Think Ahead ACCA

Technical factsheet

Property tax

CONTENTS

VAT

Option to tax

When, how and why?

A taxpayer can only opt to tax bare land and/or commercial property.

The option to tax should be notified to HMRC on Form 1614A within 30 days of making the decision to opt to tax. It should also be noted that Form 1614A can now be signed and filed electronically.

It is important to appreciate that an option to tax should only be made when the taxpayer has a reason to opt to tax. This is normally linked to the recovery of input tax but it could also improve cashflow and reduce stamp duty land tax (SDLT) on a transfer of a going concern (TOGC).

Buying commercial property

VAT would be charged by the seller when they have opted to tax the property or if the property is under three years old. If the buyer is going to use the property in their taxable trade, there is no need for the buyer to opt to tax; the input tax is deductible because the property is used in their taxable activity.

If the buyer was planning to let the property, they would need to consider opting to tax as commercial rents are exempt, which would result in irrecoverable input tax on purchase of the property.

Disapplying the option to tax

There are certain instances where the option to tax can be disapplied by the prospective buyer. VAT Notice 742A Para 3.1 provides a useful summary of those instances.

The option to tax will never affect residential property, so if you opt to tax a mixed-use property (shop with a flat above), only the income for the shop will be affected, eg standard-rated rent if renting the shop out. The rent on the flat will remain exempt.

If an opted property is sold and the buyer confirms their intent to convert to residential or relevant residential on Form 1614D, the option to tax will be disapplied. If the buyer intends to convert and then sell the converted property(ies), their sale proceeds will be zero-rated. In this instance the only reason to issue the Form 1614D on purchase would be to improve cashflow and reduce SDLT.

The option to tax can also be disapplied when the buyer (or tenant) confirms charitable use of the property.

Housing associations and DIY housebuilders can also get the option to tax disapplied on bare land.

Converting property

Consider a developer buying an opted property with a view to converting the property into flats for sale.

As the developer has conversion intent, they can issue Form 1614D on or before exchange. The seller is then obligated to make the sale exempt. This may affect the seller's capital goods scheme adjustment and/or VAT recovery on the professional fees associated with the sale. Form 1614D can be issued between exchange and completion but the seller has the discretion to reject it in this instance.

Once purchased, the developer may engage subcontractors to work on the conversion. The subcontractors' invoices will be subject to the 5% domestic reverse charge or 5% VAT where the developer confirms end-user status.

The sale or long lease (>21 years) of the flats will be zero-rated, which allows input tax recovery on the conversion costs. The developer should be mindful of the blocking order within SI1992/3222 (6), which prevents input tax recovery on building materials not ordinarily incorporated into the conversion, eg white goods.

Issuing Form 1614D was motivated by the improved cashflow and reduced SDLT liability on purchase as input tax would have been deductible on purchase.

Where the developer is unable to sell the converted flats, they should consider transferring the flats to a subsidiary company so that they may let them. The transfer would be zero-rated so input tax recovery is secure for the developer. Transferring the flats will trigger a market-value disposal for direct tax purposes, but realising profits early is a positive step, with increased corporation tax rates around the corner. The SDLT group exemption means that there is no SDLT on the transfer to the letting subsidiary.

It should be noted that if the developer was planning to convert a house into flats, the conversion work would still be at 5% but the sale of the converted flats would be exempt.

When converting mixed-use properties such as pubs, it should be noted that zero-rating is reserved for those flats that came wholly from the commercial element of the property, provided that there are more residential units in the property after conversion than there were pre-conversion.

Land sales

The sale of bare land will be exempt unless the seller has opted to tax. Sellers may have opted to tax the land to secure input tax recovery on professional fees incurred when applying planning permission on the land. It will be important for the seller to charge VAT on the sale so that any input tax recovered is not clawed back via an exempt sale. If the buyer is a housing association or DIY housebuilder, they can get the option to tax disapplied.

The most common purchase would be a developer and they cannot get the option to tax disapplied.

Building new property

Input tax will be incurred when constructing commercial property. If the newly constructed property is sold, it will be standard-rated and input tax recovery on the build is secure. If the property is let, the freeholder will need to opt to tax to secure input tax recovery on the build.

Building residential property is different in that the sale of new residential property is zero-rated, so input tax recovery is secured.

Property and TOGCs

Introduction

When a VAT-registered taxpayer sells their trade and assets to a VAT-registered buyer, the sale is normally treated as the transfer of a going concern (TOGC) and is outside the scope of VAT.

This treatment would extend to partial sales of their business where the part sold is capable of separate operation – for example, the sale of one of two shops owned.

If VAT is incorrectly charged by the seller and the buyer pays it, input tax recovery by the buyer is not permitted. In this situation, recourse would be to the seller and not HMRC.

Capital goods scheme

Property costing more than £250,000 is subject to the capital goods scheme (CGS) rules, which apply for a 10-year period.

Where the seller has been operating the CGS on property that is transferred as part of outside-the-scope TOGC, the buyer will inherit the remaining CGS periods. The CGS periods are the anniversary date of the sale but they can be adjusted to the buyer's year-end with HMRC's agreement.

This issue must be addressed in the sale contract as the buyer will need all the historical information relating to the CGS calculations and adjustment up to the date of sale. This will then enable them to continue these calculations in their books.

Buyer obligations

After the sale, the business must be carried on by the buyer. This fact is normally warranted in sales contracts and is fundamental to securing the transfer of a going concern treatment.

The purchaser must be VAT-registered. Some buyers believe that they have the choice of whether to register for VAT as they may regard themselves as a start-up. They often overlook that they will inherit the turnover of the seller. Where a seller is compulsorily VAT-registered, the buyer will also be compulsorily registered from the date of purchase. They would not have the option of not registering and paying VAT on the purchase.

If the seller was voluntarily VAT-registered, the buyer could choose not to register and may well do so if they are dealing with the public (ie non-registered customers).

However, they must bear in mind that they will inherit the seller’s turnover, which could affect their position. Assuming that the buyer is still below the VAT-registration threshold, they can choose not to register. By not registering, the TOGC conditions are breached and VAT will be charged on the sale.

The buyer will need to continue to monitor their turnover level on a monthly basis. If and when they exceed the VAT registration threshold of £85,000, they will need to register for VAT at that time. If the buyer registers within four years of the trade-and-asset purchase, and still holds the assets purchased at that point, VAT on the purchase could be recovered as pre-registration input VAT.

Standard-rated property

If there is a standard-rated property within the assets transferred (eg a new freehold commercial or an opted to tax property), this will be treated in one of two ways.

If the buyer chooses not to opt to tax, the property will be transferred outside of the TOGC and will be standard-rated. Buying a property standard-rated will increase the cashflow requirement, including the effect of higher SDLT payable on the VAT-inclusive price. It will also trigger a new 10-year cycle for the capital goods scheme where the property is £250,000 plus VAT or more.

On the other hand, if the buyer opted to tax the property, it would be transferred within the TOGC and, as such, would be outside the scope of VAT. To be effective, the buyer would need to opt to tax pre-completion to ensure that the property falls within the TOGC rules. Their option to tax must be confirmed to the seller and the buyer must confirm that there will be no disapplication of the option to tax. This is normally covered within the sale and purchase agreements. This would reduce the cashflow requirement including the SDLT payable. It would also reduce the exposure to the capital goods scheme as the buyer simply inherits the remaining capital goods scheme intervals from the seller.

Tenanted property

Tenanted properties are regarded as a business in themselves and are therefore within the TOGC provisions. The purchasing landlord would be best advised to opt to tax when buying a tenanted commercial property from a landlord that has exercised their option to tax. This would secure the TOGC treatment, making the transfer outside the scope. Rent charged to tenants would continue to be standard-rated.

Landlord selling to the tenant

However, when the tenant buys the property from the landlord, this cannot be a TOGC as the property is owner-occupied post-purchase rather than tenanted. VAT would normally be charged on such purchases as the landlord is likely to have opted to tax the commercial property. This will cause cashflow issues and will increase the SDLT payable.

The simple solution is to contact the seller’s solicitors and ask how long ago the landlord opted to tax the property. If this was more than 20 years ago, the option to tax could be revoked prior to sale by the seller sending Form 1614J to HMRC. The property sale then becomes an exempt transaction. The input tax suffered by the seller on professional fees relating to the sale should be deductible under the partial exemption *de minimis* rules.

