CLAUSE 24 – FINANCE BILL 2015

RELIEF FOR FINANCE COSTS RELATED TO RESIDENTIAL PROPERTY BUSINESSES

Comments by the Association of Taxation Technicians

1. **Introduction**

   1.1. The Association of Taxation Technicians (ATT) offers these comments to HMRC in respect of Clause 24 of the Finance Bill 2015 as published on 15 July 2015.

   1.2. Clause 24 sets out the changes to the legislation on how landlords of residential properties will claim relief for finance costs from 6 April 2017 onward.

   1.3. In section 2 below, we set out our concerns with Clause 24. These are summarised as follows:

   - The legislation as drafted does make it clear that the N% calculation in s.274A(2) is only of relevance where the finance cost relates to a partnership borrowing;
   - The legislation creates situations where the tax liability on the rental activity can exceed the commercial profit;
   - The legislation has potential implications for recipients of Child Benefit and other state benefits;
   - The legislation raises particular questions for landlords of mixed properties;
   - The legislation adds unnecessary complexity to the tax system.

2. **Our concerns with Clause 24**

   2.1. ***Potential for misinterpretation of S.274(A)***

   2.1.1. During a very useful discussion with Megan Shaw, we established that the reference to N% of profits liable to tax in S.274(A)(1)(b) is intended to apply only in the case of partners with a share in a property business. This then removes the need to consider the application of N% to 'A' in S.274A(2) in non-partnership situations. Prior to that clarification, it was unclear what the N% provision was designed to achieve and attempts to apply it in non-partnership situations produced unintended consequences.

   2.1.2. To illustrate how the legislation might be interpreted without the underlying understanding that the N% calculations only impact partnership situations, we include Example 1 (Jane) in the Appendix to this note. The reference to "liable to tax" in S.274A(1)(b) might then reasonably to taken to mean that N% was established by expressing the amount of the property business profits which after the deduction of available personal allowances were liable to tax as a percentage of the whole of those profits before the deduction of personal allowances. In a situation like that of Jane (Example 1) where there is no other income to absorb the personal allowances, that would impose a significant restriction on what was the relievable amount in accordance with S.274A(2).

   2.1.3. In order to avoid this possible ambiguity and the uncertainty that it could create, we consider that it is essential to clarify the position within the legislation. We think this can be readily achieved by the insertion at the beginning of S.274A(1)(b) of a phrase such as "where the property business is conducted by a partnership". S.274A(2) would then need consequential amending to limit the application of N% to ‘A’ to partnership situations.

2.1.4. We do not consider that it would be sufficient to provide this clarity in guidance. The legislation itself should be amended to make its meaning clear. (In passing, we note that nothing in the Explanatory Note indicates that the N% provision only applies in partnership situations.)

2.2. ***Creating tax liabilities that exceed the rental profit received***

2.2.1. By restricting the relief for finance costs that have been incurred, the legislation is adding an additional distinction between a taxpayer’s actual commercial profit and their rental profit for tax purposes.

2.2.2. Example 2 in the Appendix (Pete) demonstrates how the proposed restriction will work in 2017/18. The Clause 24 calculation brings the £1,250 of disallowed finance costs into charge to tax at Pete’s marginal tax rate of 40% before reducing his tax liability by the same amount at basic rate. In the example, this increases Pete’s tax liability on the rental profit from £400 to £650. The increase of £250 is of course £1,250 @ (40-20)%. Initially, that seems unsurprising but it is worth noting that the new liability represents an effective tax rate of 65% (being £650/£1,000) when measured against Pete’s actual commercial profit of £1,000.

2.2.3. When looking at Pete’s tax position in the tax year 2020/21 (Example 3), we can see how bringing the disallowed finance costs (now the full £5,000) into charge at Pete’s marginal rate of 40% before allowing a deduction of 20% of that amount increases his tax liability on the rental profits by £1,000 (£1,400 - £1,000). Of itself, that is again unsurprising (£5,000 @ (40-20)% = £1,000). However, the new liability of £1,400 now represents an effective tax rate of 140% on Pete’s actual (commercial) profits of only £1,000. Not only will all of Pete’s rental profit have to be spent paying his tax liability but he will also have to fund the £400 balance of his liability from his other income. We question whether this was an intended outcome.

