Practitioners Series
IR150

Inland Revenue

Taxation of rents

A guide to property income

Schedule A for income tax 1995-96
and later years

Contents

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Summary of new Schedule A

1. The key features of the new Schedule A income tax system for rents from UK properties are:

- It started on 6 April 1995.

- The first tax year is 1995-96. It runs from 6 April 1995 to 5 April 1996. But if you:
  - cease in 1995-96, use the old rules to the end;
  - start in 1994-95, use the new rules from the outset.

- FA 1998 introduced new Schedule A for companies from 1 April 1998. Very broadly, the income of a company from its Schedule A business is calculated in the same way as that of an income tax payer. Note, however, that the rules for giving relief for interest and losses are different. Details of the differences are outside the scope of this guidance. If you want further information about Corporation Tax Schedule A, you should consult your tax adviser or Tax Office.

- Profit and loss computations must be on a current fiscal year basis. That is, your profit for the year ended 5 April 1996 is charged for 1995-96 and so on for later years ***(paragraph 3)***. There are two exceptions:

  - first, a property let by a trading or professional partnership uses the trade basis period ***(paragraph 26 onwards)***;
  - second, the trade basis period applies where your letting amounts to a trade, as in hotel and guest house businesses ***(paragraph 512)***.

- The scope of the new Schedule A is the same as before except that furnished lettings are included. Apart from this, the same kinds of receipt are taxed. The new system therefore applies to both furnished and unfurnished lettings, including furnished holiday lettings ***(paragraph 410 onwards)*** and Rent a Room ***(paragraph 373 onwards)***.

- Separate charges under Case VI of Schedule D on furnished letting have been abolished (except for certain trust cases: see paragraph 50 onwards). But the old 10 per cent of net rent 'wear and tear' allowance remains available for furnished lettings within Schedule A ***(paragraph 347 onwards)***.

- Profits and losses are computed using trading principles. You begin with accounts drawn up in accordance with correct accountancy principles. Receipts and expenses of the rental business are recognised on the earnings basis ***(paragraph 64 onwards)***.

- The rules for trades in Sections 74 to 99 inclusive of ICTA 1988 apply except for Section 82 (interest paid to non-residents) and Section 96 (averaging for farmers).

- For 1995-96 the tax on Schedule A profits is due on 1 January 1996 (as before). But for 1996-97 onwards the new Self Assessment rules for payments on account and balancing payments will apply to Schedule A in the same way as to other income.

- Rents from properties outside the UK are not included in Schedule A. They are still taxed under Case V of Schedule D but the rules are similar ***(paragraph 523 onwards)***.

2. Appendices 2, 3 and 4 have some more information about the way to move from the old tax rules to the new.

Basis period and who is charged

Rental business basis period

3.The new Schedule A applies for the 1995-96 tax year onwards. The basis period for 1995-96 is the tax year itself; that is, the year to 5 April 1996. Generally, it will be easier if you draw up your rental business accounts to the 5 April each year. But you don't have to do this.

4.If you don't draw up your accounts to 5 April each year, you will have to apportion two years' accounts to find the profit or loss for the tax year. Apportionments must be made on a daily basis. For example, suppose you draw up your accounts to 31 December each year:

- the basis period for (say) the 1997-98 tax year is the year ended 5 April 1998;

- to find the profit or loss for this year you take 270 days/365 days of the accounts for year ended 31 December 1997 and 95 days/365 days of the accounts for the year ended 31 December 1998.

5.You may find in a case like this that you are unable to work out your profit or loss before the tax is due. You should then pay tax on your best estimate of the final result but you may overpay tax or underpay tax (which may lead to interest charges). A 5 April accounting date will avoid this problem and will also make the calculations a little easier.

6.Basis periods may be different for trading partnerships (paragraph 26 onwards) and properties outside the UK (paragraph 527).

Rental business - what it is

7.Profits from UK land or property are treated, for tax purposes, as arising from a business. The broad scheme is that your rental business profits are computed using the same principles as for trades but you are not actually treated as if you are trading. Thus, for example, capital gains tax reliefs for traders are not available. The computation is based on commercial accounts drawn up in accordance with correct accounting principles. In particular, your accounts should be on the 'earnings basis' but certain small cases can use the 'cash basis' (paragraph 64 onwards deals with the 'earnings basis' and paragraph 90 onwards deals with the 'cash basis').

8. For simplicity the rental activity is called a ‘rental business’ in this guide. But, as you will see, the rental business can include other types of income as well as rents.

- Paragraph 55 onwards gives more information about rents and other receipts.

- Paragraph 119 onwards gives more information about the expenditure you can set against your receipts to arrive at your taxable rental business profit.

Who carries on a rental business

9. Any person or body of persons carries on a rental business if:

- they own or have an interest in land or property in the UK; and
- they enter into transactions which produce rents or other receipts liable to income tax from that land or property.

10. The list of those who carry on a rental business includes individuals, partners, trustees, personal representatives, trustees in bankruptcy, and non- resident companies subject to income tax on their income from property. See paragraph 44 onwards for more about trusts.

11. A person will carry on a rental business even if they engage an agent to handle it for them. The person carries on the business through the agent.

12. For companies with a Schedule A business, see paragraph 1 above.

All rental business activities treated as one

13. In most cases all your various types of income from land and property in the UK are treated as parts of the same, single rental business. It does not matter how many properties you have, or how many different types of income from land and property. This means that normally all your rental business receipts and expenditure can be lumped together and, hence, that your expenses on one property can be deducted from the receipts of another.

14. There are some special rules for:

- activities you carry on in different capacities - paragraph 15 onwards;
- jointly owned property and partnerships - paragraph 19 onwards;
- trusts and trustees - paragraph 44;
- properties which are not let on commercial terms - paragraph 256 onwards;
- agricultural land - paragraph 448 onwards;
- receipts from letting a room or rooms in your own home under the Rent a Room scheme - paragraph 373 onwards;
- furnished holiday lettings - paragraph 410 onwards; and
- rents from properties outside the UK - paragraph 523 onwards.

15. In law an individual can act in different legal capacities. Rental business activities are treated as parts of a single business where the activities are carried on by the same person acting in the same legal capacity. Where different legal capacities are involved different rental businesses will result.

16. Trustees, executors and partners are common examples of cases where a person acts in a different legal capacity. Executors, for instance, act on behalf of the estate of the deceased and not for themselves. Any rental business you conduct in a different capacity must be kept separate from any personal rental business. A loss on one can’t be set against a profit on another. See paragraph 44 for more about life interest trusts.

Who is charged to tax

17. You are normally charged to tax if you carry on the rental business. But the law says the charge falls on the ‘persons receiving or entitled to the income’. In most cases the person entitled to the income will also receive it. But different people could be involved where, say, you (as a landlord) engage an agent to handle the rental business. You will then carry on the rental business through the agent. It will still usually be you who is chargeable to tax. But where you normally live abroad we may collect tax from the agent. (Section 21(1) ICTA 1988)

18. Where you normally live abroad and engage the services of an agent in the UK, see paragraph 542 onwards.

Jointly owned property

19. Where you own property jointly with one or more other persons the way the rental income is taxed depends on whether the letting is carried on in partnership. Joint letting does not, of itself, make the activity a partnership.

20. Usually, there won't be a partnership and here your share from the jointly owned property will be included as part of your personal rental business profits.

21. Less commonly, your joint letting may amount to a partnership and here your share of the profit or loss must be kept separate from any other letting income you have. A partnership loss can't be deducted from a personal rental profit and vice versa.

22. The new Schedule A rules will not alter your status. If you were a partner before you will not cease to be a partner just because of the new rules. Equally, if you were not a partner before you will not become a partner just because of the new rules. See paragraph 26 onwards for more about the cases where a partnership exists.

23. Where you have jointly owned property, make sure who is keeping the records and that you have access to them. You are personally responsible for including your share of the income in your own tax return even if you agree that someone else will keep the records.

Jointly owned property - no partnership

24. Where you are not in partnership, your share of any profit or loss arising from jointly owned property will normally be the same as the share you own of the property being let. But joint owners can agree a different division of profits and losses and so occasionally your share of the profits or losses will be different from your share in the property. Your share for tax purposes must be the same as the share actually agreed. However, where the joint owners are husband and wife, 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 ask their respective tax offices for their share of profits and losses to match the share each holds in the property.
(Section 21(1) & Section 282A ICTA 1988)

25. If your only income from land and property in the UK comes from a jointly owned property, your share alone will form your rental business. If you have other income from land and property in the UK, whether in your name alone or owned jointly with other people, your share from the jointly owned property will form a part of your rental business along with the other income and expenses on any other properties which you own alone. Once again, however, shares held in a different capacity (partner, trustee, executor) must be kept separate.

Jointly owned property - partnership

26. You may jointly own properties which are let out as part of a partnership business. This might occur where:

- you are in a trading or professional partnership which also lets some of its land or buildings (but see paragraph 501 onwards about the inclusion of rents from the temporary letting of surplus business accommodation in the trading or professional profit);

or

- more rarely, you are in a partnership which runs an investment business which does not amount to a trade and which includes, or consists of, the letting of property.

27. A partnership rental business of either of the kinds mentioned in paragraph 26 is treated as a separate business from any other rental business carried on by you and all the other individual partners on their own account. Each partner's share of the profits or losses arising from the partnership rental business can't be added to or subtracted from any individual rental business profits or losses. If you are in more than one partnership, each is dealt with as a separate rental business and the profits of one can't be set against the losses of another.

Partnership example - Simon

28. Simon owns a holiday cottage and a garage both of which he rents out on a commercial basis. He is also a partner in a haulage business which owns buildings which it lets out to other traders.

29. In this case Simon runs two different rental businesses.

- The first is his own business consisting of the cottage and the garage.

- The second is the partnership rental business consisting of the trading premises let out.

30. Simon’s share of the profits or losses from the partnership rental business must be kept separate from his other rental business. He will need to make a separate return of the profits or losses for each business on his tax return form.

When does a partnership exist?

31 Whether or not you are in partnership depends on the facts. A partnership is unlikely to exist where you are one of a group of joint owners who merely let a property which they jointly own. On the other hand, you could be in partnership where you are of a group of joint owners who let the jointly owned property and provide significant additional services in return for payment; much depends on the amount of business activity involved. The existence of a partnership depends on a degree of organisation similar to that required in an ordinary commercial business.

32. You may want to bear in mind that the existence of a partnership can have important legal consequences quite apart from tax; you may be liable for partnership debts for example.

Partners’ rental income - basis periods

33. If you are a partner, the basis period you use to calculate the rental profits chargeable to tax for any tax year depends on the type of partnership to which you belong and your personal circumstances.

Partners in trading etc partnership - basis periods

34. Many trading or professional partnerships have an ancillary source of rental income; for example, a farming partnership may own a farm which it lets to another farmer. If you are a partner in this type of partnership, the basis period used for rental profits is the same as that used for the trading or professional income.

Example - trading etc partnership - normal case

35. For example, suppose the 1997-98 partnership trading profits are based on the year ended 31 December 1997; here the 1997-98 rental business profits should also be computed for the year ended 31 December 1997 and not the year ended 5 April 1998. Only if the partnership draws up accounts for the year to 5 April will the basis period for the trade be the same as for Schedule A (namely, the current year to 5 April).

Trading etc partnerships: first and last year & changes of accounting date

36. Special basis period rules apply for the years in which you join or leave a partnership and the accounts are not made up to 5 April or where there is a

change of partnership accounting date. Page 60 onwards of our guide SAT 1(1995) has more information. See paragraph 546 onwards below to find out how to obtain SAT 1. ***(Section 111 ICTA 1988)***

Partnership trade etc started on or after 6 April 1994 - basis periods

37. Where you are a partner in a trade or profession which began after 5 April 1994, the new self-assessment basis period rules apply immediately to your (and each individual partner's) share of partnership profit. Here the basis period for Schedule A rental profits will automatically be the same as for the trade or professional profits from the start.

Partners - trade or profession started before 6 April 1994

38. However, if you are in a trading or professional partnership which started before 6 April 1994, the new rules, including the separate assessment of shares of profit, will not apply until the 1997-98 tax year. Therefore, strictly, for these partnerships rental business profits are taxed as follows:

- tax year 1995-96 - the basis period is the year ended 5 April 1996;
- tax year 1996-97 - the basis period is the year ended 5 April 1997.

39. For 1997-98 (as well as later years) the Schedule A statutory basis period for all partnerships becomes the partnership accounting period ending in that tax year.

40. To minimise temporary changes of basis period for Schedule A we accept that there is no need to change to a 5 April current-year basis period for 1995-96 and 1996-97. That is, if you wish, in 1995-96 you can go straight on to the basis which applies for 1997-98 and later years. Then the basis period will be the partnership accounting period ending in the tax year itself.

41. Appendices 3 and 4 contain more details.

Partners - investment business

42. The second type of partnership mentioned in paragraph 26 of this guide is where your partnership runs an investment business:

- which does not amount to a trade; and
- which includes the letting of property or consists entirely of property letting.

43. For a partnership investment business you always calculate the rental profits for the tax year to 5 April (just like any other rental business). Page 65 of our booklet SAT 1(1995) has more information. See paragraph 546 onwards below to find out how to obtain SAT 1.

Life interest trusts

44. Where you have an interest in land held in trust, you will need to establish who is carrying on the rental business. It will normally be the trustees who carry on or enter into the transactions giving rise to the rental income. Hence, it will be the trustees who are carrying on the rental business relating to land or property in their legal ownership and the trustees who pay the tax on the profits. If you are a trustee of this kind, the rental business carried on by you (and your co-trustees) in your capacities as trustees should include receipts and expenses from any other land or property relating to the same trust.

45. Rather less commonly you, as the life tenant, will probably carry on the rental business where:

- land is held in a strict settlement governed by the provisions of the Settled Land Act 1925; or
- your trustees have delegated their powers of leasing and management etc to you as the beneficiary under Section 29(1) Law of Property Act 1925; or
- your trustees have, by power of attorney, delegated their powers of leasing, management etc. to you as the beneficiary under Section 9 of the Trusts of Land and Appointment of Trustees Act 1996.

46. This is because in these three cases it will be you, as the tenant for life, who actually grants leases, to whom rents (but not capital money) are paid, and who meets the outgoings. So you carry on the rental business and pay the tax on it. If you are a tenant for life in such circumstances, the rental business carried on by you should include receipts and expenses from any land or property which you own beneficially. That is, you should include both your receipts and expenses from the trust and your receipts and expenses from property you own directly.

Life interest trusts and losses

47. Before 6 April 1995 it is possible that either you as life tenant or your trustees were assessed on the rental income arising from the trust. It may happen, therefore, that:

- under the new Schedule A rules for 1995-96 and later years, you (as life tenant) carry on the rental business and pay the tax (see paragraph 44 onwards); but
- your trustees were assessed before 1995-96 under the old rules and paid the tax.

48. Where this is the case your trustees' unrelieved losses at 5 April 1995 may be carried forward and set against your 1995-96 profits from your rental business. Any losses which can't be used in 1995-96 (because the profits are too small) can be carried forward to 1996-97; and so on until they are used up. If you (as life tenant) were assessed before 1995-96 you can similarly set any past losses against your profits for 1995-96 and later years.

49. See paragraph 423 onwards for more about the general rules for losses. Paragraph 430 onwards covers the rules for carrying losses forward.

Trusts where you are the settlor - losses

50. Various special provisions may apply to trusts and to those who set them up (the 'settlor'). In particular, there is a rule to prevent tax avoidance which can treat trust income as being, for tax purposes, the income of the settlor. Such income is taxed on the settlor under Case VI of Schedule D but, where the income is within Schedule A, the normal Schedule A rules apply in calculating the income. (Section 660C ICTA 1988)

51. The more common case is where your trustees carry on the Schedule A business but you are a settlor caught by Section 660A ICTA 1988. Here you can't set any rental business losses of your trustees against your personal Schedule A income. Similarly you can't merge your personal rental business losses and the trust rental business profits which are deemed to be yours and charged under Case VI of Schedule D. Thus:

- where your trustees have a rental business loss and you have a personal rental business profit, the trust loss is carried forward and you are taxed on your personal rental business profit; the amount of the trustees' rental business profit charged on you in the following year under Case VI will be reduced by the trust loss carried forward;

- where your trustees have a rental business profit and you have a personal rental business loss, you are taxed on the trust rental business profit under Case VI; your personal rental business loss can't be merged with the trust profit; but, as a separate matter, you may in some cases be able to set a personal Schedule A loss sideways against your other income, including any Case VI income deemed to arise from your trustees' rental business; see paragraph 423 onwards for more details.

52. The position is different where you are:

- the settlor; and

- the life tenant; and

- you carry on the Schedule A business (as outlined in paragraph 44 onwards).

53. Here you (the settlor) can merge your personal property losses with your deemed income from the trust and vice versa.

54. The general law and the tax law for trusts can be complex and we suggest you consult your professional adviser or tax office if you have an interest in a trust.

Income chargeable

Income within a rental business

55. The concept of profits from a rental business is broad. You bring in all your rents and similar receipts from the exploitation of your land or property in the UK. You deduct the business expenses incurred in earning the income but not capital expenditure (paragraphs 119 onwards). Some capital expenditure is relieved separately (paragraph 329 onwards).

56. Properties you own outside the UK continue to be taxed under Case V of Schedule D but, generally, the computational rules are the same (paragraph 523 onwards).

57. Most of your rental business receipts from UK properties will normally consist of rents from the tenants or licensees of your land and property. Note that:

- Rental income from furnished, unfurnished, commercial and domestic premises, and from any bare land, is taxable under Schedule A. There are no longer separate income tax Case VI charges on furnished lettings.

- When you let property furnished any separate sums you get from the tenant for the use of the furniture etc are rental business receipts. Paragraph 63 directs you to further guidance.

- Less common receipts from land (such as income from fishing rights) are taxable under Schedule A. Paragraph 58 gives more detail.

- Taxable receipts include both money payments (for example, cash) and payments in kind.
  (Section 15 Schedule A paragraph 1 ICTA 1988)

58. Receipts other than rents can also form part of the rental business income. Some of the main categories are:

- rent charges, ground rents and feu duties;

- premiums and other similar lump sums received on the grant of certain leases (see paragraph 100 onwards);

- income arising from the grant of sporting rights, such as fishing and shooting permits;

- income arising from allowing waste to be buried or stored on your land;

- income from letting others use your land - for example, where a film crew pays to film inside your house or on your land;

- grants received from local authorities or others contributing towards revenue expenses, such as repairs to a property which are deductible in computing rental business income; ‘revenue’ expenses are, broadly, running costs as opposed to capital costs;

- rental income received through enterprise zone trust schemes;

- income from caravans or houseboats where these are not moved around various locations; (but see paragraph 511);

- service charges received from tenants in respect of certain services ancillary to the occupation of property (but see paragraph 512);

- refunds or rebates of rental business expenses which have been allowed for tax;

- insurance recoveries under policies providing cover against non payment of rent.
  (Section 15 Schedule A paragraph 1(2) ICTA 1988)

59. Paragraph 93 lists income which is excluded from Schedule A.

Single transactions are treated as arising in a business

60. Rents or other receipts arising from a single transaction for the exploitation of rights over UK land are treated as if they arose in a Schedule A business. Therefore the Schedule A rental business charge extends to one-off or casual lettings that may not have the degree of organisation normally associated with a business. (Section 832(1) and Section 15, Schedule A, paragraph 1(2) ICTA 1988)

Income isn’t a trade receipt within Case I Schedule D

61. Various court cases have established the principle that income you derive from rights of property in UK land is very unlikely to be trading income except in a hotel or guest house activity, where the whole income from guests is usually chargeable as trading income. The mere fact that you spend a lot of time working in your letting business - perhaps even all your working time - does not convert Schedule A rental income into Schedule D trading income. Paragraph 512 onwards has more details. (Salisbury House Estates Ltd v Fry, 1930, 15 TC 266; Griffiths v Jackson, 1982, 56 TC 583)

62. The new Schedule A rules compute the income of your rental business, broadly, as though it were a trade. But the established distinction between exploiting the rights of ownership of land to generate investment income and carrying on a trade remains. (Section 15(1)4(1)-(2) & Section 18(3) ICTA 1988)

Furnished Lettings
63. For two special cases of furnished lettings see:

- Rent a Room (letting a room in your own home) - paragraph 373 onwards;
- Furnished holiday letting - paragraph 410 onwards.

Allocation of receipts and expenses to a tax year

64. The general rules for the allocation of rental business receipts and expenses to the correct tax year are outlined below. In brief, the principles which apply to a trade charged under Case I of Schedule D also apply to a Schedule A rental business.

When receipts included in the profit and loss computation
65. Receipts are recognised in accordance with normal accountancy principles. This means that you include all incomings earned in the tax year regardless of when they are due or when they are received. For a trading or professional partnership you will normally look at the incomings of the accounting period ending in the tax year, not the year to 5 April (paragraph 26 onwards).

66. You don't bring rent into a year's tax computation merely because you get it in the year or because it is due to be paid to you in the year. Equally, you don't exclude rent merely because you get it outside the tax year or it is due outside the tax year. You bring in the proportion of the rent which is earned in the year from the tenant's use of the property in the year. You exclude the proportion which is earned from the tenant's right to use the property outside the year.

67. Where, therefore, a lease provides that rent is payable to you in ***advance*** you:

- include the proportion of any rent due before or during the tax year which relates to use of the property during the year; and
- exclude the proportion which is for the use of the property for a period outside the tax year.

68. Where rent is payable to you in ***arrears*** the same principles apply in reverse. You:

- include the proportion of any rent due during or after the tax year which is for the use of the property in the tax year; and

- exclude the proportion which is for the use of the property for a period outside the tax year.

Example showing when income earned - Andrew
69. Andrew lets a property. He charges a rent annually in advance as follows:

- due 1 January 1997 - £100,000;

- due 1 January 1998 - £120,000.

70. Taking account of the odd days from 1-5 April the rent chargeable for 1997-98 is worked out like this (rounding each calculation up or down to the nearest pound):

- The rent due on 1 January 1997 relates partly to 1996-97 (just over three months) and partly to 1997-98 (just under nine months). So the amount chargeable for 1997-98 is 270 days/365 days x £100,000 = £73,973.

- The rent due on 1 January 1998 relates partly to 1997-98 (just over three months) and partly to 1998-99 (just under nine months). So the amount chargeable for 1997-98 is 95 days/365 days x £120,000 = £31,233.

- The total chargeable for 1997-98 is therefore £105,206 (£73,973 + £31,233).

71. The part of the rent charged for the use of Andrew's property in January, February and March 1998 is included in his 1997-98 computation even if none of the rent due on 1 January 1998 is received until after 5 April 1998. See paragraph 81 onwards for more about the methods of splitting receipts and expenses between tax years.

72. References to 'receipts' throughout this guide assume that the 'earnings basis' treatment outlined above is applied.

Bad debts

73. It follows that you may need to bring in receipts before you have received the cash. You don't exclude receipts merely because you have not actually been paid by the year end or because the debt may be bad. But you can, as a separate matter, deduct as an expense the amount of any receipt which you have included in your profit or loss computation and which is genuinely bad or doubtful. Paragraph 163 onwards has more about bad and doubtful debts.

When expenses included in the profit and loss computation

74. Expenses are also brought into the tax computation using normal accountancy principles and are the converse of the approach to receipts. This means that you deduct any allowable expenses (see paragraph 119 onwards) which relates to work done for you, or goods and services supplied to you, for a particular tax year to 5 April. For a trading or professional partnership you will normally look at the expenses of the accounting period ending in the tax year, not the year to 5 April (paragraph 26 onwards).

75. It does not matter whether you pay the bill before or after the end of the tax year. But, obviously, you can only deduct genuine business expenses. You can't, for example, claim a deduction for an uncommercial expense which you never intend to pay.

