of the house by the employee, but from the employee's right to receive a share of the profit on the later sale.

The concession treats the profit share as though it were part of the gain on the disposal of the house, so that PPR is available to cover that gain to the same extent that it covered

the gain on the disposal of the house. If the house was jointly owned, and each co-owner receives a share of the later profit, the concession applies to all of them, and not just to the employee.

.....and finally, a warning note for clients

Many smaller businesses are limited companies with one or more of the shareholder-directors owning the premises and 'renting' them to the company for it to use.

The assumption is that the company pays a rent often equivalent to the landlord's mortgage payment. The company also pays the insurance premium on the building as if it were the landlord and operates as if it had a full repairing lease by being responsible for all repairs. The above situation produces a potential problem with the building insurance policy which could be expensive in the event of a claim. Technically the building insurance should be in the name of the landlord as a separate policy from the company business insurance. At the same time the business insurance policy should be in the name of the company.

The difference between the shareholder-director as landlord and the company as tenant is important legally and from an insurance perspective if no formal lease exists. This is because the company is theoretically paying for insurance on an asset in which it has no direct interest and the landlord has no insurance at all.

Clients become involved in expensive legal disputes after major losses, because insurers have tried to argue that there was no insurable interest. The effect is significantly to slow down receipt of insurance proceeds and the expenditure of a lot of time and costs at a critical time for a business already suffering from the events that produced the claim in the first place.

In practice insurers often do pay their insureds' losses in this situation. However if one is very unlucky and the claim is repudiated then major problems can arise.

USEFUL WEBSITES AND WEBLINKS

HMRC

| | |
|--|--|
| Manuals | www.hmrc.gov.uk/manuals |
| Tax Bulletins | www.hmrc.gov.uk/bulletins |
| Tax Briefs | www.hmrc.gov.uk/briefs |
| Qualifying businesses and the 20% test | www.hmrc.gov.uk/bulletins/tb62.htm |
| Entrepreneurs' relief | www.hmrc.gov.uk/cgt/disposal.htm |
| IHT:claim to transfer unused nil rate band | www.hmrc.gov.uk/cto/iht216.pdf |

OTHER

| | |
|--|--|
| Finance Act 2008 | www.publications.parliament.uk |
| CAs:trade classifications | www.eustatistics.gov.uk |
| Enhanced CAs | www.eca.gov.uk |
| Law cases and statutes | www.bailii.org |
| Assisted areas order for BPRA (SI 107 of 2007) | www.opsi.gov.uk |

Notes



CIOT/ATT East Midlands Branch would like to thank and acknowledge the support of the sponsors who made this event possible:



For more details of how Harper Resourcing can help you please contact:
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EAST MIDLANDS CIOT & ATT – Events for 2008/2009

| Date | Details | Timetable | Venue |
|---|---|--|--|
| Wednesday 22 April 2009 4.00pm – 8.00pm Cost: £40.00 CPD Hours: 3 | The Interaction between Accounting Standards & Tax By Andrew Guntert MSc FCA Lecturer for Mercia | 4.00pm - Registration & refreshments 4.30pm - Lecture starts 6.00pm - Break for refreshments 6.15pm - Lecture resumes 8.00pm – Close | Premier Inn, Braunstone Lane East Leicester |
| Wednesday 20 May 2009 4.00pm – 8.00pm Cost: £40.00 CPD Hours: 3 | Finance Bill 2009 Mark Morton BA ATII ATT Senior Tax Lecturer for Mercia | 4.00pm - Registration & refreshments 4.30pm - Lecture starts 6.00pm - Break for refreshments 6.15pm - Lecture resumes 8.00pm – Close | Best Western - Leicester North (formerly the Comfort Inn) A46 Fosse Way Upper Broughton Leicestershire |
| Date to be advised 6.00pm – 8.00pm Cost: £15.00 CPD Hours: 1.5 | Topical Tax Issues Andrew Hubbard BMus PhD ATT CTA (Fellow) Tax Director, Tenon Group PLC | 6.00pm - Registration & refreshments 6.30pm - Lecture starts 7.45pm - Questions 8.00pm – Close | PricewaterhouseCoopers Offices Donington Court, Pegasus Business Park, Castle Donington, Derbyshire |

The Branch Committee reserves the right to alter the above programme without prior notice.

For more details of any of the above events or to book a place please contact the Branch Secretary, Martin Tomes at

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2A Peveril Drive, Nottingham. NG7 1DE

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