Implementation of the financing restriction for residential let property: the CIOT’s concerns

Personal tax

04 December 2015

CIOT raises its concerns on Clause 24 FB15

An anomaly for trusts

The CIOT has raised concerns with HMRC on the application of what has become FA 2015 s 24 (relief for finance costs related to residential property businesses) to interest in possession (IIP) trusts, personal representatives administering an estate and discretionary trusts.

Government amendments at report stage of the Finance (No 2) Bill 2015

Amendments to what was clause 24 were published at the report stage. These amendments:

- clarify that a company is outside the scope of this measure, whether it carries on a property business directly or in partnership; and
- provide that trustees will obtain a basic rate tax reduction for finance costs that have been restricted in calculating their accumulated or discretionary income.

No amendments were made in respect of trustees or beneficiaries of IIP trusts or personal representatives administering an estate that includes let residential property. HMRC’s position is that no amendment is required because the beneficiary’s entitlement to the income (on which they are taxable) will be exclusive of the disallowed finance costs. For example, if the trustee is taxable on the gross

rent of £20,000, the beneficiary will be entitled to (and therefore also taxed on) £20,000. HMRC say this approach is in line with guidance in the *Trusts, Settlements and Estates Manual* at TSEM3771 and TSEM3772.

Interest in possession trusts and personal representatives

For IIP trusts, new ITTOIA 2005 s 272A will have the effect of disallowing the interest cost at trustee level. Our primary concern is that this approach for IIP trusts and personal representatives gives rise to a significant anomaly where there is little or nil net rental profit after interest.

In these cases the trustees will pay tax at the basic rate on the gross rental income. However, there will not be enough net rental income to meet the tax liability payable by the trustees. Accordingly, the trustees' liability will have to be met out of other income or capital of the trust to the detriment of other beneficiaries.

If the life tenant is a basic rate taxpayer, he or she can reclaim the tax paid by the trustees because there is no marginal liability on the disallowed interest due to the availability of the tax reducer.

If the life tenant is a higher rate taxpayer, the effect is less marked, but they would still be in the position of not having to fund additional tax out of their own resources, unlike if the property is held directly and again this benefit is subsidised by the trust funds.

The CIOT suggested an alternative approach to HMRC to avoid this anomaly. Beneficiaries would be placed in the same position as though they held the dwelling directly and the capital in the trust would be protected. If IIP trustees have no add back (that is, they are treated as exempt in the same manner as non-resident companies), the trustees would obtain basic rate relief in the same way as they do now and pay the same tax. The beneficiary has the actual trust income (calculated as now) and a gross adjustment could be made to the taxable figure to reflect the interest that would have been disallowed under s 272A had the rental business been carried on directly. The same alternative approach would apply to personal representatives.

This approach is straightforward for trustees because there is no change other than a minor reporting requirement (attributing disallowed interest to the beneficiary). The beneficiaries would be in exactly the same situation as though they had

received the income directly. A beneficiary might have taxable income with no cash receipt, but this already happens for other reasons, for example where there are other normal disallowable expenses in a trust's business (or if there is a cash distribution, there is often a mismatch between it and the taxable amount).

Discretionary trusts

Turning to discretionary trusts, as a result of the report stage amendment both the restriction and the tax reduction is given at trustee level and the tax paid by the trustees will feed into the tax pool. However, the pool of funds available to trustees may be restricted to the income from the property. As a consequence, some discretionary trusts may be insolvent and unable to pay the increased income tax without resorting to selling the property.

Basis for apportioning a loan taken out to acquire mixed property

The CIOT requested clarification of HMRC's view of the basis for apportioning a loan taken out to acquire a mixed residential and commercial property. For example, is the intention to look at the purpose of each loan when drawn (that is, deductible if drawn to buy commercial property but disallowed if drawn to buy residential property), or an apportionment based on the overall property business based on assets, rent or another approach?

Meaning of 'dwelling-related loan' and 'dwelling house'

A dwelling is not defined for the purpose of the clause. HMRC have indicated that they take its ordinary meaning and interpret it as set out in the *Capital Allowances Manual* at paragraph CA51120. There is therefore yet another definition (albeit in guidance rather than statutory) of what constitutes a dwelling to add to the multiple definitions of residential property already in use across the tax regime. The CIOT reiterated a point made consistently by it, that adopting greater consistency of (preferably statutory) definitions would be a considerable improvement.