Air and water

JULIE BUTLER considers tax issues likely to affect those renting out rooms and grander estates.

There is much change in the world of property letting. The recent tax changes to interest for buy-to-let loans, the furnished holiday lettings and 'rent a room' rules, and the explosive impact of Airbnb on the property market, have all resulted in a time for planning and fresh thinking. On the subject of Airbnb, I suspect that the air in more than a few households may have turned blue recently if their owners or tax advisers noticed the statement at section 3.22 of the Budget *Red Book* (tinyurl.com/gted9ff): 'Rent-a-room relief – The government will consult on proposals to redesign rent-a-room relief, to ensure it is better targeted to support longer-term lettings. This will align the relief more closely with its intended purpose, to increase supply of affordable long-term lodgings.'

Although good news for hotel and B & B owners, this will not be welcome for the many homeowners who have benefited from occasional, or perhaps even more frequent, lettings through the internet-based business since it was set up in 2008. Throw into the mix the possible consequences of Brexit and it is necessary to look at the tax implications of property income 'in the round'.

Restrictions of loan interest

New rules involve the gradual reduction of income tax relief on finance costs (in essence, tax relief on loan interest paid) starting from 6 April 2017, but there is time to plan a strategy around commercial and income tax efficiency. There is no doubt that such changes could be a negative for prospective new landlords (professional property owners) wanting to enter the buy-to-let property market and will result in the consideration of other property income options.

From 6 April, the tax relief for interest on a loan to purchase a buy-to-let property will reduce from the present full relief on the interest paid given as a deduction from income (and therefore relief being given at the taxpayer's highest rate of tax) to a tax deduction at the 20% basic rate. The change will be phased in as shown in ***Interest Reductions***.

KEY POINTS

- Recent changes to property tax should prompt a review.
- Tax relief for interest is being progressively reduced.
- Tax and lettings through Airbnb.
- The tax implications of the *Stocks Fly Fishery* case.
- Inheritance tax business property relief requirements.

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Airbnb and rent-a-room

It seems that professional property owners have turned to Airbnb in record numbers as a result of the tax changes and this is probably why they are now under scrutiny. This internet business was set up in 2008 to allow homeowners to let spare rooms or entire properties for short periods. A growing number of landlords are using the website as a business and many consider that the website is changing the whole hotel and property letting industry. The question is what is the tax treatment moving forward?

Historically, some of these Airbnb property lettings have been covered by the rent-a-room relief, which allows an amount of rental income to be received tax-free from the letting of furnished accommodation in the taxpayer's own home. The limit of the relief was set at £4,250 a year for many years, but was raised to £7,500 a year from 6 April 2016. The higher amount makes a claim for this relief far more attractive, so it is important to clarify for clients when rent-a-room relief can or cannot be used. For example, the relief cannot be used when:

- the area is not a furnished room (such as a garage or driveway);
- the room is let as an office rather than residential accommodation; or
- the home is not occupied by the person who receives the rent.

Note that the rent-a-room provisions cannot apply to an activity carried on in partnership. However, if it could be shown that one of the partners carries on the letting in their own name, even though they are using a partnership asset (say a farmhouse), relief should be due.

Even though the rent-a-room threshold may have been exceeded, it is still possible to deduct the threshold amount as notional expenses as an alternative to claiming actual expenses. Note also that the threshold limit is shared equally between a married couple.

INTEREST REDUCTIONS

Year	*Proportion of Interest allowed as a deduction from income*	*Proportion of interest allowed as a 20% tax deduction*
2016-17	100%	0%
2017-18	75%	25%
2018-19	50%	50%
2019-20	25%	75%

HMRC may argue that contributions paid by adult children towards the household bills of the family home should be taken into account for the rent-a-room relief calculations. This is nonsense because rent-a-room relief is there to provide a tax exemption for income which would otherwise be taxed as profits (ITTOIA 2005, s 786). The financial arrangements between a parent and child are never intended to create a trading profit, so should be excluded from the calculations.

HMRC's guidance (tinyurl.com/z4jdgb2) confirms that relief is also available if the letting activity amounts to a trade – 'for example, if you run a guest house or bed and breakfast business, or provide services, such as meals and cleaning'.