76. There are also special rules for the payment of salaries and wages to employees. You can only deduct amounts actually paid in the tax year or within nine months of the end of it. See paragraph 229.

Example showing when expenses deductible - Judy

77. Judy owns a property which she lets:

- Judy has the property painted during March 1996; the work is finished before the end of the month;

- she is billed on 3 May 1996; and

- she pays that bill on 31 May 1996.

78. Judy deducts the full amount of the bill from the rental income for the year ended 5 April 1996. This is the year to which the work related. That same bill can't, of course, be deducted again in the year ended 5 April 1997 when it is paid. This is because the expenditure isn't for maintenance work for the year ended 5 April 1997 (and relief has been given in the previous year).

79. Suppose Judy was also due to pay the following insurance premiums on the property:

- £1,000 on 1 January 1997; this provides cover for the year ended 31 December 1997;

- £1,200 on 1 January 1998; this provides cover for the year ended 31 December 1998.

80. Just under three quarters of the £1,000 paid on 1 January 1997 (about £750) provides cover for the period 6 April 1997 to 31 December 1997 (just under nine months). Just over a quarter of the £1,200 paid on 1 January 1998 (about £300) provides cover for the period 1 January 1998 to 5 April 1998 (just over three months). So the total insurance premium deductible for the year ended 5 April 1998 is £1,050, being:

- £1,000 x 9 months/12 months = £750;

plus

- £1,200 x 3 months/12 months = £300.

Splitting receipts and expenses between years

81. As you will have seen from the examples, it is sometimes necessary to time-apportion figures to find the amount attributable to the tax year ending on 5 April. To simplify the computations for the purpose of explaining the principle in Judy's example, the five odd days at the beginning and end of the year (1 April to 5 April) were ignored. You can also do this provided you do so consistently for all items in the computation (both receipts and expenses) and the figures are small. Strict daily apportionment calculations are needed where the figures are substantial and a strict comparison would produce a materially different result.

82. For example, in the case of Judy's insurance premiums, the apportionments were made using whole months (paragraph 80). A strict daily calculation of the premiums attributable to 1997-98 is as follows (rounding answers up or down to the nearest pound):

- £1,000 premium due 1 January 1997 x 270 days/365 days = £740;

plus

- £1,200 premium due 1 January 1998 x 95 days/365 days = £312.

83. The total amount Judy can deduct on the strict basis is therefore £1,052, compared to £1,050 on the whole month basis. The difference here is negligible and the whole month basis is acceptable.

Unusual patterns of rental payments - rent holidays etc

84. Sometimes landlords will grant a lease with an initial rent-free period. For example, a landlord may grant a 20 year lease with five years to run to the next rent review. No rent is payable in the first year and a rent of £10,000 a year is payable in years 2 to 5 inclusive. There are many variations on this theme.

85. Accountancy practice in this area is developing and the current view is usually that the total rent due is spread evenly over the period of the lease to which it relates. This normally means over the period to the next rent review. Even spreading applies whether you are the tenant paying the rent under a lease of a property in your rental business or whether you are the landlord who gets the rent. (SSAP 21 paragraph 43 & Urgent Issues Task Force of the Accounting Standards Board, abstract 12 of December 1994)

86. In the example in paragraph 84 the result is to say that the total rent due in the first five years (£40,000) is split evenly between the years so that £8,000 relates to each of the first five years. If you are the landlord, you bring in £8,000 of receipts each year. If you are the tenant, you deduct £8,000 each year. This treatment reflects the substance of the matter; there isn't really a rent-free year - the total rent under the lease secures the property for the whole five years.

87. A straight line spread isn't necessarily the only correct basis but any other basis needs to be properly justified as being, in all the circumstances, a more rational and systematic solution. In most cases there will be no better way of dealing with the problem.

88. You shouldn't spread rent you receive over a period which is rent free because the property is being fitted out and your tenant can't use it. The same applies where your landlord agrees that you don't have to pay rent for a fitting out period.

89. There is a tax principle that neither a profit nor a loss can be anticipated. We do not believe that the straight-line spread normally required by correct accountancy practice means a profit or loss is anticipated. Receipts and expenses are simply correctly attributed to each year. Indeed, failure to use an even spread may itself lead to the anticipation of a profit or loss.

Use of cash basis

90. 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, your 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:

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

91. We are, therefore, 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; by a ‘small’ case we mean one where, for any year, the total gross receipts of your rental business (before allowable expenses are deducted) don’t exceed £15,000; and

- the ‘cash basis’ is used consistently; and

- the result is reasonable overall and does not differ substantially from the strict ‘earnings basis’

92. We reserve the right to apply the strict basis where there are unusual features; for this purpose we take into account any material effect on other people, including in particular anyone on the strict ‘earning basis’.

Income excluded from a rental business

93. There are certain receipts which can arise out of the use of land and which are specifically excluded by statute from a rental business. These include:

- yearly interest;

- income from your occupation of woodlands managed on a commercial basis; but income from letting such woodlands is included; income from the occupation of woodlands managed on a commercial basis arises when you cut and sell the timber;

- income from the types of concerns listed below (which are taxed under Case I of Schedule D):

  - mines and quarries (including gravel pits, sand pits and brickfields);
  - ironworks, gasworks, salt springs or works, alum mines or works and water works and streams of water;
  - canals, inland navigations, docks, and drains or levels;
  - fishings (see paragraph 94);
  - rights of markets and fairs, tolls, bridges and ferries;
  - railways and other ways;

- other concerns of a like nature to those above;
- lettings of tied premises by traders (see paragraph 510);
- farming and market gardening.

(Section 15(1)2(1) and(2) and Section 55 ICTA 1988)

Fishing concerns

94. The fishing activities excluded from Schedule A are those carried on by a substantial commercial undertaking. These are a ‘concern’ within Section 55 ICTA 1988. The letting of fishing rights isn’t usually a ‘concern’ of this type and the profits from it are included within Schedule A (see paragraph 58).

Hotels and guest houses

95. Profits from running hotels and guest houses are taxed under the rules for trades and are not part of a rental business. Paragraph 512 onwards has more details.

Lodgers and tenants in your own home

96. The regular provision of meals to lodgers or tenants in your own home is also likely to amount to a trade. The trade will usually encompass all your receipts from your lodgers or tenants in your home; that is, the payments they make for lodging, board, cleaning, laundry etc. The trade will be taxable under the trading rules of Case I of Schedule D. The Rent a Room rules may help you here; see paragraph 373 onwards.

Extra services to tenants

97. Where you let a property (which isn’t your home) and you provide additional services to your tenants:

- rent or other payments for the use of the property and furniture, furnishings, fittings etc will not be trading receipts - they will remain within the Schedule A rental business; but

- the additional services may be sufficient to give rise to a trade which is taxable under Case I of Schedule D quite separately from your Schedule A rental business; if there isn’t a trade the receipts will fall within Case VI of Schedule D.

98. Paragraph 512 gives more details about when a trade exists.

Rent from overseas properties

99. Overseas properties are charged to tax separately under Case V of Schedule D. Broadly, the computation will follow the Schedule A principles outlined in this guide. See paragraph 523 onwards.

Tax on premiums & similar receipts

100. Lump sums you receive upfront for the grant of a lease of 50 years or less are liable to tax under Schedule A on a special basis. Such receipts are generally called 'premiums'. (Section 34 ICTA 1988 & paragraph 9, Schedule 6, FA 1995)

101. The special basis also applies to other forms of consideration received in connection with the right to possession of a property. The amount chargeable under the special rules forms part of the income of your rental business. Any amount which isn't chargeable to tax as part of your rental business is either:

- a trading receipt; this will be so if you are carrying on a trade of dealing in land or property; or

- a capital receipt to which capital gains tax may apply.

Difference between a premium and rent

102. You need to distinguish a premium paid for the grant of a lease from rent due under the lease. Confusion can arise in certain unusual cases where rent is payable in advance and so looks like a premium at first sight. Paragraph 84 onwards says more about uneven amounts of rent.

Difference between a premium and the sale price of a lease

103. You also need to distinguish a premium paid for the grant of a lease from a capital sum paid on the sale of a lease. A sale is a capital gains tax matter (unless you are carrying on a property dealing trade). For example, Jeremy may pay a premium of £10,000 to his landlord to obtain the grant of a lease of 21 years at a rent of £5,000 a year. The £10,000 is within the premium rules outlined below. Ten years later Jeremy may sell the remaining eleven years of his lease to Robert for £8,000. That £8,000 is not a premium for the grant of a lease but the sale price of the lease and any gain or loss is dealt with under the capital gains tax rules (unless he is a property dealer).

Relief for premiums paid

104. You may also be entitled to relief against your rental business income for premiums you paid to obtain a property which you now let. In addition, this relief may apply where you acquire a lease for which an earlier tenant under that lease paid a premium. See paragraph 265 onwards for more details. (Section 37 ICTA 1988 & paragraph 12, Schedule 6, FA 1995)

Taxation of premiums etc received - details

105. Premiums and similar receipts related to the grant of a lease are taxable wholly or partly as income where you get them for granting a lease of fifty years or less. The part of the premium taxable as income is treated as a receipt of the rental business for the year of assessment in which the lease is granted. If you receive a lump sum for selling your existing lease these special rules don't apply: see paragraph 103. (Section 34(1) ICTA 1988)

106. The amount which is a receipt of your rental business is calculated on a sliding scale which depends on the length of the lease for which you got the payment. The longer the lease, the smaller the amount charged to Schedule A income tax but the larger the amount potentially chargeable to income tax as a trading receipt under Case I of Schedule D (in a property dealing trade) or, if there is no Case I charge, to capital gains tax. (Section 34 ICTA 1988 & paragraph 9, Schedule 6, FA 1995)

107. The rule is that the amount taxable as income of your rental business is reduced by 2 per cent of the premium for each complete year of the lease after the first. Thus:

- the full amount of a premium is taxable as income where the lease is for less than 2 years;

- 98 per cent of the premium is taxable as income if the lease is for two years or more but less than three years;

- 96 per cent of the premium is taxable as income if the lease is for three years or more but less than four years;

- and so on until the lease is for 49 years or more but less than 50 years; here 4 per cent of the premium is taxable as income; the deduction from the taxable premium is 49 complete years less 1 year = 48 years x 2 per cent = 96 per cent; thus, for example, 4 per cent is taxable if the lease for 49 years and one month or 49 years and 11 months;

- when the lease is for exactly 50 years 2 per cent of the premium is taxable as income; the deduction is 50 complete years less one year = 49 years x 2 per cent = 98 per cent;

- none of the premium is taxable as income when the lease is for over 50 years; for example, where the lease is for 50 years and one day.
  (Section 34 ICTA 1988 & Schedule 6 FA 1995)

Example illustrating basic premium case - Paul

108. Paul grants a 25 year lease to Peter on 5 June 1998. The lease agreement requires Peter to pay Paul a premium of £30,000 on 30 June 1998 in addition to rent of £400 a month. Paul must include in his rental business accounts for 1998-99 both the rent due for the period from 5 June 1998 (when the lease started) to 5 April 1999 and the taxable amount of the premium. That is, the premium is taxed in the year in which the lease is granted. The amount which Paul is treated as receiving as part of his rental business is calculated as follows:

Premium receivable	£30,000
Less: (2% of £30,000) x 24 years	£14,400
	£15,600
Plus: rent for period 5/6/98 - 5/4/99*	£4,000
Amount to include in rental business	£19,600

* This is ten months at £400 a month.

Length of lease and premiums

109. Normally, in a straightforward case, the length of a lease is the period for which it is granted. For example, if the lease says it lasts for 60 years the duration will be taken as 60 years. But there are special rules aimed at attempts to make a lease appear to be:

- long when, in substance, it is short; or
- short when, in substance, it is long.

110. The law aims to work on the true length of the lease.
(Section 38 ICTA 1988)

111. For example, a lease might be granted for 60 years at a premium but the facts known at the time the lease was granted could make it unlikely that the lease will last more than 10 years. A simple case might be a lease which provides that the rent due shoots up 100 times from year 11. Assuming that the amount of the premium reflects the 10 year period, the lease is treated as a 10 year lease.

112. The rules for deciding the length of a lease for tax purposes are complicated and we suggest you consult your professional adviser or tax office if you are in doubt.

Special kinds of premium

113. There are other kinds of receipt, and other forms of consideration relating to leases of 50 years or less, which are treated like premiums. They must be included in your rental business in the same way as an ordinary premium. These include:

- the value added to your reversionary interest in the property because the tenant agrees to spend money on improvements when you grant the lease; the 'reversionary interest' is the legal term for the rights you have in the property after you granted the lease; this rule doesn't apply to ordinary revenue repairs and maintenance; nor does it apply to temporary changes which only benefit the tenant's particular trade;

- lump sums in place of rent due under the lease;

- lump sums for the surrender of the lease made under the terms under which the lease is granted;

- receipts other than rent for the variation or waiver of the terms of a lease;

- receipts for the assignment of a lease which was originally granted by the landlord at an under-value;

- receipts for a freehold or a lease where the seller has a right to repurchase the property or to the grant of a lease back;

- informal and 'hidden' premiums (see paragraph 115).

114. The rules are mainly aimed at attempts to side-step the ordinary premium rules by providing substantially the same consideration in a different form. If you are not sure whether you received one of these special kinds of premium we suggest you consult your professional adviser or tax office. (Sections 34-36 ICTA 1988)

Informal and 'hidden' premiums

115. A premium for a lease must be included as part of your rental business whether or not it is mentioned in the written lease or other written agreements. Thus, for example, a purely oral arrangement under which you get a lump sum for handing over the keys will give rise to a premium charge. Any sum received in connection with the granting of a tenancy is presumed to have been received by way of premium unless it is shown to have been the price for something else.

116. The law looks at the substance of the matter and not at the form or the names used. For example, you are treated as receiving a premium if you ask your tenants to pay more than the market price for, say, furniture, fixtures and fittings. By paying over the odds for the fixtures and fittings, the tenants are paying you a ‘hidden’ premium.

117. Usually, you will simply let the property with the furniture etc for a rent and there will be no sale of assets to bother about. If you do sell items to the tenant we don’t normally expect you to worry about the premiums rules where you make a reasonable attempt to agree a fair price for everyday kinds of assets. We do expect you to consider seriously the possibility of a premium charge where, on any reasonable view, you charge significantly more than the value of the assets or where the charge for the assets runs into thousands of pounds.

Example of a ‘hidden’ premium - James

118. James lets a flat to Anna for two years at a rent of £6,000 a year. James also requires Anna to pay £5,000 for fixtures and fittings worth only £500. James will be treated as receiving a premium of £4,500 (£5,000 less £500) and (apart from any allowable expenses) he will have to include in his rental business receipts of £4,410 (£4,500 less 2 per cent) for the year the flat is let, in addition to the annual rent of £6,000.

Deductions in computing profits

General rules for deductions

119. Broadly speaking, in calculating your rental business profits you can deduct business expenses so long as they -

- are incurred wholly and exclusively for business purposes;

and

- are not of a capital nature.

120. We can't set out all of the expenses which are allowable for tax purposes in every circumstance. What follows aims to give you some idea of the main types of expenses which are likely to arise in a rental business and also some idea of what you usually can or cannot claim as a deduction in calculating your rental business profits.

121. The guidance assumes that you let your property at a market rent and there are no unusual factors (see paragraph 256 onwards).

Wholly and exclusively

122. The trading expenses rules in Section 74 ICTA 1988 are applied to Schedule A. This includes the 'wholly and exclusively' rule which says that you can't deduct expenses unless they are incurred wholly and exclusively for business purposes. (Section 21A ICTA 1988)

123. All the evidence has to be considered in determining whether an expense was laid out wholly and exclusively for business purposes. The evidence may include documents, agreements, notes of meetings and any other records. What you say was your purpose in incurring the expense is part of the evidence but it isn't necessarily decisive: the facts may point to another purpose. For example, suppose you live in London but have a holiday cottage in Wales. The cost of going down there for a three week family holiday is unlikely to meet the 'wholly and exclusively' test even if you say your purpose in going was to inspect the property prior to third-party letting later in the year.

124. For an expense to qualify the business purpose must be the sole purpose. A non-business or private purpose prevents any deduction from business profits where there is no objective yardstick by which any business element can be distinguished from the non-business element.

125. But where a definite part or proportion of an expense is wholly and exclusively incurred for the purposes of the business, you can deduct that part or proportion. An example is the revenue running costs (including standing charges and hire-purchase interest) of a car or van used partly for business and partly for private purposes. For example, if 20 per cent of the mileage in your car is business mileage, you can deduct 20 per cent of the costs of the car, including standing charges. See also paragraph 234 onwards for more about travelling.

126. Another example is the cost of rates, lighting and heating of premises used partly as business and partly as private accommodation. See paragraph 245 onwards.

127. Payments made by a partnership towards the personal or domestic expenses of a partner are disallowable because they fail the wholly and exclusively test.

Capital expenses

128. It is a general income tax principle that you can't deduct capital expenses in computing your taxable income. This applies to trades and rental businesses as well as to other activities. Hence you can't, for example, deduct the capital cost of the property you let or the amount of any depreciation of the property in computing taxable profits. Nor can you deduct a loss on the sale of a property or other capital assets.

129. But you can normally deduct the cost of ordinary expenditure on repairs. In addition, separate tax allowances give relief for the depreciation of some capital assets (see paragraph 329 onwards).

130. In accountancy and tax practice expenses which are deductible as an ordinary expense in computing profits are often called a 'revenue expense'. This is in contrast to a 'capital expense', which isn't deductible. But some revenue expenses will not be deductible anyway; for example, where they fail the 'wholly and exclusively' test (see paragraph 122 onwards).

131. The capital expenses and repairs rules are explained in more detail below. The main headings are:

- paragraph 132 - repairs;
- paragraph 135 - capital expenses on land and buildings;
- paragraph 137 - capital allowances for capital expenses;

- paragraph 139 - when there is capital improvement;
- paragraph 146 - extensive alterations to a property;
- paragraph 147 - ‘notional repairs’;
- paragraph 153 - capital works and repairs undertaken at the same time;
- paragraph 154 - repairs after you buy a property;
- paragraph 157 - provisions for repairs;
- paragraph 158 - repairs to assets on which capital allowances were claimed.

Repairs

132. ‘Repair’ means the restoration of an asset by replacing subsidiary parts of the whole asset. An example is the cost of replacing roof tiles blown off by a storm. There won’t be a repair if a significant improvement of the asset beyond its original condition results - that will be capital expenditure. For instance, there will be a capital improvement if you take off the roof and build on another storey.

133. A repair is normally a revenue expense which you can deduct in computing your rental business profits. Capital expenses are generally not deductible in computing profits but there is a limited concession for ‘notional repairs’ which we cover in paragraph 147 onwards. In addition, allowances are available for certain kinds of capital expenses, such as the expense of constructing or extending industrial buildings.

134. Examples of common repairs which are normally deductible in computing rental business profits include:

- exterior and interior painting and decorating;
- stone cleaning;
- damp and rot treatment;
- mending broken windows, doors, furniture and machines such as cookers or lifts;
- repointing; and
- replacing roof slates, flashing and gutters.

Cost of land and buildings is capital

135. The cost of your land and any buildings on it is capital expenditure. So is the cost of any new buildings you erect after letting has started and any improvements. You can't deduct capital expenditure in computing the profits of your rental business. Nor can you claim a revenue deduction for the depreciation of capital assets or for any loss on the disposal of capital assets. But see paragraph 137 about separate reliefs for capital expenditure.

136. Other examples of capital expenses include:

- expenditure which adds to or improves your land or property; for example, converting a disused barn to a holiday home (see paragraph 139 onwards);

- the cost of refurbishing or repairing a property you bought in a derelict or run-down state (see paragraph 154).

- expenditure on demolishing a derelict factory to clear space for a new office building; the cost of the new building;

- the cost of building a car park next to a property you let;

- expenditure on a new access road to a property;

- the cost of a new piece of land next to a property you let.

Separate reliefs for capital expenses

137. In some cases your capital expenditure on a property (but not the land itself) may qualify for 'capital allowances'. These are effectively further deductions in arriving at your taxable rental business profit. In particular, capital allowances are available for expenditure on certain industrial and agricultural buildings. Machinery or plant within buildings may qualify, for example lifts. Allowances may also be due on demolition costs. There are no capital allowances for the cost or depreciation of residential property; but a 'wear and tear' allowance may be due for the machinery and plant (furniture, furnishings etc) within furnished accommodation (paragraph 347 onwards).

138. If you are not sure whether a particular cost is capital, or whether any capital allowances are due, we suggest you consult your professional adviser or tax office. Paragraph 329 onwards has more about relief for capital expenditure generally but a full explanation is outside the scope of this guide.

When there is capital improvement

139. It is largely a question of fact and degree in each case whether expenditure on a property leads to an improvement.

140. Sometimes the improvement may be so small as to count as incidental to a repair. In the absence of other capital indications, the entire cost is then revenue expenditure.

141. Problems can arise where you do work on an old asset. A repair or replacement of a part of a building using modern materials may give an apparent element of improvement because of the greater durability, superior qualities and so forth of the new material. But the cost normally remains revenue expenditure where any improvement arises only because you use new materials which are broadly equivalent to the old materials.

142. For example, the following are usually revenue expenses in the absence of any other capital indications. The cost of replacing:

- wooden beams with steel girders;
- lead pipes with copper or plastic pipes; and
- single glazed softwood windows with single glazed PVC windows.

143. There is likely to be capital expenditure if, say, the steel girders were designed to take heavier loads so that the building could take larger machines after the work was done. The same is true if the new pipes are designed to take greater pressure or heat, or the single glazed windows are of a distinctly superior type (perhaps containing special glass).

144. But there is usually no improvement if trivial increases in performance or capacity arise solely from the replacement of old materials with newer but broadly equivalent materials. For example, the replacement of pipes or storage tanks of imperial measure with the closest metric equivalent may result in slightly increased diameter or capacity but the cost is still revenue expenditure.

145. Where a significant improvement arises from the change of materials, the whole of the cost is capital expenditure. This includes things like redecoration after the main work has been done (redecoration would ordinarily be a revenue expense). For example, if you replace single glazed softwood windows with double glazed PVC windows, the improvement element normally means that the entire cost is capital expenditure, including the expense of making good any damage to decorations. But some relief may be due for the cost of 'notional repairs': see paragraph 147 onwards.

Extensive alterations to a property

146. Alterations to a building may be so extensive as to amount to the reconstruction of the property. This will be capital expenditure and you can't deduct it as an ordinary revenue business expense. Rebuilding, whether forced on you or voluntarily undertaken, is capital expenditure and the whole cost can't be deducted in computing profits. Only the actual cost of normal revenue repairs to a part of the old building which is preserved in the rebuilt structure is allowable as an ordinary revenue business expense. But:

- capital expenditure may instead qualify in certain cases for capital allowances (see paragraph 137); or

- modest alterations may be capital yet a 'notional' repairs deduction is due (see paragraph 147);

- the whole of a payment is not necessarily either capital or revenue; it may be possible to split it between capital and revenue items: see paragraph 153.

Improvements to a property and 'notional repairs': ESC B4

147. An alteration may not amount to a reconstruction of the whole property but the expenditure may still be capital expenditure because there is an improvement to the property. For example, there will be a capital improvement where double glazed window units replace old single glazed units. By contrast, expenditure on replacing the single glazed units with new but equivalent single glazed units is usually a deductible revenue expense.

148. For periods up to April 2001, Extra Statutory Concession B4 gives a measure of revenue relief where capital improvement expenditure saves the need for repairs expenditure. That is, either you avoid repairs to the old fittings or, but for the installation of improved fittings, expenditure on equivalent replacements would have been needed. ESC B4 permits a deduction for the part of your capital expenditure which saves the estimated cost of the repair which would otherwise have been needed. In the window example, the 'notional repair' deduction is the estimated cost of replacing the single units with new but equivalent single glazed units.

