Tax-free accommodation

by Julie Butler

With rising house prices regularly making headlines, the question of tax-free accommodation for employees is of greater interest to the tax planner.

Are there employees who could qualify under the 'necessary' or 'customary' rules? Are opportunities being lost? Can tax relief be maximised under the lease premium scheme or tax planning consideration be given to joint ownership? While employees enjoy this tax-free benefit are they still managing to shelter a tax-free gain through principal private residence relief (PPR) on their 'own' property? Has the problem of shadow directorship been given due consideration? Has stamp duty land tax (SDLT) and value added tax (VAT) been considered? Are there proactive ways that accommodation can be included in a remuneration package? Can new packages be geared towards the inclusion of accommodation? Is there a way that the provision of 'accommodation' can pass from employer to employee without triggering a tax liability?

Provision of living accommodation for an employee is potentially taxable earnings under general principles. Living accommodation includes all kinds of residential facilities e.g. mansions, houses, flats, houseboats, holiday homes or apartments – but not overnight or hotel accommodation or board and lodging (See *Inland Revenue Employment Income Manual* (EIM)11321 *Accommodation: meaning of living accommodation*).

Whether such accommodation is provided for an employee is a question of fact – (EIM11405 *Living accommodation: meaning of provided: the legislation*, EIM11406 *Living accommodation: meaning of provided: practical considerations*). In *Nicoll (HMIT) v Austin* KB (1933–1935), 19 TC 531, a company maintained a large house owned and occupied by its managing director and controlling shareholder, paying the rates, fuel bills and other outgoings. The expenditure was held to be assessable on him as emoluments of his office. There is an anti-avoidance measure aimed at salary sacrifices. (*Income Tax (Earnings and Pensions) Act* 2003 (ITEPA 2003), s. 109; *Income and Corporation Taxes Act* 1988 (ICTA 1988), s. 146A; *Finance Act* 1996 (FA 1996), s. 106(2)(3).)

For any employee the basic charge is the 'cash equivalent' of any living accommodation provided to him, or to members of his family or household, by his employer for any period during or comprising a tax year. The 'cash equivalent' of the provision of accommodation for a period is the 'rental value' of the accommodation for that period less any sum made good by the employee to the person at whose cost the accommodation is provided attributable to that provision. This is relatively easy to calculate when the employer rents the accommodation. When the accommodation is owned by the employer, the tax charge is based on the gross rateable value (GRV) which is a rather complex calculation.

One tax planning opportunity that can be considered is to have the accommodation provided by someone other than the employer. However, a charge similarly arises where the accommodation is provided by a third party, someone other than the employer, but 'by reason of' the employment, i.e. where the accommodation would not have been provided, but for the employment. In practice the Inland Revenue normally assume that a benefit which is provided by someone other than the employer, but which is plainly connected with the employment, has been provided by reason of the employment. (EIM 11408, 20503 *'By reason of employment': provision by third party*).

So how can the provision of accommodation fall within the 'tax-free' status?

The 'necessary' rule

Part 3, Ch. 5 of ITEPA 2003 does not apply to living accommodation provided for an employee, if it is necessary for the proper performance of their duties that the employee should reside in the accommodation provided. The proper performance exemption does not apply to directors (see EIM 11366 *Living accommodation: directors*) unless for each such directorship he has no material interest in the company (i.e. broadly if his and/or his associates' interests in the company do not exceed five per cent and either he is a full-time working director or the company is non-profit-making (i.e. it does not carry on a trade nor is its main function the holding of investments or other property) or the company is established for charitable purposes only. (ITEPA 2003, s. 68, 99(3)-(5); ICTA 1988, s. 145 (5)(8).)

The 'customary' rule

The exemption applies where both the following are achieved:

- the accommodation is provided for better performance of the duties of the employment; and
- the employee's employment is one where it is customary for employers to provide living accommodation for their employees.

As with the proper performance exemption, the 'better performance' test is an objective one imposed by the duties of the employment. In particular, the fact that the accommodation is near to the employee's work will not carry any weight (EIM 11349 *Living accommodation Exemption: the better performance test*). The Revenue's view is that 'a practice is customary if it is recognisable as the norm and if failure to observe it is exceptional' (EIM 11347 *Living accommodation: the customary test*).

The Revenue will accept that the 'better performance' test is met where:

- the employee is on call outside normal hours; and
- he is in fact called out 'frequently' (not defined); and
- 'the accommodation is provided so that the employee may have quick access to the place of employment or other place to which the employee is called' (EIM 11350 *Living accommodation: practical consideration*).

So what classes of employee get the living accommodation exemption available under ITEPA 2003, s. 99(2)? (See EIM 65799.) They are:

- police officers (see EIM 68150 *Living accommodation provided by police authority*), Ministry of Defence police,
- prison governors, officers and chaplains (see EIM 68310 *Living accommodation provided by the prison authority*);
- clergymen and ministers of religion - unless engaged on purely administrative duties – (see EIM 60020 *Provided living accommodation*);
- members of HM Forces;
- members of the Diplomatic Service;
- managers of newsagent shops that have paper rounds, but not those that do not;
- managers of traditional off-licence shops, that is those with

opening hours broadly equivalent to those of public houses, but not those only open from 9am until 5pm or similar;

- in boarding schools where staff are provided with accommodation on or near the school premises, the head teacher, other teachers with pastoral or other irregular contractual responsibilities outside normal school hours (for example housemasters), the bursar, matron, nurse and doctor; and
- stable staff of racehorse trainers who live on the premises and certain key workers who live close to the stables.