Substantial letting income – a trade

Whether property letting is a trade is a question of fact, determined by reference to any other services that are provided as well as the accommodation. A guest house or bed and breakfast, for example, would be regarded as a trade. Another point to consider is when the property is also occupied by the owners. A plan for claiming expenses on such a trading activity would be to include all of the household running costs. These would then be reduced by a proportionate amount under the fixed rate scheme, as set out in ITTOIA 2005, s 94I ('Premises used both as a home and as business premises').

Furnished holiday let

There are many who are advising that the advantageous furnished holiday letting (FHL) accommodation tax rules could be an alternative to straightforward buy-to-lets and some argue that this is being fuelled by the Airbnb website. On the downside, FHL owners may consider themselves aggrieved by the change in tax rules from April 2011, under which any such letting losses could no longer be offset against total income. Instead, they had to be carried forward against future income from the same source (FA 2011, Sch 14 inserting ITA 2007, s 127 and s 127ZA).

As well as loss relief being restricted, claims to inheritance tax business property relief in such cases have come under persistent attack from HMRC, most prominently perhaps in *Pawson deceased v HMRC* [2013] UKUT 50(TCC). However, what has remained in the FHL regime are the positive capital gains tax reliefs.

Those renting property might therefore consider turning a straightforward buy-to-let property into an FHL with help from Airbnb. The disposal of the property can qualify for three reliefs – rollover, holdover and entrepreneurs' relief. This could provide the disenchanted 'buy to letter', who is bemoaning the restrictions on loss and interest relief, the way out that they are looking for.

Digital recording and cash basis

Landlords will not be exempt from having to update HMRC quarterly or keep their records digitally. There are some software options already on the market to help with this dramatic change. As announced in Budget 2017, quarterly reporting for most landlords and the self-employed whose turnover is less than the VAT threshold has been deferred and will now start from 6 April 2019.

Repayment and financial costs

A possible consideration for buy-to-let landlords who are already higher rate taxpayers, typically those who have high proportions of borrowing or a large property portfolio (with relatively high proportions of borrowing), is to sell other assets (say, stocks and shares). From 6 April 2016, the 20% rate of capital gains tax and the annual capital gains tax exemption (currently £11,100) could be used to realise assets and the sale proceeds could repay loans. If there is a larger portfolio of buy-to-lets, an alternative course of action might be to sell a property that has the least potential capital gains tax liability and use the proceeds to repay some or all the portfolio borrowings. Clearly such a scenario is one in which investment advice and tax advice will merge and possibly conflict. Landlords must take good investment advice to help with the decision-making. There is then the consideration of moving some of the property already held to furnished holiday accommodation to claim the maximum tax relief on the interest.

For landlords who own perhaps only one or two buy-to-let properties, these changes are unlikely to cause them to consider disposing of other assets. However, it is important that buy-to-let investors of all types are aware of the impact of the changes on their own circumstances.

Action plan

The question of letting or trading with property income is at a crossroads in terms of tax treatment, opportunity (such as Airbnb) and decisions over best financial returns. There is no doubt that some of the recent tax changes, for example, the rent-a-room increase and the reduction in tax relief on loan interest, will leave taxpayers reviewing commercial considerations.

The waters will be further muddied by the 2017 spring Budget announcement. In the meantime, professional advice will be required on the best decisions for tax savings, increasing income returns, and commercial and legal efficiency. More complex decisions of moves to the corporate structure are on the horizon for larger operations. Good luck to all those involved in the decision-making.

Something fishy

Many tax practitioners will have clients who let rooms or one or two properties; however, the tax treatment of sporting rights over land is complex. For example, in general terms, VAT is chargeable at the standard rate on the letting of fishing rights and the sale of fishing permits. Fish sold for human consumption, however, are zero-rated. On the other hand, the supply of fish to stock waters is standard-rated rather than zero-rated as food. Input VAT is

fully claimable on this expenditure by the business operating the fishing activity. Of course, if the fishing operation is too small to be VAT-registered it cannot reclaim the input VAT.

A First-tier Tribunal case, *Stocks Fly Fishery* (TC4994 – tinyurl.com/jowde7a), considered the VAT treatment of the interaction of the letting of fishing rights and the sale of fish with regard to standard and zero-rated supplies and helps to give some guidance of the tax treatment.