149. Another example is the cost of alterations made to reduce fire risks, perhaps to satisfy a local fire authority. Expenditure incurred on additional exits or fire escapes does not of itself qualify as a revenue deduction but the work may have obviated the need for some repairs. (Machinery and plant capital allowances may also be available for certified fire safety expenditure incurred on hotels and boarding houses. Ask your professional adviser or tax office about this if you think it may apply.)

150. Where the alterations are so extensive as to amount to the reconstruction of the property, only the actual cost of repairs to any part of the old building incorporated in the new may be allowed. The cost of notional repairs (for example, decorations) on the new alterations isn't deductible.

Future of notional repairs deduction: ESC B4

151. The new Schedule A rules, which apply from 6 April 1995 onwards, brought the income tax computational rules for income from property more into line with the computational rules for calculating trading income. ESC B4 will cease to have effect from April 2001.

152. The notional repairs concession only applies to the computation of rental business profits. It does not apply to the computation of trading profits under Case I or II of Schedule D.

Capital work and revenue repairs at the same time

153. Work commissioned on a property may include expenditure on capital works and also separate expenditure on repairs at the same time. Here the expenditure on repairs remains allowable. Expenditure may be apportioned on a reasonable basis to estimate the amount attributable to the repair element. An apportionment in the contractor's bill may provide a sensible basis for splitting the total; but it must be done fairly and the figures will be open to review if, say, capital expenditure is wrongly described as revenue expenditure on repairs. Ask your professional adviser or tax office if you are in doubt.

Repairs etc after you acquire a property

154. Repairs to reinstate a worn or dilapidated asset are usually deductible as revenue expenditure. The mere fact that you buy the asset not long before the repairs are made does not in itself make the repair a capital expense. But a change of ownership combined with one or more additional factors may mean the expenditure is capital. Examples of such factors are -

- You acquire a property which wasn't in a fit state for use in your business until the repairs had been carried out or you couldn't continue to let it without making repairs shortly after acquisition.

- The price you paid for the property was substantially reduced because of its dilapidated state. A deduction isn't denied where the purchase price merely reflects the reduced value of the asset due to normal wear and tear (for example, between normal exterior painting cycles). This is so even if you make the repairs just after you acquire the asset.

- You make an agreement which commits you to reinstate the property to a good state of repair. For example, you are granted a 21 lease of a property in a poor state of repair by your landlord which you, in turn, sublet. When your landlord grants your lease you agree that you will refurbish the property. Your expenditure on making good will be capital expenditure and not allowable. But your landlord may be chargeable on the value of the work under the premiums rules (paragraph 100 onwards) and you may qualify for some relief (see paragraph 265.) See also paragraph 156 for payments for dilapidations to your landlord at the end of your lease.

155. It isn't necessary for all these factors to be present for the expenditure to be capital. The underlying principle is that the cost of buying a property in good condition is clearly capital expenditure. Hence the cost of buying a dilapidated property and putting it in good order is also capital expenditure.

156. Where you are granted a lease of a property in good repair, the expenses you incur in keeping it in that state will normally be deductible. This generally includes a payment you make to your landlord at the end of your lease on account of repairs which were due but which you had not made. These over-due repairs are called 'dilapidations'.

Provisions for repairs to premises

157. You can deduct expenditure on repairs where the liability to pay for the work is incurred during the tax year but payment has not been made by 5 April. But a provision for repairs to premises which you propose to incur in the future is not deductible. For example, you can't claim a deduction for repair work you think will need doing next year but which you have not yet incurred any liability to pay. ***(Sections 21A(3) and 74(1)(d) ICTA 1988.)***

Repairs to assets on which capital allowances were claimed

158. Your right to a repairs deduction is not lost because you had, or are getting, capital allowances on the asset as a whole.

159. For example, suppose you replace a chimney which is a physical part of a factory building. This is usually a revenue expense where the new chimney is a repair to the factory, there is no improvement, the factory was not bought in a dilapidated state and so forth. If it is a repair, you can deduct the cost even though industrial buildings allowance was due on the cost of constructing the factory.

160. No further capital allowance is due on your repair expenditure if it qualifies as a revenue expense. On the other hand, if the expenditure on the new factory chimney is capital expenditure, you may be able to claim industrial buildings allowance on it.

Grants received

161. Generally any grants you get towards, say, the cost of revenue expenditure on repairs must be included in your rental business profits. Grants towards capital expenditure must similarly be deducted in arriving at the expenditure which qualifies for capital allowances.

Expenses of rent, rates, council tax, insurance

162. Expenses connected with the premises or land you let out will normally be allowed as a deduction unless the expense relates to a capital matter. Normal principles apply, such as the 'wholly and exclusively' rule (paragraph 122 onwards). Examples of allowable expenses include:

- rent which you pay to your own landlord for property you are subletting;
- business rates, council tax, ground rents or feu duties;
- the cost of insurance, whether of the building or of the contents;
- insurance against any loss of rents is also an allowable expense; any income you receive as a result of taking out such insurance must be treated as a receipt of your business.

Bad and doubtful debts

163. You have to bring in as receipts rents etc which are earned in the year even if you were not paid until after the year ended (paragraph 64 onwards). But you can deduct:

- a debt which is clearly irrecoverable;
- a doubtful debt to the extent you estimate it to be irrecoverable; the deduction is the full amount of the debt less any amount you expect to recover.
  (Section 74(1)(j) ICTA 1988)

164. You can only make a deduction where you have taken all reasonable steps to recover the debt.

165. You make the deduction in the year the debt becomes bad or doubtful. If the debt is later recovered you bring in the recovery as a receipt of your rental business in the year you get it. Similarly, if you have a doubtful debt which later looks as if it will be good, you should bring the debt back in as a receipt when prospects change.

166. You can't claim a deduction for a general bad debt reserve. For example, you can't deduct 5 per cent of your debts just to be on the safe side. Deductions for bad or doubtful debts must be properly considered and the facts relating to each debtor taken into account. But if, exceptionally, you have a large number of tenants and also records which show a stable past pattern, you may be able to calculate with sufficient accuracy the chance that a tenant already in arrear will never pay. A doubtful debt provision calculated on that basis may be deducted.

167. You can't deduct a bad or doubtful debt merely because the tenant is always a slow payer. There has to be good reason for thinking the debt is likely to be bad.

168. You can't deduct a debt you have waived for reasons other than ability to pay. For example, you can't deduct a debt waived simply because the debtor is a relative.

169. You may waive rent (payable in advance) before it is due to you because the tenant can't afford to keep up the payments originally agreed in the lease. Provided the waiver is effective in revising the terms of the lease, you will no longer be able to sue for the rent and, consequently, you will no longer be taxable on it. If you do not agree to revise the terms of the lease but simply give the tenant time to pay, you will still be taxable on the rent but the bad debt rules outlined earlier may apply if there is genuine doubt about the tenant's ability to pay in the end.

Criminal payments, bribes and blackmail etc

170. You can't claim a deduction for payments which are:

- criminal in themselves; for example, a bribe to secure a contract; or
- made in response to a blackmail threat.
  (Section 577A ICTA 1988)

Fines for breaking the law

171. You can't deduct the cost of a fine incurred as a result of your breach of the law. The fine is not incurred wholly and exclusively for the purpose of the rental business.

172. The cost of a fine on a rental business employee may be deducted where it is the employee's liability. Here the employee is taxed on the payment you make as a benefit in kind under Schedule E.

173. A revenue payment you make in settlement of a civil action arising out of your rental business can be deducted where the allegations were neither admitted nor proved. Where liability was admitted or proved, a deduction is due if the payment was restitutionary (that is, made good the loss to the other party), but not if it was punitive (that is, in the nature of a fine or penalty).

Entertaining expenses and gifts

174. You can't deduct expenditure on business entertaining and gifts. In the same way, capital allowances are not due on assets used for business entertainment. (Section 577 ICTA 1988)

175. Business entertainment includes hospitality of any kind provided by a business, or by an employee. The person entertained may be a tenant, potential tenant, landlord or any other person.

176. But you can deduct the cost of entertainment (such as meals) provided to your employees as long as the provision for them isn't incidental to the entertainment of others.

177. For example, where you provide an employee with free meals, you can deduct the cost. But where your employee takes (say) a supplier to lunch at a restaurant and you meet the bill, the whole cost is for business entertainment and can't be deducted.

178. Your employees may be liable to tax on the benefit they get from entertainment you provide and for which you get a deduction in computing your rental business profits. You have an obligation to give details of benefits when making your PAYE returns. See our booklet 480 Expenses and benefits for more details, particularly Chapter 20.

Cost of rent collection

179. Your cost of rent collection is generally deductible in computing your rental business profits provided it relates wholly and exclusively to property you let out on a commercial basis (see paragraph 119 onwards for the wholly and exclusively rule).

Cost of obtaining loans

180. Costs you incur in obtaining loan finance for your rental business are generally deductible in computing rental business profits provided they relate wholly and exclusively to property you let out on a commercial basis

(see paragraph 119 onwards for the wholly and exclusively rule). These costs include loan fees, commissions, guarantee fees and fees in connection with the security of a loan.

181. For interest deductions see paragraph 183.

'Cash-back' on loans

182. You may benefit from a 'cash-back' offer when you take out a loan. There are many variations and the tax treatment depends on the precise terms of the cash-back scheme. The impact may go beyond your expenses deductions but we have included this subject here for convenience. Broadly, the position on three main aspects is:

- ***capital gains tax***: the cash-back is not chargeable to capital gains tax where it is paid by the lender in return for your taking out the mortgage, or other loan, with them;

- ***income tax***: where the scheme provides for a one-off payment there is unlikely to be any liability to income tax; if more than one payment is involved, there is likely to be an 'annual payment' taxable under Schedule D;

- ***interest relief***: where the scheme provides for a discount on the interest due on the loan, your interest relief is limited to the net amount you pay.

Interest payable on rental business loans

183. Interest payable on loans used to buy land or property which is used in your rental business, or on loans to fund repairs, improvements or alterations, is deductible in computing the profits or losses of your rental business in the same way as other expenses.

184. Similarly, interest payable under hire purchase agreements or on an overdraft is deductible where the asset is used for business purposes.

185. The normal rental business rules apply, including the 'wholly and exclusively' rule (see paragraph 119 onwards) and the rules governing the timing of relief (see paragraph 64 onwards). You can't, for example, deduct interest on a private loan, such as a loan used to buy your private residence. See paragraph 194 for more about your home.

186. Similarly, 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 (which may be shown in the balance sheet as assets);
- to buy private assets or assets for your family;
- for the provision of the private funds you take out from your rental business.

187. Deciding what interest, if any, can be deducted may be difficult, particularly where your account with the business is overdrawn. That is, where you have drawn out more money than the profits of the rental business. The loan may have, for example, partly financed the rental business and partly met your private living expenses. Interest on a borrowing which you use to fund your private living expenses or other non-business expenditure isn't allowable. We suggest you consult your professional adviser or the tax office if you are in doubt about the interest you can deduct.

188. Interest on a partner's capital account with the business isn't deductible. It is merely an allocation of the rental business profit and is taxed under Schedule A.

Interest paid abroad - business deduction and deduction of tax

189. The residence status of the lender does not affect your right to an interest deduction in computing the profits or losses of your rental business. But where you pay interest to a lender whose usual place of abode is outside the United Kingdom, you should normally deduct income tax at the basic rate from the payments you make and account for it to the Inland Revenue. But see paragraph 190 for more about double tax agreements. (Section 349(2) ICTA 1988).

Interest paid abroad - double tax agreements

190. Where there is a double taxation agreement between the UK and the country of residence of the lender, it may be possible for the lender to obtain authority from the Revenue to have the interest paid without deduction of tax, or under a reduced rate of withholding tax. This will depend on the terms of the double taxation agreement with the country of the lender.

191. Applications by lenders who are not resident in the UK to receive interest abroad without deduction of tax, or under a reduced rate of withholding tax, should be made to:

Inland Revenue
FICO
Fitz Roy House
PO Box 46
Nottingham NG2 1BD

192. The ***borrower*** can't apply to pay the interest without deducting tax - it must be the lender. Borrowers must deduct (and pay over to the Revenue) the full amount of the basic rate tax unless they have authority from the Revenue to deduct less than the full amount. If you pay the gross interest to the non-resident lender without deducting tax, you will still have to pay the Revenue the tax you ought to have deducted.

Interest payable abroad at uncommercial rates

193. Interest you pay to a lender not resident in the United Kingdom over and above a commercial rate isn't allowable as a deduction even if it would otherwise qualify (perhaps because the loan was used to buy a rental business property). Generally, the Revenue will accept the interest charged by the lender as an allowable deduction where it is paid on an arm's length loan made on a normal commercial basis. (Section 74(1)(n) ICTA 1988)

Interest payable - letting your own home: ESC A27

194. Where you pay interest on a loan to buy your home, which is also let, the interest may be eligible for:

- mortgage interest relief (which is available for interest on a loan to buy your home whether or not you carry on a rental business, ***but see the note below***);

and

- a deduction in computing the profits or losses of your rental business.

Note that at the time of writing (March 1999) there is a Budget proposal to withdraw relief for interest on a loan to buy or improve an only or main home from 6 April 2000. If this proposal takes effect, Paragraphs 195 to 209, and Appendix 1 will apply to such interest only for years up to and including 1999/2000. If you are in any doubt about the amount of interest you may claim on a loan to buy a property used partly as your home and partly for your letting business, you should consult your tax adviser or tax office.

195. You can’t have both forms of relief, but you may choose each year whichever form of relief is better for you. See paragraph 206 onwards where your home is used both as your residence and for business purposes.

196. The most common circumstances in which your home might be let are:

- where you live in job-related accommodation and buy another property which you use as your home from time to time or which is intended to be used as your home sometime in the future (Section 356 ICTA 1988); or

- where you are temporarily absent from your home because of your job ***(Extra Statutory Concession A27)***

197. Mortgage interest relief is:

- available for interest paid on loans of up to £30,000; if the loan is more than £30,000 you can still have relief but only for interest on the first £30,000; for example, if the loan is £60,000, half the interest qualifies for relief;

- given at the rate of 10 per cent on qualifying interest; for example, if the interest paid on a loan of £20,000 loan is £1,600 the relief is £160. This is the position at the time of writing in March 1999.

198. You usually get mortgage interest relief under the MIRAS (Mortgage Interest Relief At Source) arrangements by paying less than the full amount of interest due (see paragraph 199). Your lender then claims the balance from the Inland Revenue. But in some cases the relief may be given in other ways (see paragraph 205).

Loan eligible for MIRAS
199. Where a loan is eligible for relief under the MIRAS arrangements, relief must be given under MIRAS unless the borrower elects to deduct the interest in computing the profits or losses of the rental business. (Section 375A(1) ICTA 1988).

200. There is no special form for the election but it must be made in writing. You should tell your tax office:

- that you are carrying on, or propose to carry on, a rental business;

- that interest on the loan is to be deducted in computing the profits or losses of the rental business; and

- the date from which you want the MIRAS arrangements to cease to apply.

201. The tax office will then tell the lender that the loan should be removed from MIRAS and the date on which this should be done. Where possible that will be the date you have specified in your election but it may be later. If so we will need to recover from you any extra relief you receive by making an assessment. (Section 375A(3) and (4) ICTA 1988).

202. Once an election has been made it can't be withdrawn and, strictly, the loan must stay outside the MIRAS arrangements until the rental business ceases or, in the case of a proposed business, the proposal to carry it on is abandoned. (Section 375A(2)(b) and (6) ICTA 1988). But you may still choose each year whether to claim mortgage interest relief outside MIRAS or to deduct the interest in computing the profits or losses of the rental business.

203. Where you have made an election and you let more than one property the loan to buy your home will not be eligible for relief under the MIRAS arrangements until the whole rental business ceases. In practice, however, provided it is otherwise eligible, any loan to buy your home may be put back into the MIRAS arrangements when the letting of your home ceases, or the proposal to let it is abandoned.

Time limit for making an election to opt out of MIRAS

204. You must make the election to opt out of MIRAS within 22 months of the end of the tax year in which it is first to have effect. (Section 375A(2)(a) ICTA 1988).

Loans not eligible for MIRAS

205. As indicated above, where a loan isn't eligible for MIRAS you may choose each year whether to claim mortgage interest relief or make a deduction in computing the profits or losses of the rental business. If you are an employee, the tax office will normally give you mortgage interest relief by increasing your tax code. Otherwise the relief will reduce the tax you have to pay us directly on any assessment we make or, after 1996-97, on any self-assessment.

Interest: property used for both residential & business purposes: ESC A89

206. Where a loan is used to buy a property which is used both as your home and for business purposes you can, strictly, have only one sort of relief. If you receive mortgage interest relief on the interest paid (whether through the MIRAS arrangements or otherwise) no interest on that loan is allowable as a deduction in computing the profits or losses of the rental business. Correspondingly, if interest is deducted in computing the profits or losses of the rental business, you can't have mortgage interest relief.

207. By concession, however, a single loan may be treated as two separate loans so that you may:

- have mortgage interest relief, through the MIRAS arrangements or outside MIRAS as appropriate, for the part relating to the residential use of the property; and

- deduct interest in computing the profits or losses of the rental business for the part relating to the business use.

208. This enables you to get tax relief at your highest tax rate on the full amount of the interest on the business part of the loan. (Extra Statutory Concession A89).

209. Extra Statutory Concession A89 is explained in Appendix 1.

Interest payable on property only partly used for rental business

210. A property may be let for short periods in a tax year or only part of it may be let throughout a tax year (or both); the rest of the time the property is used for private or non-business purposes. Here the interest charged on a qualifying loan on that property has to be split between the rental business use and the private or non-business use. The split is done in whatever way produces a fair and reasonable business deduction, taking account of both the proportion of business use and the length of business use. (Section 74(1)(a) & (b) ICTA 1988)

211. You don't have to split the interest if you are genuinely trying to let the property but it is empty because you have not been able to find a tenant. In this case the interest will meet the 'wholly and exclusively' test. It won't meet this test if you have not been trying to let the property or you have been using it for private or non-business purposes. (Section 74(1)(a) & (b) ICTA 1988)

Interest and Rent a Room

212. Interest paid on a loan used to buy a property cannot be claimed as a deduction in your rental business if Rent a Room relief has been claimed. Paragraph 373 onwards gives more information about Rent a Room relief.

Legal and professional costs

213. Your expenditure on professional fees of a revenue nature are deductible if they are incurred for the purposes of the rental business. Professional fees are not allowable if they are capital or they are not incurred wholly and exclusively for the purposes of the rental business. Generally, the fees are capital if they relate to a capital matter, such as the purchase of property.

214. The expenses you incur in connection with the first letting or subletting of a property for more than one year are capital expenditure and therefore not allowable. The expenses include, for example, legal expenses (such as the cost of drawing up the lease), agent's and surveyor's fees and commission. Expenses for a let of a year or less can be deducted.

215. The normal legal and professional fees you incur on the renewal of a lease are also allowable if the lease is for less than 50 years. But any proportion of the legal etc costs which relate to the payment of a premium on the renewal of a lease are not deductible. Where a replacement lease follows closely on a previous one, and is in broadly similar terms, a change of tenant will not normally make the associated legal and professional costs disallowable. Any proportion of the legal or other costs which relate to the payment of a premium on the renewal of a lease will, of course, remain disallowable. If, however, the property concerned is put to some substantial use other than letting, such as occupation by the owner between lets, or where, say, a short lease is replaced by a long one, the legal and other costs will be capital expenditure.

216. Other examples of allowable legal and professional costs you may incur include:

- costs of obtaining a valuation for insurance purposes;
- the normal accountancy expenses incurred in preparing rental business accounts and agreeing taxation liabilities (paragraph 219 onwards);
- subscriptions to associations representing the interests of landlords;
- the cost of arbitration to determine the rent of a holding;
- the cost of evicting an unsatisfactory tenant in order to relet the property.

217. Other examples of non-allowable legal and professional expenses include:

- legal costs incurred in acquiring, or adding to, a property;
- costs in connection with negotiations under the Town and Country Planning Acts;
- fees pursuing debts of a capital nature, for example the proceeds due on the sale of the property.

218. Capital expenses may be allowable in computing any capital gain or loss on the disposal of the property. Capital gains tax is outside the scope of this guidance.

Taxation accounts and negotiations

219. Fees incurred on preparing accounts for commercial reasons and on many other accountancy services will meet the ‘wholly and exclusively’ test. Hence the cost can be deducted in computing rental business profits.

220. Strictly, any additional fees incurred for computing and agreeing the tax liability on rental business profits are not deductible. But, under a long standing practice, normal recurring legal and accountancy fees incurred in preparing accounts or agreeing the rental business tax liability can be deducted.

221. This practice does not extend to other personal fees; for example, fees incurred on preparing your tax return or working out capital gains tax due.

Expense of providing services

222. As well as renting a property to a tenant you may also provide additional services. You can claim the cost of providing those services as an allowable deduction of your rental business provided the receipts you earn from them are also included as part of your rental business income. See the example of Susan in paragraph 224.

223. Exceptionally the provision of services can amount to a trade distinct from your rental business. Here neither the income nor the expenditure relating to these services will be included in your rental business. See the example of Clare in paragraph 226.

Example of rental business services - Susan

224. Susan lets out a furnished house. She charges £800 rent each calendar month. Under the terms of the agreement Susan is responsible for cleaning the house and for maintaining the garden. She pays a cleaning agency and a gardener a total of £100 a month for 16 hours general housework and 12 hours gardening every month.

225. Here the full £9,600 annual rent is assessable as a rental business receipt and the £1,200 for cleaning and gardening is allowable as a deduction in computing the assessable profits of the Schedule A rental business. The cleaning and gardening does not amount to a distinct trade; they are just ordinary incidents of the letting business.

Example of separate trade of providing services - Clare

226. Clare lets out five furnished flats to tenants on three-year leases. The flats are all in the same building and the lease agreements charge an annual rent for each flat. In addition, she makes a separate charge dependent on the size of the flat to cover the provision of the following services: electricity, gas, hot water and central heating to each flat; the provision of linen and laundry facilities in the basement; weekly cleaning of each flat and of common parts; 24-hour reception and porterage facilities and general maintenance of all machinery provided in each flat.

227. The provision of these extra services (but not the provision of the flats themselves) is agreed with the tax office to amount to a trade. Thus Clare will only include in her rental business the rental income she receives. The separate charge for services is excluded and so are the costs of those services. The service charge and service expenses will be charged to tax using the rules for trades.

Rental business isn't usually a trade

228. It is unusual for a rental business to amount to a trade except in the case of a hotel, guest house or similar activity where meals, cleaning, changes of linen etc are provided. Where there is a hotel etc trade, the earnings from guests and the cost of providing the services (meals, cleaning etc) are all included in the computation of the trading profits of that hotel etc. The costs are not then allowable as a deduction against rental business income. There is more guidance on this subject at paragraph 512 onwards.

Salaries and wages of employees

229. Salaries and wages you pay to employees engaged full time or part time on managing the land or property within your rental business are allowable. This includes any normal pension contributions you may pay for your employees. Seek help from your professional adviser or tax office where unusual or lump sum pension contributions are paid.

230. You can't claim a deduction for salaries and wages which were not paid during the tax year unless they are paid within nine months after the end of it. This is a special rule which only applies to pay. The relief isn't lost if the wages etc are paid late; in that case you get the deduction in the tax year when the payment is actually made. ***(Section 43 FA 1989)***

231. Sometimes an employee is engaged partly to manage the rental business property and partly on private work or other work outside the rental business. Here a fair and reasonable split has to be made which takes into account all the

facts; only the part of the wage or salary properly attributable to the rental business duties is allowable as a deduction in computing the rental business profit or loss.