Where 20 years has not passed since the option to tax was made, revocation of the option to tax is not possible. In this situation, it is worth considering buying the property in the name of a different person to the tenant, eg the individual shareholders of a corporate tenant. They then have the potential to secure the TOGC treatment as the property is tenanted pre- and post-purchase. The buyers would need to register for VAT and opt to tax the property at the same time. The buyers would continue to rent the property to the existing tenant, eg their own trading company. Note that if the tenant is partially exempt, making more than 20% exempt supplies, then the option to tax will be disapplied under anti-avoidance rules.

Selling to one of two tenants

It should be noted that the sale of a partly tenanted property falls within the TOGC rules.

Consider a landlord owns a property that is being rented to two tenants who are currently paying standard-rated rent on the property as it has been opted to tax.

If the landlord sells the property to one of the tenants, the sale will be standard-rated unless the purchasing tenant opts to tax the property by the completion date. By opting to tax in this way, they secure the TOGC treatment and the total purchase price is outside the scope of VAT. Rent payable by the second tenant to the new tenant-buyer is standard-rated.

DIRECT TAX ISSUES FOR DEVELOPERS

Accounting and tax treatment

The purchase of the property is posted to current assets including **all** purchase costs.

All development costs are posted to current assets as incurred so we have a running cost of the development in current assets. The balance on the current asset is then transferred to P&L when the property is sold.

Finance costs are normally written off to P&L as incurred. You can capitalise finance costs into the current asset and this delays the relief until the asset is sold. With rising corporation tax rates, it is worth capitalising the finance costs so that they are matched with the profits on sale.

Property appropriations

If a trader moves a property from fixed assets to current assets, this must be treated as a market-value appropriation. This may be the case where a property developer has a fixed asset that they use in trade (eg their trading premise), and then take that building to current assets to be developed.

For CGT purposes, the trader will be deemed to have disposed of the fixed asset (to themself) at market value so a capital gain will arise. In this instance, the trader can elect not to have a CGT disposal but instead to have the cost of the stock reduced by the chargeable gain. This will reduce the gain to nil but will result in the stock having a lower cost (and therefore a higher trading profit when the stock is eventually sold).

Illustration 1

Mentos Accountants Ltd operates from two offices in East Sussex. Due to changing working practices as a result of Covid-19, the practice feels that it can operate from just the one office going forward.

There is limited demand for office buildings so the practice has decided to develop the property: a coffee shop on the ground floor and flats above. The office building cost £250,000 in June 2006. Budgeted development costs are £120,000 plus VAT. The intention is to sell the retail unit and flats post-development for £600,000.

On 15 July 2022 all staff moved to the main office and the development began. The office was worth £400,000 in July 2022.

What are the tax implications of the decision to redevelop the office for resale?

Mentos has taken a fixed asset used in its business and has appropriated this to trading stock at £400,000. A gain of £150,000 is realised.

It now has trading stock in current assets at a value of £400,000. Once developed, any resultant profit will be taxed at 19% (if sold pre-1 April 2023).
Alternatively, Mentos can make an election under s.161(3) TCGA 1992, in which case:

1. The gain of £150,000 is reduced to nil.
2. The cost of the stock in the property development business is reduced by £150,000 and will now be £250,000.
3. The resultant profit will be £150,000 higher with the election but this simply replaces the gain the practice was looking at.

No election is possible if a CGT loss is in point, ie a CGT loss stays as a CGT loss.

It would be advisable for Mentos to make the election if it expects to sell the developed property before 1 April 2023 as it will defer the company's 19% tax bill. If the sale is expected to occur on or after 1 April 2023, it would be beneficial **not** to make the election and crystalise £150,000 of profit to be taxed at 19%.

Individuals would rarely make the election as income tax rates on development profits are higher than the CGT rates – best pay 20% on the £150k gain.

If the appropriation is from trading stock to fixed assets, we also have market-value disposal but there is no relief in this case. Tax will be paid on the profit. This could be where a developer intends to long-term let their newly built (or converted/renovated) property. If they are temporarily letting until the market improves then it can stay in current assets for the time being; do include a letter-of-representation point to confirm that they still intend to sell.

It should also be noted that when moving property between 75% group companies, it has to move under the no gain/no loss rules. So if the property is sitting in current assets in one company but another company wants to occupy (or let) it, then it must be appropriated to fixed assets first and then moved under the no gain/no loss rules. This will result in a profit (or loss) in the transferor company.

Dealing with a property crash

What if residential developers experience a slowdown in the next 12 months? They may be minded to temporarily let until the market recovers. Temporarily letting a newly constructed residential property will be exempt from a VAT perspective and input tax is at risk (subject to HMRC *de minimis* rules).

To protect developers, we should always advise them to trade through a limited company. This will give them the greatest flexibility to deal with a downturn in the property market. If the developer needs to temporarily let the new homes, they could simply set up a letting subsidiary.

The property would then be sold to the newly formed letting subsidiary. This would be a zero-rated sale from a VAT perspective and input tax recovery in the development company is secured.

The sale would be free of SDLT due to the SDLT group exemption for supplies between a parent company and its 75% subsidiary. The subsidiary will be 100% owned but you only need 75% for the SDLT group exemption.

There will be a market-value uplift in the development company for corporation tax purposes as the property needs to be appropriated before it is transferred no gain/no loss to the subsidiary company. With the corporation tax rate rising to 25% from 1 April 2023, it will be an advantage to have an uplift as the uplift is currently taxed at 19%.

PROPERTY INCOME

Rental computations

Most unincorporated landlords will prepare their accounts on a cash accounting basis unless they **elect** for the accruals basis. Corporates must prepare their accounts on the accruals basis. For corporates, this will be for their accounting year while individuals will be reporting on a tax-year basis (6 April to 5 April).

Expenses are deductible from rents only if those expenses are incurred ‘wholly and exclusively’ for the business of the letting. Examples of deductible expenses will include agent’s fees and insurance.

The landlord will also get a deduction for any repair or replacement spend on the property structure itself. The landlord must, however, be wary of improving what is already there as this will result in the spend being added back, ie not allowable.

For example, if a tenant breaks a window and the landlord repairs that window, that is a repair and the costs can be deducted from rents. Repairing a broken window will not be regarded as an improvement, ie it has not enhanced the capital value of the property.

As technology develops over time, something that may once have been seen as an improvement may become a repair. For example, double glazing is now the standard and is no longer considered an improvement, so replacing single-glazed with double-glazed windows counts as allowable expenditure on repairs.

Where an item is attached to the building, it becomes part of the building and follows the same repair-or-replace rule. This includes items such as baths, toilets, washbasins and kitchen units. For example, the replacement of an old bath with a modern equivalent would be considered a repair. This is also the case where goods such as ovens and hobs fitted into units are repaired or replaced with ones of a similar standard.

Even if the repairs are substantial, that does not make them capital provided that the character of the asset remains unchanged. For example, if a fitted kitchen is refurbished – including replacement of base units, retiling, replacement of worktops etc – this will be a repair provided that the kitchen is replaced with a similar standard kitchen. If additional units are fitted, the cost of these will be capital. However, if the whole kitchen is substantially upgraded – for example, with standard units being replaced with expensive customised units – then the whole of the expenditure will be capital.

A landlord replacing a basic kitchen with a £40,000 handmade kitchen is not likely to secure any deduction for the £40,000. In the landlord’s eyes, they may have spent the £40,000 so they can charge premium rents but the law does not recognise this. If the landlord had spent £3,000 on a basic kitchen it would have been deductible; a £40,000 kitchen is simply added to the CGT base cost of the property. None of the £40,000 is deductible against rental income.

We can also adopt the same basis when repairing or replacing movable items such as a washing machine. The repair of the washing machine will be deductible. If the landlord chooses to replace the washing machine, they will secure a deduction as long as they are replacing with the modern equivalent.

If the replacement is over and above the modern equivalent, eg a washer dryer, then the landlord will have to apportion value to the improvement element (the dryer) and add that back!

Do note that when you are improving a permanent item, it is not revenue deductible at all, yet when you improve a movable item you simply add back the improvement element. Improving permanent items is, however, far more likely.

Repairs to a property after it is acquired, which are needed in order to make the property suitable for letting, are treated as capital expenditure. If the property was lettable when acquired, then you will need to adopt the normal repair versus improvement rules.

Capital allowances may be able to be claimed in respect of capital expenditure on plant and machinery used in the rental business. For example, capital allowances can be claimed in respect of vehicles, computers and tools such as ladders and lawnmowers that are used in the property business.