2.2.4. The two sections above illustrate that the effective rate of tax increases as the ratio of the amount disallowed under S.272A to the current measure of the taxable profit increases. This means that residential property businesses that currently have only modest profits but relatively high borrowings will be impacted most by the change.

2.2.5. The possibility of an individual having a tax liability that is greater than their true commercial profit from the activity on which the tax is being charged is of particular concern in the context of an activity like property investment. The borrowing that gives rise to the finance costs will have been undertaken by reference to the law as it existed when the loan was taken out – at a time when there was no reason to anticipate this divergence between the measure of profitability for commercial and taxation purposes. Borrowings in respect of capital acquisitions are necessarily of a long-term nature. They cannot be readily repaid so the introduction of the proposed restriction has something of a retroactive quality to it.

2.2.6. The prospect of upward movement in interest rates in the foreseeable future has the potential to increase the number of individuals who will be impacted in the same way as Pete and have to pay tax at an effective rate of more than 100%. Indeed, in the scenario referred to in 2.2.4 above, the provisions mean that significant increases in interest rates will convert commercial losses (which might even suggest that the business was not being conducted commercially and therefore be non-taxable and non relievable) into taxable profits. Has that impact been considered?

*2.2.7.*We can accept that it is reasonable to expect someone who is now (since 8 July 2015) contemplating the purchase of a residential investment property to take into account the restriction of tax relief on finance costs. We consider, however, that transitional provision should be made for those who may otherwise face penal tax liabilities by reference to loan finance commitments that existed before 8 July 2015. The objective of such provision would be to cap the effective rate of tax on residential property income (by reference to the pre-clause 24 measure of profit) at what was seen accepted as a matter of policy to be an appropriate limit (being something less than 100%). That would assist landlords in Pete's position by ensuring that the Clause 24 provisions did not in the short-term create a liability significantly more than 40% on what their taxable property income would have been without those provisions.

2.2.8.Given the proposed phasing in under S.272Aof the disallowance of finance costs in the calculation of income from residential property, we think that it might be appropriate to permit the suggested transitional relief in the three tax years 2017/18 to 2019/20. Aligning the prevention of penal effective tax rates in Pete-type situations with the final phasing out of marginal rate relief on finance costs would underline the message for residential landlords to take stock of their position well before April 2020. Where appropriate, it would also permit withdrawal from residential property investment in a structured and orderly way.

2.2.9.We believe that the introduction of a transitional capping of the effective tax rate on residential property income might help to discourage alternative responses to the Clause 24 provisions such as the inappropriate incorporation of rental businesses.

2.3. **Potential implications for Child Benefit recipients**

2.3.1.We have not seen anything to suggest that the S.272A disallowance of finance costs can be ignored in the calculation of the High Income Child Benefit Charge (HICBC).

2.3.2.Assuming that the disallowance does indeed increase the income of a Child Benefit recipient's income, we have used the GOV.UK webpage https://www.gov.uk/child-benefit-tax-calculator to determine the HICBC for someone in Pete's position who has gross income before the Clause 24 adjustment of £50,000. The calculator gives the following results:

HICBC arising on Clause 24 recognition of additional income		
Number of Children	*Additional Taxable Income of £1,250*	*Additional Taxable Income of £5,000*
One	**£131**	**£548**
Two	**£218**	**£911**
Three	**£305**	**£1,274**
Four	**£393**	**£1,637**

2.3.3. Taking account of both the basic rate restriction on the finance costs and the consequential liability to HICBC, Pete's additional tax liability in 2017/18 is not the £250 mentioned in 2.2.2 above but £381 if Child Benefit is only received for one child or £643 if received for four children. Expressed as percentages of the disallowed finance cost of £1,250, the additional tax liability is 30.38% or 51.44% respectively rather than the anticipated 20% mentioned in 2.2.2 above. When the total tax due on the rental profits is expressed as a percentage of the actual commercial profit, it is not the 65% mentioned in 2.2.2 above but (650+131)/1,000 = 78.1% with one child or (650+393)/1,000 = 104.3% with four children.