232. You can't deduct anything for the time you spend yourself working in your rental business. You can deduct any wages or salaries you pay to your spouse or other relations for working in the rental business provided the amounts paid represent a proper commercial reward for the work done. Your spouse or relative will be taxable on their earnings if their income is large enough.

233. You will need to operate the Pay As You Earn (PAYE) and National Insurance Contribution (NIC) systems on payments to employees. Ask your tax office for further information if you propose to engage employees. We have a leaflet which gives a brief overview of the subject - ***IR53 Thinking of taking someone on? PAYE for employers***. Take care if you are asked by workers to make payments without accounting for tax and NIC. Even an informal, oral agreement may make them your employee. You may then have to pay us the PAYE tax or NIC even if you did not deduct it from the worker's salary or wages payments.

Travelling expenses

234. Your deductions for travelling expenses depend mainly on the 'wholly and exclusively' rule outlined at paragraph 122 onwards.

235. Your revenue costs of travelling between different properties solely for the purposes of your rental business are an allowable deduction in computing your rental business profits. But the cost of travelling from your home to the let property and back will only be allowable if your purpose in making the journey is exclusively a business one. By 'revenue' costs we mean running costs (such as fuel, road tax, bus fares etc) as opposed to the capital costs (the purchase price of a car or van for example): see paragraph 240.

236. Your travelling expenses will not be deductible if your purpose in making the journey is partly private and, for example, includes a visit to the shops to buy your weekly groceries. But you can still have a deduction for a journey made solely for business purposes if any personal benefit you get is only incidental; for example, where you happen to stop on the way to pick up a newspaper.

237. Your purpose in making a journey is a question of fact. Your stated purpose is a relevant factor but it will not be decisive if you (or your family, friends etc) actually gain a substantial private benefit.

238. Where your rental business is administered from an office outside your home, the cost of journeys between your home and either a property you let or that office will not be allowable. But the cost of travel from your business office to and from the properties, and between the properties, may be allowable provided, as always, it was incurred wholly and exclusively for business purposes.

239. You may use a car or van partly for business and partly for private purposes. If so, you can split the running costs on a mileage basis and claim a deduction for those journeys undertaken wholly and exclusively for business purposes.

240. Your capital expenditure on providing the means to travel (usually a car or van) isn't deductible in computing your rental business profits. Nor can you deduct a depreciation charge. But machinery and plant capital allowances may be available. These allowances are deducted in computing your business profit or loss. The 'wholly and exclusively' rule applies to these allowances but, as with revenue expenditure, you can claim the business proportion of the allowances. Machinery and plant allowances on cars costing more than £12,000 are also further restricted. Capital allowances are outside the scope of this guide but some more information is at paragraph 333 onwards. ***(Section 24(1)(a), 34-36 & Section 79 CAA 1990)***

Advertising expenses

241. Your revenue expenses of advertising for new tenants are allowable; for example, the cost of placing adverts in newspapers. You can't deduct the cost if it is capital expenditure; for example, expenditure on permanent signs or other permanent equipment for displaying vacancy details.

242. Your expenses of advertising property to buy or sell is also capital expenditure and not allowable as a deduction for income tax purposes. Such expenditure may possibly be taken into account for capital gains tax purposes when the property is sold but that is outside the scope of this guide.

Expenses of common parts: several tenants

243. In a block of offices or flats there may be separate parts of the building which are not let out but are used in common by the tenants. If so, you can deduct expenditure on the upkeep of the common parts from your rental business profits.

244. However, the deductions for the common parts may need to be restricted if you use part of the property privately or there are uncommercial lettings. See paragraph 245 onwards and paragraph 256 onwards.

Expenses of owner occupied property

245. Expenditure on a house, flat or other property which you occupy yourself isn't normally allowed as a deduction in computing your rental business profits.

246. For owner occupied property not only is the Section 74(1)(a) ICTA 1988 'wholly and exclusively' rule relevant but also the rule in Section 74(1)(b). This denies a deduction for:

> 'any disbursements or expenses of maintenance of the parties, their families or establishments, or any other sums expended for any other domestic or private purposes distinct from the purposes of the trade' or, in the Schedule A case, 'the business'.

247. Where, however, you genuinely run your rental business from your home, you may claim the extra business costs which you incur - such as the cost of extra lighting and heating.

248. Where a specific part of your home is used exclusively for running the rental business for a significant amount of time, whether continuously or at particular times, then a proportion of all fixed expenses referable to that room may be deducted. Examples might be rent you pay to your own landlord for your home, repairs, property insurance etc - as well as lighting and heating. But see paragraph 253 where unusually high expenses are incurred.

249. Similar common-sense principles apply where you let a part of your home. That is, you need to split expenses between private use and rental use. Periods when your home is unoccupied will normally count as non-business use unless a definite part is set aside to let and you are actively seeking a tenant.

250. Sometimes there may be general overhead expenses of running a rental business. For example, in a large business employees may repair and decorate both your private accommodation and commercial properties while office staff organise the work. An appropriate proportion of both the direct expenses (say the wages of painters) and the administrative staff needs to be allocated to the private work and excluded from the rental business profit computation.

251. It is impossible to lay down hard-and-fast rules because circumstances vary enormously. The aim is for the rental business deductions to reflect the commercial use of the property in a fair and reasonable way.

Interest on a loan on your own home

252. Interest on a loan for the purchase or improvement of your only or main residence may also be split in the way outlined in the previous paragraphs. Relief for the business element may then be claimed in computing your rental business profits. See paragraph 183 onwards for more about interest.

Exceptionally heavy expenses incurred on your own home

253. The previous paragraphs explain the usual case where the running expenses for your home remain at about the same level each year. The expenses attributable to the rental business may need to take account of unusual factors in order to produce a fair result.

254. For example, it might not be fair to split heavy expenditure on repairing a roof in a particular year on a simple time or area basis between the let or office part of your home and the private part if you have lived there for thirty years but only let part (or used part as the rental business office) for two years. Here the bulk of the expense on the roof arises out of private use of the house and a further restriction is needed to reflect the true business use of your home.

255. The adjustment can also work the other way. For example, where the whole property was let for twenty years and you have only occupied part for two years. Here it may be fairer to attribute more than a proportionate share of the cost to the rental business.

Expenses of properties let uncommercially

256. Expenses you incur on a property occupied rent free by, for example, a relative of yours is likely to be incurred for personal or philanthropic purposes - to provide that person with a home. The same applies where the property is let at less than a commercial rate or isn't let on commercial terms.

257. Unless you charge a full market rent for a property (and impose normal market lease conditions) it is unlikely that the expenses of the property are incurred wholly and exclusively for business purposes (paragraph 122). So, strictly, they can't be deducted in arriving at your rental business profits. Deductions may also be denied by the bar on relief for the maintenance of the taxpayer's family. Hence they are not allowable expenses. ***(Sections 21A, 74(1)(a) and (b) ICTA 1988)***

258. However, if you let a property below the market rate to, say, a relative (as opposed to providing it rent free), you can deduct the expenses of that property up to the rent you get from it. This means that the uncommercially let property produces neither a profit nor a loss but the excess expenses cannot be carried forward to be used in a later year.

259. A relative or friend may ‘house sit’ between normal lettings on commercial terms. Provided the property is genuinely available for commercial letting - and you are actively seeking tenants - you can deduct the expenditure incurred on that property in the normal way. The test is whether the expenditure on the property is incurred for the purposes of the rental business or whether it is really incurred for personal reasons. It isn’t possible to lay down hard and fast rules but, as a guide, ordinary house sitting by a relative for, say, a month in a period of three years or more will not normally lead to a loss of relief. On the other hand, relief will be lost if, say, the relative is really just taking a month’s holiday in a country cottage.

260. Similarly, deductions are not due for expenses incurred on a property made available to relatives, friends, business associates or personal staff (such as a gardener who only works on private property or a chauffeur). For example, the expenses of a holiday home provided free or at a low rate in this way can’t be set against the profits of commercial lettings. Deductions can be claimed up to the amount of rent you get from the property.

261. In some cases a property (such as a holiday home) may be let commercially some of the time and provided free to relatives at other times. Here the expenses will need to be apportioned on a reasonable basis between the commercial and uncommercial use. An excess of the business element of the expenses over the rent can be deducted in your overall rental business computation. But any excess relating to uncommercial use cannot.

262. Heavy expenses which essentially arise out of the non-business use of the property can’t be deducted simply because they happen to fall within the period of a short commercial let. The guidance at paragraph 253 onwards for exceptional expenditure on owner occupied property is relevant here.

263. Sometimes you may have general overhead expenses of running a rental business. For example, in a large business your employees may repair and decorate commercial properties and also private properties, or properties let at a nominal rent or otherwise on uncommercial terms. Your office staff may organise the work for all the properties. Here an appropriate proportion of both the direct expenses (say the wages of painters) and the administrative staff needs to be allocated to the uncommercial properties so that the restrictions outlined above can be made.

Relief for capital expenditure on uncommercially let property

264. Any relief for capital expenditure on uncommercial lettings may also be restricted. In particular:

- Any machinery and plant capital expenditure on uncommercially let properties must go into separate pools. The allowances are reduced on a 'just and reasonable basis' to reflect the non-business use. This rule applies both to assets which are used entirely in uncommercially let property and to assets which are partly used for that purposes and partly for normal commercial lettings; for example, vans and motor mowers. Paragraph 333 onwards has some general background about capital allowances.

- The 10 per cent 'wear and tear' allowance may be claimed on an uncommercially let furnished property. The relief will be limited to 10 per cent of the actual net rent received for the property (if any). Any allowance is added to the other expenditure on the property and it can, therefore, only be deducted up to the amount of the rent received (if any). Paragraph 347 onwards deals with the 'wear and tear' allowance.

Relief for premiums paid

265. Paragraph 100 onwards explains that there are special rules to charge lump sums (premiums) you receive in connection with a lease you grant to a tenant. There is also a corresponding relief for you where you (or an earlier tenant) paid a premium to your landlord when he or she granted your lease and you are subletting the property in your rental business. This applies where you yourself rent property from a landlord and you sublet that property so that the income forms part of your rental business income. (Section 37 ICTA 1988)

266. The premium charging and relieving rules don't apply where you sell your lease - what lawyers call an 'assignment' of the lease. There may be either a capital gains charge or, possibly, a trading charge if you deal in land.

267. The premium for which relief is due could be paid either by you or by any person who held the lease you have with your landlord before you did. The following paragraphs outline how the relief works. It is a complicated subject and we suggest you consult your professional adviser or tax office if you think the rules apply to you.

268. The relief for premiums paid is only due on amounts which are chargeable on your landlord as income (or would be if he or she were liable to tax). Thus, for example, there can be no relief for a premium paid for a lease exceeding 50 years because the landlord is never charged in these cases. But relief is due for the payment of the rental income element in a premium even where it isn't taxed on the landlord. This may happen, for example, because the landlord is a charity which is exempt from tax.

269. There are two main premium relief cases:

- first, is the case where you get no premium yourself; you simply get an annual rent for the grant of the sub-lease; see paragraph 270;

- second, is the case where you also get a premium yourself; see paragraph 281.

First case: you do not receive a premium

270. In the first case, you pay a premium (or a previous holder of your lease did) but you only receive rent from the sublease you grant - you did not get a premium. Here the relief is found by taking the amount of the premium which is taxable as income on your landlord. This is the amount chargeable within paragraph 100 onwards. The chargeable amount is then spread evenly over the duration of the head lease for which the premium was paid to your landlord. You get a notional rental deduction in computing your rental business profits for the amount attributed to each year of the head lease.

271. For example, you get a deduction of £1,000 a year for notional rent if the premium chargeable on your landlord as rental income is £10,000 and the lease you have from him lasts ten years in all. (Section 37 ICTA 1988)

272. A notional rental deduction for a premium paid to the landlord is due to the current tenant under the head lease even if a different tenant under the head lease paid the premium to the landlord (or even to a previous landlord who granted the head lease). The notional rental deduction is set against the rent which the current tenant is due to receive under the sublease he or she granted (or took over). You can’t claim relief for a lump sum (even if called a ‘premium’) you pay to a previous tenant to take over his or her lease. Your relief is based on the premium that was paid (if any) to your landlord for the grant of the lease in the first place.

273. The notional rental payment allowed as a deduction is split on a reasonable basis where the tenant only sublets part of the property for which the premium was paid. Professional valuation advice on the split may be needed in sizeable or difficult cases.

Example: relief for premium paid where no premium received: Richard

274. On 25 April 1995 David, the owner of Totleigh Towers Farm, grants Richard a lease of the whole property for 21 years. Richard has to pay David, his landlord, a premium of £20,000 and a rent of £4,000 a year.

275. David is chargeable upfront on premium income of £12,000. This is the total premium of £20,000 less 40 per cent; the 40 per cent is found by taking one year less than the life of the lease (20 years) and multiplying by 2 per cent: see paragraph 100 onwards.

276. David is also chargeable on the rent of £4,000 a year.

277. Richard sublets Totleigh Towers Farm to Robert for a rent of £7,000 a year. So we have:

- David - the owner of the freehold of Totleigh Towers Farm; he lets to -
- Richard, the lessee; he sublets to -
- Robert, the sublessee who actually occupies and farms Totleigh Towers Farm.

278. Richard is taxable on the rent of £7,000 a year he gets from Robert. He can deduct each year both the annual rent of £4,000 he pays to David, his landlord, and an extra amount of notional rent of £571 each year. This extra deduction is found by dividing the amount of £12,000 chargeable on David by 21 years, which is the length of Richard's lease of Totleigh Towers Farm.

279. Richard and his successors in the tenancy under the head lease of Totleigh Towers Farm can, therefore, deduct £4,571 each year in computing their profits or losses arising in their rental businesses.

280. A reasonable restriction in the premium relief deduction due must be made where the property is only partly used for business purposes - just as it must be made for any other expense. For example, suppose half of Totleigh Towers Farm is occupied by Richard (or his successor in title) for private use and half is sub let. Here the amount deductible from the profits from the part sub let is half the total where the value of each half is the same. Professional valuation advice may be needed to determine what part, if any, of a premium relates to the let property.

Second case: you also receive a premium

281. The second case is where you also receive a premium from your sub tenant. Broadly, instead of getting a rental deduction over the period of the lease, the chargeable amount of the premium you get is reduced by the amount of the chargeable premium paid to your landlord. But if the chargeable premium you pay is more than the chargeable premium you receive, you also get relief for the balance as notional rent over the period of the sublease you have granted (as in paragraph 270).

282. The rule is that the chargeable amount of the premium received for the sublease is reduced by an allowance not greater than the following amount:

$$\frac{\text{duration of the sublease}}{\text{duration of the head lease}} \times \text{chargeable part of premium you pay}$$

283. Then there are two possibilities:

- the amount produced by this calculation is less than the chargeable premium you get: here your chargeable premium is simply reduced by this amount and no further relief is due;

- the amount produced by this calculation is more than the chargeable premium you get: here your chargeable premium is reduced to nil and you get further relief for the balance of the premium you paid spread equally over the rest of the life of the sublease.

Example where premium received and paid- Jenny

284. Steve grants a 21 year lease to Jenny on 1 September 1999 for a premium of £10,000 and a peppercorn rent. Jenny immediately grants a 10-year lease to Nahid for a premium of £8,000 and a rent of £500 a year payable yearly in advance. (The figures are not intended to be commercial - just an illustration.)

285. Steve is chargeable for 1999-2000 on £6,000, computed as follows -

Premium receivable	£10,000
Less: 40% ((21-1) x 2%) of £10,000	£4,000
Chargeable amount	£6,000

286. Apart from the relief for premiums paid, Jenny is chargeable for 1999-2000 on -

Premium receivable by Jenny	£8,000
Less: 18% ((10-1) x 2%) of £8,000	£1,440
Chargeable on Jenny without relief	£6,560

287. But Jenny is entitled to relief for the premium she pays Steve as follows -

Premium chargeable on Jenny without relief (above)	£6,560
Less £6,000 premium chargeable on Steve x 10/21*	£2,857
Chargeable amount	£3,703
Add rent receivable from Nahid	£500
Total charge on Jenny	£4,203

* The fraction of 10/21 is the length of Nahid's sublease (ten years) over the length of Jenny's lease (twenty one years). This apportions to Jenny's income from Nahid the appropriate part (ten years) of the premium Jenny paid for the twenty one year lease from Steve.

288. The balance of the relief due to Jenny is allowable against rents received in the last eleven years of the 21 year lease she holds from Steve. This is £6,000 less £2,857 (relieved above) = £3,143. This means Jenny gets a notional rental deduction of £286 in each of the last 11 years of her lease from Steve (£3,143 ÷ 11 = £286).

Land managed as one estate

289. The rules in force before 1963-64 dealt specially with property managed as one estate: they were treated as a unit as far as maintenance expenditure was concerned. The old rules charged unlet properties to tax on their annual value. This meant that, where an owner's average expenditure on repairs and maintenance of an unlet property on an estate exceeded the annual value included in the assessable profits, the excess could be set off against the rents from the let properties on the estate.

290. These pre-1963 rules are mainly of historical interest only but they still have consequences in a few cases. The current rules enable the owner of property managed as one estate to continue to get relief on a broadly similar basis provided:

- at the end of 1962-63 land was managed as one estate and the owner elected for the one estate arrangement to continue and did so; and

- all later owners elected; this includes the current owner.

291. Where these conditions are met the current owner is able to obtain the new Schedule A version of the one estate treatment. That is, relief for expenditure on repairs of unlet property on the estate can be set against the receipts from other properties on the estate provided:

- the full current annual value of the unlet estate property is brought in as a taxable receipt of the rental business; and

- the excess, if any, of the full annual value of uncommercially let estate property over the actual rent is brought in as a taxable receipt.
  (Section 26 ICTA 1988 & Para 5 Schedule 6 FA 1995)

Note that the one estate treatment will not be available from April 2001.

292. The annual value of an estate property is defined as follows:

> "...annual value of land shall be taken to be the rent which might reasonably be expected to be obtained on a letting from year to year if the tenant undertook to pay all usual tenant's rates and taxes, and if the landlord undertook to bear the costs of the repairs and insurance, and the other expenses, if any, necessary for maintaining the subject of the valuation in a state to command that rent." ***(Section 837 ICTA 1988)***

Extra Statutory Concession B30 & annual value

293 You can use annual values calculated on this basis if you wish but we will accept gross rating values if you prefer. These depend on where the property is located:

- in England, Wales or Northern Ireland use the gross rateable value last in force for that property before the introduction of community charge and council tax;
- in Scotland use the gross rateable value fixed in the 1978 revaluation and not those fixed in 1985.

294. If you have difficulty in converting a net rateable value to a gross rateable value, ask your professional adviser or tax office for help.

295. The rateable value under ESC B30 will, almost certainly, be less than the strict annual value. This is because the statute takes the actual annual value of the property in the tax year for which your rental business profit or loss is calculated. The concessionary figures may be subject to change in the future. This guide sets out the position at the time of writing in January 1999.

296. No annual value has to be brought in for an unlet estate property which is used wholly and exclusively for the purposes of managing the estate or for the purposes of a trade, profession or vocation.

Claims and time limits for one estate treatment

297. Note that:

- new elections for one estate treatment can't be made unless an election was made at the end of 1962-63 and also on each subsequent change of ownership;
- any new elections on a change of ownership must be made within one year of the end of the tax year in which the estate was acquired; we can extend

the one year time limit but an extension will only be granted in exceptional circumstances - error or oversight, for example, isn't regarded as an exceptional circumstance;

- property which was not included in the estate in 1963 can't be added later.

298. Where the right of election described in paragraph 289 onwards is exercised:

- excess expenditure on unlet estate property can't be set against rents of properties outside the estate;

- excess expenditure on estate properties let for no more than their annual value can be set against other estate receipts but not against receipts from property outside the estate;

- excess expenditure on commercially let estate property can be set against rents from any other properties in your rental business, whether in the estate or not;

- excess expenditure on commercially let properties outside the estate can be set against the profits from the estate.

299. You will, therefore, need to separate out the various receipts and expenses to ensure they are dealt with correctly.

300. Where the expenditure on the unlet, or uncommercially let, estate properties is greater than the total receipts of the estate the excess must be separated from other business expenditure and carried forward to the following year as expenditure on unlet properties.

Maintenance funds for historic houses

301. The owner of an estate subject to a valid one estate election can continue to benefit from one estate treatment where the property is transferred into a maintenance fund. (Section 27 ICTA 1988 and paragraph 6, Schedule 6, FA 1995)

Beginning and end of rental business

Start of rental business

302. The date your rental business begins is a question of fact which depends on the nature of your rental business. Normally a rental business will begin when you first enter into a transaction which exploits your land or property in a way which gives rise to a receipt of some kind.

303. Where your rental business is letting property your business can't begin until you let the first property. You need to distinguish between activities which are preparatory to letting and those business activities which are part of letting. Once you have started a rental business all activities will be treated as carried out in the course of one business, subject to the points made at paragraph 15 about businesses carried on in different capacities and the points made at paragraph 26 about partnerships.

304. Thus, after you have let the first property, any later expenditure leading up to the letting of the second and later properties is part of the rental business and can be deducted - provided it meets the conditions outlined at paragraph 119 onwards (it is incurred wholly and exclusively for the purpose of the business, it isn't capital expenditure etc).

305. The question of when a rental business starts normally only arises, therefore, when you receive income from property for the first time, or begin to exploit your land and property for a profit for the first time. Less commonly, it may arise if you resume letting again having ceased an earlier rental business: see paragraph 313.

306. The start date can be important because it can affect the amount of expenditure allowable in calculating your rental business profits. Some expenditure incurred before your business begins may not be allowable but some may be allowable under special rules; if so, the deduction is given in computing the profits of your business in the first year. See paragraph 307 onwards for more on expenses incurred before the business begins.

Expenses incurred before rental business begins

307. You may incur expenses for the purposes of a rental business before that business starts. If so, you may be able to claim a deduction for them once the letting begins. Relief is only due under these special rules where the expenditure:

- is incurred within a period of seven years before the date you start your rental business; and
- is not otherwise allowable as a deduction for tax purposes; and
- would have been allowed as a deduction if it had been incurred after you started your rental business.
  (Section 401 ICTA 1988)

308. This means that, to be allowable, your expenditure must be incurred wholly and exclusively for the purposes of the rental business and must not be capital expenditure etc (see paragraph 119 onwards). Thus, for example, rent you pay to lease the first rental business property could be allowable under these special rules if it is due before the property is first let provided the property was acquired solely for the purposes of the rental business.

309. Relief isn't due under the special rules for, say, rent on your own private residence which is payable before you begin to let it (after, say, taking a job in another part of the country). Your expenditure on rent was not incurred wholly and exclusively for the purposes of your rental business - it was incurred to provide you with a home. Relief would be due under the ordinary rental business rules for rent for periods after the property was let commercially.

310. Qualifying pre-commencement expenditure is treated as incurred on the day on which you first carry on your rental business. This is deducted, together with the other allowable expenses of letting, from the total receipts of the business for that year.

311. Unallowed pre-commencement expenditure incurred prior to 6 April 1995 which satisfies the conditions in paragraph 307 onwards is also deducted in computing the profits of a rental business for 1995-96 or later tax years.

312. Capital expenditure does not qualify for relief but there are also further special rules for capital allowances. These are outside the scope of this guide but broadly they work in a similar way to those just outlined for revenue expenditure. Thus, for example, expenditure incurred on constructing a factory before the rental business begins may qualify for industrial buildings allowances once the building is in use for a qualifying purpose.

