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Simplifying tax for unincorporated property businesses

For the 2017/18 tax year a cash basis will apply to certain unincorporated property businesses. Clauses introducing the new legislation are included in the Finance Bill 2017-19 published earlier this month. Here we consider the new rules.

The Finance Bill confirms that the Government is to introduce a cash basis for certain unincorporated property businesses. A maximum limit will be imposed. The maximum entry limit for the trading cash basis has already increased from the VAT registration threshold (currently £83,000) to £150,000 from April 2017 and this figure will also be used as the entry limit for a property business to use the new property cash basis. Therefore, only property businesses which have receipts under this limit will be eligible to use the property cash basis.

The cash basis is the default for property businesses below the entry limit but there is a choice to opt out and use an accruals basis instead. Landlords who also have trading income will be able to make separate decisions about which basis of calculation is most appropriate for their trades or property businesses. They will not be required to use the same basis of calculation for both.

Cash basis for property businesses – the detail

The new rules apply for 2017/18 onwards.

Basis of calculation of profits - GAAP required

The profits of a property business for a tax year must be calculated in accordance with GAAP if Condition A, B, C, D or E is met.

Condition A is that the business is carried on at any time in the tax year by a company, an LLP, a corporate firm (i.e. a partner in the firm is not an individual) or the trustees of a trust.

Condition B is that the cash basis receipts for the tax year exceed £150,000 (pro rata where appropriate).

Condition C is that the property business:

- is carried on by an individual (P);
- a share of joint property income is brought into account in calculating the profits of the business for the tax year;
- a share of that joint property income is brought into account in calculating the profits for the tax year of a property business carried on by another individual (Q's property business); and
- the profits of Q's property business for the tax year are calculated in accordance with GAAP.

'Joint property income' means income to which P and Q are treated for income tax purposes as beneficially entitled in equal shares under s836 ITA 2007 (jointly held property held by individuals who are married/ civil partners and live together).

Condition D is that an allowance under Part 3A CAA 2001 (Business Premises Renovation Allowances) is made in calculating the profits of the property business and, if the profits were calculated using GAAP, there would be a day in the tax year on which the occurrence of a balancing event would give rise to a balancing adjustment for the tax year.

Condition E is that an election is made by the person who is or has been carrying on the property business which has effect in relation to the business for the tax year. An election must be made on or before the first anniversary of the normal self-assessment filing date for the tax year for which the election is made.

Basis of calculation of profits - cash basis required

The profits of a property business for a tax year must be calculated on the cash basis if none of the above conditions is met.

In calculating the cash basis profits, receipts of the business are brought into account at the time they are received and expenses brought into account at the time they are paid.

Although the default for both UK and overseas property businesses will be cash basis, certain specific rules still apply. These include:

- s34 ITTOIA 2005 - expenses not wholly and exclusively and unconnected losses;
- ss38-42 and 44 ITTOIA 2005 - employee benefit contributions;
- ss45-47 ITTOIA 2005 - business entertainment and gifts;
- s57 ITTOIA 2005 - pre-trading expenses; and
- ss58 and 59 ITTOIA 2005 - incidental costs of obtaining finance.

Property businesses using cash basis - capital expenditure

Special rules apply where the profits of a property business are calculated on the cash basis.

Cash basis - capital expenditure

No deduction is allowed for an item of a capital nature incurred on, or in connection with, the acquisition or disposal of a business or part of a business or education or training.

General prohibition on relief for capital expenditure

No deduction is allowed for an item of a capital nature incurred on, or in connection with the provision, alteration or disposal of:

- any asset that is not a depreciating asset;
- any asset not acquired or created for use on a continuing basis in the property business;
- a car;
- a non-qualifying intangible asset; or
- a financial asset.

An asset is a 'depreciating' asset if, on the date the item of a capital nature is incurred, it is reasonable to expect that before the end of 20 years beginning with that date the useful life of the asset will end or the asset will decline in value by 90% or more. The useful life of an asset ends when it could no longer be of use to any person for any purpose as an asset of a business.

Land

No deduction is allowed for an item of a capital nature incurred on, or in connection with, the provision, alteration or disposal of land other than expenditure that is incurred on the provision of a depreciating asset which, in being provided, is installed or otherwise fixed to qualifying land so as to become, in law, part of the land (i.e. fixtures). However, expenditure incurred on, or in connection with, the provision of a building; a wall, floor, ceiling, door, gate, shutter or window or stairs; a waste disposal system; a sewerage or drainage system; or a shaft or other structure in which a lift, hoist, escalator or moving walkway may be installed is not allowable.