2.3.4. Moving on to 2020/2021, Pete's additional tax liability including HICBC is £1,548 with one child or £2,637 with four children. As a percentage of the disallowed finance cost of £5,000, those additional liabilities represent 30.96% and 52.74% respectively rather than the anticipated 20%. The total tax on the adjusted rental profit expressed as a percentage of the actual commercial profit is (1,400+548)/1,000 = 194.8% with one child or (1,400+1,637)/1,000 = 303.7% with four children.

2.3.5. We are not making a special case in relation to HICBC. We anticipate that the provisions may have a similarly anomalous impact on a range of state benefits. We are simply using it to demonstrate that even the surprisingly high effective tax rates on the actual rental profits of 65% and 140% for 2017/18 and 2020/21 respectively can in some relatively common situations (like HICBC) very substantially understate the position. In 2020/21, Pete (if he had four children) would have to find £2,037 out his other income to pay the amount of tax on his rental income which exceeded his actual rental income (£1,400+£1,637-£1,000 = £2,037).

2.3.6. We think that interactions like that of HICBC with the basic rate restriction emphasise the need for the type of transitional relief suggested in 2.2.7 and 2.2.8 above.

2.4. ***The impact on landlords with mixed use properties***

Different methods of apportioning finance costs

2.4.1. Clause 24 will add complexity to the tax position of someone who owns and rents out a mixed property. We think that it will be essential to publish departmental guidance on how finance costs should be apportioned in such cases as there are a number of options for doing so (rental values, market values, original cost or floor space) with the result that there could be a number of differing outcomes depending on the method chosen. This will create uncertainty for landlords and could introduce a degree of unfairness. We would be pleased to review any draft guidance if that would be helpful.

Disincentive to let out a flat above a shop

2.4.2. We are particularly concerned about the effect this measure will have on owners of shop premises with a flat above who have ongoing finance costs. In previous years, there have been specific tax reliefs and allowances made available to landlords of such properties (such as the flat conversion allowance) to *encourage* them to make the flat available for residential occupation to ease housing shortages.

2.4.3. Clause 24 will, in contrast, provide an absolute *discouragement* to let out the flat since the alternative, to let it for storage with the shop below, should enable full relief for the finance costs to continue. We could indeed envisage such landlords considering whether to convert the flat to make it part of the business premises in a much more structural way, thereby permanently depleting the available housing stock.

2.5. ***Complexity***

2.5.1. The calculation for the tax reducer in S.274A introduces a complex sequence of steps that many landlords will struggle to deal with on their own. It will also require significant upgrades to third party software in order to provide digital assistance with the calculations.

2.5.2. We consider that the legislation as currently drafted is far more complicated than it needs to be. We are sure that there must be a simpler way of achieving the intention of restricting the tax relief on finance costs to the basic rate of income tax.

2.5.3. We think for example that a provision could be included within the legislation such that if, in a straightforward case, the individual's income (including the rental income as adjusted by the S.272A finance cost restriction) did not take them above the basic rate band, there should be no requirement to negotiate the complexities of S.274A. They should simply be allowed basic rate relief on the whole of the finance costs disallowed under S.272A. A gateway that permitted such fast-tracking to the required tax reduction would produce the same result without the complexities of calculation introduced by S.274A.

2.5.4. For those situations where it is necessary to apply the more complex provisions, we think that the legislation could be made easier to negotiate by the use of introductory signposts indicating the circumstances when they applied and adopting the more modern style of legislation used elsewhere in Part 3 of ITTOIA 2005.