Cessation of a rental business

313. Whether a rental business has ceased for tax purposes is a question of fact. The answer depends normally on whether your activities after a given date are:

- merely concerned with winding up the activity, perhaps before retirement; here the business has ceased and you are getting rid of the business assets or changing their use; or

- a continuation of the business to facilitate the realisation of the assets; here you continue to carry on the business, perhaps in the hope of selling a going concern for a higher price.

314. Where your rental business consists of letting property it will normally cease when you dispose of the last of the properties you are renting out or, alternatively, you begin to use all the properties for a non business purpose. For example, if your business only consisted of letting a single house, it would cease when the tenant left and you began to use the house as a private residence or, alternatively, when you decided the house wouldn't be re-let. But your rental business wouldn't stop if you bought another property for letting at the same time.

315. For a rental business to cease you must end all activities giving rise to receipts from land and property. If, for example you built up a rental business of fifty rented properties and later sold forty-nine of them, the rental business would continue until the last one was sold or the last one ceased to be used for rental business purposes.

316. Your rental business activities may stop and, after an interval, you may begin again. Here 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. This too is a question of fact and much will depend on things like:

- whether the same property is let before and after the period of dormancy, and, if so, whether the property has been substantially altered during the period of dormancy;

- how long the interval between lettings lasts;

- what type of activities constitute the rental business before and after the period of dormancy.

317. For example, if your rental business consists of letting a single property, it will not normally cease just because the tenant quits and the property is empty while you are looking for a new tenant.

318. A general rule of thumb for Schedule A businesses is that your old business stops where there is an interval of more than three years and different properties are let in your old and your new activities. We offer this for guidance only. In practice, we will not normally suggest that your old business stopped where the gap is less than three years and you were trying to continue. But you would need to provide convincing evidence to show that the same business was carried on where the gap is three years or more.

319. Whether a rental business has ceased may not always matter because receipts or expenses arising after cessation may be taxed or relieved anyway under special rules (paragraph 322 onwards). But a cessation is particularly important where the old activity had unrelieved losses because, as paragraph 430 explains, losses can only be carried forward and set against future profits of the same business. Therefore, where you cease one rental business and start a new rental business at a later date, losses from the first business can't be set against profits of the second.

320. There are special rules for receipts and expenditure after cessation: see paragraph 322 onwards. The main point here is that post-cessation expenses can only be relieved for up to seven years after cessation, while there is no limit on carrying forward rental business deductions for a business which genuinely continues.

321. We suggest you consult your professional adviser or your tax office if you are unsure whether you are carrying on the same rental business.

Post cessation receipts

322. A receipt which arises from your rental business after it has ceased is taxable under special rules provided, of course, you have not already included that receipt in the computation of your rental business profits. You may also be able to claim relief for post cessation expenses for which you have had no relief: see paragraph 325.

323. You may get post cessation receipts where, for example, your rental business consisted of a single let property and, after you have sold the property and thus ceased your rental business, you receive an insurance payout under a policy which covers a tenant who defaults on the rents. The unpaid rent (or the insurance recovery) would have been taxable as business receipts while your

rental business was continuing. Once the business has ceased the receipt can't form part of your rental business. Instead it is taxed separately under Case VI of Schedule D.

324. Another common example of a taxable post cessation receipt is the recovery of bad debts. These are taxable if you previously claimed a deduction on the grounds that the debts were unlikely to be paid. They are obviously not taxable again if you previously included the debt as a receipt and made no claim for a bad or doubtful debt deduction. (Section 21(B) & Sections 103-104 ICTA 1988)

Post cessation expenses

325. In arriving at the tax due on post cessation receipts you can deduct any allowable business losses that were left unrelieved when the business ceased and also other expenses which would have been allowable had the business continued. Thus, for example, if you recover a bad debt after cessation, you can deduct the costs incurred in collecting that debt. Another example might be the cost of background heating for empty premises to keep down condensation and so maintain the value of the property for later sale. (Sections 21(B) & Section 105, 109A ICTA 1988)

Post cessation expenses but no post cessation receipts

326. Where you don't have any post cessation receipts you may still be able to claim relief sideways for post cessation bad debts and certain specific defined post cessation expenses. The sideways deduction is against other taxable income and capital gains of the year in which the debts proved to be bad or the payments were made.

Post cessation expenses - time limits

327. A claim to relief must be made within the following time limits:

- for 1994-95 and 1995-96 the time limit is two years from the end of the tax year in which the payment was made;
- for 1996-97 and later years the time limit is just under 22 months from the end of the tax year in which the payment is made. See paragraph 544 for more details.

328. If you are in doubt whether any sum can be deducted from a post cessation receipt we suggest you consult your professional adviser or tax office.

Allowances for capital expenditure

329. In arriving at the profit or loss of your rental business for tax purposes you cannot make any deductions for capital expenditure. This means you must not deduct the following in working out your rental business profits:

- the cost of buying, altering, building, installing or improving fixed assets used in your rental business; or

- the depreciation of any capital asset (land, leases and other interests in land, buildings, machinery, plant etc); or

- any loss which arises on the sale of any capital asset.

330. More information about capital expenditure is in paragraph 135 onwards.

331. But you may be able to claim special tax allowances to take account of the depreciation of some capital assets (but not land) used for rental business purposes. There are three main categories of allowance . These are:

- 'capital allowances' (see paragraph 333 onwards);

- 'wear and tear allowance' (see paragraph 347 onwards);

- 'renewals allowance' (see paragraph 363 onwards).

332. Each allowance is only due in the circumstances outlined below.

Capital allowances

333. You can claim tax allowances called 'capital allowances' for some types of capital expenditure. Like other expenses, these are deducted in working out your taxable rental business profits or added to any loss.

334. A balancing adjustment may arise when you sell an item on which capital allowances have been given, or give it away or stop using it in your business. This aims to line up the allowances given with the actual depreciation of the asset. Balancing charges (recovery of allowances) are treated as part of the income of your rental business. Balancing allowances (further allowances) are treated as an expense of the rental business, like other capital allowances. ***(Paragraphs 8 & 29-35, Schedule 6, FA 1995)***

Grants towards capital expenses

335. Grants towards capital expenditure are normally deducted in arriving at the amount on which capital allowances are due.

336. There are capital allowances for certain expenditure on:

- ***Machinery and plant*** but not, generally, assets in residential accommodation. Machinery and plant covers assets like vehicles, tools, ladders, computers, business furniture, furnishing and fittings, lifts, central heating and air-conditioning which belong to you and are employed or let in the rental business. The allowance is a 25 per cent reducing balance writing-down allowance; see paragraph 342 for more about residential accommodation.

- ***Industrial buildings and structures***. This covers factories as well as a range of other types of building. The allowance is a 4 per cent straight line writing-down allowance.

- ***Agricultural buildings and works***. The allowance is a 4 per cent straight line writing-down allowance.

- ***Hotels***. The allowance is a 4 per cent straight line writing-down allowance.

337. In all the cases listed above there are detailed rules governing which type of asset qualifies. For example, only hotels which meet certain conditions get an allowance. In no case are allowances due on the cost of land or interests in land.

338. A ‘reducing balance’ allowance is one where the percentage is applied each year to the remaining balance of unrelieved expenditure. For example, if you spend £1,000 on machinery or plant, you normally get 25 per cent of £1,000 (£250) in the first year. In the second year you get 25% of £750, which is £188; and so on. A ‘straight line’ allowance is one where the allowance is the same every year until the expenditure has all been relieved. For example, if you spend £1,000 on an industrial building, you normally get a fixed allowance of £40 each year for 25 years.

339. A 100 per cent allowance is available for expenditure incurred in a few, fairly small, parts of the UK called ‘Enterprise Zones’. These zones each have a life of ten years and most have now ceased. Not only is the rate of allowance very high (100 per cent) but it is due on a wider range of assets. That is, not only do industrial buildings and structures and qualifying hotels get the 100 per cent allowance but also certain commercial buildings and structures (like offices and shops). Ask your professional adviser or your tax office if you think you may incur capital expenditure within the area of a zone and also within its ten year life.

340. Capital allowances are not due on the cost of houses, flats and other residential accommodation. Nor are they due on most kinds of commercial building outside enterprise zones, including shops and offices. Some warehouses may qualify for industrial buildings allowance and some will not: it depends on the exact nature of the use.

341. Allowances for machinery and plant (such as cars or vans) are subject to the 'wholly and exclusively' rule (paragraph 122 onwards). Allowances on cars costing more than £12,000 are restricted. ***(Section 24(1)(a), 34-36 & Section 79 CAA 1990)***

Residential accommodation

342. Machinery and plant capital allowances are not available on any furniture and equipment supplied with residential accommodation you let furnished. Instead 'wear and tear allowance' renewals may be available: see paragraph 347 onwards. The position is different for furnished holiday accommodation: see paragraph 410 onwards.

Hire purchase and capital allowances

343. If you buy machinery and plant on hire purchase, you may be able to claim capital allowances on the capital element in the hire charges. The interest or other charges count as a normal business expense, see paragraph 183 onwards.

How capital allowances are given

344. Under the old Schedule A rules, allowances for capital expenditure were given separately. Under new Schedule A rules the allowances are treated as if they were an expense in arriving at the profit of the Schedule A business. Similarly any balancing charges are treated as a Schedule A receipt. In this way allowances for capital expenditure form part of the overall Schedule A business profit or loss. This parallels the treatment for trades which are taxed under Case I of Schedule D.

345. Our Leaflet IR 106 ***Capital Allowances for vehicles or machinery*** gives a little more guidance.

346. Capital allowances are a complex topic and it isn't possible to give details of all the rules in this guide. We suggest you consult your professional adviser or your tax office if you think allowances may be due.

Wear and tear allowance for furnished residential property

347. Where you let a residential property furnished, machinery and plant capital allowances can't be claimed on furniture, furnishings or fixtures within the property. But you can claim a deduction for either:

- a wear and tear allowance of 10 per cent of the 'net rent' (see paragraph 352) from the furnished letting to cover the depreciation of machinery and plant, such as furniture, fridges etc supplied with the accommodation (see paragraph 353) ;

or

- the net cost of replacing a particular item of furniture etc, but not the cost of the original purchase; this is called a 'renewals allowance' (see paragraph 363 onwards).
  (Extra Statutory Concession B47)

348. You may let both furnished and unfurnished property. If so, you must ensure that the 10 per cent is calculated only on the net rent from the furnished lettings.

349. Before 1975-76, when the general 10 per cent basis started, there were several bases in common use. We will not disturb these so long as the let properties to which they apply remain in the same ownership and they continue to be used. But you can change to the 10 per cent basis if you wish. Any new properties must use the 10 per cent basis.

Furnished holiday lettings are different

350. Furnished holiday lettings are different because machinery and plant capital allowances may be claimed as if the activity were a trade. For these lettings you can claim machinery and plant allowances on machinery and plant in the accommodation and the wear and tear allowance isn't available. See paragraph 410 onwards.

What the 10% wear and tear allowance covers

351. The 10 per cent wear and tear allowance is only designed to provide a measure of relief for the depreciation of the machinery and plant within a residential property. It isn't intended to cover:

- the capital cost of the residential property itself or the cost of improvements to the property; but you may be able to claim relief for repairs (see paragraph 132 onwards);

- machinery and plant in other kinds of furnished accommodation, such as offices (where capital allowances may be claimed).

352. The wear and tear allowance is calculated by taking 10 per cent of the net rent received for the furnished residential accommodation. To find the 'net rent' you deduct charges and services which would normally be borne by a tenant but are, in fact, borne by you (for example, council tax, water and sewerage rates etc).

353. The 10 per cent deduction is given to cover the sort of machinery and plant assets that a tenant or owner occupier would normally provide in unfurnished accommodation. These are things like:

- movable furniture or furnishings, such as beds or suites;
- TVs;
- fridges and freezers;
- carpets and floor-coverings;
- curtains;
- linen;
- crockery or cutlery;
- machinery and plant chattels of a type which, in unfurnished accommodation, a tenant would normally provide for himself (for example, cookers, washing machines, dishwashers).

354. This list isn't meant to be complete but gives an idea of the assets the wear and tear allowances covers.

355. Title to the 10% deduction does not depend on the provision of each and every item in the list. The relief is calculated simply on the net rents and not on the cost of particular items. But the deduction is only due if furnished accommodation is genuinely provided. A furnished property is one which is capable of normal occupation without the tenant having to provide their own beds, chairs, tables, sofas and other furnishings, cooker etc. The provision of nominal furnishings will not meet this requirement. If the accommodation isn't furnished, or only partly furnished, the 10 per cent wear and tear allowance isn't due.

Possible advantages of 10% wear and tear allowance

356. The possible advantages of the 10 per cent wear and tear allowance over the alternative, (the renewals allowance) are that:

- it is simple to calculate;
- you get a deduction from the outset; the renewals basis - outlined below - only gives relief when you replace the furnishings etc.

357. If you chose to take the 10 per cent wear and tear allowance, you can't later claim for the cost of replacing the assets (but you can claim the cost of repairing them). You can't deal with some assets on one basis and some the other. If you take the 10 per cent wear and tear allowance that is the only relief you can have for the depreciation of machinery and plant (furniture, furnishings and fixtures etc) of a type which, in unfurnished accommodation, a tenant would normally provide for himself (see paragraph 353).

Renewals & 10% wear and tear allowance

358. However, in addition to the 10 per cent allowance, you can also deduct the net cost of renewing or repairing fixtures which are an integral part of the buildings. The net cost means the cost of the replacement less any amount received for the old item. See paragraph 364 for renewals of fixtures in unfurnished property.

359. Fixtures integral to the building are those which are not normally removed by either tenant or owner if the property is vacated or sold. For example, baths, washbasins, toilets, central heating installations. Expenditure on renewing such items is normally a revenue repair to the building. It is due even though the 10 per cent wear and tear allowance has been deducted.

360. But you can't deduct:

- the original cost of installing these fixtures;
- the extra cost of replacing a fixture with an improved version; for example, where a worn out but basic, cheap bathroom suite is replaced with an expensive, high quality suite; you can only deduct the cost of replacing like with like.

361. The original cost of installation means either the cost of installing the assets for the first time in a new property or the cost of replacing worn out assets in an old property you have bought to let or which you are converting to let. See paragraph 128 for more about capital expenditure (not allowable) and repairs (allowable).

Future of wear and tear allowance

362. The new rules which apply from 6 April 1995 brought the income tax computational rules for income from property more into line with the computational rules for calculating trading income but the existing 10 per cent wear and tear allowance was left in place. It may be appropriate in the future to look again at this non-statutory relief. This guide sets out the concessionary rules applicable at the time of writing in January 1999.

Renewals: furnished & unfurnished property

363. The cost of replacing machinery and plant supplied with the property can be claimed as an expense where neither the 10 per cent wear and tear allowance nor machinery and plant capital allowances are claimed. This is called the 'renewals basis'. It is like the wear and tear allowance for furnished letting in that:

- the renewals basis covers the same kind of assets; that is, free-standing movable machinery and plant assets like furniture, carpets, curtains, cookers, fridges etc; and

- as a separate matter, revenue relief may also be due for replacing fixtures in the same way as in the wear and tear case (see paragraph 358 onwards).

364. The renewals allowance is also available for unfurnished property. Here you will mainly be concerned with fixtures (see paragraph 358 onwards). But you may also provide some machinery and plant assets to the tenant (such as a heating boiler) although the let can't be regarded as 'furnished'. You can claim a renewals deduction in the same way but you can't claim the 10 per cent wear and tear allowance (see paragraph 355).

365. Whatever basis is chosen must be followed consistently. It isn't possible to chop and change between the wear and tear allowance and the renewals allowance from year to year.

Example illustrating renewals principles - Malcolm

366. Malcolm replaces a washing machine in a flat he lets. He sells the old washing machine for £20 and buys a washer dryer costing £559 to replace it. The cost of buying a new washing machine like the old one would have been £399. Malcolm deducts from the £559 both the £20 received for the old machine and the £160 which represents the difference in cost between a washing machine and a washer dryer. His renewals deduction is therefore £379.

367. Sometimes it is impossible to find the current cost of replacing an old asset with something identical. In the previous example, the old washing machine may be of a kind which is no longer made. Common-sense has to be used to find the cost of a reasonable equivalent modern replacement.

Expenses - cost of sea walls

368. A sea wall is a wall or an embankment needed to protect land or property from flooding by the sea or any tidal river.

369. Revenue expenditure incurred on repairing a sea wall is allowable as a deduction, in the same way as expenditure on the repair of the property itself, where the property which the sea wall protects is part of the rental business.

370. Capital expenditure on making or extending a sea wall isn't allowable as a normal rental business expense but it is allowable as a deduction under special rules. These rules allow the expenditure to be written off over a fixed 21 year period. (Section 30 ICTA 1988 & paragraph 7, Schedule 6, FA 1995)

371. Suppose, for example, you spent £63,000 during 1998-99 on the construction of a sea wall. You would be entitled to a deduction of £3,000 against your rental business income for 1998-99 and for each of the following 20 years (£63,000 ÷ 21 years). The deduction is treated like a business expense - it isn't deducted separately as an allowance.

372. You can't continue to claim any remaining allowance if you sell the land protected by the sea wall so that it no longer forms part of your business. The remaining allowance will become due to the new owner where the property forms part of his or her rental business. The remaining allowance can't be used if the property isn't used for business purposes; for example, where it is used as part of a private residence.

Rent a Room scheme

373. You may want to take advantage of the special Rent a Room rules which can apply to furnished residential accommodation you let in your only or main home on or after 6 April 1992. For example, you may benefit where you take in a lodger. The rules either exempt rental income or tax it on a more favourable basis.

Summary

374. Under Rent a Room you can be exempt from income tax on profits from furnished accommodation in your only or main home if the gross receipts you get (that is, before expenses) are £4,250 or less. But you can't then claim any of the expenses of the letting. (Paragraph 9, Schedule 10, F(No 2)A 1992)

375. In addition, receipts over the £4,250 exemption limit can be taxed on an alternative basis which may produce a lower tax bill. Briefly, the excess of the gross receipts over the exemption limit is treated as the taxable rental income instead of the actual profit. But you can't then claim any of the expenses of the letting. (Paragraph 11, Schedule 10, F(No 2)A 1992)

376. For the purposes of the Rent a Room scheme, gross receipts include not only rents but also payments made to you for the provision of any other goods or services (such as meals, cleaning, laundry etc) in connection with the letting.

377. The £4,250 limit may be halved if someone else gets rents from letting in your home (paragraph 381).

378. The Rent a Room scheme applies to ordinary lettings of living accommodation in your own home. It does not apply to rooms let as an office or for other business purposes. But the scheme applies to genuine lodgers who study in your home or who do some of their business work in your home in the evenings or at weekends.

379. Where you have taxable receipts after Rent a Room has applied, they are normally taxable under Schedule A together with the rest of your rental business income (if you have any). In some cases, income from a lodger etc may be taxed separately as a trade (see paragraph 387 onwards).

380 Rent a Room applies to people who let a room in a home they rent as well as to people who own their homes. It isn't relevant for tax but you may want to check whether:

- your lease allows you to take in a lodger (where you rent your home);
- your lender minds you taking in a lodger (where you have a mortgage on your home);
- your insurance company is content; your cover may not be adequate if circumstances have changed.

Details - Rent a Room exemption limits

381. The exemption limit of £4250 is reduced to £2,125 if during the tax year to 5 April, someone else received income from letting accommodation in the same property. This may happen where you own your home jointly with another person. (But see paragraph 387 onwards about basis periods for traders.)

382. If the period of letting is less than 12 months, the limit of £4,250 is reduced to £2,125 if some other person lets accommodation in the same residence at any time in any period of 12 months which includes that 'short' basis period.

383. The amounts of £4,250 (and £2,125) in the preceding paragraphs apply for the year 1997/8 onwards. For 1992/3 to 1996/7, the limits were £3,250 (and £1,625).

You move home during the year
384. The Rent a Room rules apply to the total gross furnished letting receipts for the tax year from your own home. If you move home, and lettings in both your old and new home qualify for Rent a Room relief during the same year, you must add together the rents from both to find the total receipts. ***(Paragraph 2, Schedule 10, F(No 2)A 1992)***

You move abroad
385. If you let your home in the United Kingdom while you live abroad, you will not normally be within Rent a Room. This is because the let property will not usually be a residence of yours at any time during the basis period for the letting. We suggest you consult your professional adviser or your tax office, especially if you were within Rent a Room before you left.

You are below the exemption limit

386. Where you are below the exemption limit you are automatically exempt from tax on rents from your home. But you can ask to be taxed in the normal way - that is, on your receipts less expenses. This may be to your advantage where, for example, you have a loss and you would like to use that loss. A similar point may arise where you are taxed on the excess of your receipts over the exemption limit but you actually made a loss. See:

- paragraph 402 onwards for more about losses;

- paragraph 407 onwards for more about time limits.

Lodger provided with services which amount to a trade - basis period

387. Some lettings may amount to a trade. This is likely to happen where you run a guest house or bed and breakfast business or if you provide material services. For example, meals and cleaning: see paragraph 222 onwards and paragraph 512 onwards. If your lettings amount to a trade Rent a Room relief may still be claimed but you should exclude any taxable profits from your rental business and return them as trading profits.

388. The basis period for a Schedule A business must be the tax year itself (the year to 5 April) or the actual period of letting if shorter. But traders are chargeable under Case I of Schedule D and they can choose a different annual period (generally a period of one year ending on a date in the tax year). You will usually find your tax computations easier if you stick to a 5 April year.

389. Where your basis period is not the year to 5 April, you apply the rule in paragraph 381 to the circumstances of the trade’s basis period; that is, you halve the limit if someone else gets income from your home during the basis period and not during the tax year to 5 April. In addition, the same rules in paragraph 382 about ‘short’ basis periods also apply to trades.

390. Generally, trading profits are computed in the same way as Schedule A rental business profits. Often in continuing cases there will not be much practical difference between trading treatment and Schedule A treatment unless there are losses. Normally, trading losses can be set against your other income but Schedule A losses generally can’t: see paragraph 423 onwards.

Two Rent a Room methods for receipts above exemption limit

391. The Rent a Room scheme provides two ways to work out your tax when your receipts are above the exemption limit of £4,250 (or £2,125 if someone else also got income from the same property in the same period). You can choose which of the following two methods is best for you:

A: paying tax on the profit you make from letting worked out in the normal way for a rental business (that is, rents received less expenses);
or
B: paying tax on the gross amount of your receipts (including receipts for any related services you provide) less the £4,250 (or £2,125) exemption limit.

392. Method A applies automatically unless you tell the tax office within the time limit that you want method B. See paragraph 399 onwards.

393. Once you have elected for method B it continues to apply in the future until you tell the tax office you want method A. You must tell your tax office within the time limit if you decide you no longer want method B to apply. You may want to do this where the taxable profit is less under method A or where expenses are more than the rents (so there is a loss).

394. For example, your gross receipts may be £5,000 but your expenses are £6,000 so you have a loss of £1,000. Unless you opt out of method B, you will still be taxed on the excess of the gross receipts of £5,000 over the exemption limit of £4,250; that is, the taxable profit from letting in your own home will be £750.

- Paragraph 402 onwards says more about losses.
- Paragraph 407 onwards explains the time limit rules.

Example where method B is better - Florence
395. Florence lets out a room in her own home for £100 a week. Nobody else lets a room in the house. Her gross receipts for the year are £5,200. She isn't exempt from tax because her gross receipts exceed the exemption limit of £4,250. She has expenses of £1,000 so her profit is £4,200. The excess of her receipts over £4,250 is £950 (£5,200 less £4,250).

- Using method A, she pays tax on her actual profit of £4,200.
- Using method B, she pays tax on a profit of £950.

396. In Florence's case, method B is better and she elects for it. The profit of £950 is included in Florence's overall business computation if she has other rental business income from lettings outside her home. The profit of £950 will be the only rental business profit if Florence has no other letting income.

