

CHAPTER 14

PROPERTY INCOME: FURTHER ASPECTS

14.1 Furnished Holiday Lettings

[ITTOIA 2005,
ss. 322-328](#)

We need to identify any income or losses made in respect of **furnished holiday lettings**. This is because landlords with a furnished holiday let (FHL) can benefit from certain tax advantages.

However, this beneficial treatment was **not available** if the property in question was situated outside the UK. This treatment may not have been compliant with European law and therefore the rules in respect of furnished holiday lets will be reviewed and amended from 6 April 2011.

A property will be treated as a FHL if all of the following conditions are satisfied:

- a) The property needs to be **furnished**.
- b) The property must be situated in the UK. However, in the 2009 Budget HMRC stated that they will regard this condition as having been met if the property is located anywhere in the European Economic Area.
- c) The property must be **available** for commercial letting to the public **for at least 140 days in the relevant period (usually 12 months)**.
- d) Out of those 140 days, the property must **actually be let out for 70 days or more**.

Accommodation is not normally regarded as holiday accommodation where it is let for a period of "**longer-term occupation**" - i.e. a continuous period of **more than 31 days** during which the property is in the same occupation. Therefore, properties normally let on a long-term basis do not qualify.

Any such periods of longer term occupation must in any event not exceed 155 days in the tax year.

Some longer-term lettings can still qualify where circumstances giving rise to longer-term occupation are not "normal". The word "normal" ensures that genuine cases are not denied FHL relief due to exceptional and unforeseen circumstances. This will cover examples such as where a holiday-maker falls ill or has an accident and cannot vacate the accommodation on time, or where holiday visitors unexpectedly require a longer vacation. Qualifying lettings exceeding 31 days should be the exception rather than the rule, so HMRC will review such claims critically.

All of these conditions must be satisfied, and you will find them listed in Sections 322 to 326 of ITTOIA 2005.

As we have said the reason why we need to define a FHL is that landlords with FHLs can benefit from **certain tax advantages**.

[ITTOIA 2005, s. 322](#)

The first advantage of a FHL is that the landlord may **treat any profits** from that letting as **earned income**. This is important if the landlord wishes to make **pension contributions**, because the amount a taxpayer can pay into his or her pension depends on the level of their earnings.

Profits on normal letting activities are not regarded as earnings for pension purposes. We shall look at pensions in a later chapter.

Another important advantage of having a FHL comes when the letting gives rise to a loss. Under normal principles, UK property business losses are carried forward against future UK property income only. If a taxpayer makes a loss on a furnished holiday let, if he so wishes he can still carry this loss forward against future rental profits. However, with FHLs there is a more attractive alternative. **Any losses on FHLs can be set against any income** (not necessarily rental income) **in the same or the previous tax year**. This is the only time a rental loss can be set against non rental income.

For example, if a taxpayer has a FHL and makes a loss of, say, £1,000, that loss can be set against his employment income, or his bank interest, or his dividend income, to either reduce his tax liability or perhaps generate a tax repayment. This is not permitted with normal property business losses. Losses on FHLs are treated in the same way as trading losses. This will become clearer when you look at the taxation of business income.

FHLs qualify for certain capital gains reliefs that normal lettings do not. These reliefs will include roll-over relief, gift relief and entrepreneurs' relief. This will become clear when you have studied the capital gains tax part of your course.

Finally you should note that a landlord **cannot claim wear & tear allowances** in respect of furnished holiday letting. Instead, capital allowances will be available. These will be covered in the Business Tax part of your course.

14.2 Overseas property business

If a taxpayer lets out an overseas property, such as a villa in Spain, any profits are charged to income tax as income from an overseas property business.

[ITTOIA 2005, s. 269](#)

To calculate the profits on the foreign property, we use the same rules as for the UK property business - i.e. rents receivable less expenses payable - to arrive at the overseas property business profit or loss.

However, an overseas property business loss - e.g. a loss on a villa in Spain - **cannot be set off against UK property business income** - i.e. from properties situated in the UK. This also applies the other way round, so there is never any mixing of UK and overseas property business profits and losses.

If a taxpayer has an overseas property business loss, that **loss can only be carried forward and set against future overseas property business income.**

The only exception to the rule which doesn't permit the mixing of UK and overseas property business profits and losses, is if the UK property business losses are losses on a furnished holiday letting. Remember that **losses on FHLs can be set against any income in the same or the previous tax year, and any income will include income from overseas.**

14.3 Non-resident landlords

[ITA 2007, s. 971](#)

[SI 1995/2902](#)

If a tenant living in the UK rents a property from a landlord who lives outside the UK, the UK tenant is paying rents to a non-resident landlord. Even though the landlord doesn't live in the UK, he will still be taxable in the UK on his UK rental income.