However, capital allowances cannot be claimed in respect of furniture and household equipment provided for use in a furnished residential property. The one exception to this is if the property is a furnished holiday letting.

Jointly owned property

Tax issues in relation to jointly owned assets are quite straightforward, right? Simply split income and gains 50:50 and if one of the co-owners dies, charge IHT on the value of a 50% interest. Job done.

Well, yes and no. This is the UK tax system, so things are never as simple as they may seem.

This section will consider jointly owned assets and in particular:

- how income is allocated between spouses/civil partners
- how income is allocated between joint owners who are not spouses.

We will concentrate on income from jointly owned land and buildings (and in particular residential dwellings) simply because these are the assets which generate the most queries.

Any legal references are to the law in England and Wales.

Legal and beneficial interests

Under English law, there can be separation of legal title and beneficial ownership. For example, those persons holding the legal title of asset (ie the owner of the property as registered at the Land Registry) may not necessarily be the same as those who hold the beneficial (ie the financial) interest.

A person can be said to have a beneficial interest in land or property if they have a right to the income from the property (or the right to a share of it), or a right to the proceeds from the sale of the property (or part of those proceeds). Beneficial owners are not registered on the title deeds at the Land Registry.

A legal interest therefore gives the owner a right of control over the property. A beneficial interest is a right to benefit from the property (ie an economic benefit). Where the legal and beneficial owners are different, the arrangement is effectively a trust under which the legal owners act as trustees and hold and control the property on behalf of the beneficial owners (beneficiaries).

Where two (or more) people buy property together, under English law they must register their legal co-ownership position as either joint tenants or as tenants in common.

A joint tenancy means that both co-owners are equally entitled to the whole property and one joint tenant cannot force a sale of the whole or part of a property without the consent of the other. On death, the deceased’s share of the property will automatically pass by survivorship to their fellow joint tenant. This arrangement is common where the co-owners are spouses/civil partners.

Alternatively, the co-owners may register their co-ownership of the property as tenants in common, which means that each owns a specified share of the property (and is free to deal with this as they choose). On death, the respective shares of the co-owners will pass in accordance with their will (or under intestacy).

Declarations of trust

Where property is registered jointly, the supposition is that beneficial interests are equal unless there is documentary evidence to the contrary.

Co-owners who wish to separate legal and beneficial ownership or who wish to record their different beneficial interests in a property can do so by a declaration of trust (DoT). This is common in situations when two people (normally non-spouses/civil partners) buy a property together and contribute unequal shares to the acquisition costs; for example, one person may have contributed more savings towards a deposit for a mortgage and may naturally want a higher interest. The owners will want to ensure that their beneficial share of the property reflects their contributions and that income from the property and proceeds of sale are thereafter divided in proportion to those contributions.

If two (or more) co-owners hold a property as tenants in common and thereafter want to change their beneficial interests, the most common way to achieve this is via a DoT. This is a specific agreement – most commonly a written document executed as a deed – which confirms the proportions in which the property will be held going forward.

The DoT sets out the economic interests of each beneficial owner and can be worded so as to give beneficial owners rights to all economic benefits or just some. For example, a DoT could give the beneficial owners a right to the rental income but not to the capital proceeds on sale.

DoTs are typically drafted by a solicitor and are relatively standard documents. Templates are available on the internet if solicitor costs are prohibitive, although care should be exercised when using these.

How property income is allocated between spouses/civil partners

The default position is provided by S.836 ITA 2007, which says that income from property held jointly by spouses/civil partners who are living together is automatically split equally between them for income tax purposes. This 50:50 rule applies regardless of whether the joint owners are entitled to benefit equally from the property.

Therefore, if a married couple (H and W) own a rental property and H is beneficially entitled to 75% of the asset and W to 25%, each would be taxable on 50% of the rental profits. Their actual beneficial interests in the property are ignored for income tax purposes.

This means that if (for example) X owns a rental property outright and wishes for some profits to be allocated to their civil partner (Y), X could simply gift a 1% interest in the property to Y. The property would then be jointly owned (and registered as such), so income would be split 50:50. This is a simple and effective solution where X essentially wishes to share the income but retain the asset.

It is important to note that S.836 only applies for the purposes of income tax. The CGT and IHT treatment follow actual beneficial entitlement. Therefore, on a disposal of the property, the gain would be split 75:25 between H and W (or 99:1 between X and Y).

Similarly, on (say) H's death, their estate would include the value of a 75% interest (in this case being 75% of the whole under the IHT 'related-property' rules).

Exceptions

There are some exceptions to the 50:50 rule, most commonly:

- income from partnerships
- income from UK or non-UK furnished holiday lettings (FHLs)
- income from jointly held shares in a close company.

Spousal or civil partner partnerships

In the case of a jointly owned (non-FHL) property portfolio, the 50:50 default position can be circumvented by spouses/civil partners forming a partnership and allocating their property business profits in accordance with the partnership agreement.

Some care needs to be taken here because, according to HMRC:

> *Joint ownership of property does not, of itself, create a partnership. There can only be a partnership if, exceptionally, the exploitation of the property constitutes the carrying on of a business jointly with a view to profit.*

To verify the existence of a partnership, HMRC will often ask to see the partnership agreement and will look to see whether the income from the property has been declared as partnership income under self-assessment. Individuals can be in partnership without having a formal partnership agreement as long as it can be established that they are '*carrying on a business in common with a view to profit'.* This requires the owners to be actively managing the properties on a day-to-day basis (rather than passively collecting rents).

In the absence of any evidence that a spousal/civil partner partnership exists, profits will be split 50:50.

Furnished holiday lets

There are no such issues with qualifying furnished holiday lets. Assuming that the appropriate letting and availability tests are met, profits are treated as arising from what is effectively a trading business and can be allocated for income-tax purposes in whatever proportions the couple so choose.

Overriding the 50:50 treatment

There may be reasons why a couple may wish for the income from their jointly held asset to be taxed in a different way.

For example, one may be a higher/additional rate taxpayer while the other may have unused personal allowances or may pay income tax at basic rate only. It may also be useful for the co-owners to reallocate income between them so that both have total income of less than £100,000 (to preserve full entitlement to personal allowances) or to bring income under the £50,000 threshold for clawback of child benefit.

If the couple wishes to be taxed in accordance with their *actual* beneficial interests in the property (thereby overriding the 50:50 default position), they can do so by making an election under S.837 ITA 2007. In practice, this is achieved by making a declaration using HMRC's Form 17 ('Declaration of beneficial interests in joint property and income'). Like pretty much everything nowadays, this can be done online.

A Form 17 election sets aside S.836 and means that, from the date of the declaration, each spouse/civil partner is chargeable to income tax on the income to which they are actually beneficially entitled. So, in the case of H (who is beneficially entitled to 75% of their co-owned rental property) and W (who is beneficially entitled to 25%), a Form 17 election would mean that rental profits are thereafter split 75:25, thereby pushing more taxable income into H's hands.

The Form 17 election cannot be used to alter the actual beneficial ownership of the asset and will not therefore permit the income from the asset to be divided in any way that does not align with beneficial entitlement. For example, if H and W own a property 75:25, they cannot use Form 17 to allocate rental income (say) 20:80. If the couple want a 20:80 split of income, they will have to take legal steps to change their actual beneficial entitlement (for example, by means of a DoT).

On receiving Form 17, HMRC may ask the couple to provide evidence that they are in fact entitled to a non-equal share in the property. *In the event of an enquiry, the onus is on the taxpayer(s) to prove that the beneficial ownership is different from the legal ownership.* Such evidence normally takes the form of a written DoT or trust deed. Attaching the DoT to the Form 17 is common practice and puts this issue to bed.

Form 17 elections are made on an asset-by-asset basis and must state the asset to which the declaration relates. The election must be signed by both and is effective from the date of the last of the couple to sign, provided it is submitted to HMRC within 60 days of that date. It cannot be backdated.

For example, if a couple wish to make an election in respect of a rental property and wish to make the new arrangement effective from 6 April 2022, they must both sign and date on 6 April 2022 and submit the election to HMRC by 4 June 2022. If the election is submitted after the 60-day time limit has elapsed, it will not take effect and a new one must be submitted. Until the new one is in place, income will continue to be split 50:50. There is no limit on the number of declarations a couple can make in respect of the same asset.

Once in place, the election will apply until either:

- the couple separate
- one partner dies

- there is a change in the couple's beneficial interests in the property.