Example where method A is better - John

397. John lets out a room in his own home for a rent of £100 a week plus contributions to the heating and lighting. His total letting receipts for the year from letting the room are £5,200 rent plus £200 for light and heating = £5,400. He has expenses of £4,500 so his profit is £900. The excess of his gross receipts over £4,250 is £1,150 (£5,400 less £4,250).

- John pays tax on his actual profit of £900 if he uses method A.

- John pays tax on a profit of £1,150 if he uses method B.

398. In John's case, method A is better. Therefore he either does not elect for method B or, if he has already done so, he tells his tax office that he no longer wants it to apply. The profit of £900 is included in John's overall business computation if he has other rental business income from lettings outside his home. The profit of £900 will be the only rental business profit if John has no other letting income.

Changing from method A to method B and vice versa

399. You can change from method A to method B (or vice versa) from year to year. But each time you want to change you must tell your tax office within the time limit.

400. Method B will automatically cease if the rent you get drops below the exemption limit of £4,250 (or £2,125). You will then be automatically exempt from tax unless you ask within the time limit for your actual profit or loss to be taken into account. If, in the following year, your gross receipts go up and you want to use method B again, you must tell your tax office within the time limit. Otherwise you are automatically taxed on the normal rental business basis (receipts less expenses).

401. Paragraph 407 onwards explains the time limit rules.

Rent a Room and losses

402. Losses can't be created under the Rent a Room scheme. So, if you are under the exemption limit or you are taxed under method B, any actual loss you make can't be relieved unless you tell your tax office within the time limit that you don't want Rent a Room to apply.

403. But any losses outstanding from earlier years when your rents were not within the Rent a Room scheme are not wasted. They are dealt with as follows.

- Suppose your gross receipts from letting in your own home in the current year are no more than £4,250 (or £2,125) and you therefore have no tax to pay on that income. Here the full amount of any losses from an earlier year can be brought forward and set against any other rental business profits of the current year. If there are no other rental business profits in the current year, the losses can go forward to be set against the first rental business profits of a later year. The losses are not reduced because Rent a Room exempts or reduces your tax bill for the year.

- Suppose your gross receipts from letting in your own home are more than £4,250 (or £2,125). Here the earlier losses can be set against your net rental profits in the normal way - however the taxable profits are calculated. That is, whether the income from letting in your own home is computed under method A or B and whether or not there is any other letting. For example, suppose you have no other lettings and you chose method B. Here your rental business profits will be the excess over £4,250 (or £2,125) and it is this excess amount which will absorb any losses. Any remaining losses will then be allowable against the taxable rental business profit of the following or later year, however calculated.

Interest and Rent a Room

404. Interest paid on a loan used to buy a property can't be claimed as a deduction in your rental business if Rent a Room applies during a year. That is, if:

- your receipts from your own home are below the exemption limit and you have not opted out of Rent a Room; or

- you elect for method B, where the tax is simply based on the excess of receipts over the exemption limit.

405. This is just the same treatment as applies to any other expenses.

406. But relief under the MIRAS arrangements (see paragraph 198) will not normally be affected unless you let more than one third of your home. See Appendix 1, paragraph 6 for more details.

<u>See also paragraph 194 about the proposal to withdraw mortgage interest relief from 6 April 2000.</u>

Rent a Room time limits

407. There are time limits within which you must tell the tax office if:

- you don't want to be exempt when your gross receipts are below the exemption limit of £4,250 (or £2,125); or

- you want method B to apply or you want it to stop applying (method B means you are taxed on the excess of your gross receipts over the exemption limit).

408. The time limits are:

- just under 22 months from the end of the tax year for 1996-97 and later years; see paragraph 544 for more details;

- 12 months of the end of the tax year for 1995-96 and earlier years.

Extension of time limits for Rent a Room

409. The time limits for letting the tax office know what you want done are strictly applied. But we may extend the time limits in certain exceptional circumstances; for example, where you have been seriously ill for some time and it was impossible for you to deal with your tax affairs. The limits are unlikely to be extended if you leave everything to the last minute and then have a minor illness. If you have, for some good reason, missed a time limit, please explain the circumstances to your tax office.

Furnished Holiday Lettings

Summary

410. Properties which meet the qualifying tests for furnished holiday lettings are also charged under Schedule A for 1995-96 onwards (instead of Case VI of Schedule D as in the past).

411. For 1995-96 and later years trading principles apply to furnished holiday lettings in just the same way as they apply to other lettings. Hence the explanations given in the rest of this guide about the way receipts and expenses are dealt with apply equally to furnished holiday lettings.

412. The new Schedule A basis period rules also apply. That is, the profits of the tax year to 5 April are charged. For example, the profits of the year ended 5 April 2001 are charged for the tax year 2000-2001.

413. But furnished holiday lettings have some tax advantages over other lettings, including in particular relief for losses on the same basis as traders (paragraph 423 onwards) and the ability to benefit from capital gains tax reliefs for traders - roll-over and retirement reliefs may be especially important.

414. A letting is regarded as a furnished holiday letting where the property is furnished and the letting meets all three qualifying tests in paragraph 415 (Sections 503-504 ICTA 1988)

Furnished holiday letting - qualifying tests

415. For the period explained in paragraph 416 (normally the tax year) the property must be:

- available for holiday letting to the public on a commercial basis for 140 days or more; and

- let commercially for 70 days or more; and

- not occupied for more than 31 days by the same person in any period of 7 months.

416. The period to be considered for the above tests is:

- in a continuing period of holiday letting: the tax year ended 5 April; or
- in the first year of letting: the twelve months starting with the date of the first letting;
- in the final year of letting: the twelve months ending with the date of the last letting.

417. You may have more than one unit of accommodation let for holiday purposes. If so, it isn't necessary for each unit to have actually been let for at least 70 days to meet the 70 day rule provided each unit satisfies the 140 day and 7 month rules. You may claim averaging treatment in order to satisfy the 'actual lettings' test. (Section 504(6) ICTA 1988)

Example illustrating the averaging rule - Joe

418. Joe lets four holiday cottages, and all would otherwise qualify as furnished holiday lettings. The actual letting periods are:

No 1	90 days
No 2	78 days
No 3	70 days
No 4	50 days
Total	288 days

288 days divided by 4 cottages = 72 days.

419. By averaging the four, all will qualify. Without averaging, No 4 wouldn't qualify.

Time limit for Furnished holiday letting averaging

420. An averaging claim must be made within just under 22 months of the end of the tax year to which it relates: see paragraph 544 for more details. For 1995-96 and earlier years the time limit is two years from the end of the tax year.

Furnished holiday letting profit calculated separately

421. The major advantages under the special rules are:

- entitlement to machinery and plant capital allowances on furniture, furnishings, etc in the let property, as well as on machinery and plant used outside the property (such as vans and tools); but there are no capital allowances for the cost of the property itself or the land on which it stands; paragraph 333 onwards says a little more about capital allowances generally;

- losses can be set against your total income and are not restricted to the rental business; paragraph 423 onwards deals with normal rental business losses and paragraph 479 onwards deals with furnished holiday lettings losses;

- capital gains tax reliefs such as roll-over relief and retirement relief. These reliefs are outside the scope of this guide. Ask your professional adviser or tax office if you think these reliefs may be due.

422. You need to calculate the profit or loss arising from qualifying furnished holiday lettings separately from your other rental business profits and losses to see whether you can take advantage of the special rules. But any overall profit is included in the general rental business result; and so is any loss unless you use it separately against other income.

Rental business losses

423. Your rental business losses are calculated in the same way as your rental business profits. The main method of relieving a loss in practice is to carry it forward and deduct it from your future rental business profits (see paragraph 430 onwards).

424. Where carry forward loss relief is due you must use it in full against the first available rental business profits. You can't opt to take a smaller amount.

425. There are three other methods of relieving losses but they are not available in all cases. The three other methods are:

- relief against general income to the extent the loss is due to certain capital allowances (see paragraph 440 onwards);

- sideways relief against general income to the extent the loss is due to certain agricultural expenses (see paragraph 448 onwards);

- sideways relief against general income to the extent the loss is due to furnished holiday lettings (see paragraph 479 onwards).

426. Where you claim sideways loss relief, you must take the full amount of the loss available up to the amount of your general income. You can't opt to take a smaller amount - either you claim for the full loss or you claim for none.

427. All the loss relief rules apply where your loss arises from ordinary commercial letting. Expenses of properties which you let on uncommercial terms (for example, at a nominal rent to a relative) can only be deducted up to the amount of the rent or other receipts generated by the uncommercially let property. The excess of the expenses over the receipts from the uncommercially let property can't be deducted in the rental business and can't, therefore, create a loss (paragraph 256 onwards). (Section 74(1)(a) & (b) ICTA 1988)

428. Losses made in one rental business can't be carried across to any other rental business you carry on at the same time in a different legal capacity (see paragraph 15).

429. See paragraph 47 for more about unrelieved losses of life interest trusts brought forward from 5 April 1995.

Losses against future rental business profits

430. The general rule is that any rental business loss is automatically carried forward and set off against rental business profits of the following year. Rental business losses can't be carried forward against any of your other income. No special claim is required and, if appropriate, you must deduct any losses brought forward from the previous year when calculating your rental business profit for the current year. ***(Section 379A(1) ICTA 1988)***

431. The rental business profit of the current year may be too small to give relief for all the loss of the previous year. In that case the unused part of the loss is carried forward to the next year; and so on indefinitely until relief can be given. Similarly, if there is also a loss in the current year, you add the loss brought forward to it and carry the combined sum forward to the following year; and so on until the loss is relieved.

432. But rental business losses can only be set off against profits from the same rental business. They can't be carried forward after the rental business has stopped. Where, after an interval, you start a new rental business you can't deduct losses from your old rental business. Whether a rental business has stopped and a new business started depends on the circumstances of each case (see paragraph 302 onwards).

Unrelieved losses, expenses & interest from old Schedule A

433. Before 6 April 1995 certain expenses and losses which went unrelieved under the rules then in force could be carried forward to later years where letting income was not large enough to relieve them. These expenses and losses were:

- expenditure paid in a tax year which was allowable under the old rules;
- losses made on furnished lettings charged to tax under Case VI of Schedule D; Case VI furnished letting losses in 1994-95 must be set against any other Case VI profits in that year - but only any balance of Case VI rental losses can be carried forward to the new Schedule A rental business in 1995-96; and
- interest which qualified for relief under the old rules but only where the qualifying conditions for allowing interest for 1994-95 were also met for 1995-96.

434. Where any of the above expenses or losses have not been relieved by 5 April 1995 they are carried forward from 1994-95 and treated as if they were a new style loss relievable in 1995-96 against the profits of your rental business. This can only be done where, under the old rules, the losses would otherwise have been taken into account in calculating the profits or losses of the rental business for 1995-96. ***(Paragraph 19(2)& (3), Schedule 6, FA 1995)***

435. The profits in 1995-96 may be too small to absorb all the deemed loss brought forward. If so, any unused amount can be carried forward to 1996-97 and relieved against later rental business profits; and so on for later years in the same way as an ordinary loss of the year (paragraph 430 onwards). ***(Paragraph 19(2) & (3), Schedule 6, FA 1995)***

436. See also paragraph 47 onwards for more about the carry forward of losses from 1994-95 in the case of a life interest trust.

Example of losses carried forward - Clarissa

437. Clarissa is taxable under Schedule A on her letting income. The results of her letting for 1996-97 to 1999-2000 are:

- 1996-97: loss £5,000
- 1997-98: profit £3,000
- 1998-99: loss £1,000
- 1999-2000: profit £8,000

438. Clarissa has no excess capital allowances or agricultural expenses for any of these years (and can't therefore make any claims for sideways relief against general income).

439. Clarissa's Schedule A position for these years are:

- 1996-97: no profit chargeable - loss carried forward £5,000;
- 1997-98: no profit chargeable - profit £3,000 less loss brought forward £3,000; balance of loss carried forward (£5,000 less £3,000) = £2,000;
- 1998-99: no profit chargeable - loss carried forward £3,000 (loss for the year, £1,000 + loss brought forward £2,000);
- 1999-2000: £5,000 profit chargeable - profit £8,000 less loss brought forward £3,000.

Losses against other income: capital allowances

440. The general rule is that you can't set rental business losses against the rest of your income. But you may be able to do so where you have made a loss in your rental business in a tax year and rental business capital allowances are due. In this case you may make a claim to have some or all of the capital allowances part of the loss set against your general income.

441. You can't include capital allowances in a loss relief claim if those allowances arise from equipment which you let to someone who does not use it for the purposes of a trade. For example, where you let a building containing machinery and plant to a local authority. Special rules also apply to furnished holiday lettings where capital allowances are included in loss relief claims: see paragraph 482.
(Section 379A(2) & (9) ICTA 1988)

442. You can set the capital allowances part of the loss against your general income of either:

- the tax year in which the rental business loss was made; or
- the tax year following that in which the rental business loss was made.

443. Thus, a loss for 1997-98 attributable to capital allowances can be set against either your general income of 1997-98 or your general income of 1998-99.

444. The amount of loss relief available because of capital allowances is restricted to the smallest of the following three figures:

- your total general income for the year after deducting rental business losses brought forward (to the extent of the rental business income) and after deducting any sideways relief for the previous year's loss (see paragraph 442);
- the amount of the rental business loss made in the year;
- the net capital allowances after setting off any balancing charge. But you must exclude any capital allowances on equipment let to someone else who does not use the equipment for the purposes of a trade.
(Section 379A(4), (5) & (6) ICTA 1988)

Claims & time limits: sideways set off of capital allowances
445. You must make a claim to obtain sideways relief for capital allowances against your total income.

446. Claims must be made within just under 22 months after the end of the tax year in which the relief is to be given: see paragraph 544 for more details. For example, suppose the relief is for 1996-97. Here the tax year ends on 5 April 1997 and claims must be made by 31 January 1999.

447. For 1995-96 only, the time limit for claims is 2 years after the end of the tax year in which relief is to be given. (Section 379A(3) ICTA 1988)

Losses against other income: agricultural

448. Where you have made a loss in your rental business in a year of assessment and agricultural land forms part of your rental business, you may make a claim to have the agricultural part of the loss set against your general income. The agricultural part is the expenditure claimed in your business accounts on maintenance, repairs, insurance and management of the agricultural land. Note that interest payable isn't an agricultural expense. ***(Section 379A(8) ICTA 1988)***

449. You can set the loss against your general income of either:

- the tax year in which the rental business loss was made; or
- the tax year following that in which the rental business loss was made.

450. Thus, a loss for 1998-99 attributable to agricultural land can be set against either your general income for 1998-99 or your general income of 1999-2000.

451. The amount of loss relief available is restricted to the smallest of the following three figures:

- your total general income for the year after deducting rental business losses brought forward (to the extent of the rental business income) and after deducting any sideways relief for the previous year's loss (see paragraph 442);
- the amount of the rental business loss made in the year;
- the expenditure on repairs, maintenance, insurance or management of the agricultural land. ***(Section 379A(2)(b) ICTA 1988)***

452. The sideways relief does not include uncommercial agricultural expenses. The expenses must be deductible in computing the loss and uncommercial expenses will only be deductible up to the amount of the income from the agricultural property (paragraph 256 onwards). Uncommercial losses arise where

the terms of your letting are not based on those of the normal open market; for example, where you agreed to charge a relative a nominal rent or a rent below the going rate for a similar kind of lease. ***Sections 379A(2)(b) and (8) ICTA 1988)***

Claims & time limits for sideways set off of agricultural loss

453. You must make a claim to obtain this sideways relief against your total income.

454. Claims must be made within just under 22 months after the end of the tax year in which the relief is to be given: see paragraph 544 for more details. For example, suppose the relief is for 1997-98. Here the tax year ends on 5 April 1998 and the claims must be made by 31 January 2000.

455. For 1995-96 only, the time limit for claims is 2 years after the end of the tax year in which relief is to be given. ***(Section 379A(3) ICTA 1988)***

Example: sideways losses: capital allowances & agricultural expenses

456. Michael has substantial professional income taxed under Case II of Schedule D. He also lets a number of properties including shops, factories and farms. All the properties are let on open market terms. The income and expenses of all the lettings are included in a single rental business under the new Schedule A.

457. During 1999-2000 Michael incurs exceptional (but allowable) revenue expenditure in relation to his letting business which results in a Schedule A loss of £50,000.

458. The following items are included in arriving at the £50,000 loss:

- capital allowances: £28,000;
- balancing charge £26,000;
- agricultural expenses £30,000.

459. Schedule A losses cannot normally be relieved sideways against non-Schedule A income: they can only be carried forward to set against later Schedule A profit. Michael is, however, entitled to a net amount of capital allowances and to agricultural expenses. He can claim under Section 379A(3) to set these sideways, as a Schedule A loss, against general income of 1999-2000 and (if that year's income is insufficient to absorb them) general income of 2000-2001.

460. If Michael has sufficient income he can therefore claim relief for 1999-2000 for losses of £32,000. This is:

- net capital allowances: £2,000 (capital allowances £28,000 less balancing charge £26,000); and

- agricultural expenses £30,000

461. The balance of the £50,000 loss (£18,000) is carried forward to set against future Schedule A profits. ***(Section 379A(3)(b) ICTA 1988)***

Example: restrictions on sideways relief: relievable income reduced by Schedule A loss brought forward: Brenda

462. Brenda's income for 1998-99 is:

Schedule A profit:	£1,000
Other	<u>£10,000</u>
Total	£11,000

463. At 6 April 1997 Brenda had Schedule A losses brought forward from 1996-97 under Section 379A(1) ICTA 1988 of £5,000. She makes a valid claim under Section 379A(3) to set a 1997-98 Schedule A loss of £12,000 attributable to capital allowances sideways against general income of 1998-99. Brenda could have chosen to set her capital allowances against her 1997-98 general income but did not do so. See paragraph 440 onwards for the background.

464. Section 379A(6)(a) ICTA 1988 requires that the loss brought forward under Section 379A(1) first be set against the Schedule A profit before calculating relievable income (it was sustained before the Section 379A(3) claim loss).

465. The loss brought forward covers the £1,000 Schedule A profit for 1998-99 (the balance £4,000 is carried forward) and relievable income for that year is therefore £10,000.

466. The 1997-98 losses relieved against general income for 1998-99 are therefore restricted to £10,000 with the balance of £2,000 (together with the unrelieved losses of £4,000 brought forward from 1996-97) carried forward.

Example: restrictions on sideways relief: relievable income reduced by Schedule A loss brought forward and sideways: Oliver

467. Oliver has Schedule A losses attributable to capital allowances eligible for sideways relief claims as follows:

- 1998-1999: loss £20,000;
- 1999-2000 loss £15,000.

468. Suppose Oliver's total income for 1999-2000 is £25,000. He makes a sideways claims for relief for both years of loss against 1999-2000 income. (Section 379A(3) ICTA 1988)

469. To calculate the relievable income for 1999-2000 for the 1999-2000 loss, the 1998-99 loss (for which there is also a claim) must be deducted first from the total income of 1999-2000. The effect of this is that the earlier loss is set off first. ***(Section 379A(6)(b) ICTA 1988)***

470. In Oliver's case the 1999-2000 relievable income for the 1998-99 loss is £25,000 and for the 1999-2000 loss is £5,000. This is the 1999-2000 income of £25,000 less the 1998-1999 loss of £20,000. Oliver will get relief as follows:

1999-2000 total income	£25,000
less 1998-99 loss	£20,000
balance of income left	£5,000
less 1999-2000 loss	£5,000
Taxable	nil

471. The set off order ensures that the balance of the 1999-2000 loss of £10,000 (£15,000 less £5,000) can be taken forwards and also, if Oliver wishes, sideways against general income of the following year, under Section 379A(3) ICTA 1988.

Example: restrictions on sideways relief: net capital allowances or agricultural expenses greater than Schedule A loss: Pamela

472. Pamela's Schedule A business produces a loss for 1998-99 of £3,000. That loss includes:

- capital allowances: £10,000
- balancing charge: £3,000

473. Pamela's relievable income for 1998-99 is £35,000. Pamela claims sideways relief against general income for 1998-99 (Section 379A(3) ICTA 1988). Her net capital allowances are £7,000 (£10,000 less £3,000). Although the net capital allowances are smaller than her relievable income it is greater than her overall Schedule A loss of £3,000. Her relief is therefore limited to £3,000. ***(Section 379A(4) ICTA 1988)***

474. The same restriction would have applied if the amount of net capital allowances had, instead, been an amount of agricultural expenses.

Example: restrictions on sideways relief: insufficient relievable income over two years to absorb loss: Guy

475. Guy's Schedule A business makes a loss of £30,000 in 2000-2001 after taking into account capital allowances. For that year Guy has net capital allowances (after deducting balancing charges) of £35,000 for his Schedule A business. The entire loss of £30,000 is therefore eligible for sideways loss claims for 2000-2001 and 2001-2002. ***(Section 379A(3) ICTA 1988)***

476. Guy has no Schedule A losses brought forward under Section 379A(1) ICTA 1988 at 6 April 2000. But Guy's total relievable income for the two years together is £20,000 and relief for this amount only can be given sideways. ***(Section 379A(3) ICTA 1988)***

477. The balance of Guy's 2000-2001 loss (£10,000) can be carried forward under and set against later Schedule A profits but not against general income. ***(Section 379A(1) ICTA 1988)***

478. If Guy claims sideways relief, he will lose the benefit of his personal allowances for 2000-2001 and 2001-2002. Guy needs to consider all the consequences carefully before making a claim, bearing in mind that he can't claim part of the loss sideways. For example, depending on the facts, it could pay Guy not to claim sideways loss relief because his personal allowances could then be set against his other income for 2000-2001 and 2001-2002 and the amount of loss relief to go forward against future rental business profits would be greater. A decision might need to take into account both the total amount of relief available overall and the cash-flow advantages of early relief.

Furnished holiday lettings losses against general income

479. Furnished holiday lettings are treated like a trade for loss purposes and get the same loss reliefs as trades. Thus, where a Schedule A rental business includes sources of furnished holiday lettings any losses arising in that part of the business

may be relieved either sideways or backwards against general income. Otherwise the losses will be relieved against any other Schedule A profits for the year. See:

- paragraph 481 onwards for sideways relief; and
- paragraph 495 onwards for carry back relief.
  (Section 503(1) ICTA 1988)

480. Any surplus of unrelieved loss is carried forward and set off against Schedule A profits of subsequent years so long as the Schedule A business continues.

Sideways set off of furnished holiday letting loss
481. Where you let property as a furnished holiday letting (see paragraph 410 onwards) and make a loss on all properties let as furnished holiday accommodation taken together you can choose whether to set that loss:

- against your general income; or
- any losses not claimed against general income must be set first against any other profits of your rental business in the same tax year; any balance remaining is carried forward against the first available profits.

482. Your furnished holiday letting loss may consist, wholly or partly, of machinery and plant capital allowances. The whole loss, including the capital allowances, can be set against any other profits of your rental business for the same year or, if appropriate, carried forward and set against profits of the same business in later years (see paragraph 483 onwards).

483. Where your rental business is made up solely of furnished holiday lettings any losses can either be set against your general income or carried forward (see paragraph 430 onwards).

484. Where your rental business is made up partly of furnished holiday lettings and partly of other land and property you can choose whether to set any loss made from your furnished holiday lettings against your other general income. Any losses not claimed against general income must be set against first against any other profits of your rental business in the same tax year. Any balance of loss is carried forward against the first available profits of the same rental business in later tax years.

485. The distinction between ordinary lettings and furnished holiday lettings may be important in some situations because you may be able to save tax by making the right choice.

486. For example, this may be the case when you have ordinary rental business profits of £1,000 (not furnished holiday lettings) in the current tax year and also ordinary rental business losses of £1,000 brought forward from an earlier tax year. The earlier rental business losses will reduce your ordinary rental business profits of the current year to nil. Then a loss of, say, £500 arising from your furnished holiday lettings can be set off sideways against your general income.