HMRC has had difficulty in persuading taxpayers who live abroad to pay their tax bill, so what they ask **the tenant** to do is to **withhold basic rate tax** (currently 20%) **from the rents paid to the non-resident landlord.** If the letting is through an agent, the agent will do this on the tenant's behalf.

For example, if the tenant is due to pay rents of £1,000 to the non-resident landlord, what the tenant should actually do is send the landlord a cheque for £800 and send HMRC a cheque for the remaining £200. This is HMRC's way of at least getting some tax in the event that the non-resident landlord decides to ignore his UK tax obligations.

If the non-resident landlord prefers, he or she can make an **application** to HMRC **to receive his rental income gross** from the tenant.

HMRC will only agree to this application if the non-resident landlord promises to file a **self-assessment return and pay his income tax** in the normal way. Before agreeing the application, HMRC will look at the landlord's record for filing returns and paying income tax.

If the landlord has a good record and is up to date etc, HMRC will agree to him receiving rents gross. Otherwise the Tax Office will reject the application and seek 20% tax at source from the tenant.

If no application is made, it is the **tenant/agent's responsibility to withhold tax** from the rents before they are remitted to the non-resident landlord. To do so the tenant must inform HMRC Residency. Tax should be withheld at the basic rate and sent to the CNR **30 days after each calendar quarter.** Calendar quarters run to 30 June, 30 September, 31 December and 31 March. The tenant should continue to withhold tax until notified otherwise by HMRC.

Basic rate tax is applied to **gross rents, less any tax deductible expenses** paid by the tenant or letting agent out of the rental income.

Each year, the tenant/agent will **complete a return and submit it to HMRC**. The return is due by 5 July after the tax year and certifies the rents paid and the tax withheld.

The tenant/agent will also produce a **certificate for the landlord** showing the tax withheld from the rents. The landlord will use this certificate to complete his self-assessment return. The tax paid will be credited against any tax owing to leave additional tax due or repayable.

14.4 Real Estate Investment trusts (REITs)

[FA 2006,
s.121](#)

Companies which invest in property may elect for special rules to apply to their property business and to the profits they distribute to their shareholders. Those companies who make an election are known as UK-REITs (Real Estate Investment Trusts).

For UK-REITs, their **qualifying rental income and gains on disposals of investment properties will be exempt from corporation tax**. Any profits and gains on any other activities carried on by the UK-REIT will be subject to corporation tax in the normal way.

Dividends paid out by a UK-REIT out of tax-exempt property income or gains, will be **treated as UK property income in the hands of its shareholders** (as opposed to "normal" dividend income).

Investors will be deemed to have received a UK-REIT dividend **under deduction of basic rate income tax (20%)**.

UK-REIT dividends will therefore be taxed as **non-savings income carrying a 20% tax credit** (repayable to non-taxpayers). Dividends paid out of other profits will be treated as normal dividends for UK tax purposes.

A company can fall within the UK-REIT regime if:

- it is UK resident for tax purposes;
- its shares are listed on a recognised stock exchange;
- it distributes at least 90% its tax-exempt profits each year;
- 75% or more of its assets must be investment property;
- 75% or more of its income must be rental income; and
- no single investor is entitled to 10% or more of the shares.

[FA 2006,
s.106 & 108](#)

14.5 Premiums on leases

A "lease" is a right to occupy property for a specified period of time and, usually, for a specified rent.

A "premium" is the amount paid by a tenant to a landlord for the grant of a lease. The person who grants the lease is called the "lessor" and the person to whom the lease is granted is called the "lessee". So, any premium will be paid by the lessee to the lessor.

If a landlord owns the freehold of a property, we mean that the individual owns the land and the building outright i.e. he is not leasing it from someone else.

If the landlord grants a lease to the tenant, he is giving the tenant a right to occupy his property for a certain period of time. In return, the tenant will pay the landlord a premium for the grant of this lease. Note that the landlord still owns the freehold of the house, so when the lease comes to an end, the landlord can take the property back.

This premium is taxed in the hands of the landlord as property income. The way in which it is taxed will depend on the length of the lease.

If the lease is granted for a period of more than 50 years, there is no income tax charge. Instead the full amount of the premium will be charged to capital gains tax.