The *Stocks Fly Fishery* case

The facts of the case were that Stocks Fly Fishery argued it was making two supplies. One was the sale of fishing permits or tickets and the other was, in the opinion of the business, the sale of zero-rated supplies.

Anglers who wished to fish at Stocks Fly Fishery had to buy a ticket in advance. It could be a sporting ('catch and return') ticket for £17.50 or a 'take' ticket for £24, which gave the right to catch and keep up to five fish. Stocks Fly Fishery argued that the difference between the two prices should be zero-rated because it related to the sale of fish. HMRC disagreed, saying there was a single standard-rated supply of the right to fish in the reservoir. The tribunal upheld HMRC's view that Stocks was not making two transactions but one: the principal standard-rated supply of fishing. Obviously, because most customers are not VAT-registered the decision represents a disadvantage to the fishing community.

One transaction of fishing

In the view of the tribunal in *Stocks Fly Fishery,* fishing was the essential feature of the transaction. Such a consideration was the main motive of anglers going to the fishery. The judge said: 'When it comes to anglers with take tickets, this is not, in our view, at the time of supply, a sale of fish (even contingently). This is because there is no guarantee (or, put another way, any contractually enforceable promise) that any fish will be caught, much less any such guarantee or promise that an angler will catch the authorised bag. Ultimately, the bag depends not only on the skill and determination of the fisherman but also good, old-fashioned luck.'

It was considered by the tribunal that taking away fish was ancillary to the principal supply of the activity. The decision can be understood to reflect the facts that no part of the fee relates to the sale of fish because there is a chance that no fish will be caught. However, the decision does not reflect the commercial necessity many would consider. The *Stocks Fly Fishery* case shows it is possible for a single supply of fishing outcome even if separate elements are being sold. This is really negative for the sport of fishing. VAT planning around 'members' clubs' and the like can be considered, but in light of all the other taxes.

Fishing and income tax

With this negative result some fishing enterprises might consider operating as a separate trade that is below the VAT limit. The disadvantage of this direction is the concern over artificial separation and the risk of losing inheritance tax reliefs.

In general, income from the letting of sporting rights over land will be treated as income from land. Sporting rights include the right to fish and/or take the catch. If the income is small relative to other trading income, it may be included as part of the trade. There might seem a contradiction with regard to VAT and income tax in that the granting of sporting rights is standard-rated, but income from land is normally an exempt supply. It may therefore be argued that standard-rated supply reflects trading and a serviced activity.

If the fishing rights are exploited commercially – in other words run as a trade by the owners rather than simply let – the activity would be treated as a trade. To qualify as such, the landowner would have to operate the fishing as a business; issuing permits and licences, maintaining the fishing waters and incurring bailiff and/or keepering expenses where appropriate. Merely granting the rights to a fishing club, for example, while retaining the maintenance and keepering of the fishing waters may not be enough to qualify as a trade because it could be argued that these are simply the actions of a landlord.

With the current stance of HMRC on the definition between income from land and trading activity in so many areas of farm diversification, such as holiday lets and DIY livery, this decision highlights the need to be careful with sporting rights disclosure at so many tax levels. On the year-end calculation of the stock of fish for income tax, they are *ferae naturae*, which means they cannot be owned so have no value for tax purposes.

Inheritance tax and capital gains

To qualify for inheritance tax business property relief (BPR), the activity under review must be deemed to be a business or a trade. The importance of trading and not simply letting sporting rights will be key to protecting business tax reliefs. If the letting of sporting rights is part of an overall trade or estate with a great deal of trading activity, relief can be achieved.

The principle of the *Earl of Balfour v HMRC* (2009) UK FTT 101) will help here because the land and property income can be part of the overall trading activity if the trading income exceeds the property income. A full and detailed fact find of the whole operation must be undertaken to ensure that the VAT and tax compliance is correct before moving forward with overall tax planning. To achieve more favourable business capital gains tax reliefs, for example the 10% entrepreneurs' relief tax rate and rollover relief to shelter the gain, again it is essential that there is a trading activity on the land.

Action plan

In light of *Stocks*, it is essential that the overall tax treatment of commercial (and non-commercial) fishing operations is considered 'in the round'. With the increased interest in UK holidays post-Brexit, fishing can play a large part in potential holiday businesses. Fishing operations represent healthy diversification for landowners and it is vital that the overall tax position, including VAT, is understood by their advisers. ■

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