487. If, instead, you left your furnished holiday lettings losses merged into your general rental business result, the outcome would be:

- a net rental business loss of £500 (current profit of £1,000 less loss brought forward £1,000 and furnished holiday lettings loss of £500;

- no sideways losses to set against general income; and

- a loss of £500 to carry forward to the next tax year.

Which years sideways furnished holiday letting loss is used

488. Relief for furnished holiday lettings losses against general income (excluding your rental business income) is given in the same way as trading losses.

489. The new rules for trading losses will generally apply in full:

- from 1994-95 for all new activities which start on or after 6 April 1994; or

- from 1994-95 for any existing activity treated as starting on or after 6 April 1994 where there is a change in the members of a partnership ***(Section 113(1) ICTA 1988)***; or

- from 1997-98 for all businesses.

490. Once the new rules apply you can claim to set your furnished holiday lettings losses against your other general income for either the tax year in which the loss was made or the year before the year the loss arose.

491. Before the new rules apply the choice of years of set off is either the tax year in which the loss was made or the following year. But there are special rules for the transitional year, 1996-97. See our booklet SAT1 (1995), paragraph 6.81 onwards for more details (paragraph 546 below) or ask your professional adviser or tax office for more details.

Claims & time limits for sideways set off of furnished holiday loss

492. For 1996-97 and later years claims must be made within just under 22 months after the end of the tax year in which the loss arose: see paragraph 544 for more details. Thus, for 1999-2000, the claim must be made by 31 January 2002. ***(Sections 380 & 381 ICTA 1988)***

493. For 1995-96 and earlier years the time limit is 2 years from the end of the tax year in which relief is to be given.

494. If your furnished holiday letting started after 6 April 1994, different rules will apply for losses arising in 1994-95 and 1995-96. Losses for these years can be claimed against other general income for either the year the loss arose or the previous year and the time limit for making a claim is just under 22 months after the end of the tax year in which the loss arose. See paragraph 544 for more details.

Furnished holiday lettings - carry back losses of first four years

495. When you first let a property as a furnished holiday letting and you make a loss in any of the first four tax years after the start of your rental business, you can set this loss against your other income of the three tax years before the year of loss. This means you may be able to get back tax paid on income received before you started the furnished holiday letting. ***(Sections 381 & 503 ICTA 1988)***

496. In deciding which are the first four years for the purposes of the carry back relief, you only look at properties you let as furnished holiday lettings. You don't count other lettings. But you have to look at all the furnished holiday lettings and the four year commencement period begins with the first letting of any of these properties as furnished accommodation. It does not matter whether that letting qualified at the time as a furnished holiday letting. (Section 503(3) ICTA 1988) See paragraph 302 for more about when a rental business starts.

Claims & time limits for carry back of furnished holiday letting losses

497. For 1996/7 and later years, the time limit is just under 22 months after the end of the year of loss in all cases; see paragraph 544 for more details. For earlier years, the time limit is two years after the end of the year for which the loss is claimed.

Furnished holiday lettings - losses set against capital gains

498. If your losses exceed your income you can also choose to set your losses set against your capital gains - see your professional adviser or tax office for further details. Special rules also may apply if your furnished holiday letting ceases and you have made losses. Again, you should ask your professional adviser or tax office for further details.

Claims for loss relief generally

499. To make any of these loss claims, please tell your tax office in writing that:

- your rental business has made a loss;
- which kind of loss relief you want to claim;
- the year in which the loss was made; and
- the year for which you want to use the loss relief.

500. Remember that you must make a claim within the time limits set out above, and that relief for each £1 of loss can be only allowed once.

Rents related to a trade or profession

Trading premises - rents of surplus part let

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

502. If you carry on a trade or profession and have such surplus accommodation which you let, you can, if you wish, treat the rent you get for it as a trading or professional receipt. This can only be done in the following circumstances:

- the accommodation must be temporarily surplus to current business requirements;
- 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 under Schedule A;
- 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.

503. Receipts from the letting of surplus business accommodation are treated as trading income and will not form a part of your rental business (provided they meet the conditions in paragraph 502). Any expenditure on the surplus accommodation is deducted in the computation of the trading or professional profits and must be excluded from your rental business.

Separate property surplus to requirements of your trade

504. You may carry on a trade or profession in which a separate property becomes surplus to your trading or professional requirements. If you don’t sublet the property, you can usually deduct the rent and other expenses of that property in computing your trading or professional profits. The test is whether you undertook the rental obligations etc of the surplus property ‘wholly and exclusively’ for the purposes of your trade or profession. ***(Hyett v Leonard, 1940, 23 TC 346)***

505. Normally, the test would be met if you entered into the lease in order to use the property in your trade or profession. But the expenses of a private property or a rental business property wouldn't meet this test. Nor would the expenses of a former trading or professional property where, after it became surplus:

- you renewed the lease, perhaps because you wished to continue subletting; or
- you don't exercise any option to terminate the lease which may be available; for example, by giving notice to the landlord.

506. If you sublet the surplus property (and the expenses are deductible in computing the profits of your trade or profession) the position is:

- strictly, any rents etc you receive are taxed under Schedule A with no deductions for those expenses which qualify as expenses of the trade or profession, since the 'wholly and exclusively' test isn't met for the rental business; but you can, if you wish, deduct those expenses in the rental business instead of your trade or profession so that only the net profit is charged under Schedule A;

- any excess of expenses over receipts from the surplus property can be deducted in computing the profits of your trade or profession, provided the expenses meet the 'wholly and exclusively' test (see paragraph 504).

Expenses of let properties held as trading stock

507. You may be a property dealer or developer who holds property as trading stock. The running costs of that property while awaiting sale (such as maintenance or background heating) will be expenses of your trade as a property dealer or developer. You can't deduct those expenses in any rental business you also carry on.

508. You may temporarily let the property you hold as trading stock while awaiting a buyer. Here the rental receipts will fall into your Schedule A rental business, or will create one if you did not already have one. Then:

- Any revenue expenses of the letting of the trading stock must be deducted, in the first place, from the letting receipts.

- Any net profit will be part of the Schedule A rental business result.

- Any excess of letting expenditure of the trading stock over the rental business receipts is an expense of your property dealing or developing trade.

509. In some cases you may buy a property, such as a block of flats, and you then buy out the tenants over a period with a view to selling on the whole block. In this case you will need to separate the expenses of the let flats from those you no longer intend to let and which therefore cease to be part of your rental business. Following the principles already outlined, the expenses of the unlet flats can only be deducted in computing the property dealing profit or loss.

Tied premises

510. Rents from tied premises are wholly trading receipts and do not form part of your rental business. The same applies to the taxable amount of any premium received. Any expenditure on the tied premises will be deducted in the computation of the trading profits and should similarly be excluded from your rental business. ***(Section 98 ICTA 1988)***

Caravan sites: trading and letting income

511. You may be the proprietor of a caravan site who carries on material activities associated with the operation of that site which amount to trading. If so, receipts of that trade can include any receipts from letting caravans even though the letting does not, of itself, amount to a trade. Such receipts will not, therefore, be part of your letting business and nor will the associated expenses. ***(Extra Statutory Concession B29)***

Letting property and providing additional services

512. Where you let property and provide additional services to your tenants it is a question of fact whether:

- the whole activity (the letting of property and the services) amounts to a trade; or
- the whole activity is part of your Schedule A rental business; or
- the provision of services amounts to a trade which is separate from your Schedule A rental business.

Whole activity a trade

513. Your whole letting activity is only likely to amount to a trade where you remain in occupation of the property and you provide services substantially beyond those normally offered by a landlord. This will be the case if your business consists of providing bed and breakfast, or if you run a hotel or guest house. Normally, however, income from property isn’t trading income even if you work full time running your rental business (paragraph 61 onwards).

Whole activity part of a Schedule A rental business

514. To run a separate trade of providing services (in addition to your Schedule A rental business) you need to show that what you offer goes well beyond the services normally provided by a landlord. Examples of services normally provided by a landlord include:

- the cleaning of stairs and passages in multi-unit premises;
- the provision of hot water and heating;
- supervision involving rent collection and arranging new tenancies;
- arranging for repairs to the property.

515. The fact that you provide any or all of the services listed in the previous paragraph does not mean that your whole activity is a trade or that any separate earnings from those services arise from a trade. The receipts are part of your Schedule A rental business. Where you have a large rental business you may need to work full time in order to provide these services; but that doesn’t change their nature - it is just a result of the number of properties you own.

Separate trade in addition to rental business

516. You may, however, carry on a separate trade where you provide the following services:

- the regular cleaning of rooms when they are let and not just between changes of tenant;
- the regular supply of clean linen;
- the regular provision of meals.

517. The provision of these services does not, however, make the whole rental business a trade.

518. Your receipts from the trading services are taken into account in calculating a separate trading profit chargeable under Case I of Schedule D and the rents you get for letting the property are included in calculating your rental business profits. Where you get a single payment for the two separate activities you will need to split it for tax purposes. You should do this on a reasonable basis which reflects the value of each activity.

519. Your expenses will similarly need to be split between your trade and your Schedule A rental business.

Practical considerations

520. Whether there is any practical difference between Schedule A rental business treatment and actual trading treatment with a charge under Case I of Schedule D isn't a straightforward question. For many continuing businesses there may be nothing in it. The issue could be important where you have losses because trading losses can go sideways against your other income but rental business losses generally can't. Trading treatment may also be beneficial for capital gains tax purposes because roll-over and retirement reliefs are available for traders but not for those who carry on a Schedule A rental business (with the exception of furnished holiday lettings - see paragraph 410 onwards).

521. Consult your professional adviser or tax office if you are not sure whether you are carrying on a trade of providing services in addition to letting a property, or whether, exceptionally, your entire letting activity amounts to a trade. Where your provision of services amounts to a trade which is separate from your rental business, the receipts from those services are taken into account in calculating a trading profit from the provision of services. Only the rents received in respect of the letting should be included in calculating your rental business profits.

522. Where you get a single payment for the two separate activities you will need to split it for tax purposes. You should do this on a reasonable basis which reflects the value of each activity.

Rent from properties outside the UK

523. Rent and other receipts from properties outside the UK continue to be taxed separately under Case V of Schedule D. But for 1995-96 onwards the profits or losses are normally calculated just like those of a Schedule A rental business. That is, like Schedule A, Case V profits and losses are computed using the principles for a trade within Case I of Schedule D.

524. Thus, the other parts of this guide generally apply to receipts and expenses of properties outside the UK as well as those within the UK. But the Case I approach does not apply if you are entitled to the benefit of the remittance basis for overseas income: see paragraph 538. ***(Section 41(1) FA 1995 amending Section 65(4) ICTA 1988)***

525. Case V profits or losses are not combined with the Schedule A rental business profits or losses; they are taxed separately and losses on one can't be set against profits on the other.

526. The new rules don't apply to a property if it ceases to be let in 1995-96. The old Case V rules apply to the end.

Case V rental business basis periods

527. The Case V basis period rules are a little different from those for Schedule A.

- The current, fiscal year basis applies to income from properties which were first let on or after 6 April 1994. The basis period is therefore the year to 5 April, the same as for the new Schedule A. For example, the profit of the year ended 5 April 1997 is charged for the tax year 1996-97.

- The previous year basis (including for 1996-97, the transitional rules) applies for letting income from any property which first gave rise to income before 6 April 1994. But for 1997-98 and later years all properties are charged on the current, fiscal year basis (the year ended 5 April).

- Thus, from 6 April 1997 the Case V basis period rules will all be the same as for Schedule A although the computation and charge will remain separate.

528. These rules apply separately to each overseas property for 1995-96 and 1996-97. So some may be on one basis and some on another until 1997-98.

Case V rental business - computing profit

529. The rules for computing the amount of the Case V rental profit or loss in the same way as for Schedule A apply for 1995-96 and later tax years. Every property outside the UK has its profits computed using Case I principles for 1995-96 and later years whatever basis periods are used.

530. This means that the Case V profit or loss for a property for 1995-96 will either be based on the receipts and expenditure of the year ended 5 April 1996 or, where the previous year basis still applies, those of the year to 5 April 1995.

531. For 1997-98 and later years you compute the profit or loss for the rental business as whole and not the result for individual properties. But you will need to make separate computations for Tax Credit Relief purposes. This is to ensure that the overseas tax you pay on income from a property in one foreign country is only set against the UK tax on that property; you can't set that foreign tax against UK tax due on income a property in another country.

532. The special rules for furnished holiday lettings don't apply to overseas properties.

Case V travel

533. There are special rules for travel connected with overseas trades. These don't apply to rental income. But deductions are due for travel costs on the same basis as for Schedule A. That is, you must be able to show that the travel was incurred wholly and exclusively for business purposes and not (wholly or partly) for some other purpose (such as a holiday). Paragraph 234 onwards has more details.

Case V premiums

534. The Schedule A rules for charging premiums also apply to premiums obtained for overseas properties from 6 April 1995. But the charge is made under Case V of Schedule D. Paragraph 100 onwards outlines the premium rules. ***(Section 41(4) FA 1995)***

Case V and capital allowances

535. Capital allowances are available but normal capital allowances rules apply. For example, there is a rule which denies industrial buildings allowance for a building outside the UK unless it is used for the purposes of a trade which is taxable under Case I of Schedule D. Paragraph 333 onwards has a little more detail. ***(Section 41(3) FA 1995, Section 161(2A) CAA 1990 & Section 18(3) CAA 1990)***

Case V and losses

536. No statutory relief for Case V losses is available for years up to and including 1997-98. But, by concession, any loss on an overseas property (including caravans and houseboats) can be carried forward and set against future profits from the same property. The loss can't be set against any other income of the same year. This means, in particular, that each property has to be looked at separately and a loss on one can't be set against a profit on another. (Extra Statutory Concession B25)

537. For 1998-99 and later years new loss rules apply to Case V rental income. All the overseas properties are treated as a single Case V letting business. Hence excess expenditure on one overseas property is automatically set against surplus receipts from other overseas properties. Any overall overseas rental business loss can be carried forward and set against future Case V rental business profits; but it can't be set against Schedule A rental business profits or against any other income. (Section 41(8) FA 1995)

Remittance basis

538. Overseas property income is taxed on the remittance basis where the rental income belongs to -

- a person domiciled outside the United Kingdom.
- a Commonwealth citizen or a citizen of the Irish Republic who isn't ordinarily resident in the United Kingdom.

539. No loss can ever arise on income taxed on the remittance basis.

540. Consult your professional adviser or tax office if you think the remittance basis applies to you.

Case V tax credit relief

541. Normally, the tax authorities of the country where the let property is situated will also charge tax on the letting profits. This means that a UK-resident landlord will pay tax on the same profits both here and abroad. But the double charge is relieved by deducting the overseas tax paid on the property income from the UK tax due on the same income. This is done either under the terms of a Double Taxation Treaty with the overseas country or, where no treaty exists, under separate UK rules.

Rents paid to persons living abroad

542. If you usually live abroad your letting agent (or tenant, if you have no letting agent and the rent is more than £5,200 a year) has to deduct tax from the income of your rental business. However, you can apply to the Inland Revenue's Financial Intermediaries and Claims Office (FICO) for approval to receive the income of your rental business with no tax deducted if:

- your UK tax affairs are up to date, or
- you have never had any UK tax obligations, or
- you don't expect to be liable to UK income tax.

543. You should get leaflet IR140 ***Non resident landlords, their agents and tenants*** from any Tax Office or Inland Revenue Enquiry Office, or from FICO at :

Inland Revenue
FICO (Residence Advice and Liabilities - Unit 373)
St John's House
Merton Road
BOOTLE
Merseyside L69 9BB.

Time limits under self assessment

544. For convenience in this guide we say that the normal self-assessment time limit for losses is just under 22 months after the tax year to which a loss claim etc relates. The time limit is actually five days less than 22 months because the deadline is the 31 January in the tax year next after the year of loss.

545. For example, suppose a claim is made for a loss of 1997-98. This is the year ended 5 April 1998 and the time limit expires on 31 January 2000 - five days less than 22 months later.

More information - booklets and leaflets

Information directly relevant to property income

546. We produce a range of leaflets and booklets which you may find helpful. Each one is designed to explain a different aspect of the tax system. The main ones relevant for property cases are:

- SAT1(1995) ***The new current year basis of assessment***. This explains the technical background to new current year basis for Schedule A. Chapter 9 deals with rental income. This booklet costs £7.50.

- SAT2 (1995) ***Self Assessment: the legal framework***. This has guidance on the new ‘process now check later’ system for the assessment and collection of tax. This booklet costs £5.

- IR140 ***Non resident landlords, their agents and tenants***. This is free.

547. Copies of the SAT guides for which a charge is made can be ordered from the Inland Revenue Library, New Wing, Somerset House, Strand, London WC2R 1LB. Our internal booklet ***Rent a Room - Guidance to Staff*** is also available from this address for £2. Please make cheques out to ‘Inland Revenue’.

548. IR140 ***Non resident landlords, their agents and tenants*** is available from any Tax Office or Inland Revenue Enquiry Office, or from FICO at the address in paragraph 543.

Other information

549. Our free list Catalogue of leaflets and booklets shows all the free publications you can get from Inland Revenue Enquiry Centres and Tax Offices. Addresses are in your local phone book under Inland Revenue. Most offices are open to the public from 8.30am to 4.30pm, Monday to Friday, and some are also open outside these hours.

550. Some other free booklets you may find useful are:

- 480 ***Expenses and benefits: a tax guide***. This is a detailed guide to the taxation of employee’s expenses and perks.

- IR1 ***Extra -Statutory Concessions***. This sets out those areas where the strict application of the law has been modified by concession.

551. We publish all our internal guidance manuals for our staff through a commercial publisher. These manuals are not free but copies may be available in your local library or Citizen’s Advice Bureau. They may also have copies of our leaflets and booklets.

552. We also produce a newsletter called Tax Bulletin at regular intervals. This shows some of our current thinking on technical aspects of taxation. Tax Bulletin is only available on annual subscription. For 1998 the cost is £20. If you would like to subscribe please send your name and address to:

Inland Revenue
Finance Division
Barrington Road
Worthing
West Sussex BN12 4XH.

553. Please cross cheques and make them payable to ‘Inland Revenue’.

554. Inland Revenue Enquiry Centres or Tax Offices will also try to help you with any problems.

555. If you want to know more about the general law on letting property, ask your nearest Citizens Advice Bureau for a copy of the Department of Environment leaflets ***Want to Rent a Room? and Letting Rooms in your Home.***

Appendix 1: mortgage interest paid

Mortgage interest relief: property used for residential and business purposes: ESC A89

<u>Note that if the Budget proposal mentioned in paragraph 194 is enacted, this concession will cease to have effect from 6 April 2000.</u>

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1. It is becoming increasingly common for properties to be used both for residential and business purposes. If a loan is used to buy such a property and mortgage interest relief is claimed as an income tax reduction (Section 353 ICTA 1988) or through the Mortgage Interest Relief At Source (MIRAS) arrangements (Section 369 ICTA 1988), no interest on that loan is allowable as a deduction in computing the profit or loss of a business assessable under Schedule A or Case I or II of Schedule D (Section 368 and Section 369(3) respectively).

2. This contrasts with the situation where separate loans are taken out to acquire the business and residential parts of a property. Here interest on the loan to acquire the residential part qualifies for mortgage interest relief and interest on the business part can be allowed as a business deduction.

3. Extra Statutory Concession A89 (published on 3 May 1995), which applies for 1995-96 onwards, addresses this discrepancy. It allows a single loan to be treated as two separate loans so that mortgage interest relief may be claimed for the part relating to the residential use of the property and a deduction made in computing profits for the part relating to the business use.

4. The concession provides that where a part of a property, which is the borrower’s only or main residence, is used exclusively for business purposes the loan in question may be apportioned on the basis of the proportion of the property so used. Mortgage interest relief may then be claimed for the interest on the part of the loan attributable to residential use and a deduction may be allowed for the interest on the part of the loan attributable to business use.

5. Where a part of a property, which is the borrower’s only or main residence, is only sometimes used for business purposes (but for a significant amount of time and then exclusively) the loan in question may be apportioned on any reasonable basis that takes account of both the proportion of the property so used and the duration of such use. Mortgage interest relief may then be claimed

for the interest on the part of the loan attributable to residential use and a deduction may be allowed for the interest on the part of the loan attributable to business use.

6. A loan to buy a main residence may be included in the MIRAS arrangements only if the property is used 'wholly or to a substantial extent' as the borrower's home. This condition is normally regarded as satisfied if at least two thirds of the property is used as the borrower's main residence. Where part of a residential property is used for some other purpose but is nevertheless used 'to a substantial extent' as the borrower's home, all the interest qualifies for relief through MIRAS (subject to the £30,000 qualifying maximum).

7. Where relief is given through the MIRAS arrangements and the part of the loan attributable to residential use is less than the £30,000 qualifying maximum, some or all of the part of the loan attributable to business use will have been relieved through MIRAS. In these circumstances only the additional relief over and above that received through MIRAS will be allowed as a business deduction. Examples 1, 3 and 5 show you how to calculate this.

Example 1 - Jenny

Jenny takes out a loan of £30,000 to acquire her main residence. Two of the ten rooms are used exclusively for business purposes. Total interest paid amounts to £3,000.

Mortgage interest relief

Loan attributable to private residence =

£30,000 x 8/10 = £24,000

Interest relief available = £3,000 x 24,000/30,000 =	£2,400

Business deduction

Loan attributable to business use = £30,000 x 2/10 =	£6,000
Interest deduction available = £3,000 x 6,000/30,000 =	£600

If the loan was in MIRAS, Jenny would have received relief on £3,000 at 15%.

The business deduction would therefore be calculated as follows:

If Jenny is liable at 25% -

Relief due on business deduction £600 x 25% =	£150
less MIRAS £600 x 15% =	£90
Additional relief due	£60

Convert additional relief to a deduction: £60 ÷ 25% = £240

If Jenny is liable at 40% -

Relief due on business deduction £600 x 40% =	£240
less MIRAS £600 x 15% =	£90
Additional relief due	£150

Convert additional relief to a deduction: £150 ÷ 40% = £375

If Jenny is marginally liable (say £200) at 40% -

Relief due on business deduction:

£200 x 40% =	£80
£400 x 25% =	£100
	£180
less MIRAS £600 x 15% =	£90
Additional relief due	£90

Convert additional relief to a rental business deduction :

£80 ÷ 40% =	£200
£10 ÷ 25% =	£40
£90 Relief =	£240 rental business deduction due.

Example 2 - Steve

Assume the facts are the same as for Jenny in Example 1 except that a loan of £50,000 is taken out and the interest paid is £5,000.

Mortgage interest relief

Loan attributable to private residence = £50,000 x 8/10 = £40,000

This exceeds the statutory limit (£30,000) for which relief is available. Interest relief restricted to: £5,000 x £30,000/£50,000 = £3,000

Business deduction

Loan attributable to business use = £50,000 x 2/10 = £10,000

Interest deduction available = £5,000 x 10,000/50,000 = £1,000

If the loan was in MIRAS the business deduction would still be £1,000 because the part of the loan attributable to the residential use is not less than the £30,000 qualifying maximum.

Example 3 - Sam

Sam takes out a loan of £30,000 to acquire his main residence. Two out of the ten rooms are used solely for business purposes for periods amounting to 26 weeks in the year. Total interest paid amounts to £3,000.