Contrast this with the grant of a lease by a landlord to a tenant for a period of 50 years or less. Leases of 50 years or less are called "short" leases. On the grant of a short lease, part of the premium received by the landlord is chargeable to income tax under property income. The part of the premium which is not charged to income tax, will instead be charged to capital gains tax.

To calculate the income tax charge we take the premium (P) and we deduct the amount which will be charged to capital gains tax (C):

Premium	P
Less: $2\% \times P \times (n-1)$	<u>(C)</u>
Property income	<u>A</u>

In the formula above, "n" is the number of years in the lease.

This amount is chargeable to income tax as property income in the year in which the premium is received by the landlord.

An alternative formula for calculating the amount of the premium chargeable as property income is:

$$P \times \left(\frac{50-Y}{50} \right)$$

Where P is the amount of the premium and Y is the length of the lease minus one year. This formula is found in s.277 of ITTOIA 2005.

If the lease provides for some rents to be paid by the tenant to the landlord for the duration of the lease, these rents are charged on the landlord in the normal way using the accruals basis.

Illustration 1

Beth owns a property and on 5 October 2010 she grants a 20 year lease on that property to a tenant called Donald. The premium paid by Donald is £30,000. As this is a short lease, some of the premium will be chargeable to income tax on Beth as follows:

Premium	£ 30,000
Less: 2% x £30,000 x (20-1)	<u>(11,400)</u>
Property income	<u>£18,600</u>

All of this £18,600 is taxed in the year of receipt - i.e. in 2010/11 - as non-savings income. The fact that it is received half way through the year makes no difference as the accruals basis only applies to rents, not to premiums.

Normally as part of the rental agreement, Donald will also be required to pay an annual rent for the use of the property. If he does, the rents receivable by Beth in 2010/11 will need to be added on to the taxable premium to give the total property income figure for the year.

14.6 Grant of a sub-lease

A slightly convoluted area is dealing with the grant of a sub-lease. We will look at these rules by working through an illustration.

[ITTOIA 2005, s.288](#)

Illustration 2

Referring back to the previous illustration, Donald has a right to occupy Beth's property for the next 20 years having paid Beth a premium of £30,000.

In March 2011, Donald decides that he no longer wishes to live in the property so he grants a 5 year sub-lease to a sub-tenant called Angela. In return Angela pays Donald a premium of £10,000 for the grant of this short sub-lease.

A premium received by a taxpayer for the grant of a short lease is partly chargeable to income tax and partly chargeable to capital gains tax.

However, where a taxpayer has a lease and from that lease he grants a short sub-lease, that taxpayer receives an allowance for part of the original premium paid.

To calculate this deduction, we take the amount chargeable to income tax in the hands of the head Landlord and multiply this by a fraction as follows:

$$\begin{array}{rcc} \text{Property Income} & & \text{Length of sub-lease} \\ \text{for Landlord} & \times & \text{Length of head lease} \end{array}$$

The calculation of the amount chargeable to income tax for Donald will therefore be as follows:

	£
Premium	10,000
Less: 2% x £10,000 x (5-1)	<u>(800)</u>
	9,200
Less: Allowance for original premium paid	
$£18,600 \times \frac{5}{20}$	<u>(4,650)</u>
Property income for Donald	<u>£4,550</u>

Example 1

Steve lets out 3 properties giving rise to the following profits and losses:

	<i>Profit/(Loss)</i>
	£
Flat in West London	(1,000)
Apartment in New York	16,000
Villa in Tuscany (long term let)	(3,000)

He has no other income.

Calculate his net income.

Example 2

Harriet grants a 25 year lease on a property to Anita on 1 January 2011.

Anita pays a premium of £40,000 plus an annual rent (in advance) of £8,000.

Calculate Harriet's property income for 2010/11.

Answer 1

	£
Profit on apartment in New York	16,000
Less: Loss on villa in Tuscany	<u>(3,000)</u>
Overseas property business profit	<u>13,000</u>
Loss on flat in London (carry forward against future UK property business income)	<u>(1,000)</u>
Net Income	<u>£13,000</u>

Answer 2

	£
Premium received	40,000
Less: 2% x £40,000 x (25-1)	<u>(19,200)</u>
	20,800
Add: Rents receivable (8,000 x $\frac{3}{12}$)	<u>2,000</u>
Property income	<u>£22,800</u>

Note:

An alternative method for calculating the amount of the premium assessable as property income is:

$$£40,000 \times \left(\frac{50 - 24}{50} \right) = £20,800$$