If there is a change in the couple's beneficial interests in the property, the existing Form 17 election becomes invalid and the default 50:50 position is reinstated until such time as a new declaration is put in place.

One very important thing to note (and one that is often overlooked) is that a Form 17 declaration can only be made if the co-owners hold the property as tenants in common. Most spouses tend to hold property as joint tenants (very often the 'joint tenants' box on the Land Registry form is ticked without much thought), so if a Form 17 declaration is being contemplated, the joint tenancy would need to be severed in favour of a tenancy in common.

CGT issues

CGT follows beneficial ownership. In other words, it follows the money.

As mentioned above, neither S.836 nor Form 17 have effect for CGT, so on a disposal of the property, the capital proceeds (and, as a consequence, the resulting capital gains) will be split on the basis of beneficial ownership (as evidenced by the DoT). So if no Form 17 election has been made and income is split 50:50, capital gains may still be taxed in a different proportion.

If this is not desired, a DoT to change beneficial rights to capital proceeds can be entered into just before the sale of the property to ensure that gains are taxed in a CGT-efficient way (for example, to use annual exempt amounts, 18% bands and brought-forward capital losses). This sort of planning is rarely challenged by HMRC (even where the gap between the DoT and the sale is perilously close) because this is simply seen as the couple maximising reliefs entitled to them.

Where spouses enter into a DoT and change their beneficial rights to capital proceeds, this is a disposal by the spouse whose beneficial interest is going down. However, this is of limited concern as the transfer will be treated as taking place at no gain/no loss.

Watch out for the 'settlements legislation'

The only real danger lurking at the bottom of this particular pool is the shadow of the settlements legislation, which HMRC can (and will) use when one spouse/civil partner (typically the higher earner) tries to divert income to the other to reduce their overall income tax burden but without accompanying that with a right to capital.

A 'settlement' is widely defined and includes any disposition or arrangement that confers 'bounty' or has gratuitous intent. A transfer of assets between spouses/civil partners is therefore a settlement.

Under S.624 ITTOIA 2005, where a spouse/civil partner ('A') creates a settlement for the benefit of another spouse/civil partner ('B'), the income of the settlement is taxed on A unless:

- the gift is an outright gift of an asset

- the gift is unconditional
- the gift carries a right to the whole of the income
- the gifted property is not substantially a right to income.

The settlements legislation will be in play where a couple enter into a DoT to change their beneficial interests in a property, but the DoT deals with income only. If the DoT acts simply to divert a right to rental income from A to B but does change beneficial entitlement to proceeds on disposal, the gift can be construed as being a gift of a right to income. S.624 will then tax A on the income diverted to B, making the planning ineffective.

Therefore, where couples wish to play around with DoTs and Form 17 elections to ensure that income is 'in the right place' for income tax purposes, they must ensure that the paperwork is drafted so as to ensure that income and capital rights are aligned. If B is to be allocated (say) 80% of the rental income, B must similarly have a beneficial right to 80% of the proceeds of sale. Otherwise, an HMRC attack under the settlements legislation should be expected.

How income is allocated between joint owners who are not spouses/civil partners

The 50:50 rule in S.836 ITA 2007 only applies to spouses/civil partners living together. It does **not** apply to jointly held property in any other relationship.

Where S.836 does not apply, income (and indeed gains) are divided between the joint owners in accordance with their actual beneficial ownership.

Nor does the 'equal-split' rule apply in cases where a couple co-own property with a third (or fourth) party. Per the HMRC Trusts, Settlements and Estates Manual (TSEM9810):

> *Sometimes a married couple or civil partners hold assets jointly with others. The 50/50 rule does not apply in such cases. It applies only to income arising from property held in the names of individuals who are married to, or who are civil partners of, each other, and who live together.*

So, in cases where parents co-own a rental property with (say) their two adult children, any rental profits will be divided between the four parties in accordance with their actual beneficial ownership. No Form 17 election is necessary.

Changing beneficial interests by declaration of trust

Where the joint owners are spouses/civil partners, the DoT itself will not change the income tax position as this is determined by S.836 (which automatically divides income 50:50). The division of income will only be changed if the DoT is followed by a Form 17 declaration. Gains will be split in accordance with the beneficial entitlements specified in the DoT with effect from the date of the DoT (as S.836, and by definition Form 17, has no effect for CGT).

Where the joint owners are not spouses or civil partners, the position is more straightforward. The execution of a DoT to alter beneficial entitlement will drive the tax treatment from that point. Income and gains will thereafter be divided in the proportions specified by the DoT. No Form 17 is required. We simply follow the money.

The income tax position is very simple. Income will be split in whatever proportions the parties have agreed in the DoT. This can be tailored to the tax situations of the co-owners, so (for example) an unmarried couple can agree to divide income from their rental property in any way they choose so as to utilise allowances and tax bands in the most efficient way. This can be varied year-on-year depending on their financial circumstances.

The main issue to consider for unmarried co-owners is CGT. Where beneficial interests in the property itself (not just the rental income) are changed by a DoT, this is a disposal of an interest in a chargeable asset by the co-owner whose interest is decreasing. As this will not be a bargain at arm's length, the disposal will be treated for CGT as taking place at market value, potentially giving rise to a chargeable gain (depending on the CGT base cost – part-disposal rules will apply to determine this).

As most rental properties (FHLs excepted) are not 'business assets', deferral relief will not be available. There may be the option to pay the CGT in instalments under S.281 TCGA 1992, but this merely postpones the inevitable. And the instalments will be interest-bearing.

The solution is to draft the DoT such that it deals with the allocation of income but leaves capital entitlements unchanged. There is, then, no disposal and no resulting gain.

This will be a 'settlement' – being an arrangement that confers bounty in the form of a right to income – but as the settlements rules in S.624 only catch income diverted to spouses/civil partners, these are of no consequence.

The settlement's rules will impact on the arrangement if the DoT allocates a beneficial interest in an asset away from a parent and into the hands of a minor unmarried child. In this case, the income that thereafter arises to the child (assuming it exceeds £100 per annum) will be taxed on the parent settlor under S.629.

'Minor' children are those under the age of 18. Therefore, parents can use DoTs to divert rental income into the hands of children over 18 in order to use personal allowances and basic-rate bands (which may otherwise be wasted). This could be a useful way of funding (say) higher education costs and is more tax-efficient than simply making cash gifts from post-tax income. As a matter of good practice, if income is diverted using a DoT, the income should be paid into the bank account of the beneficiary (not the gifting parent(s)).

Example

Fred and Gina own an investment property, which is rented out and generates profits of £10,000 per annum. This income is split equally between them. Both are higher rate taxpayers. The net income (being £6,000) is gifted to their daughter, Imogen, who is 19 and at college. The gifts go towards paying Imogen's rent and college expenses.

Fred and Gina sever their joint tenancy and enter into a DoT, under which Imogen is given a beneficial right to 100% of the rental income. The DoT gives Imogen no entitlement to proceeds of sale.

For income tax purposes, Imogen has rental income of £10,000 per annum. This is covered by her personal allowances. There is no attribution of income to her parents as Imogen is over 18. Imogen now has £10,000 to spend on rents and college fees. HMRC is now helping fund her education.

Inheritance tax

Any mention of 'gifts' makes an IHT practitioner prick up their ears, so if the donor's estate has diminished as a result of the transfer of income, a potentially exempt transfer (PET) could arise. However, given that this is a gift of income, it is likely that the exemption for normal gifts out of income (S.21 IHTA 1984) would apply and a PET would be avoided.

As IHT also follows beneficial ownership, where a beneficial interest in an asset (and not just a right to income) has been shifted from person A to person B, this will be a PET, and IHT will be an issue if the donor dies within seven years.

Given the nature of the asset, business property relief is unlikely to be available. This is the case even where beneficial interests in FHLs are being transferred. (FHLs might be a trade for income tax and CGT but case law suggests otherwise for IHT.)

Stamp duty land tax (SDLT)

SDLT will always rear its head where arrangements include transfers of property interests, but SDLT is a percentage of consideration and if there is no consideration, there is no SDLT.

Remember, however, that the assumption or transfer of debt is treated as consideration for SDLT, so if beneficial interest changes are accompanied by a parallel shift in liability for a mortgage, SDLT could be payable (and at higher rates if the 'purchaser' simultaneously has another residential interest, which will often be the case).

The effects of consideration

Where the joint owners are non-spouses, a DoT to alter beneficial entitlement is more likely to be done in return for consideration.