Mortgage interest relief

Loan attributable to private residence:

£30,000 x 8/10 + (£30,000 x 2/10 x 26/52) = £27,000

Interest relief available = £3,000 x 27,000/30,000 = £2,700

Business deduction

Loan attributable to business use =

£30,000 x 2/10 x 26/52 = £3,000

Interest deduction available = £3,000 x 3,000/30,000 = £300
If the loan was in MIRAS, Sam would have received relief on £3,000 at 15%. The business deduction would therefore be calculated as follows:

If Sam is liable at 25% -

Relief due on business deduction £300 x 25% =	£75
less MIRAS £300 x 15% =	£45
Additional relief due	£30

Convert additional relief to a rental business deduction:

£30 ÷ 25% = £120

If Sam is liable at 40% -

Relief due on business deduction £300 x 40% =	£120
less MIRAS £300 x 15% =	£45
Additional relief due	£75

Convert additional relief to a rental business deduction:

£75 ÷ 40% = £188

If Sam is marginally liable (say £200) at 40% -

Relief due on business deduction

£200 x 40% =	£80
£100 x 25% =	£25
Total	£105
less MIRAS £300 x 15% =	£45
Additional relief due	£60

Convert additional relief to a rental business deduction:

£60 ÷ 40% = £150.

Example 4 - Douglas

Facts as in Sam's case in Example 3 except that the loan is £50,000 and the interest paid is £5,000.

Mortgage interest relief

Loan attributable to private residence:

£50,000 x 8/10 + (£50,000 x 2/10 x 26/52) = £45,000

This exceeds the statutory limit (£30,000) for which relief is available. Interest relief restricted to: £5,000 x 30,000/50,000 = £3,000

Business deduction

Loan attributable to business use = £50,000 x 2/10 x 26/52 = £5,000

Interest deduction available = £5,000 x 5,000/50,000 = £500

If the loan was in MIRAS, the business deduction would still be £500 because the part of the loan attributable to the residential use is not less than the £30,000 qualifying maximum.

Example 5 - Kathy

Kathy takes out a loan of £40,000 to acquire her main residence. Three of the ten rooms are let exclusively in her Schedule A business. Total interest paid amounts to £4,000.

Mortgage interest relief

Loan attributable to private residence = £40,000 x 7/10 = £28,000

Interest relief available = £4,000 x 28,000/40,000 = £2,800

Business deduction

Loan attributable to business use = £40,000 x 3/10 = £12,000

Interest deduction available = £4,000 x 12,000/40,000 = £1,200

If the loan was in MIRAS, because the part of the loan attributable to residential use is less than the £30,000 qualifying maximum, part of the interest relating to business use will have been relieved through MIRAS.

Interest qualifying for MIRAS = £4,000 x 30,000/40,000 = £3,000

Interest attributable to private residence = £4,000 x 28,000/40,000 = £2,800

Interest attributable to business use = £3,000 less £2,800 = £200

The business deduction would therefore be calculated as follows:

If Kathy is liable at 25% -

Relief due on business deduction £1,200 x 25% =	£300
less MIRAS £200 x 15%=	£30
Additional relief due	£270

Convert additional relief to a rental business deduction:

£270 ÷ 25% = £1,080

If Kathy is liable at 40% -

Relief due on business deduction £1,200 x 40% =	£480
less MIRAS £200 x 15% =	£30
Additional relief due	£450

Convert additional relief to a rental business deduction:

£450 ÷ 40% = £1,125

If Kathy is marginally liable (say £200) at 40% -

Relief due on business deduction:

£200 x 40% =	£80
£1,000 x 25% =	£250
Total	£330
less MIRAS £200 x 15% =	£30
Additional relief due	£300

Convert additional relief to a rental business deduction :

£80 ÷ 40% =	£200
£220 ÷ 25% =	£880
£300 Relief =	£1,080 rental business deduction.

Appendix 2 - transition to new Schedule A

How to make the transition to the new Schedule A

First published in Tax Bulletin December 1995

1. From 6 April 1995, new rules apply where profits from land and property in the UK are charged to income tax. These rules are to be found in Section 39 and Schedule 6, Finance Act 1995.

2. The key changes which apply for the tax year 1995-96 and later years are that:

- profits for tax purposes must be calculated for the tax year itself - this is the year to 5 April. It is no longer possible to use a different basis period (with the exception of trading partnerships with ancillary Schedule A income - see Appendix 3); and

- the starting point for the calculation of the Schedule A income is the profit computed in accordance with normal commercial accountancy principles.

3. We have been asked to:

- provide examples of situations where transitional adjustments are necessary; and

- explain the action to be taken where a transitional adjustment is to be made in the 1995-96 assessment (because 1994-95 has already been agreed).

Transitional adjustments

4. As part of the process of moving onto the new rules, a special one-off transitional adjustment may be needed. An Inland Revenue Press Release dealing with Schedule A transitional proposals was issued on 10 February 1995 and that guidance has now been incorporated in the Revenue Guide SAT1 (1995) - Notes on the new current year basis of assessment.

5. An adjustment may be needed for two reasons:

- first, receipts or expenses may be double counted or omitted entirely because of the change from a “cash basis” or “entitlement” basis to accruals basis in 1995-96;

- second, there may be a gap between the basis periods for 1994-95 and 1995-96 which is not taxed and the profits or losses of the period are untypically high or low.

6. In some cases, both situations may apply.

7. In small cases, or cases where profits are much the same from year to year, either no adjustment will be due under transition or the adjustment will be small.

8. The transitional adjustment cannot be calculated by taking only the items which work in a taxpayer's favour; everything must be brought in. Tax Offices may make further enquiries where the computations put forward for 1994-95 or 1995-96 appear to be materially unreasonable; for example, where untypically high profits fall out of charge in the gap period. There may be special circumstances to be taken into account.

When to make the adjustment

9. As stated in our previous guidance, any adjustment should be made in 1994-95. This should still be the aim but it may not be possible if that year was settled early. In that case the adjustment should be calculated in the same way but made in 1995-96.

Situations where adjustments commonly needed

10. It is only possible to cover here the more common situations giving rise to a transitional adjustment. The examples have been simplified to illustrate the principles.

Receipts or expenses double counted or omitted

11. Receipts and expenses are taken into account in arriving at the taxable profit in different ways under the old and new rules and this means items could be counted twice or omitted altogether.

12. Double counting or omissions may arise as follows:

- receipts could be taxed twice, both under the old rules as income of 1994-95 and under the new rules for 1995-96;

- receipts could fall out of account altogether. In practice, this is unlikely unless rents are due substantially in arrear (which is not common in commercial situations);

- expenses could be deductible under the old rules for 1994-95 and under the new rules for 1995-96 - this would give a double deduction;

- expenses could fall out of account under both the old and new rules; hence the expenses are not deducted at all.

13. The general aim is to correct any double counting and omissions and to ensure that the profits or losses of any gap period (which drops out of charge) are average amounts.

14. The following examples show how the need for a transitional adjustment arises where the old Schedule A basis applied and how to compute a fair measure of relief. But similar principles may apply where furnished letting under Case VI of Schedule D has been dealt with in the past on a fiscal year cash basis. For simplicity, these examples make apportionments to the nearest month. But if the taxpayer prefers these can, of course, be dealt with on a daily basis (which is the strictly correct approach). A daily basis should also be used if the figures are substantial and a strict computation would produce a materially different result.

Example 1

15. A house is let unfurnished from 1 July 1993 onwards.

16. The following rent is charged

- £4,000 for each half year payable half yearly in advance from 1 July 1993
- £6,000 for each half year payable half yearly in advance from 1 January 1995
- £8,000 for each half year payable half yearly in advance from 1 January 1996.

17. Accounts have been prepared each year to 5 April and the profit shown in those accounts is charged for that tax year.

18. The assessments will be as follows:

1994-95

19. The assessment is based on rents to which the taxpayer was entitled in that year

1 July 1994	£4,000
1 January 1995	£6,000
Total	£10,000

1995-96

20.The assessment is based on the amount earned in that year

6 April 1995 to 30 June 1995: 3/6 x £6,000 =	£3,000
1 July 1995 to 31 December 1995:	£6,000
1 January 1995 to 5 April 1996: 3/6 x £8,000 =	£4,000
Total	£13,000

21. Note: the date the rent was due and the date the rent was paid don't affect the calculation of the rent earned.

Transitional adjustment

22 Of the 6 months rent of £6,000 due on 1 January 1995, 3 months rent has been double counted on the move to the new system. The entire £6,000 was charged in 1994-95 and £3,000 of it is charged again in 1995-96.

23. A transitional adjustment of £3,000 should therefore be made subject to any other adjustments to be made.

Example 2

24. Taking the same facts as Example 1, insurance premiums are paid annually in advance on 1 January as follows:

- £1,000 on 1 January 1995
- £1,200 on 1 January 1996

25. Relief will be due as follows:

1994-95:
£1,000 (the premium paid in the year)

1995-96:

6 April 1995 to 31 December 1995: £1,000 x 9/12 =	£750
1 January 1996 to 5 April 1996: £1,200 x 3/12 =	£300
Total	£1,050

Transitional adjustment
26.Part of the expense has been counted twice. The entire premium paid on 1 January 1995 was deducted in 1994-95 and 9/12 ths of it (£750) was also deducted in 1995-96. The taxpayer has had too much relief by £750.

Example 3

27.Bringing Examples 1 and 2 together, the transitional adjustment will be calculated as follows:

1994-95

Rent to which the taxpayer is entitled for the year	£10,000
less insurance premium for the year	£1,000
	£9,000
Less net transitional adjustment	£2,250
	£6,750

28. The transitional adjustment is calculated as follows:

Double counting of rent due (Example 1)	£3,000 +
Less insurance expense counted twice (Example 2)	£750 -
Net transitional adjustment	£2,250

29. If the 1994-95 assessment has already been finalised in the sum of £9,000, the transitional adjustment of £2,250 should be deducted from the 1995-96 assessment.

Gaps in basis periods

30. The new Schedule A rules tax the profit for the tax year. The first year to which they apply is the tax year 1995-96. This fiscal year basis is compulsory for 1995-96 and later years (apart from trading partnerships with ancillary Schedule A income). A gap may arise where the assessment for 1994-95 was not based on the results of the year ended 5 April 1995.

31. There are two separate points to note. First, the profit of the gap is not taxed. The Revenue accepts this as one of the consequences of the transition to the new system. Equally, however, any loss in the gap is not allowable.

32. Second, there can still be an unfair result where the profits or losses of the gap period are untypical. But this will only produce a material adjustment if the results of the gap period are significantly different from the results for the basis period used for 1994-95.

33. The aim in gap cases is to see whether the rate of profit for the gap period is the same as that for the basis period used for the 1994-95 assessment. To do this, it is necessary to look at the sum of the profits or losses:

- for the basis period used for the 1994-95 assessment; and
- the gap (the gap is the period which begins immediately after the basis period used for 1994-95 and runs to 5 April 1995).

34. A transitional adjustment arising because of a gap is illustrated by the following example.

Example 4

35. A cottage is let furnished. Accounts have been drawn up to 5 April each year using proper accruals accounting principles. This means that there are no adjustments due to double counting or omissions. The accounts have shown agreed taxable profits as follows:

Year ended 5 April 1993	£5,230
Year ended 5 April 1994	£6,122
Year ended 5 April 1995	£1,963
Year ended 5 April 1996	£4,875

36. By agreement between the taxpayer and the Revenue, assessments were made in the past under Case VI on a previous year basis. Without a transitional adjustment, the assessments would be:

1993-94: year ended 5 April 1993	£5,230
1994-95: year ended 5 April 1994	£6,122
1995-96: year ended 5 April 1996	£4,875

37. The profits of the gap - the year ended 5 April 1995 - are not taxed but they are taken into account in the averaging computation.

- The period to be averaged runs from 6 April 1993 (immediately following the basis period for the 1993-94 assessment) to 5 April 1995.

- The average profit for the 24 months is £8,085 (£6,122 plus £1,963). The average profit for 12 months is £8,085 x 12/24 = £4,042.

- The transitional adjustment is £6,122 minus £4,042 = £2,080. The 1994-95 assessment can therefore be reduced to £4,042.

38. If the 1994-95 assessment has already been finalised in the sum of £6,122, the transitional adjustment of £2,080 should be deducted from the 1995-96 assessment.

Double counting, omissions and gap in same case

39. Where, under the old rules, a taxpayer used the profits of an accounting period not ending on 31 March or 5 April as the basis period, it is likely that he or she will be using a method to compute profits for Schedule A that is acceptable for Case I of Schedule D. In such circumstances, it will usually be the case that taxing an average profit (as described in Example 4) will be sufficient and no other change should be needed.

40. There may, however, be a few cases where it becomes necessary to consider double counting, omissions and the gap in the same case.

Example 5

41. A house is let furnished. The profits for the tax year were based on the results of the previous tax year. Until 5 April 1995, accounts were drawn up on a cash basis. After that date, a proper system of accruals was used.

42. The annual rent is due and paid on 1 January each year. The rent due is:

1 January 1993	£8,000
1 January 1994	£10,000
1 January 1995	£12,000
1 January 1996	£18,000

43.The profits chargeable (for simplicity, ignoring expenses) are:

1993-94: year ended 5 April 1993	£8,000
1994-95: year ended 5 April 1994	£10,000
1995-96:	
9/12 x 12,000 due on 1 January 1995 =	£9,000
3/12 x 18,000 due on 1 January 1996 =	£4,500
Total	£13,500

44. A repair bill of £4,000 is paid on 10 April 1995. The bill was for repairs in the year ended 5 April 1994 but payment was delayed because of a dispute with the builder.

45. There is both an expense omission and a gap:

- the repairs of £4,000 are not included in any of the accounts including the gap account. The change to accruals accounting means it appears nowhere. So the repairs of £4,000 are deducted from the profit of £10,000 for the year ended 5 April 1994 (which is otherwise taxable for 1994-95);

- the gap is the period from 6 April 1994 to 5 April 1995. The profit for this period is £12,000 and it is not chargeable to tax. The average annual profit of the 24 month period 6 April 1993 (immediately following the end of the 1993-94 basis period) to 5 April 1995 is £6,000 plus £12,000 = £18,000 x 12/24 = £9,000. The figure of £6,000 is the profit of £10,000 for the year ended 5 April 1994 less the expenses of £4,000.

46. The 1994-95 assessment is therefore reduced from £10,000 to £9,000 by means of a transitional adjustment of £1,000.

47. If the 1994-95 assessment has already been finalised in the sum of £10,000, the transitional adjustment of £1,000 should be deducted from the 1995-96 assessment.

How to make the averaging computation

48. Note that the averaging computation is made in the same way whether the transitional adjustment is made in 1994-95 or 1995-96. Where, for example, the basis period for each tax year up to 1994-95 inclusive has been the year ended on the previous 5 April, the averaging computation does not look at the average profits of the 2 years ended 5 April 1996. The period to consider for the purposes of transition is the 2 years ended 5 April 1995.

49. A transitional adjustment should only be made in the 1995-96 assessment where such an adjustment is in the taxpayer's favour. Where a transitional adjustment increases the profits (or reduces the losses) beyond the strict statutory figure under the new rules for 1995-96, the strict statutory figure should be used with no adjustment for transition.

Disagreement: method of computation or basis periods

50. We explained our approach to disagreements about the computation for 1994-95 in paragraph 9.115 of the Revenue Guide SAT1(1995). This said:

> "Where no agreement is possible the Inspector should determine the Case VI basis period under Section 69 ICTA 1988 to correspond to the fairest possible result and assess Schedule A by reference to the profits of the fiscal year 1994-95. In both instances this should be by apportionment of profits of different accounting periods if necessary."

51.Where 1994-95 is final and there are disagreements, the transitional adjustment to be made in the 1995-96 assessment should be calculated in accordance with the above guidance. There will, of course, be no separate Case VI assessment because all UK rental profits will be included in the Schedule A computation.

Appendix 3: transition for partnerships

Basis periods - trading and professional partnerships with ancillary letting income - transition

First published in Tax Bulletin February 1996

1. Finance Act 1995 introduced new rules for calculating taxable income from UK property under Schedule A. These rules apply for income tax purposes only and apply for the 1995-96 tax year and later years. Our booklet SAT1(1995) explains the general approach to the transition from old to new Schedule A at paragraph 9.94 onwards but says nothing specific about ancillary letting income of trading and professional partnerships. This note covers several detailed points about basis periods.

Commencement of trade or profession after 5 April 1994

2. Where the trade or profession started after 5 April 1994, the partnership's rental income is immediately taxed on a current year accounts basis. The effect of this rule is that a partner's share of rental income will be assessed using the same basis period as that for trading or professional income. No special transitional problem arises and this article says nothing more about these cases.

Commencement of trade or profession before 6 April 1994

3. But if the partnership's trade or profession started before 6 April 1994, the current year accounts basis will not normally apply to Schedule A ancillary sources until 1997-98 and an extra transitional difficulty arises. Strictly, ancillary partnership rental income is taxed for 1995-96 and 1996-97 on a fiscal year basis, that is, taking the results of the years to 5 April 1996 and 5 April 1997 respectively. But for 1997-98 (and later years) the current year accounts basis must be used. In some cases this can mean that the Schedule A basis periods have to be changed from an accounts basis to a fiscal basis, and then back to an accounts basis again.

4. The rest of this article is about the way to avoid this problem.

Partnership used current year accounts basis for 1994-95

5. In Tax Bulletin, Issue 18, we said that, where a partnership's trade or profession started before 6 April 1994, we will accept that ancillary partnership Schedule A or Case VI rental income previously assessed on a current year accounts basis, including 1994-95, can retain the same basis for 1995-96 and 1996-97. A current year accounts basis will then apply under statute for 1997-98 and later years. This avoids the change of basis period for 1995-96 and 1996-97.

Partnership used previous year accounts basis for 1994-95

6. We have now been asked whether a similar approach may be used for trading or professional partnerships which started before 6 April 1994 and where Schedule A or furnished lettings income was assessed on a previous year accounts basis. It can. We will accept that a current year accounts basis may be used in 1995-96 and 1996-97 in these cases. This means that, for these cases, the transition to new Schedule A will include a change from a previous year accounts basis for 1994-95 to a current year accounts basis for 1995-96.

Partnership used fiscal year basis for 1994-95

7. The ancillary rental income of some partnerships may have been taxed up to 1994-95 on the current fiscal year basis (that is, the year to each 5 April). Here the 5 April basis should continue to be used for 1995-96 and 1996-97 and then the current year accounts basis must be used for 1997-98.

Transitional Schedule A adjustment for 1994-95 in partnership cases

8. Our booklet SAT 1(1995) explains how to work out any transitional adjustment needed because of gaps between the basis periods for 1994-95 and 1995-96 (paragraph 9.94 onwards). The calculation must be made for 1994-95 and, ideally, made in 1994-95. Where, however, the 1994-95 assessment is final and is not capable of further amendment, any transitional adjustment (calculated as for 1994-95) should be made in the 1995-96 assessment. The previous Tax Bulletin gave some examples (Issue 20 and now at Appendix 2 above). Further guidance is set out below for trading and professional partnerships which started before 6 April 1994 and which have ancillary rental income.

Transitional Schedule A adjustment -
- current year accounts basis used for 1994-95

9. There are two separate cases where the partnership used a current year accounts basis for ancillary rental income in 1994-95 and earlier years.

10. First, there is the case where the partnership decides to stay on the current year accounts basis for 1995-96 and 1996-97. Here there will be no change of basis period and no transitional basis period adjustment will be needed on this account. This approach may be preferable because it is simpler and gets the transition over quickly.

11. Second, there is the case where the partnership decides to change to the fiscal year basis for 1995-96 and 1996-97. Here there will be a gap between the 1994-95 and 1995-96 basis periods and a transitional basis period adjustment on this account will need to be considered. The partnership will have to change back to a current year accounts basis in 1997-98. The 1997-98 charge will be based on the full profits of the current year account.

Transitional Schedule A adjustment -
- previous year accounts basis used for 1994-95

12. Where a previous year accounts basis has been used in the past for rental income there will always be a gap between the basis period for 1994-95 and 1995-96. Any transitional adjustment because of the gap should be calculated using the principles explained in SAT 1(1995) and the Tax Bulletin Issue 20. There are two cases.

13. First, there is the case where the partnership decides to change at once to a current year accounts basis for 1995-96. Changing at once to the current year accounts basis may be preferable because it gets the transition over.

14. Second, there is the case where the partnership chooses to adopt the fiscal year basis for 1995-96 and 1996-97. Here the partnership will also have to change to a current year accounts basis in 1997-98.

Transitional Schedule A adjustment - fiscal year basis used for 1994-95

15. In this case there will be no change of basis period after 1994-95 because the fiscal year basis will continue to be used up to and including 1996-97. Hence no 1994-95 transitional adjustment for a gap can arise.

Identification of transitional overlap profit, or genuine overlap profit, in 1997-98

16. See Appendix 4 for further details.

Appendix 4: transition for partnerships

Basis periods -Case I/II partnerships with ancillary letting income overlap profit

First published in Tax Bulletin February 1998
This appendix deals with specific situations where:

- the non-statutory accounts basis was used for years up to 1994/5 inclusive; and

- the statutory current year fiscal basis was used for 1995/6 and 1996/7 (Section 21(2) ICTA 1988): and

- the statutory current year accounts basis applies - as it must - for all trading and professional partnerships - for 1997/8 onwards (Section 111(7) ICTA 1988)

Current year accounts basis used for 1996/7 onwards
Where the current year accounts basis has been used by concession for 1996/7 (see Appendix 3), that basis should be used for all subsequent years and no further transitional adjustment is required.

Current year fiscal basis used for 1995/6 and 1996/7
Where the strict current year fiscal basis has been used for 1995/6 and 1996/7, it is necessary to consider what adjustments are needed following the change to the current year accounts basis for 1997/8 since some Schedule A profits may otherwise be taken into account twice.

Example

ABC is a trading partnership with the following ancillary Schedule A profits (divisible equally between the three partners A, B and C):

1994/5	
ABC accounts basis for year ended 30/09/94	£10,000
1995/6	
year ended 05/04/96	£12,000
1996/7	
year ended 05/04/97	£14,000
1997/8	
accounts basis for year ended 30/09/97	£15,000

For years up to 1994/5 inclusive, the current year accounts basis had been accepted for Schedule A. And the strict current year fiscal basis was adopted for 1995/6 and 1996/7.

For 1997/8, new section 111 ICTA 1988 applies and the partners' shares of Schedule A income are assessable on a current year basis. This means that there is an overlap between the Schedule A basis periods for 1996/7 and 1997/8. And the Schedule A profits for the period 01/10/96 to 05/04/97 are brought into account twice. So the profits of this overlap period (£7,000, ignoring odd days, divisible equally between the partners) are treated as "overlap profit" giving rise to overlap relief in due course.

Overlap relief

General guidance on overlap relief may be found at paragraphs 1.81 onwards of SAT 1(1995) and the same principles may be applied to the ancillary letting income of trading and professional partnerships. Overlap relief will be given in two situations:

- at a change of basis period given by Section 62(2)(b) ICTA 1988; or
- on cessation of the trade or profession (not the cessation of the Schedule A business) when the basis period is given by section 63 ICTA 1998.

Losses

Where Schedule A losses occur, Section 63A(4) ICTA 1988 applies (by virtue of Section 111(8) ICTA) ensuring that the losses cannot be relieved more than once. If, in the example above, the accounts for the year ended 5 April 1997 showed a loss of £14,000, and the accounts for the year ended 30 September 1997 showed a loss of £15,000, the loss attributable to the period 1 October 1996 to 5 April 1997 of £7,000 (ignoring odd days)will already have been taken into account for 1996/7.

The Schedule A loss for 1997/8 (based on the accounts to 30 September 1997) must therefore be reduced from £15,000 to £8,000 (the Schedule A losses brought forward from 1996/7 amount to £14,000.

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These notes are for guidance only and reflect the tax position at the time of writing. The guide is not binding in law and in a particular case there may be special circumstances which will need to be taken into account. They do not affect any right of appeal.

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