Residential property lets

No deduction is allowed for an item of a capital nature incurred on, or in connection with, the provision, alteration or disposal of an asset for use in ordinary residential property (subject to new ss11A ITTOIA 2005 (replacement domestic items relief)).

An 'ordinary property business' means so much of a UK property business as does not consist of the commercial letting of furnished holiday accommodation in the UK or in one or more EEA states.

Furnished holiday lets are excluded from these rules on capital expenditure.

Intangible assets

'Intangible asset' means anything that is capable of being an intangible asset within the meaning of FRS 105 and, in particular, includes an internally-generated intangible asset and intellectual property. An intangible asset is 'non-qualifying' unless, by virtue of having a fixed maximum duration, it must cease to exist before the end of 20 years beginning with the date on which the item of a capital nature is incurred.

An intangible asset is also 'non-qualifying' if it consists of a right, whether conditional or not, to obtain an intangible asset without a fixed maximum duration by virtue of which that asset must, assuming the right is exercised at the last possible time, cease to exist before the end of 20 years beginning with the date on which the item of a capital nature is incurred.

Where the person carrying on the property business ('P') has an intangible asset and they grant a licence or any other right in respect of that asset to another person, any intangible asset that consists of a licence or other right granted to P in respect of the intangible asset is 'non-qualifying'.

Financial assets

A 'financial asset' means any right under or in connection with a financial instrument or an arrangement that is capable of producing a return that is economically equivalent to a return produced under any financial instrument.

Similar changes on deductions for capital expenditure in calculating taxable profits of trades, etc. using the cash basis are made.

Capital receipts and deemed capital receipts

New rules are introduced to deal with capital receipts under, or after leaving, cash basis.

Broadly, where:

- disposal proceeds in respect of an asset disposal are received in a cash basis tax year and a deduction for an amount of the capital expenditure relating to the asset was made in calculating profits of a tax year. If this deduction was made under GAAP, a deduction must have also been allowable if cash basis had instead been used; or
- in the year of the disposal of an asset, profits of the business are calculated using GAAP but had been previously calculated using cash basis in an earlier year and there was a deduction for the capital expenditure on that asset in that cash basis year or a GAAP year preceding it
- the disposal proceeds or capital refund are recognised as receipts in calculating the profits of the property business.

In addition, where:

- an asset ceases to be used for business purposes without an actual disposal, it is to be regarded as a disposal of the asset at market value for the purposes of s307E ITTOIA 2005; and
- if the non-business use of an asset increases, this is to be regarded as a disposal of the relevant portion of the asset at market value similarly.

Similar changes are made for cash basis trades.

Cash basis - deduction for costs of loans

S307D ITTOIA 2005 applies in calculating the profits of a property business for a tax year if Conditions A to C are met.

- Condition A is that the profits of the business are calculated on the cash basis for the tax year.
- Condition B is that, apart from s272A ITTOIA 2005 (restricting deductions for finance costs related to residential property) and s307D ITTOIA 2005 (cash basis - modification of deduction for costs of loans), a deduction for costs of a loan would be allowed in calculating the profits of the business for the tax year. Such a loan is referred to as a 'relevant loan'.
- Condition C is that L > V where L is the total loan amount for the tax year and V is the sum of the values of all the properties involved in the property business on the last day of the tax year.

The 'total loan amount for the tax year' is the business amount of that loan or, if there are two or more relevant loans, is found by calculating the business amount of each of those loans and adding them together.

The 'business amount' of a relevant loan is X/Y x A where:

- A is the amount borrowed by way of the loan;
- X is the amount of the deduction for costs of the loan that would be allowed, apart from ss272A and 307D ITTOIA 2005, in calculating the profits of the business for the tax year; and
- Y is the amount of the deduction for costs of the loan that would be allowed, apart from the wholly and exclusively rule and ss272A and 307D ITTOIA 2005, in calculating the profits of the business for the tax year.

The 'value' of a property is the total of the market value of the property at the time that it is first involved in the property business and any expenditure of a capital nature incurred by the person carrying on the business in respect of the property as is not brought into account in calculating the profits of the business for the tax year or any previous tax year.