For example, where two friends co-own an investment property and friend A agrees to reduce their beneficial interest in the property in favour of friend B, it is not unreasonable for friend B to pay consideration to friend A for relinquishing part of their rights to income and proceeds on sale.

The payment of consideration has no effect for income tax. For CGT, the consideration will act as sale proceeds as long as the arrangement has no gratuitous intent. If the transfer does not constitute a bargain at arm's length, market value will stand in place of actual proceeds.

For IHT, as long as the consideration represents fair value for the beneficial interest foregone, there is no fall in value of friend A's estate and no PET. A transfer of value will only arise if friend A is deliberately selling at undervalue.

The consideration will be liable to SDLT being an amount paid by a purchaser to acquire an interest in land. Higher rate duty will be due if friend B already owns a residential property. However, be aware that no SDLT will be due if the consideration paid is less than £40,000.

Other issues

Finally, don't forget that shifting beneficial interests in property using a DoT has non-tax considerations as well and may impact on things such as:

- mortgages – in most cases the mortgage lender will need to be informed about (and may need to give consent to) changes in beneficial ownership
- wills – these may need to be revisited if estates are changing substantially.

Invoicing a non-resident landlord

When accountants invoice a non-resident landlord, they simply have a B2B service so outside the scope of VAT. The only way it would be subject to UK VAT is if the non-resident landlord had a fixed establishment in the UK, eg staff employed by them to manage their UK property portfolio.

MTD for landlords

The digital obligations that relate to MTD for income tax from April 2024 encompass:

- the requirement to keep digital records
- the requirement to provide 'periodic' (quarterly) updates
- the requirement to provide an end-of-period statement.

Landlords with rental income over £10,000 pa will be within the MTD rules.

Digital record-keeping

The requirement for businesses to keep digital records encompasses the use of 'functional compatible software'. This term was also used in the VAT Regulations, and covers one or more software products but also includes spreadsheets, which when used together provide the following functions:

- the creation of a digital record of transactions
- the retention of that record for the requisite period required by tax law
- the submission of quarterly updates and end-of-period statements to HMRC using application programming interfaces (API) architecture

- the receipt of information from HMRC relevant to compliance with these processes using API architecture.

The precise content of the digital records in terms of the analysis of transactions will be provided by an ‘update notice’, which is to be issued under the Regulations, but it is safe to assume that it will not be much different to the present analysis on the relevant self-assessment supplementary pages – that is SA103 for the self-employed and SA105 for property businesses.

Software houses are in the process of developing bespoke landlord software, eg Xero for Landlords, FreeAgent for Landlords.

Digital records – specific content

The information that needs to be captured digitally is similar to the VAT rules in providing only a requirement for brief data items as follows:

For each transaction:

- the amount of the transaction
- the date of the transaction (according to the basis used for reporting for income tax purposes – cash accounting or full GAAP accounting under ITTOIA 2005)
- the category into which the transaction falls.

Timing of digital record-keeping

Transactions must be entered into the digital records at the earlier of:

- the deadline for submission of the quarterly update
- the point at which the quarterly submission is about to be submitted.

So, in practice, this allows record-keeping to be done at a minimum on a quarterly basis, although many advisers will probably decide that real-time record-keeping (or as near to it as possible) will be their preferred solution.

Quarterly updates

The primary legislation sets out the requirement for quarterly updates, which stands alone and separate from the requirement to file information under s8 TMA 1970 – so this requirement is imposed whether or not a business has received an s8 notice.

The regulations provide us with a lot more detail about quarterly updates.

Period during which quarterly updates required

The start date for quarterly updates is the digital start date, unless the person is exempt under the income exemption rules.

Quarterly updates must then be filed **for each business** for each quarter shown in the table below until the quarter including the cessation date for the business. If the person becomes exempt under the income-limit rules, the last quarterly update will be filed for the final quarter of the tax year before the exemption applied.

Quarter dates

The regulations (Reg 7) specify the following quarter dates:

Quarterly period	Start date	End date	Filing deadline
1	6 April	5 July	5 August
2	6 July	5 October	5 November
3	6 October	5 January	5 February
4	6 January	5 April	5 May

So every business and every person within MTD will file to the same dates and have the same due dates. This has significant implications for workflow patterns within firms.

Calendar quarter election

A person can make an election (on a business-by-business basis) for the filing intervals to be calendar quarters – ie ending on the last day of the preceding month compared with the months in the table above.

The election must be made by the due date for the first quarter's return in any tax year and will remain in force for the whole tax year and all subsequent years until it is withdrawn. Do note that the election applies on a business-by-business basis, so you will need to make the election for all businesses where a client has more than one trade or property business. In the first year of the election, the Quarter 1 period starts on 6 April; thereafter, it will start on 1 April.

Withdrawing the election will take effect for the current tax year if made before the deadline for the Quarter 1 update, and from the following year if made after that date.

Obviously, firms will wish to consider what is most appropriate for them and their clients, and the basis-period reform for trading clients may also affect these decisions, but the extra five days' filing window is useful here.

Content of quarterly updates

The specific detailed content will be identical to the current SA 105 (UK property) and the SA 106 (overseas property).

The regulations allow this to vary for different types of business, and this is likely to be the case in particular for property businesses.

For a quarterly update for the final period of the business, the update must include the date that the business ceased and a statement that, because of the cessation, this is the final update for that business.

Note that there is no declaration about 'correct and complete' for the quarterly updates, and there will be no compliance effort directed at the content of quarterly updates provided it reflects the transactions and these are recorded in compliance with the digital record-keeping requirements.

Businesses with annual turnover below the VAT registration threshold of £85,000 will be able to submit a simplified quarterly update comprising only two figures, ie total income and total expenses. Landlords will have to separately report their finance costs in order to claim the 20% tax reducer on those costs.

End of period statements (EOPS)

It is crucial to note that the requirement for the end of period statement applies to each business and is quite distinct from the quarterly updates. The EOPS relates to the **basis period** for the tax year under consideration; for landlords, this will be the year to 5 April (as it would for traders under the current year basis reform), so this will effectively finalise the four quarterly uploads.

The EOPS includes all the year-end adjustments, capital allowance claims and other reliefs relevant to the business and a declaration that the statement is correct and complete to the best of the taxpayer's knowledge. We, as agents, will therefore follow the same procedure for authorising an EOPS before submission as we now follow for a self-assessment return. A broad parallel to the EOPS is the SA 103 or SA 105, part of the current self-assessment return.

The EOPS due date is set by the primary legislation as 31 January after the fiscal year in which the accounting period ends (using the normal basis period rules for a continuing business). There is no difference in timing between submission of an EOPS and the old requirement to file a self-assessment return.

Content of EOPS

An 'end of period notice' will be issued by HMRC to specify exactly what the EOPS must include, but it will include at least the following (Reg 13):

- designatory information
- details of the relevant period to which the statement refers (ie the dates of the accounting period or basis period if different)
- the totals of the amounts falling within the specified categories of transactions for the relevant period
- details of the properties forming part of the property business
- information on:
    - adjustments, allowances, balancing charges or costs
    - losses or exemptions
    - reliefs and allowances.

Once again, the end of period notice may specify different information for different types of business.

The EOPS will be identical in terms of format to the quarterly update and, as such, will be the same information currently provided on SA 105 and SA 106. Two-line reporting is also permitted if business income is under the VAT registration threshold of £85,000.

CAPITAL TAXES

Main residence relief

Private Residence Relief (PRR) is available on the gain on your main residence. If the garden is larger than half a hectare, the garden must be required for reasonable enjoyment of the property to enjoy full exemption.

The amount of PRR will depend on your period of occupation versus period of ownership. Occupation includes actual and deemed occupation.

Deemed occupation

If a residence has been your main residence at some point then the last nine months of ownership will always be your deemed PRR. Nominations are often used to ensure that all residences will get at least the last nine months as PRR when sold.

Deemed occupation is also extended where the taxpayer lived in the property at some point before **and** after the following periods of absence:

- any period where the owner is required by their employer to work abroad
- up to four years when working away from home
- up to three years for any reason.

These periods can run cumulatively.

You are also allowed 24 months of PRR between buying and occupying, which allows for extensions etc before moving in.

Main residence relief issues on separation and divorce

Introduction

There are myriad tax issues to be considered on the breakdown of a relationship with the rules differing depending on whether it is a marriage/civil partnership or not.

PRR issues for spouses/civil partners – general principles

Spouses/civil partners are treated as a single person for PRR purposes and can accordingly only have one exempt residence between them. This will typically be the matrimonial home, which will often therefore escape a CGT charge on disposal.