3. Final comments

3.1. We have outlined our concerns about some of the practical implications of Clause 24.

3.2. We are disappointed that a measure with such an extensive impact was not put forward for consultation before inclusion in the Finance Bill. We think that there is strong case for reconsidering how the policy objective can best be served without creating transitional difficulties and unnecessarily complex legislation. Given that the new provisions will not apply until April 2017, we think that there is still an opportunity for consultation as it would be possible to introduce amendments to the Clause 24 provisions in Finance Bill 2016.

3.3. On a final point, we are aware that Clause 24 does not currently indicate how the new rules will apply to Trustees and that an addition to Clause 24 covering this point will be made available shortly. We are keen to review this addition to the legislation and would be grateful if you could ensure that a copy is emailed to the contact email address in section 3.4 below as soon as it is available.

Contact details

3.4. Should you wish to discuss any aspect of these comments, please contact our relevant Technical Officer, Alison Ward, on 07762 947 910 or at award@att.org.uk.

Association of Taxation Technicians

1 September 2015

Note on the Association of Taxation Technicians

The Association is a charity and the leading professional body for those providing UK tax compliance services. Our primary charitable objective is to promote education and the study of tax administration and practice. One of our key aims is to provide an appropriate qualification for individuals who undertake tax compliance work. Drawing on our members' practical experience and knowledge, we contribute to consultations on the development of the UK tax system and seek to ensure that, for the general public, it is workable and as fair as possible.

Our members are qualified by examination and practical experience. They commit to the highest standards of professional conduct and ensure that their tax knowledge is constantly kept up to date. Members may be found in private practice, commerce and industry, government and academia.

The Association has over 7,700 members and Fellows together with over 5,600 students. Members and Fellows use the practising title of 'Taxation Technician' or ‘Taxation Technician (Fellow)’ and the designatory letters 'ATT' and 'ATT (Fellow)' respectively.

Attachment: Appendix of examples

APPENDIX: – EXAMPLES

Example 1: JANE IN 2017/18 demonstrating possible misreading of S.274A(1) and (2)

Jane owns one rental property. The rental income received and expenses and mortgage interest incurred for 2017/18 are:-

	£
Rental income	25,000
Expenses	4,000
Mortgage interest	5,000
75% of the above	3,750
Profit (current rules)	16,000
Profit (new rules)	17,250

Jane's anticipated tax position for 2017/18 under both the current and new rules:

	TAX POSITION UNDER CURRENT RULES	TAX POSITION UNDER NEW RULES
Total income – rental profit	16,000	17,250
Less: Personal allowance	11,200	11,200
Taxable income	4,800	6,050
Tax due @20%	960	1,210
Less: tax reduction **(see below)**	N/A	88
Tax due on rental profit	**960**	**1,122**

Comment: Despite being a basic rate taxpayer, Jane (under the misreading) is worse off under the new rules by £162.

The ambiguity would be avoided by a clear indication in S.274(A)(1)(b) that the N% restriction only applies in partnership situations.

Misreading of the Tax Reducer rule in S.274A(1) to (3)

- Amount of finance costs disallowed (A) — 1,250
- Percentage of rental profits liable to tax (N%)
  (i.e. 6,050/17,250 x 100) — **35%** (the misreading)
- Relievable amount is (N% of A)
  (35% of 1,250) — 438
- L is the lower of
  (i) The relievable amount — 438
  (ii) Rental profits — 17,250
  (iii) Rental profits liable to tax — 6,050