A property is 'involved in the property business' if it is a property whose exploitation forms the whole or part of the business.

'Costs', in relation to a loan, means interest on the loan or incidental costs of obtaining finance by means of the loan.

Cash basis - modification of deduction for costs of loans

Where s307C ITTOIA 2005 above applies, the amount which is allowed as a deduction for costs of a relevant loan in calculating the profits for the tax year is the non-adjusted deduction multiplied by the relevant fraction. This is subject to s272A ITTOIA 2005 (restricting deductions for finance costs related to residential property).

'The non-adjusted deduction' means the deduction for costs of the relevant loan that would be allowed, apart from ss272A ITTOIA 2005 and this section, in calculating the profits of the business for the tax year.

'The relevant fraction' is V/L where V and L as above.

Joining and leaving cash basis

The rules relating to adjustment income apply to property businesses using the cash basis when they transition into calculating profits on the cash basis from GAAP or vice versa.

However, s331 ITTOIA 2005 is amended to add that these provisions are subject to the new s334A ITTOIA 2005, which determines the effect of spreading adjustment income on leaving the cash basis.

Ss239A (spreading on leaving cash basis) and 239B ITTOIA 2005 (election to accelerate charge under s239A) apply for the purposes the new property business cash basis. These rules require the spreading of any adjustment income over six tax years subject to an election to bring an additional amount into charge in a tax year. An election made under s239B ITTOIA 2005 as applied by new s334A ITTOIA 2005 must be made by all members of a firm where the property business this relates to is carried on by a partnership.

Where a person enters the cash basis for a tax year with unrelieved qualifying expenditure, relating to an item that would qualify for a cash basis deduction, a deduction is given for the cash basis deductible amount which would be allowed if the unrelieved expenditure was treated as paid in that year.

However, where a person enters the cash basis for a tax year with expenditure on plant and machinery that has not been fully paid for but for which capital allowances have been claimed and the asset is one which would qualify for a cash basis deduction, the difference between the amount actually paid and the amount of capital allowances received at the date of entering the cash basis is treated as a deduction of the business where the amount paid is the greater amount or a receipt of the business where it is the lesser amount.

Amendments of other Acts

CGT

The CGT rules are amended to exclude any receipts brought into account under the cash basis by new ss96A or 307E ITTOIA 2005 above from the consideration on disposal of an asset for CGT purposes.

The cash basis exemption for disposals of certain wasting assets by persons using the cash basis are also amended.

Capital allowances

Persons who have calculated profits of a trade, profession, vocation or property business on the cash basis are not generally entitled to allowances or liable to charges except for expenditure on a car.

When a person carrying on a relevant activity enters the cash basis after incurring qualifying expenditure in an earlier year, and no deduction would be allowable for that expenditure under the cash basis, the person is still liable to any charges which arise in connection with that expenditure and any a disposal value arising in connection with that expenditure is still to be brought into account.

Any unrelieved qualifying expenditure which is a cash basis deductible amount cannot be carried forward from the last day of the tax year prior to the one in which the trade, profession, vocation or property business enters the cash basis. Effectively, unrelieved qualifying expenditure on a car is carried forward.

In addition, if a trade, profession, vocation or property business leaves the cash basis in a chargeable period and the person has incurred expenditure which, if a cash basis election had not applied, would have been qualifying expenditure, then special rules apply.

If a person carrying on a trade enters the cash basis for a tax year, no cash basis deductible amount may be carried forward as unrelieved qualifying expenditure from the chargeable period ending with the basis period for the previous tax year.

For the purposes of determining the person's available qualifying expenditure in a pool, the whole of the expenditure must be allocated to the appropriate pool in that chargeable period and the available qualifying expenditure in a pool is then reduced by the relieved portion of that expenditure.

The 'relieved portion' of the expenditure is the amount of that expenditure for which a deduction was allowed in calculating the profits of the trade or a deduction would have been allowed if the expenditure had been incurred wholly and exclusively. The 'unrelieved portion' is any remaining amount.

Losses from a property business

There is no property loss relief against general income available for a business using the cash basis (s120 ITA 2007 allows loss relief against general income to the extent that it includes capital allowances).

Conclusion

As you will see there is quite a bit of detail to this simplification for unincorporated property businesses. Plenty to talk to clients about and digest.