This state of play operates for as long as the couple are living together as spouses/civil partners. This single ‘spousal unit’ for PRR is therefore broken on separation, at which point each party is thereafter entitled to PRR on their own main residences.

The date of separation is generally taken to be the date at which the relationship is irretrievably broken and, in most cases, has historically been signalled by one partner leaving the matrimonial home.

But these are strange times. At the moment, it may be impossible for some separated couples to physically move into separate households. This is partly due to the economic pressures we are currently experiencing; couples may no longer have the financial capacity to meet the costs of running two separate households.

It is possible to formally separate in the eyes of the law while remaining under the same roof. I don’t think we need to go into what ‘living together as husband and wife’ means as that takes us into an altogether different genre. But a couple can be living together while separated. This will not be uncommon in the current climate, so conversations might need to be had with our clients to find a separation date.

Disposals after separation – property transferred between the parties

Separation (or, more likely, divorce) will often bring about the sale or transfer or all or part of a property which had at some point been the main residence of the divorcing parties. This will constitute a disposal by the spouse/civil partner giving up their interest.

The first step is therefore to calculate the chargeable gain.

If the transfer takes place in the tax year of separation, the disposal takes place at no gain/no loss. This, it must be said, is relatively unusual as the course of the law rarely runs that quickly. Even divorces under the new no-fault divorce process are likely to take six to eight months to complete.

If this can be organised, a swift transfer brings with it the obvious advantage that the donor spouse/civil partner does not then need to worry about PRR, as there is no gain to relieve. The donee spouse/civil partner will inherit their (low?) original base cost, but this is unlikely to prove to be an issue since the likelihood is that the donee spouse/civil partner will have full PRR to shelter whatever gains arise on an eventual disposal.

But the no gain/no loss window shuts on 5 April in the tax year of separation. If the transfer takes place between the 6 April following separation and the date of the divorce, the consideration for the disposal is deemed to be the market value of the interest transferred at the date of transfer. This is because the parties (despite being estranged) are still ‘connected persons’ for CGT.

If the transfer takes place on or after the divorce (meaning the decree absolute), the parties are no longer connected persons. HMRC normally then accepts that a subsequent sale of a property by one party to the other is a ‘transaction at arm’s length’. No deemed market value is imputed and the disposal consideration is simply the money (or money’s worth) changing hands.

One word of caution here is that divorced spouses/civil partners could still be ‘connected’ for CGT by virtue of being business partners, should this business relationship still continue after the marriage/civil partnership has been dissolved. This may, therefore, act to impute a market value where one is not expected.

Where the transfer of the property is made in pursuance of a court order, HMRC practice is to deem the disposal consideration to be equal to the market value of the asset at the date of disposal. This is because an order of the court is not a ‘bargain’ between the parties as it is the court that decides the terms of the agreement, not the parties themselves. As such, the transaction cannot be a ‘bargain at arm’s length’ and S.17 TCGA therefore applies to impute market value.

However, it should be borne in mind that the open-market value of an interest in the matrimonial home is normally heavily discounted to take account of the rights of occupation of the spouse/civil partner residing in the home under the Matrimonial Homes Act 1967 (so very often a substantial discount will be in order to reflect these rights).

The basis of the valuation should be disclosed in the tax return and might thereafter be referred to the HMRC Valuation Office Agency.

Disposals after separation – property sold to an unconnected purchaser

The other option, of course, is for the couple to sell the house and divide the proceeds.

In the event of a third-party disposal of a jointly held property, the capital gain on each owner’s share of the property should be computed and reported separately.

Remember that from April 2020, the disposal – provided it produces a CGT liability – must be reported on an online Capital Gains Tax UK property disposals return within 60 days (30 days prior to 27 October 2021) of completion, together with a payment on account of the estimated CGT. An online return is required for each joint seller. No online return is therefore required for gains wholly covered by PRR.

The sale proceeds, costs of sale, costs of acquisition (including enhancement costs) and incidental expenses of acquisition should be divided between the parties in the ratio of their respective beneficial interests. These ratios may or may not be obvious.

In many cases, beneficial interests will follow the legal interests, so a husband and wife who are the joint registered owners of a property will normally each have a 50% beneficial interest.

However, if one partner has contributed towards the costs of acquiring the property or towards the mortgage payments without being a registered owner, they will have acquired an equitable interest in the home proportional to those contributions and is thereby entitled to a share of the proceeds on sale. This beneficial share will dictate the CGT treatment.

If the respective beneficial shares cannot be determined by mutual agreement, they will be determined by the courts. Where such an agreement is reached, both parties will be considered to have held their equitable interests in the home from the outset.

PRR

Once the gain is established, the next step is to work out how much PRR is due.

PRR is based on ownership and occupation. Occupation means actual physical occupation of the property as one's 'home' plus deemed occupation being periods when the CGT legislation pretends a taxpayer was living in the home even though they were not.

The final nine months of ownership is treated as occupation provided that the taxpayer had some actual occupation at some point.

Therefore, assuming that the gap between the cessation of actual occupation and the transfer of the property exceeds nine months, a chargeable gain will arise.

One side-effect of separating couples living under the same roof is that the taxpayer making the disposal is likely to have a longer period of actual occupation than they would have had if they had left the matrimonial home when the relationship failed. This may, in some cases, act to shorten non-qualifying periods for PRR.

Illustration 1

Mark and Kelly married in June 2012. In July 2012 they bought a house, in joint names, for £200,000. They each had 50% beneficial interests. The house was occupied as their main residence.

In May 2020 Mark and Kelly decided that their marriage had broken down irretrievably and decided to separate. However, Mark was unable to leave the marital home until the end of June 2020, at which point he moved into their holiday flat on the south coast of England.

Kelly continued to reside in the house after the separation. The couple were divorced in March 2022, at which point Mark transferred his half share in the matrimonial home to Kelly.

The house was valued at £800,000 in March 2022 with a 50% interest in the property valued at £350,000 with vacant possession. The Valuation Office Agency accepted that the value of Mark's 50% interest subject to Kelly's rights of occupation would be £300,000.

Mark's chargeable gain in March 2022 will be as follows:

		£
Proceeds		300,000
Less: Cost	1/2 x £200,000	(100,000)
Gain		200,000
Less: PRR	£200,000 x 105/117	(179,487)
Chargeable gain		20,513

PRR:

	Qualifying months	Non-qualifying months
July 2012 – June 2020	96	
July 2020 – June 2021		12
July 2021 – March 2022 (nine months)	9	
	105	12

Note that in the above example, as the PRR 'spousal unit' was broken at the date of separation, Mark's new home (being the holiday flat) will become a qualifying property from the date he occupies it as a home. No nomination is necessary as this property is, as a question of fact, his main residence.

However if, after the date of separation, Mark has more than one property available use as a residence (and he concurrently resides in both), he is entitled to make a nomination. The two-year time limit for nominating runs from the date of separation.

S.225B TCGA 1992

The CGT charge can be mitigated in appropriate cases by S.225B TCGA 1992.

S.225B allows the former matrimonial home to be treated as the only or main residence of the transferring spouse (Mark) from the date their occupation ceased (July 2020) until the date of transfer. In this instance, the period from July 2020 to March 2022 would be a period of deemed occupation for Mark, thereby extinguishing his chargeable gain.

However, there are some stings in this particular tail:

1) Relief under S.225B is only available where an interest in a property is transferred to a former spouse/civil partner. Therefore, where the couple is selling to an external third-party buyer, S.225B cannot extend the occupation period (even if proceeds are subsequently transferred to the former spouse/civil partner). Relief is not available for transfers between couples who are not married/in a civil partnership.

2) Throughout the period between the individual ceasing to reside in the property and the disposal to the spouse/civil partner, the property must continue to be the only or main residence of the spouse/civil partner. If the former spouse/civil partner moves out before the transfer takes place, S.225B relief will be denied.

3) An S.225B claim can only be made if the departing spouse/civil partner has not made an election for a different property to be their qualifying residence. This prevents two properties qualifying for PRR simultaneously.

Condition 3) is normally the most troublesome hurdle as an S.225B claim will not be beneficial if the departing spouse/civil partner has acquired a new residence after the date of separation (which is common) and that property is appreciating in value.

If the departing spouse/civil partner has a new residence and nevertheless wishes to make a claim for relief under S.225B in respect of the old residence, their occupation of their new residence will be treated as a period of absence until the disposal of the former marital home.

