Finance Bill 2016 cl 26 – relief for finance costs related to residential property businesses

OMB

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FB 2016 corrects drafting errors but fails to rectify the anomaly for interest in possession trusts.

Clause 26 rectifies drafting errors in the legislation introduced by Finance (No 2) Act 2015 s 24. Unfortunately the amendments fail to address the anomaly raised by the CIOT in 2015 – that is, its application to interest in possession (IIP) trusts and personal representatives (PRs) that carry on a property business in circumstances in which there is low or nil net rental income after finance costs. The current tax treatment undermines the basis of taxation of an IIP trust and, perhaps to a lesser extent, of PRs. The CIOT has therefore reiterated the need for further amendment.

Suppose a property is let for £20,000 a year net of allowable deductions and the interest charge is also £20,000 a year. If the property is held in trust and the life tenant is a basic rate taxpayer, the trustees would have to pay tax at the basic rate on the gross rental income (20% x £20,000 = £4,000). In such cases there will not be enough net rental income to meet the trustees' tax liability. Accordingly, their liability will have to be met out of other income or capital of the trust to the detriment of other beneficiaries. This is especially difficult if there is no other income and trust capital is illiquid.

A basic rate paying life tenant can then reclaim the tax paid by the trustees because there is no liability on the disallowed interest due to the availability of the tax reducer (tax due £4,000 less tax reducer of £4,000). Despite there not being any income in the trust to which he is entitled, he or she would benefit from the tax paid by the trustees to the detriment of the remainderman.

If PRs or IIP trustees have significant finance costs, it will be a problem. This will be particularly so for IIPs. For PRs, although they would have to find the tax from other capital, the legatee receiving the diminished capital may well be the same person who was getting the income anyway, so it would come out 'in the wash'. This would not be the case for an IIP because the life tenant and remainderman would be different people and the former ends better off at the expense of the latter.
Since PRs and IIPs are basic rate taxpayers, it would be better to exclude them from the provisions in the same way as non-resident companies are excluded by virtue of ITTOIA 2005 s 272A(5). In that way the trustees or PRs would pay basic rate tax on the net profit. The disallowance would then be made at beneficiary or legatee level (with a corresponding reducer) in the same way as if the rental business was carried on by the individual. This would reflect the underlying principle of an IIP trust that the beneficiary is treated as though they own the asset directly because they have the entitlement to the income.