Relief is BR x L so 20% of 438 — 88

Example 2		**Pete in tax year 2017/2018**					***Notes***
Pete owns one rental property and also has employment income					£49,000		
The rental income, expenses and mortgage interest are:				£			
	Gross Rental income			10,000			
	Expenses			4,000			
	Mortgage interest			5,000			
	Allowable % of the interest		75%	3750			
	Property Business Profit (current rules)			1,000			*="B"*
	Property Business Profit (new rules)			2,250			
Tax position:		**Current rules**			**Clause 24**	***Difference***	
		£			£	***£***	
Property Business Profit		**1,000**			**2,250**	***1,250***	*= "A"*
Emloyment income		49,000			49,000		
Total income		50,000			51,250		
Less: Personal allowance (say)		11,200			11,200		
Taxable Income		**38,800**			**40,050**	***1,250***	
Tax due on Taxable Income @							
20%	£32,400	£6,480		£32,400	£6,480		
40%	£6,400	**£2,560**		£7,650	**£3,060**	***500***	
Less PAYE on salary		£8,640			£8,640		
Less Tax Reduction (see below)		0			£250	***250***	
Tax due on rental profit		**£400**			**£650**	***£250***	***1 and 2***
Tax Reduction under proposed s.274A (1) – (3):					£		
Amount of finance costs disallowed ("A")					1,250		
Basic rate relief is allowed on the **lowest** ("L") of:							
(i)	The relievable amount				**1,250**		
(ii)	Property Business Profit				2,250		
So, Tax Reduction is:		20%	of	£1,250	**£250**		
Notes:							
1	The additional tax of	£250	is	**20.00%**	of (A =)	£1,250	
2	"Effective rate" of tax on actual profit (B) is:			**£650**	/	**£1,000**	**65.00%**
3	If Pete is liable to HICBC, the additional taxable income increases both the tax on the						
	disallowed finance costs and the effective rate as follows:						
	HICBC	+ Addn Tax	Total	% of A	+ Tax on Rent	Total	% of B
	One child £131	£250	£381	**30.48%**	£650	£781	**78.10%**
	Two children £218	£250	£468	**37.44%**	£650	£868	**86.80%**
	Three children £305	£250	£555	**44.40%**	£650	£955	**95.50%**
	Four children £393	£250	£643	**51.44%**	£650	£1,043	**104.30%**

Example 3		**Pete in tax year 2020/2021**					***Notes***
Pete owns one rental property and also has employment income					£49,000		
The rental income, expenses and mortgage interest are:				£			
	Gross Rental income			10,000			
	Expenses			4,000			
	Mortgage interest			5,000			
	Allowable % of the interest		0%	0			
	Property Business Profit (current rules)			1,000			*="B"*
	Property Business Profit (new rules)			6,000			
Tax position:		**Current rules**			**Clause 24**	***Difference***	
		£			£	***£***	
Property Business Profit		**1,000**			**6,000**	***5,000***	*= "A"*
Emloyment income		49,000			49,000		
Total income		50,000			55,000		
Less: Personal allowance (say)		11,200			11,200		
Taxable Income		**38,800**			**43,800**	***5,000***	
Tax due on Taxable Income @							
20%	£32,400	£6,480		£32,400	£6,480		
40%	£6,400	**£2,560**		£11,400	**£4,560**	***2,000***	
Less PAYE on salary		£8,640			£8,640		
Less Tax Reduction (see below)		0			£1,000	***1,000***	
Tax due on rental profit		**£400**			**£1,400**	***£1,000***	***1 and 2***
Tax Reduction under proposed s.274A (1) – (3):					£		
Amount of finance costs disallowed ("A")					5,000		
Basic rate relief is allowed on the **lowest** ("L") of:							
(i)	The relievable amount				**5,000**		
(ii)	Property Business Profit				6,000		
So, Tax Reduction is:		20%	of	£5,000	**£1,000**		
Notes:							
1	The additional tax of	£1,000	is	**20.00%**	of (**A** =)	£5,000	
2	"Effective rate" of tax on actual profit (**B**) is:			**£1,400**	/	**£1,000**	**140.00%**
3	If Pete is liable to HICBC, the additional taxable income increases both the tax on the						
	disallowed finance costs and the effective rate as follows:						
	HICBC	+ Addn Tax	Total	% of **A**	+ Tax on Rent	Total	% of **B**
	One child £548	£1,000	£1,548	**30.96%**	£1,400	£1,948	**194.80%**
	Two children £911	£1,000	£1,911	**38.22%**	£1,400	£2,311	**231.10%**
	Three children £1,274	£1,000	£2,274	**45.48%**	£1,400	£2,674	**267.40%**
	Four children £1,637	£1,000	£2,637	**52.74%**	£1,400	£3,037	**303.70%**