Note here that it is not possible for an S.225B claim to be varied so as to only apply for part of a period of absence (for example, to leave enough gain in charge to be covered by the annual CGT exemption).

Condition 2) above is also a potential pitfall and must be carefully navigated.

Illustration 2

James and Amy separate. James leaves the family home and moves in with his brother. James and Amy agree that Amy will buy James's share of the property for an agreed discounted value as part of their divorce settlement.

Amy puts the house on the market for sale before the divorce is finalised.

If James wishes to claim relief under S.225B and avoid a CGT liability on the disposal of his share in the property, he must transfer his share to Amy before she moves out. Otherwise, a claim will fail as the property is no longer Amy's main residence.

Given the reduction in the final period PRR exemption to nine months, it is now increasingly likely that a partner who leaves the family home as a result of separation will find themself with a chargeable gain when and if their interest in the property is sold or transferred on divorce.

Be aware that S.225B can fix this, but is not always a tool that is available.

Changes from 6 April 2023

Legislation will be introduced in Finance Bill 2022-23 that will provide that separating spouses/civil partners be given up to three years after the year they cease to live together in which to make no gain/no loss transfers.

No gain/no loss treatment will also apply to assets that separating spouses/civil partners transfer between themselves as part of a formal divorce agreement.

A spouse/civil partner who retains an interest in the former matrimonial home will be given an option to claim PRR when it is sold.

Individuals who have transferred their interest in the former matrimonial home to their ex-spouse/civil partner and are entitled to receive a percentage of the proceeds when that home is eventually sold will be able to apply the same tax treatment to those proceeds when received that applied when they transferred their original interest in the home to their ex-spouse/civil partner.

Furnished holiday lets

Furnished holiday lettings (FHLs) are a useful planning asset and should not be confined to a 'cottage by the sea'. They can easily apply to short lettings in London.

Consider a client who has held a residential buy to let in London for many years and is looking at a 28% CGT bill on a substantial gain. If they were to move the property into FHL lettings for at least 24 months before selling, then the CGT reduces to 10%. It should be noted that the qualification period was 12 months for disposals prior to 6 April 2019 but the principle was the same.

It should also be noted that FHLs are not caught by the interest restrictions from 2017/18.

The furniture will also qualify for the Annual Investment Allowance – so a full deduction when under £1m. FHL income is also treated as earned income for pension contribution purposes. In addition, FHLs are qualifying assets for business asset disposal relief and/or rollover relief – a useful destination for proceeds when selling your business.

FHLs are unlikely to qualify for 100% business property relief for IHT purposes as few will have the required level of services to be akin to a hotel.

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

- The property needs to be furnished.
- The property must be situated in the UK or any other state in the European Economic Area (EEA).
- The property must be available for commercial letting as holiday accommodation to the public for at least 210 days in the relevant 12-month period (usually the tax year).
- Out of those 210 days, the property must actually be let out for 105 days or more as holiday accommodation – the 'letting' condition.

The 105 days actual occupation test can be met by making an election to average periods of occupation of any or all of the furnished holiday lettings owned by the taxpayer. However, an averaging election has to be made separately for properties in the UK and properties in any other EEA state.

Do check the local letting rules as some areas of the UK have a short-term letting restriction of 90 days. This was initially introduced in Greater London with the objective of restricting unlicensed short letting activity eg Airbnb. The 90-day rule is expected to be introduced in other UK cities going forward.

Accommodation is not normally regarded as holiday accommodation for the purposes of the letting condition where it is let for a period of ‘longer term occupation’ – ie 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 holidaymaker 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 322-326 of ITTOIA 2005.

It is possible that a property could qualify as a furnished holiday letting in one year but fail to qualify in the next year as it was not actually let for enough days.

Where a property fails to qualify because it was not actually let for enough days, the taxpayer can make an election to treat the property as continuing to qualify as a furnished holiday letting for the first year in which the letting condition is not met and, if necessary, the next year as well. The individual must have had a genuine intention to meet the letting condition in each year.

This election must be made by the anniversary of 31 January following the first tax year in which the failure occurs.

Business rates or council tax?

From April 2023 the government is changing the rules so that second homes that are not genuine holiday lets will result in the owners paying council tax rather than small business rates.

Currently, by simply declaring an intention to let their second home out to holidaymakers, second homeowners can avoid paying council tax. However, from April 2023, to be eligible to pay small business rates, second homeowners will have to prove that their properties are:

- being rented out for a minimum of 70 days a year
- available to be rented out for 140 days a year.

Evidence is likely to take the form of a website or brochure used to advertise the property, as well as letting details and accounts.

CGT reporting

UK and non-UK residents are required to report the sale of UK residential property, and pay any CGT due, within 60 days of completion.

The sale is also reported on the individual's self-assessment return, which may well contain more accurate numbers than the in-year submission.

Using family trust for gifts of property

Consider a couple with a property portfolio who are looking for CGT and/or IHT mitigation strategies.

Placing some of their properties into a trust removes those assets from their estates while still allowing them to have a say in how the assets are used and, ultimately, whom they pass to.

Using a trust as a vehicle to hold assets is particularly valuable in circumstances where the clients would like minor children to be able to benefit from the assets without giving them full control over the asset(s) gifted.

The simplest and most common type of trust is a discretionary trust under which the trustees have full discretion over how the assets of the trust (and any income generated by those assets) is used.

The settlors will appoint the trustees and nominate persons (or a group or persons) to be the beneficiaries. The trustees will manage and control the trust. The beneficiaries are the only persons allowed to benefit from it. Eventually, when the trustees see fit, the trust will be wound up and the assets distributed to the beneficiaries.

In a typical 'grandparent' trust, the settlor would nominate their children to be trustees and the children and their descendants to be the beneficiaries. This then gives scope for any additional grandchildren to automatically become beneficiaries of the trust as they are born.

The settlors can act as trustees should they so wish. However, the settlors should be excluded from being able to benefit from the trust as this has negative tax implications.

If the settlor does not wish to be a trustee, the settlor(s) can still influence the decisions of the trustees by a non-binding letter of wishes, which sets out the settlors' hopes and desires as to how the trust fund should be managed and allocated.

A trust is created by a deed, which needs to be drawn up by a solicitor. These are standard documents and are relatively inexpensive. The solicitor would also help draft a letter of wishes.

Inheritance tax issues

A gift to a trust is immediately chargeable to IHT. However, IHT is only charged where the value of the transfer – being the value of the assets gifted – exceeds the IHT nil band. The IHT nil band is currently £325,000. For a trust with joint settlors, this means that up to £650,000 of value can be transferred to the trust without creating a liability. Such trusts are called ‘nil-band’ trusts.

A transfer in excess of the nil band will suffer an immediate IHT charge at 20%, so it is advisable to restrict the value of the gifted assets to £650,000.

The creation of a nil-band trust immediately removes £650,000 of value (£325,000 per person) from the respective estates.

If both clients survive seven years from creating the trust, this saves £260,000 in IHT. If only one of them survives seven years, the IHT saving is £130,000. If both clients were to die within seven years, the position is IHT neutral – ie the value moves back into their estate as it is now.

If the trust is a route the client wants to pursue, it would be advisable for the arrangement to be put in place as soon as possible so as to start the seven-year clock.

There will be no effect for the tenants of the properties being transferred into trust as the trust would simply agree to take over the tenancy responsibilities.

The assets in the trust are not in the estate of any of the beneficiaries. Therefore, to prevent trust assets falling outside the IHT regime completely, trusts are subject to a tax charge on their value every 10 years (a ‘10-year charge’).

This charge is 6% of the value of the trust assets in excess of the then nil band. For example, if the trust was formed by a transfer of properties with a combined value of £650,000 and those properties increased in value by 3% pa over 10 years, using the current nil band of £325,000, the 10-year charge would be in the region of £13,000. Many trustees provide for this charge by retaining some income each year to meet the liability. If the annual capital growth was 3%, the tax liability is likely to be less than this as the nil-rate band will be increased.

This charge can be avoided by winding up the trust after nine years and 11 months. Whether this is appropriate will depend on the situation of the beneficiaries at that point. Some of the grandchildren might be adults and ready to accept a share of the fund outright; this would reduce the 10-year charge. Alternatively, part of the fund could be appointed onto separate bare trusts for each beneficiary to then take outright at 18 (which again avoids a 10-year charge). These are options to be discussed with the trustees nearer the time.