There are some classes of employee for whom the Revenue accept that the customary test is met, but for whom the better performance test has to be considered in each individual case. For example, veterinary surgeons assisting in veterinary practices and managers of camping and caravan sites living on or adjacent to the site will be accepted as meeting the test that provision of accommodation is 'customary', but must individually satisfy the test that the provision is for the 'better performance' of their duties. (See EIM 11346 *Living accommodation: customary and better performance* and following.)

It might seem unnecessary to list all the above, but there could be opportunities to provide tax-free accommodation not currently provided, but allowable.

The 'customary' rule again does not apply to directors. In the same way that directors cannot enjoy tax-free benefits under the 'necessary' and 'customary' exemption nor can 'shadow' directors. This is looked at in EIM 11413 *Living accommodation: avoidance area: shadow directors*. A shadow director is:

> 'A person in accordance with whose directions or instructions the directors of a company are accustomed to act is deemed to be a director of that company by Section 67(1) ITEPA 2003. Where such a person (known as a shadow director) is provided with living accommodation by the company the individual had held a formal appointment as a director. Section 67(1) defines director in relation to the benefits code and section 63 ITEPA 2003 includes Part 3 Chapter 5 within the benefits code.'

This interpretation was supported by the House of Lords in October 2001 in the case of *R v Allen* [2001] BTC 421. Lord Hutton held that:

> 'it was the intention of Parliament in enacting the concluding part of Section 168(8) that accommodation and benefits in kind received by a shadow director should be taxed n the same way as those received by a director'. (ICTA 1988, s. 168(8) is now ITEPA 2003, s. 67(1))

Board and lodgings are generally not taxable. However, the exemptions are the lower paid and agricultural workers, which includes stable staff. Generally, an agricultural worker whose contract provides for a net cash wage and free board and lodging will be entitled under The *Agricultural Wages Act* 1948 to take a higher cash wage and make his or her own arrangements for accommodation. In these circumstances the worker would normally be taxable on the higher wage, see EIM 01020 *Board and lodging*. By concession, the Revenue accepts that, provided certain conditions are met, the agricultural worker is chargeable on the net cash wage – excluding any payments for board and lodging. This puts the agricultural worker in the same position as employees in other industries. The conditions that have to be met are set out in the concession. For the text of extra-statutory concession (ESC)A60 *Agricultural workers' board and lodging.* (See EIM 50012 *Board and lodging exemption for lower paid: text of concession.*)

A practical tax-planning tool is the 'rent-a-room' relief scheme. Under ESC A60 the board and lodgings could be made under a contract direct to a third party. The recipient of the board and lodging could also have a tax-free receipt if it complies with the rent-a-room provisions.

Other areas of tax planning opportunities where a tax benefit is due are lease premium cases and the co-ownership position. In view of the way the accommodation benefit is calculated and charged via the calculation of rent paid, the key could be to reduce rent paid perhaps via a lease premium. The summary position here is that where a large premium and small rent is paid by the employer to a third party for a short lease on living accommodation, it can be argued that none of the premium can be treated as rent for the purpose of measuring the cash equivalent of the benefit.

The employer and employee can co-own the living accommodation for potential tax planning opportunities. The usual arrangement is that the employer and employee own the property as tenants in common through a trust. A tenant in common has a legal right to use 100% of the property 100% of the time even though a tenant in common may only own a much smaller interest in the property. It is argued that the employee's rights to use the living accommodation come from the employee's legal rights as a tenant in common. So it is argued that no living accommodation has been provided by reason of the employment. The Revenue is obviously prepared to fight this.

In addition to the 'necessary' and 'customary' exemptions there is also accommodation provided by the special security threat. This is a rare exemption in practice.

Employees who are provided with tax-free accommodation might worry that they are not enjoying the potential tax-free capital growth in their own properties. Properties can be owned by eligible employees and be let out. Provided certain conditions are met, PPR for capital gains tax can still be achieved so employees can enjoy the tax-free benefit on accommodation and the tax-free growth of their own house through PPR.

Even if the accommodation is a tax-free benefit, the employee will be taxable on the costs of the accommodation paid by the employer, e.g. telephone bills, use of furniture, appliances and repairs, internal decoration, heating, lighting and cleaning. Section 315 of ITEPA 2003 sets out limited exemption for expenses.

Other tax planning angles which could be considered in relation to staff accommodation are VAT and SDLT (effective from 1 December 2003). As the provision of accommodation is residential there should be no output VAT concerns. However, the ability to claim back input VAT on the costs of the property needs to be carefully considered.

Over the last decade many farmers, to cope with reducing staff requirements, have entered into short assured leasehold tenancies with their employees, to prevent them gaining long-term occupation rights. The input VAT which was previously claimed on those employees' cottages, as attributable to taxable farming activities, must now be must be seen as attributable to exempt supplies, namely the letting of the cottages. It is not permissible to 'look through' those exempt supplies to the purpose for which the employee is engaged, namely the taxable farming activities. Input VAT incurred on such accommodation can therefore no longer be claimed, subject to the partial exemption de minimis limits. This applies even where the rent is a mere peppercorn or is covered by the farmer through an uplifted salary.

Thus, if job related accommodation is proved to be tax-free by virtue of it complying with the 'performance' or 'customary' rules, then the input VAT will be able to be claimed, but only if there is no lease in place. Likewise, SDLT could be due on the rent arrangements on property let to employees. However, if the accommodation is provided tax-free there will normally be no rental arrangements on which to charge SDLT.

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