Capital gains tax issues

A transfer of an asset is a disposal for CGT purposes. The donor is treated as having sold the asset at its current market value and, in the absence of any reliefs, would pay CGT in the gain arising.

No CGT would be payable on a gift to trust as a claim can be made for the gains to be deferred.

The CGT deferral is the main reason why advisers recommend the use of a nil-band trust as opposed to a direct gift of properties to children or grandchildren. No CGT deferral relief is available on direct gifts, so removing assets from the clients' estate by outright gift will come at a 28% CGT cost. The trust route avoids the 28% CGT.

It should be noted that gift relief is effectively deferring the CGT from the clients' hands into that of the next generation. If the properties are ever sold by the trust, they will have a low base cost as a result of the gift relief claim.

Stamp duty land tax issues

SDLT is paid by the purchaser of an acquisition of property. However, where property is transferred at nil consideration – for example, on a gift to trust – the SDLT is zero.

'Consideration' for SDLT includes the transfer of debt. Therefore, where a property is transferred to a trust and the trustees assume responsibility for the mortgage attached to the property, the amount of the mortgage transferred is liable to SDLT. As the purchaser would be a trust, the additional 3% SDLT surcharge will apply.

Consequently, if a property (or properties) are to be transferred to a nil-band trust as part of an IHT planning exercise, the properties should ideally be mortgage-free.

Income tax issues

The income from the transferred properties would no longer be taxed in the settlors' hands. Instead, the trustees will pay income tax on their annual trust income. This is disclosed under self-assessment in the same way as for individuals.

The tax rates are 20% on the first £1,000 of annual income and 45% thereafter.

Tax relief is available for the annual expenses of managing the trust (such as any trustee expenses or accounting/tax return preparation fees).

If we assume a 5% rental return, annual trust income would be around £32,500.

If we assume trust management expenses of £1,000 (which is reasonable for a nil-band trust holding property), the income tax would be around £13,800, leaving net income of £17,700 available to either accumulate within the trust or pay to the beneficiaries.

Each grandchild could receive an income distribution of (say) £1,650. This would carry a 45% tax credit of £1,350, equating to gross income of £3,000 each.

As the gross income would be covered by the beneficiaries' personal allowances, the tax credit of £1,350 could then be reclaimed (giving a total annual tax refund of £12,150). Managed in this way, the actual income tax paid by the trust is very small.

Income distributions do not have to be made annually to achieve this result. For example, income could be retained in the trust and then distributed in (say) year 3. Each beneficiary would then receive £9,000 of gross income covered by personal allowances with the tax credits then repaid.

Similarly, beneficiaries do not have to receive the same amount (although care should be taken to ensure that gross income distributions fall within personal allowances to maximise the tax refund).

However, I would support the idea of annual distributions as this enables the parents to then divert these sums (and the subsequent tax repayments) into products such as junior ISAs, which can then build up tax-free for the grandchild to access at 18 (in time for going to college or university, or for help in acquiring a home).

Conclusion

The IHT effectiveness of the trust option relies on both of you surviving for another seven years. The younger you start thinking about IHT planning, the better!

Growth shares

Family investment companies often use alphabet growth shares as an IHT planning option.

These shares are issued with no voting or dividend rights. They do, however, carry capital rights but only if the company's values exceed a pre-determined amount. The pre-determined amount is normally what the company is worth today – or possibly a little more so as to ensure the shares have no 'hope' value on issue.

These growth shares can be issued to the parents and then gifted to their children or issued direct to the children. The shares have no initial value.

On the death of the parent(s), any growth in the company value would be attributed to the growth shares and, as such, would be outside the parents' death estate.

Growth shares are also used on property incorporations with the same intent. This could be in conjunction with preference shares as incorporation relief is not dependent on the type of shares issued to the sole trader/partnership.

Loan companies

The 2006 IHT case of Phillips indicated that business property relief (BPR) would be available on shares owned in a loan-making company. This would be useful in a family investment structure where we can isolate the money-lending company.

The Phillips case involved a family-owned company which was financing the activities of sister companies through interest-bearing loans. When a sister company wanted to acquire assets, it would request a loan from the finance company. This would then be considered by the directors and, if the position was commercially sound, a loan would be granted. Because the finance company's activities did not amount to investment, the Special Commissioners concluded that BPR was available to reduce the value of the shares to nil for IHT purposes. The value of the shares in sister companies was also reduced to the extent of their indebtedness to the finance company.

One would have thought HMRC would take steps to counter this position but the law has not been changed and, as such, we do have IHT planning opportunities.

The company's articles must allow it to operate as a money-lending business. The familiar badges of trade should be considered and it's crucial that the business qualifies as a trade of making loans, rather than investing in loans. The terms of any loan made should be similar to loans made on commercial terms between third parties. For example, a commercial rate of interest, bearing in mind any specific circumstances, should be charged and paid by the creditor company. The loan may be unsecured. It's helpful if the money-lending business reports its income on its tax return as trade income rather than non-trade credits. The company's accounts should also make note of its trading status.

When set up correctly, the value of the loan-making company is covered by BPR and, as such, will not be chargeable on death.

DEVELOPMENTS IN SDLT AND ATED

Multiple dwellings relief (MDR)

MDR has been abolished for land transactions with an effective date falling on or after 1 June 2024.

Until 31 May 2024, MDR is a valuable relief that can be claimed when buying more than one property from the same person at the same time. The relief simply takes the total price paid and divides it by the number of properties acquired to arrive at the average price. You then work out the SDLT on the average price, remembering to apply the 3% supplement to all bands. Once you have the SDLT on the average price, you multiply the result by the number of properties acquired to work out the total SDLT due.

MDR gives you greater access to the lower bands and should produce a lower SDLT charge.

There are many cases where buyers state that they are buying two properties and claim MDR as a result.

Keith Fiander and Samantha Brower acquired a property with an annexe, garage and summerhouse, and claimed MDR on the annexe to reduce their SDLT by £10,000. HMRC denied MDR as the annexe was part of the main dwelling when acquired. The first tier tribunal and upper tribunal supported HMRC as the annexe lacked the privacy and security to be treated as separate.

Michael and Anthea Mullane acquired a property with a linked annexe. An MDR claim on the annexe reduced their SDLT to £16,400. The first tier tribunal ruled that a lack of a kitchen in the annexe meant that it could not be a separate dwelling.

Mixed-use properties

Mixed-use properties get the non-residential SDLT band, which is lower than the residential bands. There is also no 3% supplement if the individual owns another residential property.

Many taxpayers have tried to claim the non-residential rate on essentially residential property.

In the case of Nael Khatoun, his equitable interest in communal gardens did not make his £9,375,000 property non-residential for SDLT! He was seeking an SDLT refund of £861,750.

In the two cases of Hyman and Goodfellow, the court of appeal held that two large estates were residential – despite having barns, meadows and stables.

Non-residents and the 2% surcharge

For non-residents purchasing residential property from 1 April 2021, 2% is added to all the relevant bands. This can be on top of the 3% supplement and on top of the 15% annual tax on enveloped dwellings (ATED) related amount.

It will apply where the purchase is a major interest (not leasehold with seven years or less to run) and the chargeable consideration ≥ £40,000. Where this includes rent, the chargeable amount other than rent must be ≥ £40,000 and annual rent must be ≥ £1,000.

Annual tax on enveloped dwellings (ATED)

ATED is an annual charge on high-value UK dwellings held in a corporate. High value is over £500k at 1 April 2017 or acquisition date if later, but this has now been reset to 1 April 2022, which will impact 2023/24 liabilities.

The annual ATED charges have also increased by 3.1% for 2022/23. For properties between £500,000 and £1m, the annual charge is £3,800. The rates increase in bands up to a top rate of £244,750 for properties over £20m.

It should be noted that ATED returns are due for the year to 31 March but the return (and tax) is due by 30 April in the ATED period, ie within 30 days of the start of the year!

With the April 2022 valuation reset, some clients would be coming into ATED for the first time from April 2023. Care should be taken to communicate the impact of ATED to clients well before the end of April 2023.

In the year of acquisition, the return (and tax) must be submitted within 30 days of completion (extended to 90 days for new builds).

A company can claim an annual exemption from ATED if the property held is:

- let to an unconnected third party
- part of a development trade
- used by an employee owning < 10% of the company
- a farmhouse.

The exemption will need to be claimed each year.

This factsheet has been compiled by Dean Wootten, CPD lecturer and tax consultant.

JUNE 2024